CHAPTER 2

Understanding the Accounting Cycle

LEARNING OBJECTIVES

After you have mastered the material in this chapter, you will be able to:

1. Record basic accrual and deferral events in a horizontal financial statements model.
2. Organize general ledger accounts under an accounting equation.
3. Prepare financial statements based on accrual accounting.
4. Describe the closing process, the accounting cycle, and the matching concept.
5. Explain how business events affect financial statements over multiple accounting cycles.
6. Classify accounting events into one of four categories:
   - **a.** asset source transactions.
   - **b.** asset use transactions.
   - **c.** asset exchange transactions.
   - **d.** claims exchange transactions.

CHAPTER OPENING

Users of financial statements must distinguish between the terms *recognition* and *realization*. **Recognition** means formally *reporting* an economic item or event in the financial statements. **Realization** refers to collecting money, generally from the sale of products or services. Companies may recognize (report) revenue in the income statement in a different accounting period from the period in which they collect the cash related to the revenue. Furthermore, companies frequently make cash payments for expenses in accounting periods other than the periods in which the expenses are recognized in the income statement.

To illustrate assume Johnson Company provides services to customers in 2012 but collects cash for those services in 2013. In this case, realization occurs in 2013. When should Johnson recognize the services revenue?

Users of *cash basis* accounting recognize (report) revenues and expenses in the period in which cash is collected or paid. Under cash basis accounting Johnson would recognize the revenue in 2013. When it collects the cash. In contrast, users of **accrual accounting** recognize revenues and expenses in the period in which they occur, regardless of when cash is collected or paid. Under accrual accounting Johnson would recognize the revenue in 2012 (the period in which it performed the services) even though it does not collect (realize) the cash until 2013.

Accrual accounting is required by generally accepted accounting principles. Virtually all major companies operating in the United States use it. Its two distinguishing features are called *accruals* and *deferrals*

- The term **accrual** describes a revenue or an expense event that is recognized ***before*** cash is exchanged. Johnson's recognition of revenue in 2012 related to cash realized in 2013 is an example of an accrual.
- The term **deferral** describes a revenue or an expense event that is recognized ***after*** cash has been exchanged. Suppose Johnson pays cash in 2012 to purchase office supplies it uses in 2013. In this case the cash payment occurs in 2012 although supplies expense is recognized in 2013. This example is a deferral.

The Curious Accountant

Suppose Arno Forst wishes to purchase a subscription to *Fitness magazine* for his sister for her birthday. He pays $12 for a one-year subscription to the **Meredith Corporation**, the company that publishes *Fitness, American Baby, Better Homes and Gardens, The Ladies Home Journal,* and several other magazines. It also owns 12 television stations. His sister will receive her first issue of the magazine in October.

How should Meredith Corporation account for the receipt of this cash? How would this event be reported on its December 31, 2012, financial statements? (Answer on page 60.)

ACCRUAL ACCOUNTING

LO 1

Record basic accrual and deferral events in a horizontal financial statements model.

The next section of the text describes seven events experienced by Cato Consultants, a training services company that uses accrual accounting.

EVENT 1 Cato Consultants was started on January 1, 2012, when it acquired $5,000 cash by issuing common stock.

The issue of stock for cash is an **asset source transaction.** It increases the company's assets (cash) and its equity (common stock). The transaction does not affect the income statement. The cash inflow is classified as a financing activity (acquisition from owners). These effects are shown in the following financial statements model:

Assets	=	Liab.	+	Stockholders' Equity								
Cash	=			Com. Stk.	+	Ret. Earn.	Rev.	−	Exp.	=	Net Inc.	Cash Flow
5,000	=	NA	+	5,000	+	NA	NA	−	NA	=	NA	5,000 FA

Accounting for Accounts Receivable

EVENT 2 During 2012 Cato Consultants provided $84,000 of consulting services to its clients. The business has completed the work and sent bills to the clients, but not yet collected any cash. This type of transaction is frequently described as providing services *on account*.

Accrual accounting requires companies to recognize revenue in the period in which the work is done regardless of when cash is collected. In this case, revenue is recognized in 2012 even though cash has not been realized (collected). Recall that revenue represents the economic benefit that results in an increase in assets from providing goods and services to customers. The specific asset that increases is called **Accounts Receivable.** The balance in Accounts Receivable represents the amount of cash the company expects to collect in the future. Since the revenue recognition causes assets (accounts receivable) to increase, it is classified as an asset source transaction. Its effect on the financial statements follows.

Assets			=	Liab.	+	Stockholders' Equity								
Cash	+	Accts. Rec.	=			Com. Stk.	+	Ret. Earn.	Rev.	−	Exp.	=	Net Inc.	Cash Flow
NA	+	84,000	=	NA	+	NA	+	84,000	84,000	−	NA	=	84,000	NA

Notice that the event affects the income statement but not the statement of cash flows. The statement of cash flows will be affected in the future when cash is collected.

EVENT 3 Cato collected $60,000 cash from customers in partial settlement of its accounts receivable.

The collection of an account receivable is an **asset exchange transaction.** One asset account (Cash) increases and another asset account (Accounts Receivable) decreases. The amount of total assets is unchanged. The effect of the $60,000 collection of receivables on the financial statements is as follows.

Assets			=	Liab.	+	Stockholders' Equity								
Cash	+	Accts. Rec.	=			Com. Stk.	+	Ret. Earn.	Rev.	−	Exp.	=	Net Inc.	Cash Flow
60,000	+	(60,000)	=	NA	+	NA	+	NA	NA	−	NA	=	NA	60,000 OA

Notice that collecting the cash did not affect the income statement. The revenue was recognized when the work was done (see Event 2). Revenue would be double counted if it were recognized again when the cash is collected. The statement of cash flows reflects a cash inflow from operating activities.

Other Events

EVENT 4 Cato paid the instructor $10,000 for teaching training courses (salary expense).

Cash payment for salary expense is an **asset use transaction.** Both the asset account Cash and the equity account Retained Earnings decrease by $10,000. Recognizing the expense decreases net income on the income statement. Since Cato paid cash for the expense, the statement of cash flows reflects a cash outflow from operating activities. These effects on the financial statements follow.

Assets			=	Liab.	+	Stockholders' Equity								
Cash	+	Accts. Rec.	=			Com. Stk.	+	Ret. Earn.	Rev.	−	Exp.	=	Net Inc.	Cash Flow
(10,000)	+	NA	=	NA	+	NA	+	(10,000)	NA	−	10,000	=	(10,000)	(10,000) OA

EVENT 5 Cato paid $2,000 cash for advertising costs. The advertisements appeared in 2012.

Cash payments for advertising expenses are asset use transactions. Both the asset account Cash and the equity account Retained Earnings decrease by $2,000. Recognizing the expense decreases net income on the income statement. Since the expense was paid with cash, the statement of cash flows reflects a cash outflow from operating activities. These effects on the financial statements follow.

Assets			=	Liab.	+	Stockholders' Equity								
Cash	+	Accts. Rec.	=			Com. Stk.	+	Ret. Earn.	Rev.	−	Exp.	=	Net Inc.	Cash Flow
(2,000)	+	NA	=	NA	+	NA	+	(2,000)	NA	−	2,000	=	(2,000)	(2,000) OA

EVENT 6 Cato signed contracts for $42,000 of consulting services to be performed in 2013.

The $42,000 for consulting services to be performed in 2013 is not recognized in the 2012 financial statements. Revenue is recognized for work actually completed, *not* work expected to be completed. This event does not affect any of the financial statements.

Assets			=	Liab.	+	Stockholders' Equity								
Cash	+	Accts. Rec.	=			Com. Stk.	+	Ret. Earn.	Rev.	−	Exp.	=	Net Inc.	Cash Flow
NA	+	NA	=	NA	+	NA	+	NA	NA	−	NA	=	NA	NA

Accounting for Accrued Salary Expense (Adjusting Entry)

It is impractical to record many business events as they occur. For example, Cato incurs salary expense continually as the instructor teaches courses. Imagine the impossibility of trying to record salary expense second by second! Companies normally record transactions when it is most convenient. The most convenient time to record many expenses is when they are paid. Often, however, a single business transaction pertains to more than one accounting period. To provide accurate financial reports in such cases, companies may need to recognize some expenses before paying cash for them. Expenses that are recognized before cash is paid are called **accrued expenses.** The accounting for Event 7 illustrates the effect of recognizing accrued salary expense.

EVENT 7 At the end of 2012. Cato recorded accrued salary expense of $6,000 (the salary expense is for courses the instructor taught in 2012 that Cato will pay cash for in 2013).

Accrual accounting requires that companies recognize expenses in the period in which they are incurred regardless of when cash is paid. Cato must recognize all salary expense in the period in which the instructor worked (2012) even though Cato will not pay the instructor again until 2013. Cato must also recognize the obligation (liability) it has to pay the instructor. To accurately report all 2012 salary expense and year-end obligations, Cato must record the unpaid salary expense and salary liability before preparing its financial statements. The entry to recognize the accrued salary expense is called an **adjusting entry.** Like all adjusting entries, it is only to update the accounting records; it does not affect cash.

This adjusting entry decreases stockholders' equity (retained earnings) and increases a liability account called **Salaries Payable.** The balance in the Salaries Payable account represents the amount of cash the company is obligated to pay the instructor in the future. The effect of the expense recognition on the financial statements follows.

Assets			=	Liab.	+	Stockholders' Equity								
Cash	+	Accts. Rec.	=	Sal. Pay.	+	Com. Stk.	+	Ret. Earn.	Rev.	−	Exp.	=	Net Inc.	Cash Flow
NA	+	NA	=	6,000	+	NA	+	(6,000)	NA	−	6,000	=	(6,000)	NA

This event is a **claims exchange transaction.** The claims of creditors (liabilities) increase and the claims of stockholders (retained earnings) decrease. Total claims remain unchanged. The salary expense is reported on the income statement. The statement of cash flows is not affected.

Be careful not to confuse liabilities with expenses. Although liabilities may increase when a company recognizes expenses, liabilities are not expenses. Liabilities are obligations. They can arise from acquiring assets as well as recognizing expenses. For example, when a business borrows money from a bank, it recognizes an increase in assets (cash) and liabilities (notes payable). The borrowing transaction does not affect expenses.

CHECK YOURSELF 2.1

During 2012, Anwar Company earned $345,000 of revenue on account and collected $320,000 cash from accounts receivable. Anwar paid cash expenses of $300,000 and cash dividends of $12,000. Determine the amount of net income Anwar should report on the 2012 income statement and the amount of cash flow from operating activities Anwar should report on the 2012 statement of cash flows.

Answer Net income is $45,000 ($345,000 revenue − $300,000 expenses). The cash flow from operating activities is $20,000, the amount of revenue collected in cash from customers (accounts receivable) minus the cash paid for expenses ($320,000 − $300,000). Dividend payments are classified as financing activities and do not affect the determination of either net income or cash flow from operating activities.

EXHIBIT 2.1

Transaction Data for 2012 Recorded in General Ledger Accounts

1 Cato Consultants acquired $5,000 cash by issuing common stock.
2 Cato provided $84,000 of consulting services on account.
3 Cato collected $60,000 cash from customers in partial settlement of its accounts receivable.
4 Cato paid $10,000 cash for salary expense.
5 Cato paid $2,000 cash for 2012 advertising costs.
6 Cato signed contracts for $42,000 of consulting services to be performed in 2013.
7 Cato recognized $6,000 of accrued salary expense.

	Assets			=	Liabilities	+	Stockholders' Equity			
Event No.	**Cash**	+	**Accounts Receivable**	=	**Salaries Payable**	+	**Common Stock**	+	**Retained Earnings**	**Other Account Titles**
Beg. bal.	0		0		0		0		0	
1	5,000						5,000			
2			84,000						84,000	Consulting revenue
3	60,000		(60,000)							
4	(10,000)								(10,000)	Salary expense
5	(2,000)								(2,000)	Advertising expense
6										
7					6,000				(6,000)	Salary Expense
End bal.	53,000	+	24,000	=	6,000	+	5,000	+	66,000	

Summary of Events and General Ledger

LO 2

Organize general ledger accounts under an accounting equation.

The previous section of this chapter described seven events Cato Consultants experienced during the 2012 accounting period. These events are summarized in Exhibit 2.1. The associated general ledger accounts are also shown in the exhibit. The information in these accounts is used to prepare the financial statements. The revenue and expense items appear in the Retained Earnings column with their account titles immediately to the right of the dollar amounts. The amounts are color coded to help you trace the data to the financial statements. Data in red appear on the balance sheet, data in blue on the income statement, and data in green on the statement of cash flows.

Vertical Statements Model

LO 3

Prepare financial statements based on accrual accounting.

The financial statements for Cato Consultants' 2012 accounting period are represented in a vertical statements model in Exhibit 2.2. A vertical statements model arranges a set of financial statement information vertically on a single page. Like horizontal statements models, vertical statements models are learning tools. They illustrate interrelationships among financial statements. The models do not, however, portray the full, formal presentation formats companies use in published financial statements. For example, statements models may use summarized formats with abbreviated titles and dates. As you read the following explanations of each financial statement, trace the color coded financial data from Exhibit 2.1 to Exhibit 2.2.

LO 5

Prepare a vertical financial statements model.

EXHIBIT 2.2 Vertical Statements Model

CATO CONSULTANTS
Financial Statements*
Income Statement
For the Year Ended December 31, 2012

Consulting revenue		$84,000
Salary expense		(16,000)
Advertising expense		(2,000)
Net income		$66,000

Statement of Changes in Stockholders' Equity
For the Year Ended December 31, 2012

Beginning common stock	$ 0	
Plus: Common stock issued	5,000	
Ending common stock		$ 5,000
Beginning retained earnings	0	
Plus: Net income	66,000	
Less: Dividends	0	
Ending retained earnings		66,000
Total stockholders' equity		$71,000

Balance Sheet
As of December 31, 2012

Assets		
Cash	$53,000	
Accounts receivable	24,000	
Total assets		$77,000
Liabilities		
Salaries payable		$ 6,000
Stockholders' equity		
Common stock	$ 5,000	
Retained earnings	66,000	
Total stockholders' equity		71,000
Total liabilities and stockholders' equity		$77,000

Statement of Cash Flows
For the Year Ended December 31, 2012

Cash flows from operating activities		
Cash receipts from customers	$60,000	
Cash payments for salary expense	(10,000)	
Cash payments for advertising expenses	(2,000)	
Net cash flow from operating activities		$48,000
Cash flow from investing activities		0
Cash flows from financing activities		
Cash receipt from issuing common stock	5,000	
Net cash flow from financing activities		5,000
Net change in cash		53,000
Plus: Beginning cash balance		0
Ending cash balance		$53,000

*In real-world annual reports, financial statements are normally presented separately with appropriate descriptions of the date to indicate whether the statement applies to the entire accounting period or a specific point in time.

Income Statement

The income statement reflects accrual accounting. Consulting revenue represents the price Cato charged for all the services it performed in 2012, even though Cato had not by the end of the year received cash for some of the services performed. Expenses include all costs incurred to produce revenue, whether paid for by year-end or not. We can now expand the definition of expenses introduced in Chapter 1. Expenses were previously defined as assets consumed in the process of generating revenue. Cato's adjusting entry to recognize accrued salaries expense did not reflect consuming assets. Instead of a decrease in assets, Cato recorded an increase in liabilities (salaries payable). An **expense** can therefore be more precisely defined as *a decrease in assets or an increase in liabilities resulting from operating activities undertaken to generate revenue*.

Statement of Changes in Stockholders' Equity

The statement of changes in stockholders' equity reports the effects on equity of issuing common stock, earning net income, and paying dividends to stockholders. It identifies how an entity's equity increased and decreased during the period as a result of transactions with stockholders and operating the business. In the Cato case, the statement shows that equity increased when the business acquired $5,000 cash by issuing common stock. The statement also reports that equity increased by $66,000 from earning income and that none of the $66,000 of net earnings was distributed to owners (no dividends were paid). Equity at the end of the year is $71,000 ($5,000 + $66,000).

Balance Sheet

The balance sheet discloses an entity's assets, liabilities, and stockholders' equity at a particular point in time. Cato Consultants had two assets at the end of the 2012 accounting period: cash of $53,000 and accounts receivable of $24,000. These assets are listed on the balance sheet in order of liquidity. Of the $77,000 in total assets, creditors have a $6,000 claim, leaving stockholders with a $71,000 claim.

Statement of Cash Flows

The statement of cash flows explains the change in cash from the beginning to the end of the accounting period. It can be prepared by analyzing the Cash account. Since Cato Consultants was established in 2012, its beginning cash balance was zero. By the end of the year, the cash balance was $53,000. The statement of cash flows explains this increase. The Cash account increased because Cato collected $60,000 from customers and decreased because Cato paid $12,000 for expenses. As a result, Cato's net cash inflow from operating activities was $48,000. Also, the business acquired $5,000 cash through the financing activity of issuing common stock, for a cumulative cash increase of $53,000 ($48,000 + $5,000) during 2012.

Comparing Cash Flow from Operating Activities with Net Income

The amount of net income measured using accrual accounting differs from the amount of cash flow from operating activities. For Cato Consulting in 2012, the differences are summarized below.

	Accrual Accounting	Cash Flow
Consulting revenue	$84,000	$60,000
Salary expense	(16,000)	(10,000)
Advertising expense	(2,000)	(2,000)
Net income	$66,000	$48,000

Many students begin their first accounting class with the misconception that revenue and expense items are cash equivalents. The Cato illustration demonstrates that a company may recognize a revenue or expense without a corresponding cash collection or payment in the same accounting period.

The Closing Process

LO 4

Describe the closing process, the accounting cycle, and the matching concept.

Recall that the temporary accounts (revenue, expense, and dividend) are closed prior to the start of the next accounting cycle. The closing process transfers the amount in each of these accounts to the Retained Earnings account, leaving each temporary account with a zero balance.

Exhibit 2.3 shows the general ledger accounts for Cato Consultants after the revenue and expense accounts have been closed to retained earnings. The closing entry labeled Cl.1 transfers the balance in the Consulting Revenue account to the Retained Earnings account. Closing entries Cl.2 and Cl.3 transfer the balances in the expense accounts to retained earnings.

EXHIBIT 2.3

General Ledger Accounts for Cato Consultants

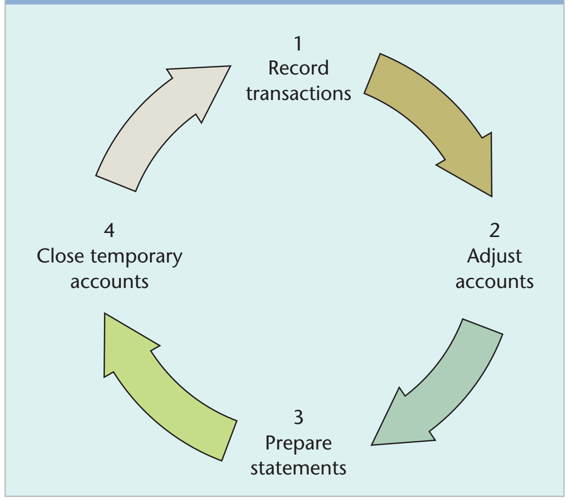
Assets		= Liabilities		+ Stockholders' Equity	
Cash		**Salaries Payable**		**Common Stock**	
(1)	5,000	(7)	6,000	(1)	5,000
(3)	60,000	Bal.	6,000		
(4)	(10,000)			**Retained Earnings**	
(5)	(2,000)			Cl.1	84,000
Bal.	53,000			Cl.2	(16,000)
				Cl.3	(2,000)
Accounts Receivable				Bal.	66,000
(2)	84,000				
(3)	(60,000)			**Consulting Revenue**	
Bal.	24,000			(2)	84,000
				Cl.1	(84,000)
				Bal.	0
				Salary Expense	
				(4)	(10,000)
				(7)	(6,000)
				Cl.2	16,000
				Bal.	0
				Advertising Expense	
				(5)	(2,000)
				Cl.3	2,000
				Bal.	0

Steps in an Accounting Cycle

An accounting cycle, which is represented graphically in Exhibit 2.4, involves several steps. The four steps identified to this point are (1) recording transactions; (2) adjusting the accounts; (3) preparing financial statements; and (4) closing the temporary accounts. The first step occurs continually throughout the accounting period. Steps 2, 3, and 4 normally occur at the end of the accounting period.

EXHIBIT 2.4

The Accounting Cycle



The Matching Concept

Cash basis accounting can distort reported net income because it sometimes fails to match expenses with the revenues they produce. To illustrate, consider the $6,000 of accrued salary expense that Cato Consultants recognized at the end of 2012. The instructor's teaching produced revenue in 2012. If Cato waited until 2013 (when it paid the instructor) to recognize $6,000 of the total $16,000 salary expense, then $6,000 of the expense would not be matched with the revenue it generated. By using accrual accounting, Cato recognized all the salary expense in the same accounting period in which the consulting revenue was recognized. A primary goal of accrual accounting is to appropriately match expenses with revenues, the **matching concept.**

Appropriately matching expenses with revenues can be difficult even when using accrual accounting. For example, consider Cato's advertising expense. Money spent on advertising may generate revenue in future accounting periods as well as in the current period. A prospective customer could save an advertising brochure for several years before calling Cato for training services. It is difficult to know when and to what extent advertising produces revenue. When the connection between an expense and the corresponding revenue is vague, accountants commonly match the expense with the period in which it is incurred. Cato matched (recognized) the entire $2,000 of advertising cost with the 2012 accounting period even though some of that cost might generate revenue in future accounting periods. Expenses that are matched with the period in which they are incurred are frequently called **period costs.**

Matching is not perfect. Although it would be more accurate to match expenses with revenues than with periods, there is sometimes no obvious direct connection between expenses and revenue. Accountants must exercise judgment to select the accounting period in which to recognize revenues and expenses. The concept of conservatism influences such judgment calls.

The Conservatism Principle

When faced with a recognition dilemma, **conservatism** guides accountants to select the alternative that produces the lowest amount of net income. In uncertain circumstances, accountants tend to delay revenue recognition and accelerate expense recognition. The conservatism principle holds that it is better to understate net income than to overstate it. If subsequent developments suggest that net income should have been higher, investors will respond more favorably than if they learn it was really lower. This practice explains why Cato recognized all of the advertising cost as expense in 2012 even though some of that cost may generate revenue in future accounting periods.

SECOND ACCOUNTING CYCLE

LO 5

Explain how business events affect financial statements over multiple accounting cycles.

The effects of Cato Consultants' 2013 events are as follows:

EVENT 1 **Cato paid $6,000 to the intructor to settle the salaries payable obligation.**

Cash payments to creditors are ***asset use transactions.*** When Cato pays the instructor, both the asset account Cash and the liability account Salaries Payable decrease. The cash payment does not affect the income statement. The salary expense was recognized in 2012 when the instructor taught the classes. The statement of cash flows reflects a cash outflow from operating activities. The effects of this transaction on the financial statements are shown here.

Assets	=	Liab.	+	Stk. Equity						
Cash	=	Sal. Pay.			Rev.	−	Exp.	=	Net Inc.	Cash Flow
(6,000)	=	(6,000)	+	NA	NA	−	NA	=	NA	(6,000) OA

Prepaid Items (Cost versus Expense)

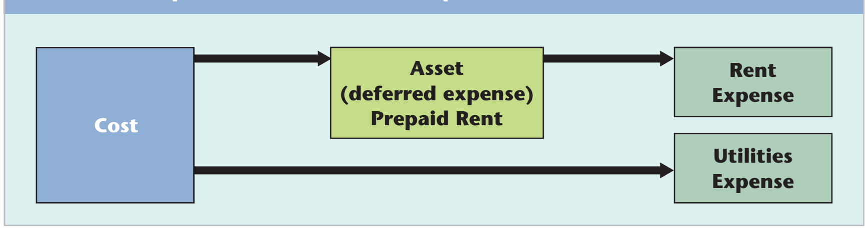
EVENT 2 **On March 1, 2013, Cato signed a one-year lease agreement and paid $12,000 cash in advance to rent office space. The one-year lease term began on March 1.**

Accrual accounting draws a distinction between the terms *cost* and *expense*. *A* **cost** *might be either an asset or an expense*. If a company has already consumed a purchased resource in the process of earning revenue, the cost of the resource is an *expense*. For example, companies normally pay for electricity the month after using it. The cost of electric utilities is therefore usually recorded as an expense. In contrast, if a company purchases a resource it will use in the future to generate revenue, the cost of the resource represents an *asset*. Accountants record such a cost in an asset account and ***defer*** recognizing an expense until the resource is used to produce revenue. Deferring the expense recognition provides more accurate ***matching*** of revenues and expenses.

The cost of the office space Cato leased in Event 2 is an asset. It is recorded in the asset account *Prepaid Rent*. Cato expects to benefit from incurring this cost for the next twelve months. Expense recognition is deferred until Cato uses the office space to help generate revenue. Other common deferred expenses include *prepaid insurance* and *prepaid taxes*. As these titles imply, deferred expenses are frequently called **prepaid items.** Exhibit 2.5 illustrates the relationship between costs, assets, and expenses.

EXHIBIT 2.5

Relationship between Cost and Expense



Purchasing prepaid rent is an asset exchange transaction. The asset account Cash decreases and the asset account Prepaid Rent increases. The amount of total assets is unaffected. The income statement is unaffected. Expense recognition is deferred until the office space is used. The statement of cash flows reflects a cash outflow from operating activities. The effects of this transaction on the financial statements are shown here.

Assets			=	Liab.	+	Stk. Equity						Cash Flow
Cash	+	Prep. Rent					Rev.	−	Exp.	=	Net Inc.	
(12,000)	+	12,000	=	NA	+	NA	NA	−	NA	=	NA	(12,000) OA

Accounting for Receipt of Unearned Revenue

EVENT 3 **Cato received $18,000 cash in advance from Westberry Company for consulting services Cato agreed to perform over a one-year period beginning June 1, 2013.**

Cato must defer (delay) recognizing any revenue until it performs (does the work) the consulting services for Westberry. From Cato's point of view, the deferred revenue is a liability because Cato is obligated to perform services in the future. The liability is called **unearned revenue.** The cash receipt is an ***asset source transaction.*** The asset account Cash and the liability account Unearned Revenue both increase. Collecting the cash has no effect on the income statement. The revenue will be reported on the income statement after Cato performs the services. The statement of cash flows reflects a cash inflow from operating activities. The effects of this transaction on the financial statements are shown here.

Assets	=	Liab.	+	Stk. Equity						Cash Flow
Cash	=	Unearn. Rev.			Rev.	−	Exp.	=	Net Inc.	
18,000	=	18,000	+	NA	NA	−	NA	=	NA	18,000 OA

Accounting for Supplies Purchase

EVENT 4 **Cato purchased $800 of supplies on account.**

The purchase of supplies on account is an ***asset source transaction.*** The asset account Supplies and the liability account Accounts Payable increase. The income statement is unaffected. Expense recognition is deferred until the supplies are used. The statement of cash flows is not affected. The effects of this transaction on the financial statements are shown here.

Assets	=	Liab.	+	Stk. Equity						Cash Flow
Supplies	=	Accts. Pay.			Rev.	−	Exp.	=	Net Inc.	
800	=	800	+	NA	NA	−	NA	=	NA	NA

Other 2013 Events

EVENT 5 **Cato provided $96,400 of consulting services on account.**

Providing services on account is an ***asset source transaction.*** The asset account Accounts Receivable and the stockholders' equity account Retained Earnings increase.

Revenue and net income increase. The statement of cash flows is not affected. The effects of this transaction on the financial statements are shown here.

Assets	=	Liab.	+	Stk. Equity						
Accts. Rec.	=			Ret. Earn.	Rev.	−	Exp.	=	Net Inc.	Cash Flow
96,400	=	NA	+	96,400	96,400	−	NA	=	96,400	NA

EVENT 6 Cato collected $105,000 cash from customers as partial settlement of accounts receivable.

Collecting money from customers who are paying accounts receivable is an ***asset exchange transaction.*** One asset account (Cash) increases and another asset account (Accounts Receivable) decreases. The amount of total assets is unchanged. The income statement is not affected. The statement of cash flows reports a cash inflow from operating activities. The effects of this transaction on the financial statements are shown here.

Assets			=	Liab.	+	Stk. Equity						
Cash	+	Accts. Rec.					Rev.	−	Exp.	=	Net Inc.	Cash Flow
105,000	+	(105,000)	=	NA	+	NA	NA	−	NA	=	NA	105,000 OA

EVENT 7 Cato paid $32,000 cash for salary expense.

Cash payments for salary expense are ***asset use transactions.*** Both the asset account Cash and the equity account Retained Earnings decrease by $32,000. Recognizing the expense decreases net income on the income statement. The statement of cash flows reflects a cash outflow from operating activities. The effects of this transaction on the financial statements are shown here.

Assets	=	Liab.	+	Stk. Equity						
Cash	=			Ret. Earn.	Rev.	−	Exp.	=	Net Inc.	Cash Flow
(32,000)	=	NA	+	(32,000)	NA	−	32,000	=	(32,000)	(32,000) OA

EVENT 8 Cato incurred $21,000 of other operating expenses on account.

Recognizing expenses incurred on account are ***claims exchange transactions.*** One claims account (Accounts Payable) increases and another claims account (Retained Earnings) decreases. The amount of total claims is not affected. Recognizing the expenses decreases net income. The statement of cash flows is not affected. The effects of this transaction on the financial statements are shown here.

Assets	=	Liab.	+	Stk. Equity						
		Accts. Pay.	+	Ret. Earn.	Rev.	−	Exp.	=	Net Inc.	Cash Flow
NA	=	21,000	+	(21,000)	NA	−	21,000	=	(21,000)	NA

EVENT 9 Cato paid $18,200 in partial settlement of accounts payable.

Paying accounts payable is an ***asset use transaction.*** The asset account Cash and the liability account Accounts Payable decrease. The statement of cash flows reports a cash outflow for operating activities. The income statement is not affected. The effects of this transaction on the financial statements are shown here.

Assets	=	Liab.	+	Stk. Equity						
Cash	=	Accts. Pay.			Rev.	−	Exp.	=	Net Inc.	Cash Flow
(18,200)	=	(18,200)	+	NA	NA	−	NA	=	NA	(18,200) OA

EVENT 10 Cato paid $79,500 to purchase land it planned to use in the future as a building site for its home office.

Purchasing land with cash is an ***asset exchange transaction.*** One asset account, Cash, decreases and another asset account, Land, increases. The amount of total assets is unchanged. The income statement is not affected. The statement of cash flows reports a cash outflow for investing activities. The effects of this transaction on the financial statements are shown here.

Assets			=	Liab.	+	Stk. Equity						
Cash	+	Land					Rev.	−	Exp.	=	Net Inc.	Cash Flow
(79,500)	+	79,500	=	NA	+	NA	NA	−	NA	=	NA	(79,500) IA

EVENT 11 Cato paid $21,000 in cash dividends to its stockholders.

Cash payments for dividends are ***asset use transactions.*** Both the asset account Cash and the equity account Retained Earnings decrease. Recall that dividends are wealth transfers from the business to the stockholders, not expenses. They are not incurred in the process of generating revenue. They do not affect the income statement. The statement of cash flows reflects a cash outflow from financing activities. The effects of this transaction on the financial statements are shown here.

Assets	=	Liab.	+	Stk. Equity						
Cash	=			Ret. Earn.	Rev.	−	Exp.	=	Net Inc.	Cash Flow
(21,000)	=	NA	+	(21,000)	NA	−	NA	=	NA	(21,000) FA

EVENT 12 Cato acquired $2,000 cash from issuing additional shares of common stock.

Issuing common stock is an ***asset source transaction.*** The asset account Cash and the stockholders' equity account Common Stock increase. The income statement is unaffected. The statement of cash flows reports a cash inflow from financing activities. The effects of this transaction on the financial statements are shown here.

Assets	=	Liab.	+	Stk. Equity						
Cash	=			Com. Stk.	Rev.	−	Exp.	=	Net Inc.	Cash Flow
2,000	=	NA	+	2,000	NA	−	NA	=	NA	2,000 FA

Adjusting Entries

Recall that companies make adjusting entries at the end of an accounting period to update the account balances before preparing the financial statements. Adjusting entries ensure that companies report revenues and expenses in the appropriate accounting period; adjusting entries never affect the Cash account.

Accounting for Supplies (Adjusting Entry)

EVENT 13 After determining through a physical count that it had $150 of unused supplies on hand as of December 31, Cato recognized supplies expense.

Companies would find the cost of recording supplies expense each time a pencil, piece of paper, envelope, or other supply item is used to far outweigh the benefit derived from such tedious recordkeeping. Instead, accountants transfer to expense the total cost of all supplies used during the entire accounting period in a single year-end adjusting entry. The cost of supplies used is determined as follows.

Beginning supplies balance + Supplies purchased = Supplies available for use

Supplies available for use − Ending supplies balance = Supplies used

Companies determine the ending supplies balance by physically counting the supplies on hand at the end of the period. Cato used $650 of supplies during the year (zero beginning balance + $800 supplies purchase = $800 available for use; $800 available for use − $150 ending balance = $650). Recognizing Cato's supplies expense is an ***asset use transaction.*** The asset account Supplies and the stockholders' equity account Retained Earnings decrease. Recognizing supplies expense reduces net income. The statement of cash flows is not affected. The effects of this transaction on the financial statements are shown here.

Assets	=	Liab.	+	Stk. Equity						
Supplies	=			Ret. Earn.	Rev.	−	Exp.	=	Net Inc.	Cash Flow
(650)	=	NA	+	(650)	NA	−	650	=	(650)	NA

Accounting for Prepaid Rent (Adjusting Entry)

EVENT 14 Cato recognized rent expense for the office space used during the accounting period.

Recall that Cato paid $12,000 on March 1, 2013, to rent office space for one year (see Event 2). The portion of the lease cost that represents using office space from March 1 through December 31 is computed as follows.

$12,000 Cost of annual lease ÷ 12 Months = $1,000 Cost per month

$1,000 Cost per month × 10 Months used = $10,000 Rent expense

Recognizing the rent expense decreases the asset account Prepaid Rent and the stockholders' equity account Retained Earnings. Recognizing rent expense reduces net income. The statement of cash flows is not affected. The cash flow effect was recorded in the March 1 event. These effects on the financial statements follow.

Assets	=	Liab.	+	Stk. Equity						
Prep. Rent	=			Ret. Earn.	Rev.	−	Exp.	=	Net Inc.	Cash Flow
(10,000)	=	NA	+	(10,000)	NA	−	10,000	=	(10,000)	NA

CHECK YOURSELF 2.2

Rujoub Inc. paid $18,000 cash for one year of insurance coverage that began on November 1, 2012. Based on this information alone, determine the cash flow from operating activities that Rujoub would report on the 2012 and 2013 statements of cash flows. Also, determine the amount of insurance expense Rujoub would report on the 2012 income statement and the amount of prepaid insurance (an asset) that Rujoub would report on the December 31, 2012, balance sheet.

Answer Since Rujoub paid all of the cash in 2012, the 2012 statement of cash flows would report an $18,000 cash outflow from operating activities. The 2013 statement of cash flows would report zero cash flow from operating activities. The expense would be recognized in the periods in which the insurance is used. In this case, insurance expense is recognized at the rate of $1,500 per month ($18,000 ÷ 12 months). Rujoub used two months of insurance coverage in 2012 and therefore would report $3,000 (2 months × $1,500) of insurance expense on the 2012 income statement. Rujoub would report a $15,000 (10 months × $1,500) asset, prepaid insurance, on the December 31, 2012, balance sheet. The $15,000 of prepaid insurance would be recognized as insurance expese in 2013 when the insurance coverage is used.

Accounting for Unearned Revenue (Adjusting Entry)

EVENT 15 Cato recognized the portion of the unearned revenue it earned during the accounting period.

Recall that Cato received an $18,000 cash advance from Westberry Company to provide consulting services from June 1, 2013, to May 31, 2014 (see Event 3). By December 31, Cato had earned 7 months (June 1 through December 31) of the revenue related to this contract. Rather than recording the revenue continuously as it performed the consulting services, Cato can simply recognize the amount earned in a single adjustment to the accounting records at the end of the accounting period. The amount of the adjustment is computed as follows.

$18,000 ÷ 12 months = $1,500 revenue earned per month

$1,500 × 7 months = $10,500 revenue to be recognized in 2013

The adjusting entry moves $10,500 from the Unearned Revenue account to the Consulting Revenue account. This entry is a ***claims exchange transaction.*** The liability account Unearned Revenue decreases and the equity account Retained Earnings increases. The effects of this transaction on the financial statements are shown here.

Assets	=	Liab.	+	Stk. Equity						
		Unearn. Rev.	+	Ret. Earn.	Rev.	−	Exp.	=	Net Inc.	Cash Flow
NA	=	(10,500)	+	10,500	10,500	−	NA	=	10,500	NA

Recall that revenue was previously defined as an economic benefit a company obtains by providing customers with goods and services. In this case the economic benefit is a decrease in the liability account Unearned Revenue. **Revenue** can therefore be more precisely defined as *an increase in assets or a decrease in liabilities that a company obtains by providing customers with goods or services*.

CHECK YOURSELF 2.3

Sanderson & Associates received a $24,000 cash advance as a retainer to provide legal services to a client. The contract called for Sanderson to render services during a one-year period beginning October 1, 2012. Based on this information alone, determine the cash flow from operating activities Sanderson would report on the 2012 and 2013 statements of cash flows. Also determine the amount of revenue Sanderson would report on the 2012 and 2013 income statements.

Answer Since Sanderson collected all of the cash in 2012, the 2012 statement of cash flows would report a $24,000 cash inflow from operating activities. The 2013 statement of cash flows would report zero cash flow from operating activities. Revenue is recognized in the period in which it is earned. In this case revenue is earned at the rate of $2,000 per month ($24,000 ÷ 12 months = $2,000 per month). Sanderson rendered services for three months in 2012 and nine months in 2013. Sanderson would report $6,000 (3 months × $2,000) of revenue on the 2012 income statement and $18,000 (9 months × $2,000) of revenue on the 2013 income statement.

Answers to The Curious Accountant

Because the **Meredith Corporation** receives cash from customers before actually providing any magazines to them, the company has not earned any revenue when it receives the cash. Thus, Meredith has a liability called *unearned revenue.* If it closed its books on December 31, then $3 of Arno's subscription would be recognized as revenue in 2012. The remaining $9 would appear on the balance sheet as a liability.

Meredith Corporation actually ends its accounting year on June 30 each year. A copy of the 2009 balance sheet for the company is presented in Exhibit 2.6. The liability for unearned subscription revenue was $319.1 ($170.7 + $148.4) million—which represented about 30.1 percent of Meredith's total liabilities!

Will Meredith need cash to pay these subscription liabilities? Not exactly. The liabilities will not be paid directly with cash. Instead, they will be satisfied by providing magazines to the subscribers. However, Meredith will need cash to pay for producing and distributing the magazines supplied to the customers. Even so, the amount of cash required to provide magazines will probably differ significantly from the amount of unearned revenues. In most cases, subscription fees do not cover the cost of producing and distributing magazines. By collecting significant amounts of advertising revenue, publishers can provide magazines to customers at prices well below the cost of publication. The amount of unearned revenue is not likely to coincide with the amount of cash needed to cover the cost of satisfying the company's obligation to produce and distribute magazines. Even though the association between unearned revenues and the cost of providing magazines to customers is not direct, a knowledgeable financial analyst can use the information to make estimates of future cash flows and revenue recognition.

EXHIBIT 2.6 Balance Sheet for Meredith Corporation

CONSOLIDATED BALANCE SHEETS

Meredith Corporation and Subsidiaries
As of June 30 (amounts in thousands)

	2009	2008
Assets		
Current assets		
Cash and cash equivalents	$ 27,910	$ 37,644
Accounts receivable		
(net of allowances of $13,810 in 2009 and $23,944 in 2008)	192,367	230,978
Inventories	28,151	44,085
Current portion of subscription acquisition costs	60,017	59,939
Current portion of broadcast rights	8,297	10,779
Deferred income taxes	—	2,118
Other current assets	23,398	17,547
Total current assets	340,140	403,090
Property, plant, and equipment		
Land	19,500	20,027
Buildings and improvements	125,779	122,977
Machinery and equipment	276,376	273,633
Leasehold improvements	14,208	12,840
Construction in progress	9,041	17,458
Total property, plant, and equipment	444,904	446,935
Less accumulated depreciation	(253,597)	(247,147)
Net property, plant, and equipment	191,307	199,788
Subscription acquisition costs	63,444	60,958
Broadcast rights	4,545	7,826
Other assets	45,907	74,472
Intangible assets, net	561,581	781,154
Goodwill	462,379	532,332
Total assets	$1,669,303	$2,059,620
Liabilities and Shareholders' Equity		
Current liabilities		
Current portion of long-term debt	$ —	$ 75,000
Current portion of long-term broadcast rights payable	10,560	11,141
Accounts payable	86,381	79,028
Accrued expenses		
Compensation and benefits	42,667	40,894
Distribution expenses	12,224	13,890
Other taxes and expenses	26,653	47,923
Total accrued expenses	81,544	102,707
Current portion of unearned subscription revenues	170,731	175,261
Total current liabilities	349,216	443,137
Long-term debt	380,000	410,000
Long-term broadcast rights payable	11,851	17,186
Unearned subscription revenues	148,393	157,872
Deferred income taxes	64,322	139,598
Other noncurrent liabilities	106,138	103,972
Total liabilities	1,059,920	1,271,765
Shareholders' equity		
Series preferred stock, par value $1 per share	—	—
Common stock, par value $1 per share	35,934	36,295
Class B stock, par value $1 per share, convertible to common stock	9,133	9,181
Additional paid-in capital	53,938	52,693
Retained earnings	542,006	701,205
Accumulated other comprehensive income (loss)	(31,628)	(11,519)
Total shareholders' equity	609,383	787,855
Total liabilities and shareholder' equity	$1,669,303	$2,059,620

Accounting for Accrued Salary Expense (Adjusting Entry)

EVENT 16 Cato recognized $4,000 of accrued salary expense.

The adjusting entry to recognize the accrued salary expense is a ***claims exchange transaction.*** One claims account, Retained Earnings, decreases and another claims account, Salaries Payable, increases. The expense recognition reduces net income. The statement of cash flows is not affected. The effects of this transaction on the financial statements are shown here.

Assets	=	Liab.	+	Stk. Equity						
		Sal. Pay.	+	Ret. Earn.	Rev.	−	Exp.	=	Net Inc.	Cash Flow
NA	=	4,000	+	(4,000)	NA	−	4,000	=	(4,000)	NA

Summary of Events and General Ledger

The previous section of this chapter described sixteen events Cato Consultants experienced the during the 2013 accounting period. These events are summarized in Exhibit 2.7 on page 63. The associated general ledger accounts are also shown in the exhibit. The account balances at the end of 2012; shown in Exhibit 2.3, become the beginning balances for the 2013 accounting period. The 2013 transaction data are referenced to the accounting events with numbers in parentheses. The information in the ledger accounts is the basis for the financial statements in Exhibit 2.8 on pages 64 and 65. Before reading further, trace each event in the summary of events into Exhibit 2.7.

Vertical Statements Model

Financial statement users obtain helpful insights by analyzing company trends over multiple accounting cycles. Exhibit 2.8 presents for Cato Consultants a multicycle **vertical statements model** of 2012 and 2013 accounting data. To conserve space, we have combined all the expenses for each year into single amounts labeled "Operating Expenses," determined as follows.

	2012	2013
Other operating expenses	$ 0	$21,000
Salary expense	16,000	36,000
Rent expense	0	10,000
Advertising expense	2,000	0
Supplies expense	0	650
Total operating expenses	$18,000	$67,650

Similarly, we combined the cash payments for operating expenses on the statement of cash flows as follows.

	2012	2013
Supplies and other operating expenses	$ 0	$18,200*
Salary expense	10,000	38,000
Rent expense	0	12,000
Advertising expense	2,000	0
Total cash payments for operating expenses	$12,000	$68,200

*Amount paid in partial settlement of accounts payable

EXHIBIT 2.7

Ledger Accounts with 2013 Trnsaction Data

1. Cato paid $6,000 to the instructor to settle the salaries payable obligation.
2. On March 1, Cato paid $12,000 cash to lease office space for one year.
3. Cato received $18,000 cash in advance from Westberry Company for consulting services to be performed for one year beginning June 1.
4. Cato purchased $800 of supplies on account.
5. Cato provided $96,400 of consulting services on account.
6. Cato collected $105,000 cash from customers as partial settlement of accounts receivable.
7. Cato paid $32,000 cash for salary expense.
8. Cato incurred $21,000 of other operating expenses on account.
9. Cato paid $18,200 in partial settlement of accounts payable.
10. Cato paid $79,500 to purchase land it planned to use in the future as a building site for its home office.
11. Cato paid $21,000 in cash dividends to its stockholders.
12. Cato acquired $2,000 cash from issuing additional shares of common stock.

The year-end adjustments are:

13. After determining through a physical count that it had $150 of unused supplies on hand as of December 31, Cato recognized supplies expense.
14. Cato recognized rent expense for the office space used during the accounting period.
15. Cato recognized the portion of the unearned revenue it earned during the accounting period.
16. Cato recognized $4,000 of accrued salary expense.

Assets = Liabilities + Stockholders' Equity

Assets

Cash

Bal.	53,000
(1)	(6,000)
(2)	(12,000)
(3)	18,000
(6)	105,000
(7)	(32,000)
(9)	(18,200)
(10)	(79,500)
(11)	(21,000)
(12)	2,000
Bal.	9,300

Accounts Receivable

Bal.	24,000
(5)	96,400
(6)	(105,000)
Bal.	15,400

Supplies

Bal.	0
(4)	800
(13)	(650)
Bal.	150

Prepaid Rent

Bal.	0
(2)	12,000
(14)	(10,000)
Bal.	2,000

Land

Bal.	0
(10)	79,500
Bal.	79,500

Liabilities

Accounts Payable

Bal.	0
(4)	800
(8)	21,000
(9)	(18,200)
Bal.	3,600

Unearned Revenue

Bal.	0
(3)	18,000
(15)	(10,500)
Bal.	7,500

Salaries Payable

Bal.	6,000
(1)	(6,000)
(16)	4,000
Bal.	4,000

Stockholders' Equity

Common Stock

Bal.	5,000
(12)	2,000
Bal.	7,000

Retained Earnings

Bal.	66,000

Dividends

Bal.	0
(11)	(21,000)
Bal.	(21,000)

Consulting Revenue

Bal.	0
(5)	96,400
(15)	10,500
Bal.	106,900

Other Operating Expenses

Bal.	0
(8)	(21,000)
Bal.	(21,000)

Salary Expense

Bal.	0
(7)	(32,000)
(16)	(4,000)
Bal.	(36,000)

Rent Expense

Bal.	0
(14)	(10,000)
Bal.	(10,000)

Supplies Expense

Bal.	0
(13)	(650)
Bal.	(650)

EXHIBIT 2.8 Vertical Statements Model

CATO CONSULTANTS
Financial Statements
Income Statements
For the Years Ended December 31

	2012	2013
Consulting revenue	$84,000	$106,900
Operating expenses	(18,000)	(67,650)
Net income	$66,000	$ 39,250

Statements of Changes in Stockholders' Equity
For the Years Ended December 31

	2012	2013
Beginning common stock	$ 0	$ 5,000
Plus: Common stock issued	5,000	2,000
Ending common stock	5,000	7,000
Beginning retained earnings	0	66,000
Plus: Net income	66,000	39,250
Less: Dividends	0	(21,000)
Ending retained earnings	66,000	84,250
Total stockholders' equity	$71,000	$ 91,250

Balance Sheets
As of December 31

	2012	2013
Assets		
Cash	$53,000	$ 9,300
Accounts receivable	24,000	15,400
Supplies	0	150
Prepaid rent	0	2,000
Land	0	79,500
Total assets	$77,000	$106,350
Liabilities		
Accounts payable	$ 0	$ 3,600
Unearned revenue	0	7,500
Salaries payable	6,000	4,000
Total liabilities	6,000	15,100
Stockholders' equity		
Common stock	5,000	7,000
Retained earnings	66,000	84,250
Total stockholders' equity	71,000	91,250
Total liabilities and stockholders' equity	$77,000	$106,350

continued

EXHIBIT 2.8 *Concluded*

Statements of Cash Flows
For the Years Ended December 31

	2012	2013
Cash Flows from Operating Activities		
Cash receipts from customers	$60,000	$123,000
Cash payments for operating expenses	(12,000)	(68,200)
Net cash flow from operating activities	48,000	54,800
Cash Flows from Investing Activities		
Cash payment to purchase land	0	(79,500)
Cash Flows from Financing Activities		
Cash receipts from issuing common stock	5,000	2,000
Cash payments for dividends	0	(21,000)
Net cash flow from financing activities	5,000	(19,000)
Net change in cash	53,000	(43,700)
Plus: Beginning cash balance	0	53,000
Ending cash balance	$53,000	$ 9,300

Recall that the level of detail reported in financial statements depends on user information needs. Most real-world companies combine many account balances together to report highly summarized totals under each financial statement caption. Before reading further, trace the remaining financial statement items from the ledger accounts in Exhibit 2.7 to where they are reported in Exhibit 2.8.

The vertical statements model in Exhibit 2.8 shows significant interrelationships among the financial statements. For each year, trace the amount of net income from the income statement to the statement of changes in stockholders' equity. Next, trace the ending balances of common stock and retained earnings reported on the statement of changes in stockholders' equity to the stockholders' equity section of the balance sheet. Also, confirm that the amount of cash reported on the balance sheet equals the ending cash balance on the statement of cash flows.

Other relationships connect the two accounting periods. For example, trace the ending retained earnings balance from the 2012 statement of stockholders' equity to the beginning retained earnings balance on the 2013 statement of stockholders' equity. Also, trace the ending cash balance on the 2012 statement of cash flows to the beginning cash balance on the 2013 statement of cash flows. Finally, confirm that the change in cash between the 2012 and 2013 balance sheets ($53,000 − $9,300 = $43,700 decrease) agrees with the net change in cash reported on the 2013 statement of cash flows.

CHECK YOURSELF 2.4

Treadmore Company started the 2012 accounting period with $580 of supplies on hand. During 2012 the company paid cash to purchase $2,200 of supplies. A physical count of supplies indicated that there was $420 of supplies on hand at the end of 2012. Treadmore pays cash for supplies at the time they are purchased. Based on this information alone, determine the amount of supplies expense to be recognized on the income statement and the amount of cash flow to be shown in the operating activities section of the statement of cash flows.

Answer The amount of supplies expense recognized on the income statement is the amount of supplies that were used during the accounting period. This amount is computed below.

$580 Beginning balance + $2,200 Supplies purchases = $2,780 Supplies available for use

$2,780 Supplies available for use − $420 Ending supplies balance = $2,360 supplies used

The cash flow from operating activities is the amount of cash paid for supplies during the accounting period. In this case, Treadmore paid $2,200 cash to purchase supplies. This amount would be shown as a cash outflow.

TRANSACTION CLASSIFICATION

LO 6

Classify accounting events into one of four categories:

a. asset source transactions.
b. asset use transactions.
c. asset exchange transactions.
d. claims exchange transactions.

Chapters 1 and 2 introduced four types of transactions. Although businesses engage in an infinite number of different transactions, all transactions fall into one of four types. By learning to identify transactions by type, you can understand how unfamiliar events affect financial statements. The four types of transactions are

1. *Asset source transactions:* An asset account increases, and a corresponding claims account increases.
2. *Asset use transactions:* An asset account decreases, and a corresponding claims account decreases.
3. *Asset exchange transactions:* One asset account increases, and another asset account decreases.
4. *Claims exchange transactions:* One claims account increases, and another claims account decreases.

Also, the definitions of revenue and expense have been expanded. The complete definitions of these two elements are as follows.

1. **Revenue:** Revenue is the *economic benefit* derived from operating the business. Its recognition is accompanied by an increase in assets or a decrease in liabilities resulting from providing products or services to customers.
2. **Expense:** An expense is an *economic sacrifice* incurred in the process of generating revenue. Its recognition is accompanied by a decrease in assets or an increase in liabilities resulting from consuming assets and services in an effort to produce revenue.

<< A Look Back

This chapter introduced accrual accounting. Accrual accounting distinguishes between *recognition* and *realization.* Recognition means reporting an economic item or event in the financial statements. In contrast, realization refers to collecting cash from the sale of assets or services. Recognition and realization can occur in different accounting periods. In addition, cash payments for expenses often occur in different accounting periods from when a company recognizes the expenses. Accrual accounting uses both *accruals* and *deferrals.*

- The term *accrual* applies to a revenue or an expense event that are recognized before cash is exchanged. Recognizing revenue on account or accrued salaries expense are examples of accruals.
- The term *deferral* applies to a revenue or an expense event that are recognized after cash has been exchanged. Supplies, prepaid items, and unearned revenue are examples of deferrals.

Virtually all major companies operating in the United States use accrual accounting.

A Look Forward >>

Chapters 1 and 2 focused on businesses that generate revenue by providing services to their customers. Examples of these types of businesses include consulting, real estate sales, medical services, and legal services. The next chapter introduces accounting practices for businesses that generate revenue by selling goods. Examples of these companies include **Wal-Mart**, **Circuit City**, **Office Depot**, and **Lowes**.

A step-by-step audio-narrated series of slides is provided on the text website at www.mhhe.com/edmondssurvey3e

www.mhhe.com/edmondssurvey3e

SELF-STUDY REVIEW PROBLEM

Gifford Company experienced the following accounting events during 2012.

1. Started operations on January 1 when it acquired $20,000 cash by issuing common stock.
2. Earned $18,000 of revenue on account.
3. On March 1 collected $36,000 cash as an advance for services to be performed in the future.
4. Paid cash operating expenses of $17,000.
5. Paid a $2,700 cash dividend to stockholders.
6. On December 31, 2012, adjusted the books to recognize the revenue earned by providing services related to the advance described in Event 3. The contract required Gifford to provide services for a one-year period starting March 1.
7. Collected $15,000 cash from accounts receivable.

Gifford Company experienced the following accounting events during 2013.

1. Earned $38,000 of cash revenue.
2. On April 1 paid $12,000 cash for an insurance policy that provides coverage for one year beginning immediately.
3. Collected $2,000 cash from accounts receivable.
4. Paid cash operating expenses of $21,000.
5. Paid a $5,000 cash dividend to stockholders.
6. On December 31, 2013, adjusted the books to recognize the remaining revenue earned by providing services related to the advance described in Event 3 of 2012.
7. On December 31, 2013, Gifford adjusted the books to recognize the amount of the insurance policy used during 2013.

Required

a. Record the events in a financial statements model like the following one. The first event is recorded as an example.

Event No.	Assets					=	Liab.	+	Stockholders' Equity								Cash Flow
	Cash	+	Accts. Rec.	−	Prep. Ins.	=	Unearn. Rev.	+	Com. Stk.	+	Ret. Earn.	Rev.	−	Exp.	=	Net Inc.	Cash Flow
1	20,000	+	NA	−	NA	=	NA	+	20,000	+	NA	NA	−	NA	=	NA	20,000 FA

b. What amount of revenue would Gifford report on the 2012 income statement?

c. What amount of cash flow from customers would Gifford report on the 2012 statement of cash flows?

d. What amount of unearned revenue would Gifford report on the 2012 and 2013 year-end balance sheets?

e. What are the 2013 opening balances for the revenue and expense accounts?

f. What amount of total assets would Gifford report on the December 31, 2012, balance sheet?
g. What claims on assets would Gifford report on the December 31, 2013, balance sheet?

Solution to Requirement a

The financial statements model follows.

	Assets					=	Liab.	+	Stockholders' Equity									
Event No.	Cash	+	Accts. Rec.	+	Prep. Ins.	=	Unearn. Rev.	+	Com. Stk.	+	Ret. Earn.	Rev.	−	Exp.	=	Net Inc.	Cash Flow	
2012																		
1	20,000	+	NA	+	NA	=	NA	+	20,000	+	NA	NA	−	NA	=	NA	20,000	FA
2	NA	+	18,000	+	NA	=	NA	+	NA	+	18,000	18,000	−	NA	=	18,000	NA	
3	36,000	+	NA	+	NA	=	36,000	+	NA	+	NA	NA	−	NA	=	NA	36,000	OA
4	(17,000)	+	NA	+	NA	=	NA	+	NA	+	(17,000)	NA	−	17,000	=	(17,000)	(17,000)	OA
5	(2,700)	+	NA	+	NA	=	NA	+	NA	+	(2,700)	NA	−	NA	=	NA	(2,700)	FA
6*	NA	+	NA	+	NA	=	(30,000)	+	NA	+	30,000	30,000	−	NA	=	30,000	NA	
7	15,000	+	(15,000)	+	NA	=	NA	+	NA	+	NA	NA	−	NA	=	NA	15,000	OA
Bal.	51,300	+	3,000	+	NA	=	6,000	+	20,000	+	28,300	48,000	−	17,000	=	31,000	51,300	NC
	Asset, liability, and equity account balances carry forward											Rev. & exp. accts. are closed						
2013																		
Bal.	51,300	+	3,000	+	NA	=	6,000	+	20,000	+	28,300	NA	−	NA	=	NA	NA	
1	38,000	+	NA	+	NA	=	NA	+	NA	+	38,000	38,000	−	NA	=	38,000	38,000	OA
2	(12,000)	+	NA	+	12,000	=	NA	+	NA	+	NA	NA	−	NA	=	NA	(12,000)	OA
3	2,000	+	(2,000)	+	NA	=	NA	+	NA	+	NA	NA	−	NA	=	NA	2,000	OA
4	(21,000)	+	NA	+	NA	=	NA	+	NA	+	(21,000)	NA	−	21,000	=	(21,000)	(21,000)	OA
5	(5,000)	+	NA	+	NA	=	NA	+	NA	+	(5,000)	NA	−	NA	=	NA	(5,000)	FA
6*	NA	+	NA	+	NA	=	(6,000)	+	NA	+	6,000	6,000	−	NA	=	6,000	NA	
7†	NA	+	NA	+	(9,000)	=	NA	+	NA	+	(9,000)	NA	−	9,000	=	(9,000)	NA	
Bal.	53,300	+	1,000	+	3,000	=	0	+	20,000	+	37,300	44,000	−	30,000	=	14,000	2,000	NC

*Revenue is earned at the rate of $3,000 ($36,000 ÷ 12 months) per month. Revenue recognized in 2012 is $30,000 ($3,000 × 10 months). Revenue recognized in 2013 is $6,000 ($3,000 × 2 months).

†Insurance expense is incurred at the rate of $1,000 ($12,000 ÷ 12 months) per month. Insurance expense recognized in 2013 is $9,000 ($1,000 × 9 months).

Solutions to Requirements b–g

b. Gifford would report $48,000 of revenue in 2012 ($18,000 revenue on account plus $30,000 of the $36,000 of unearned revenue).

c. The cash inflow from customers is $51,000 ($36,000 when the unearned revenue was received plus $15,000 collection of accounts receivable).

d. The December 31, 2012, balance sheet will report $6,000 of unearned revenue, which is the amount of the cash advance less the amount of revenue recognized in 2012 ($36,000 − $30,000). The December 31, 2013, unearned revenue balance is zero.

e. Since revenue and expense accounts are closed at the end of each accounting period, the beginning balances in these accounts are always zero.

f. Assets on the December 31, 2012, balance sheet are $54,300 [Gifford's cash at year end plus the balance in accounts receivable ($51,300 + $3,000)].

g. Since all unearned revenue would be recognized before the financial statements were prepared at the end of 2013, there would be no liabilities on the 2013 balance sheet. Common stock and retained earnings would be the only claims as of December 31, 2013, for a claims total of $57,300 ($20,000 + $37,300).

KEY TERMS

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QUESTIONS

1. What does accrual accounting attempt to accomplish?
2. Define *recognition*. How is it independent of collecting or paying cash?
3. What does the term *deferral* mean?
4. If cash is collected in advance of performing services, when is the associated revenue recognized?
5. What does the term *asset source transaction* mean?
6. What effect does the issue of common stock have on the accounting equation?
7. How does the recognition of revenue on account (accounts receivable) affect the income statement compared to its effect on the statement of cash flows?
8. Give an example of an asset source transaction. What is the effect of this transaction on the accounting equation?
9. When is revenue recognized under accrual accounting?
10. Give an example of an asset exchange transaction. What is the effect of this transaction on the accounting equation?
11. What is the effect on the claims side of the accounting equation when cash is collected in advance of performing services?
12. What does the term *unearned revenue* mean?
13. What effect does expense recognition have on the accounting equation?
14. What does the term *claims exchange transaction* mean?
15. What type of transaction is a cash payment to creditors? How does this type of transaction affect the accounting equation?
16. When are expenses recognized under accrual accounting?
17. Why may net cash flow from operating activities on the cash flow statement be different from the amount of net income reported on the income statement?
18. What is the relationship between the income statement and changes in assets and liabilities?
19. How does net income affect the stockholders' claims on the business's assets?
20. What is the difference between a cost and an expense?
21. When does a cost become an expense? Do all costs become expenses?
22. How and when is the cost of the *supplies used* recognized in an accounting period?
23. What does the term *expense* mean?
24. What does the term *revenue* mean?
25. What is the purpose of the statement of changes in stockholders' equity?
26. What is the main purpose of the balance sheet?
27. Why is the balance sheet dated *as of* a specific date when the income statement, statement of changes in stockholders' equity, and statement of cash flows are dated with the phrase *for the period ended?*
28. In what order are assets listed on the balance sheet?
29. What does the statement of cash flows explain?
30. What does the term *adjusting entry* mean? Give an example.
31. What types of accounts are closed at the end of the accounting period? Why is it necessary to close these accounts?
32. Give several examples of period costs.
33. Give an example of a cost that can be directly matched with the revenue produced by an accounting firm from preparing a tax return.
34. List and describe the four stages of the accounting cycle discussed in Chapter 2.

MULTIPLE-CHOICE QUESTIONS

Multiple-choice questions are provided on the text website at www.mhhe.com/edmondssurvey3e.

www.mhhe.com/edmondssurvey3e

EXERCISES

All applicable Exercises are available with McGraw-Hill's *Connect Accounting.*

Where applicable in all exercises, round computations to the nearest dollar.

LO 2, 3

Exercise 2-1 *Effect of accruals on the financial statements*

Valmont, Inc., experienced the following events in 2012, in its first year of operation.

1. Received $20,000 cash from the issue of common stock.
2. Performed services on account for $50,000.
3. Paid the utility expense of $12,500.
4. Collected $39,000 of the accounts receivable.
5. Recorded $9,000 of accrued salaries at the end of the year.
6. Paid a $5,000 cash dividend to the shareholders.

Required

a. Record the events in general ledger accounts under an accounting equation. In the last column of the table, provide appropriate account titles for the Retained Earnings amounts. The first transaction has been recorded as an example.

VALMONT, INC. General Ledger Accounts								
Event	Assets		=	Liabilities	+	Stockholders' Equity		Acct. Titles for RE
	Cash	Accounts Receivable		Salaries Payable		Common Stock	Retained Earnings	
1.	20,000					20,000		

b. Prepare the income statement, statement of changes in stockholders' equity, balance sheet, and statement of cash flows for the 2012 accounting period.

c. Why is the amount of net income different from the amount of net cash flow from operating activities?

LO 2, 3

Exercise 2-2 *Effect of collecting accounts receivable on the accounting equation and financial statements*

Schroder Company earned $14,000 of service revenue on account during 2012. The company collected $11,500 cash from accounts receivable during 2012.

Required

Based on this information alone, determine the following. (*Hint:* Record the events in general ledger accounts under an accounting equation before satisfying the requirements.)

a. The balance of the accounts receivable that Schroder would report on the December 31, 2012, balance sheet.

b. The amount of net income that Schroder would report on the 2012 income statement.

c. The amount of net cash flow from operating activities that Schroder would report on the 2012 statement of cash flows.

d. The amount of retained earnings that Schroder would report on the 2012 balance sheet.

e. Why are the answers to Requirements *b* and *c* different?

LO 2, 3

Exercise 2-3 *Effect of prepaid rent on the accounting equation and financial statements*

The following events apply to 2012, the first year of operations of Sentry Services.

1. Acquired $45,000 cash from the issue of common stock.
2. Paid $18,000 cash in advance for one-year rental contract for office space.

3. Provided services for $36,000 cash.
4. Adjusted the records to recognize the use of the office space. The one-year contract started on May 1, 2012. The adjustment was made as of December 31, 2012.

Required

a. Write an accounting equation and record the effects of each accounting event under the appropriate general ledger account headings.
b. Prepare an income statement and statement of cash flows for the 2012 accounting period.
c. Explain the difference between the amount of net income and amount of net cash flow from operating activities.

Exercise 2-4 *Effect of supplies on the financial statements*

LO 1, 3

Green Copy Service, Inc., started the 2012 accounting period with $16,000 cash, $10,000 of common stock, and $6,000 of retained earnings. Green Copy Service was affected by the following accounting events during 2012.

1. Purchased $9,600 of paper and other supplies on account.
2. Earned and collected $39,000 of cash revenue.
3. Paid $7,000 cash on accounts payable.
4. Adjusted the records to reflect the use of supplies. A physical count indicated that $2,200 of supplies was still on hand on December 31, 2012.

Required

a. Show the effects of the events on the financial statements using a horizontal statements model like the following one. In the Cash Flows column, use OA to designate operating activity, IA for investing activity, FA for financing activity, and NC for net change in cash. Use NA to indicate accounts not affected by the event. The beginning balances are entered in the following example.

Event No.	Assets			=	Liab.	+	Stockholders' Equity			Rev.	−	Exp.	=	Net Inc.	Cash Flows
	Cash	+	Supplies	=	Accts. Pay	+	C. Stock	+	Ret. Earn.						
Beg. Bal.	16,000	+	0	=	0	+	10,000	+	6,000	0	−	0	=	0	0

b. Explain the difference between the amount of net income and amount of net cash flow from operating activities.

Exercise 2-5 *Effect of unearned revenue on financial statements*

LO 1, 3, 5

Michael Stone started a personal financial planning business when he accepted $120,000 cash as advance payment for managing the financial assets of a large estate. Stone agreed to manage the estate for a one-year period, beginning April 1, 2012.

Required

a. Show the effects of the advance payment and revenue recognition on the 2012 financial statements using a horizontal statements model like the following one. In the Cash Flows column, use OA to designate operating activity, IA for investing activity, FA for financing activity, and NC for net change in cash. Use NA if the account is not affected.

Event No.	Assets	=	Liab.	+	Stockholders' Equity	Rev.	−	Exp.	=	Net Inc.	Cash Flows
	Cash	=	Unearn. Rev.	+	Ret. Earn.						

b. How much revenue would Stone recognize on the 2013 income statement?
c. What is the amount of cash flow from operating activities in 2013?

Exercise 2-6 *Unearned revenue defined as a liability*

LO 3

Harry Baldwin received $500 in advance for tutoring fees when he agreed to help Joseph Jones with his introductory accounting course. Upon receiving the cash, Harry mentioned that he would have to record the transaction as a liability on his books. Jones asked, "Why a liability? You don't owe me any money, do you?"

Required

Respond to Jones' question regarding Baldwin's liability.

LO 3

Exercise 2-7 *Distinguishing between an expense and a cost*

Eddie Kirn tells you that the accountants where he works are real hair splitters. For example, they make a big issue over the difference between a cost and an expense. He says the two terms mean the same thing to him.

Required

a. Explain to Eddie the difference between a cost and an expense from an accountant's perspective.

b. Indicate whether each of the following events produces an asset or an expense.

(1) Recognized accrued salaries.

(2) Paid in advance for insurance on the building.

(3) Used supplies on hand to produce revenue.

(4) Purchased supplies on account.

(5) Purchased a building for cash.

LO 3

Exercise 2-8 *Revenue and expense recognition*

Required

a. Describe an expense recognition event that results in a decrease in assets.

b. Describe an expense recognition event that results in an increase in liabilities.

c. Describe a revenue recognition event that results in an increase in assets.

d. Describe a revenue recognition event that results in a decrease in liabilities.

LO 3

Exercise 2-9 *Transactions that affect the elements of financial statements*

Required

Give an example of a transaction that will

a. Increase a liability and decrease equity (claims exchange event).

b. Increase an asset and increase equity (asset source event).

c. Decrease a liability and increase equity (claims exchange event).

d. Increase an asset and decrease another asset (asset exchange event).

e. Increase an asset and increase a liability (asset source event).

f. Decrease an asset and decrease a liability (asset use event).

g. Decrease an asset and decrease equity (asset use event).

LO 3

Exercise 2-10 *Identifying deferral and accrual events*

Required

Identify each of the following events as an accrual, deferral, or neither.

a. Provided services on account.

b. Collected accounts receivable.

c. Paid one year's rent in advance.

d. Paid cash for utilities expense.

e. Collected $2,400 in advance for services to be performed over the next 12 months.

f. Incurred other operating expenses on account.

g. Recorded expense for salaries owed to employees at the end of the accounting period.

h. Paid a cash dividend to the stockholders.

i. Paid cash to purchase supplies to be used over the next several months.

j. Purchased land with cash.

Exercise 2-11 *Prepaid and unearned rent*

LO 2

On August 1, 2012, Woodworks paid Warehouse Rentals $54,000 for a 12-month lease on warehouse space.

Required

a. Record the deferral and the related December 31, 2012, adjustment for Woodworks in the accounting equation.

b. Record the deferral and the related December 31, 2012, adjustment for Warehouse Rentals in the accounting equation.

Exercise 2-12 *Classifying events on the statement of cash flows*

LO 3

The following transactions pertain to the operations of Fleming Company for 2012.

1. Acquired $40,000 cash from the issue of common stock.
2. Performed services for $12,000 cash.
3. Provided $55,000 of services on account.
4. Received $36,000 cash in advance for services to be performed over the next two years.
5. Incurred $30,000 of other operating expenses on account.
6. Collected $45,000 cash from accounts receivable.
7. Paid $4,000 cash for rent expense.
8. Paid $12,000 for one year's prepaid insurance.
9. Paid a $5,000 cash dividend to the stockholders.
10. Paid $22,000 cash on accounts payable.

Required

a. Classify the cash flows from these transactions as operating activities (OA), investing activities (IA), or financing activities (FA). Use NA for transactions that do not affect the statement of cash flows.

b. Prepare a statement of cash flows. (There is no beginning cash balance.)

Exercise 2-13 *Effect of accounting events on the income statement and statement of cash flows*

LO 3

Required

Explain how each of the following events and the related adjusting entry will affect the amount of *net income* and the amount of *cash flow from operating activities* reported on the year-end financial statements. Identify the direction of change (increase, decrease, or NA) and the amount of the change. Organize your answers according to the following table. The first event is recorded as an example. If an event does not have a related adjusting entry, record only the effects of the event. All adjustments are made on December 31.

	Net Income		Cash Flows from Operating Activities	
Event No.	**Direction of Change**	**Amount of Change**	**Direction of Change**	**Amount of Change**
a	NA	NA	NA	NA

a. Acquired $50,000 cash from the issue of common stock.

b. Paid $4,800 cash on October 1 to purchase a one-year insurance policy.

c. Collected $18,000 in advance for services to be performed in the future. The contract called for services to start on September 1 and to continue for one year.

d. Earned $22,000 of revenue on account. Collected $18,000 cash from accounts receivable.

e. Sold land that had cost $10,000 for $10,000.

f. Accrued salaries amounting to $8,000.

g. Provided services for $12,000 cash.

h. Paid cash for other operating expenses of $3,500.

i. Purchased $1,800 of supplies on account. Paid $1,500 cash on accounts payable. The ending balance in the Supplies account, after adjustment, was $600.

LO 1, 6

Exercise 2-14 *Identifying transaction type and effect on the financial statements*

Required

Identify whether each of the following transactions is an asset source (AS), asset use (AU), asset exchange (AE), or claims exchange (CE). Also show the effects of the events on the financial statements using the horizontal statements model. Indicate whether the event increases (I), decreases (D), or does not affect (NA) each element of the financial statements. In the Cash Flows column, designate the cash flows as operating activities (OA), investing activities (IA), or financing activities (FA). The first two transactions have been recorded as examples.

						Stockholders' Equity							
Event No.	Type of Event	Assets	=	Liabilities	+	Common Stock	+	Retained Earnings	Rev.	−	Exp.	=	Net Inc.	Cash Flows
a	AS	I		NA		I		NA	NA		NA		NA	I FA
b	AE	I/D		NA		NA		NA	NA		NA		NA	D IA

a. Acquired cash from the issue of common stock.

b. Purchased land for cash.

c. Paid cash advance for rent on office space.

d. Collected cash from accounts receivable.

e. Performed services for cash.

f. Purchased a building with part cash *and* issued a note payable for the balance.

g. Paid cash for operating expenses.

h. Paid cash for supplies.

i. Paid a cash dividend to the stockholders.

j. Incurred operating expenses on account.

k. Paid cash on accounts payable.

l. Received cash advance for services to be provided in the future.

m. Recorded accrued salaries.

n. Performed services on account.

o. Adjusted books to reflect the amount of prepaid rent expired during the period.

p. Paid cash for salaries accrued at the end of a prior period.

LO 1

Exercise 2-15 *Effect of accruals and deferrals on financial statements: the horizontal statements model*

K. Little, Attorney at Law, experienced the following transactions in 2012, the first year of operations.

1. Purchased $2,800 of office supplies on account.
2. Accepted $30,000 on February 1, 2012, as a retainer for services to be performed evenly over the next 12 months.
3. Performed legal services for cash of $87,000.
4. Paid cash for salaries expense of $38,500.
5. Paid a cash dividend of $10,000 to the stockholders.

6. Paid $1,800 of the amount due on accounts payable.
7. Determined that at the end of the accounting period, $300 of office supplies remained on hand.
8. On December 31, 2012, recognized the revenue that had been earned for services performed in accordance with Transaction 2.

Required

Show the effects of the events on the financial statements using a horizontal statements model like the following one. In the Cash Flow column, use the initials OA to designate operating activity, IA for investing activity, FA for financing activity, and NC for net change in cash. Use NA to indicate accounts not affected by the event. The first event has been recorded as an example.

Event No.	Assets			=	Liabilities			+	Stk. Equity	Rev.	−	Exp.	=	Net Inc.	Cash Flow
	Cash	+	Supp.	=	Accts. Pay.	+	Unearn. Rev.	+	Ret. Earn.						
1	NA	+	2,800	=	2,800	+	NA	+	NA	NA	−	NA	=	NA	NA

Exercise 2-16 *Effect of an error on financial statements*

LO 2, 3

On May 1, 2012, Virginia Corporation paid $18,000 cash in advance for a one-year lease on an office building. Assume that Virginia records the prepaid rent and that the books are closed on December 31.

Required

a. Show the payment for the one-year lease and the related adjusting entry to rent expense in the accounting equation.
b. Assume that Virginia Corporation failed to record the adjusting entry to reflect using the office building. How would the error affect the company's 2012 income statement and balance sheet?

Exercise 2-17 *Net income versus changes in cash*

LO 2, 3

In 2012, Cherry Design billed its customers $58,000 for services performed. The company collected $46,000 of the amount billed. Cherry Design incurred $41,000 of other operating expenses on acount. Cherry Design paid $30,000 of the accounts payable. Cherry Design acquired $40,000 cash from the issue of common stock. The company invested $20,000 cash in the purchase of land.

Required

Use the preceding information to answer the following questions. (*Hint:* Identify the six events described in the paragraph and record them in general ledger accounts under an accounting equation before attempting to answer the questions.)

a. What amount of revenue will Cherry Design report on the 2012 income statement?
b. What amount of cash flow from revenue will Cherry Design report on the statement of cash flows?
c. What is the net income for the period?
d. What is the net cash flow from operating activities for the period?
e. Why is the amount of net income different from the net cash flow from operating activities for the period?
f. What is the amount of net cash flow from investing activities?
g. What is the amount of net cash flow from financing activities?
h. What amounts of total assets, liabilities, and equity will Cherry Design report on the year-end balance sheet?

LO 3

Exercise 2-18 *Adjusting the accounts*

Keystore Systems experienced the following accounting events during its 2012 accounting period.

1. Paid cash to purchase land.
2. Recognized revenue on account.
3. Issued common stock.
4. Paid cash to purchase supplies.
5. Collected a cash advance for services that will be provided during the coming year.
6. Paid a cash dividend to the stockholders.
7. Paid cash for an insurance policy that provides coverage during the next year.
8. Collected cash from accounts receivable.
9. Paid cash for operating expenses.
10. Paid cash to settle an account payable.

Required

a. Identify the events that would require a year-end adjusting entry.
b. Explain why adjusting entries are made at the end of the accounting period.

LO 4, 5

Exercise 2-19 *Closing the accounts*

The following information was drawn from the accounting records of Kwon Company as of December 31, 2012, before the temporary accounts had been closed. The Cash balance was $4,000, and Notes Payable amounted to $2,000. The company had revenues of $6,000 and expenses of $3,500. The company's Land account had a $9,000 balance. Dividends amounted to $500. There was $6,000 of common stock issued.

Required

a. Identify which accounts would be classified as permanent and which accounts would be classified as temporary.
b. Assuming that Kwon's beginning balance (as of January 1, 2012) in the Retained Earnings account was $2,600, determine its balance after the nominal accounts were closed at the end of 2012.
c. What amount of net income would Kwon Company report on its 2012 income statement?
d. Explain why the amount of net income differs from the amount of the ending Retained Earnings balance.
e. What are the balances in the revenue, expense, and dividend accounts on January 1, 2013?

LO 4

Exercise 2-20 *Closing accounts and the accounting cycle*

Required

a. Identify which of the following accounts are temporary (will be closed to Retained Earnings at the end of the year) and which are permanent.
   (1) Land
   (2) Salaries Expense
   (3) Retained Earnings
   (4) Prepaid Rent
   (5) Supplies Expense
   (6) Common Stock
   (7) Notes Payable
   (8) Cash
   (9) Service Revenue
   (10) Dividends
b. List and explain the four stages of the accounting cycle. Which stage must be first? Which stage is last?

Exercise 2-21 *Closing entries*

LO 4

Required

Which of the following accounts are closed at the end of the accounting period?

a. Accounts Payable
b. Unearned Revenue
c. Prepaid Rent
d. Rent Expense
e. Service Revenue
f. Advertising Expense
g. Dividends
h. Retained Earnings
i. Utilities Expense
j. Salaries Payable
k. Salaries Expense
l. Operating Expenses

Exercise 2-22 *Matching concept*

LO 4

Companies make sacrifices known as *expenses* to obtain benefits called *revenues.* The accurate measurement of net income requires that expenses be matched with revenues. In some circumstances matching a particular expense directly with revenue is difficult or impossible. In these circumstances, the expense is matched with the period in which it is incurred.

Required

Distinguish the following items that could be matched directly with revenues from the items that would be classified as period expenses.

a. Sales commissions paid to employees.
b. Utilities expense.
c. Rent expense.
d. The cost of land that has been sold.

Exercise 2-23 *Identifying source, use, and exchange transactions*

LO 6

Required

Indicate whether each of the following transactions is an asset source (AS), asset use (AU), asset exchange (AE), or claims exchange (CE) transaction.

a. Acquired cash from the issue of stock.
b. Paid a cash dividend to the stockholders.
c. Paid cash on accounts payable.
d. Incurred other operating expenses on account.
e. Paid cash for rent expense.
f. Performed services for cash.
g. Performed services for clients on account.
h. Collected cash from accounts receivable.
i. Invested cash in a certificate of deposit.
j. Purchased land with cash.

Exercise 2-24 *Identifying asset source, use, and exchange transactions*

LO 6

Required

a. Name an asset exchange transaction that will *not* affect the statement of cash flows.
b. Name an asset exchange transaction that will affect the statement of cash flows.
c. Name an asset source transaction that will *not* affect the income statement.
d. Name an asset use transaction that will affect the income statement.
e. Name an asset use transaction that will *not* affect the income statement.

LO 3

Exercise 2-25 *Relation of elements to financial statements*

Required

Identify whether each of the following items would appear on the income statement (IS), statement of changes in stockholders' equity (SE), balance sheet (BS), or statement of cash flows (CF). Some items may appear on more than one statement; if so, identify all applicable statements. If an item would not appear on any financial statement, label it NA.

a. Prepaid rent
b. Net income
c. Utilities expense
d. Supplies
e. Cash flow from operating activities
f. Service revenue
g. Auditor's opinion
h. Accounts receivable
i. Accounts payable
j. Unearned revenue
k. Dividends
l. Beginning cash balance
m. Ending retained earnings
n. Rent expense
o. Ending cash balance

Exercise 2-26 *Analyzing the cash flow effects of different types of expenses*

The following income statements are available for Hopi, Inc., and Zuni, Inc., for 2012.

	Hopi, Inc.	Zuni, Inc.
Revenue	$100,000	$100,000
Wages expense	70,000	55,000
Depreciation expense	10,000	25,000
Net earnings	$ 20,000	$ 20,000

Required

Assume that neither company had beginning or ending balances in its Accounts Receivable or wages Payable accounts. Explain which company would have the lowest *net cash flows from operating activities* for 2012.

PROBLEMS

connect ACCOUNTING

All applicable Problems are available with McGraw-Hill's *Connect Accounting.*

LO 1

CHECK FIGURES
Net Income: $15,300
Ending Cash Balance: $33,200

Problem 2-27 *Recording events in a horizontal statements model*

The following events pertain to King Company.

1. Acquired $25,000 cash from the issue of common stock.
2. Provided services for $5,000
3. Provided $18,000 of services on account.
4. Collected $11,000 cash from the account receivable created in Event 3.
5. Paid $1,400 cash to purchase supplies.
6. Had $300 of supplies on hand at the end of the accounting period.
7. Received $3,600 cash in advance for services to be performed in the future.

8. Performed one-half of the services agreed to in Event 7.
9. Paid $6,000 for salaries expense.
10. Incurred $2,400 of other operating expenses on account.
11. Paid $2,000 cash on the account payable created in Event 10.
12. Paid a $2,000 cash dividend to the stockholders.

Required

Show the effects of the events on the financial statements using a horizontal statements model like the following one. In the Cash Flows column, use the letters OA to designate operating activity, IA for investing activity, FA for financing activity, and NC for net change in cash. Use NA to indicate accounts not affected by the event. The first event is recorded as an example.

	Assets						=	Liabilities			+	Stockholders' Equity			Rev.	−	Exp.	=	Net Inc.	Cash Flows	
Event No.	Cash	+	Accts. Rec.	+	Supp.		=	Accts. Pay.	+	Unearn. Rev.	+	Com. Stk.	+	Ret. Earn.							
1	25,000	+	NA	+	NA		=	NA	+	NA	+	25,000	+	NA	NA	−	NA	=	NA	25,000	FA

Problem 2-28 *Effect of deferrals on financial statements: three separate single-cycle examples*

eXcel

CHECK FIGURES
a. Net Income: $80,000
b. Net Income: $12,500

Required

a. On February 1, 2012, Heider, Inc., was formed when it received $80,000 cash from the issue of common stock. On May 1, 2012, the company paid $60,000 cash in advance to rent office space for the coming year. The office space was used as a place to consult with clients. The consulting activity generated $120,000 of cash revenue during 2012. Based on this information alone, record the events and related adjusting entry in the general ledger accounts under the accounting equation. Determine the amount of net income and cash flows from operating activities for 2012.

b. On January 1, 2012, the accounting firm of Bonds & Associates was formed. On August 1, 2012, the company received a retainer fee (was paid in advance) of $30,000 for services to be performed monthly during the next 12 months. Assuming that this was the only transaction completed in 2012, prepare an income statement, statement of changes in stockholders' equity, balance sheet, and statement of cash flows for 2012.

c. Edge Company had $2,200 of supplies on hand on January 1, 2012. Edge purchased $7,200 of supplies on account during 2012. A physical count of supplies revealed that $900 of supplies was on hand as of December 31, 2012. Determine the amount of supplies expense that should be recognized in the December 31, 2012 adjusting entry. Use a financial statements model to show how the adjusting entry would affect the balance sheet, income statement, and statement of cash flows.

Problem 2-29 *Effect of adjusting entries on the accounting equation*

LO 2

Required

Each of the following independent events requires a year-end adjusting entry. Show how each event and its related adjusting entry affect the accounting equation. Assume a December 31 closing date. The first event is recorded as an example.

CHECK FIGURE
b. adjustment amount: $1,250

	Total Assets						Stockholders' Equity		
Event/ Adjustment	Cash	+	Other Assets	=	Liabilities	+	Common Stock	+	Retained Earnings
a	−7,200		+7,200		NA		NA		NA
Adj.	NA		−5,400		NA		NA		−5,400

a. Paid $7,200 cash in advance on April 1 for a one-year insurance policy.
b. Purchased $1,400 of supplies on account. At year's end, $150 of supplies remained on hand.
c. Paid $8,400 cash in advance on March 1 for a one-year lease on office space.
d. Received a $18,000 cash advance for a contract to provide services in the future. The contract required a one-year commitment starting September 1 to be provided evenly over the year.
e. Paid $24,000 cash in advance on October 1 for a one-year lease on office space.

LO 3, 5, 6

eXcel

CHECK FIGURES

b. Net Income, 2012: $19,300
b. Net Income, 2013: $84,650

Problem 2-30 *Events for two complete accounting cycles*

Energy Consulting Company was formed on January 1, 2012.

Events Affecting the 2012 Accounting Period

1. Acquired cash of $80,000 from the issue of common stock.
2. Purchased $4,200 of suplies on account.
3. Purchased land that cost $30,000 cash.
4. Paid $4,200 cash to settle accounts payable created in Event 2.
5. Recognized revenue on account of $75,000.
6. Paid $46,000 cash for other operating expenses.
7. Collected $68,000 cash from accounts receivable.

Information for 2012 Adjusting Entries

8. Recognized accrued salaries of $5,800 on December 31, 2012.
9. Had $300 of supplies on hand at the end of the accounting period.

Events Affecting the 2013 Accounting Period

1. Acquired an additional $10,000 cash from the issue of common stock.
2. Paid $5,800 cash to settle the salaries payable obligation.
3. Paid $6,000 cash in advance for a lease on office facilities.
4. Sold land that had cost $25,000 for $25,000 cash.
5. Received $8,400 cash in advance for services to be performed in the future.
6. Purchased $1,800 of supplies on account during the year.
7. Provided services on account of $90,000.
8. Collected $92,000 cash from accounts receivable.
9. Paid a cash dividend of $10,000 to the stockholders.

Information for 2013 Adjusting Entries

10. The advance payment for rental of the office facilities (see Event 3) was made on September 1 for a one-year lease term.
11. The cash advance for services to be provided in the future was collected on June 1 (see Event 5). The one-year contract started June 1.
12. Had $350 of supplies on hand at the end of the period.
13. Recognized accrued salaries of $6,500 at the end of the accounting period.

Required

a. Identify each event affecting the 2012 and 2013 accounting periods as asset source (AS), asset use (AU), asset exchange (AE), or claims exchange (CE). Record the effects of each event under the appropriate general ledger account headings of the accounting equation.
b. Prepare an income statement, statement of changes in stockholders' equity, balance sheet, and statement of cash flows for 2012 and 2013, using the vertical statements model.

LO 2, 3

CHECK FIGURES

b. $33,000
h. ($3,000)

Problem 2-31 *Effect of events on financial statements*

Reed Company had the following balances in its accounting records as of December 31, 2012.

Assets		Claims	
Cash	$ 75,000	Accounts Payable	$ 32,000
Accounts Receivable	45,000	Common Stock	90,000
Land	30,000	Retained Earnings	28,000
Totals	$150,000		$150,000

The following accounting events apply to Reed's 2012 fiscal year:

Jan.	1	Acquired an additional $50,000 cash from the issue of common stock.
April	1	Paid $8,400 cash in advance for a one-year lease for office space.
June	1	Paid a $4,000 cash dividend to the stockholders.
July	1	Purchased additional land that cost $15,000 cash.
Aug.	1	Made a cash payment on accounts payable of $28,000.
Sept.	1	Received $9,600 cash in advance as a retainer for services to be performed monthly during the next eight months.
Sept.	30	Sold land for $12,000 cash that had originally cost $12,000.
Oct.	1	Purchased $1,500 of supplies on account.
Dec.	31	Earned $75,000 of service revenue on account during the year.
	31	Received $70,000 cash collections from accounts receivable.
	31	Incurred $24,000 other operating expenses on account during the year.
	31	Recognized accrued salaries expense of $8,000.
	31	Had $400 of supplies on hand at the end of the period.
	31	The land purchased on July 1 had a market value of $21,000.

Required

Based on the preceding information, answer the following questions. All questions pertain to the 2012 financial statements. (*Hint:* Record the events in general ledger accounts under an accounting equation before answering the questions.)

a. What two transactions need additional adjusting entries at the end of the year?
b. What amount would be reported for land on the balance sheet?
c. What amount of net cash flow from operating activities would Reed report on the statement of cash flows?
d. What amount of rent expense would be reported in the income statement?
e. What amount of total liabilities would be reported on the balance sheet?
f. What amount of supplies expense would be reported on the income statement?
g. What amount of unearned revenue would be reported on the balance sheet?
h. What amount of net cash flow from investing activities would be reported on the statement of cash flows?
i. What amount of total expenses would be reported on the income statement?
j. What total amount of service revenues would be reported on the income statement?
k. What amount of cash flows from financing activities would be reported on the statement of cash flows?
l. What amount of net income would be reported on the income statement?
m. What amount of retained earnings would be reported on the balance sheet?

Problem 2-32 *Identifying and arranging elements on financial statements*

LO 3

excel

CHECK FIGURES

2012 Net Income: $59,000
2012 Total Assets: $178,500

The following information was drawn from the records of Paso & Associates at December 31, 2012.

Supplies	$ 2,500	Unearned revenue	$ 5,400
Consulting revenue	120,000	Notes payable	40,000
Land	70,000	Salaries payable	9,000
Dividends	10,000	Salary expense	58,000
Cash flow from fin. activities	30,000	Common stock issued	30,000
Interest revenue	6,000	Beginning common stock	40,000
Ending retained earnings	50,100	Accounts receivable	32,000
Cash	66,000	Cash flow from inv. activities	(21,000)
Interest payable	4,000	Cash flow from oper. activities	18,000
Interest expense	9,000	Prepaid rent	8,000

Required

Use the preceding information to construct an income statement, statement of changes in stockholders' equity, balance sheet, and statement of cash flows. (Show only totals for each activity on the statement of cash flows.)

LO 3

Problem 2-33 *Relationship of accounts to financial statements*

CHECK FIGURES

a. BS

z. BS

Required

Identify whether each of the following items would appear on the income statement (IS), statement of changes in stockholders' equity (SE), balance sheet (BS), or statement of cash flows (CF). Some items may appear on more than one statement; if so, identify all applicable statements. If an item would not appear on any financial statement, label it NA.

a. Accumulated depreciation
b. Salary expense
c. Prepaid insurance
d. Beginning common stock
e. Beginning retained earnings
f. Supplies expense
g. Operating expenses
h. Cash flow from operating activities
i. Debt to assets ratio
j. Total liabilities
k. Ending common stock
l. Interest expense
m. Consulting revenue
n. Cash flow from investing activities
o. Service revenue
p. Unearned revenue
q. Certificate of deposit
r. Interest receivable
s. Depreciation expense
t. Accounts receivable
u. Notes payable
v. Insurance expense
w. Salaries payable
x. Total assets
y. Accounts payable
z. Notes receivable
aa. Cash
bb. Supplies
cc. Cash flow from financing activities
dd. Interest revenue
ee. Ending retained earnings
ff. Net income
gg. Dividends
hh. Office equipment
ii. Debt to equity ratio
jj. Land
kk. Interest payable
ll. Rent expense

LO 3, 5

excel

Problem 2-34 *Missing information in financial statements*

CHECK FIGURES

n. $8,000

t. $5,000

Required

Fill in the blank (as indicated by the alphabetic letters in parentheses) in the following financial statements. Assume the company started operations January 1, 2010, and that all transactions involve cash.

	For the Years		
	2010	2011	2012
Income Statements			
Revenue	$ 700	$ 1,300	$ 2,000
Expense	(a)	(700)	(1,300)
Net income	$ 200	$ (m)	$ 700
Statement of Changes in Stockholders' Equity			
Beginning common stock	$ 0	$ (n)	$ 6,000
Plus: Common stock issued	5,000	1,000	2,000
Ending common stock	5,000	6,000	(t)
Beginning retained earnings	0	100	200
Plus: Net income	(b)	(o)	700
Less: Dividends	(c)	(500)	(300)
Ending retained earnings	100	(p)	600
Total stockholders' equity	$ (d)	$ 6,200	$ 8,600

continued

Balance Sheets			
Assets			
Cash	$ (e)	$ (q)	$ (u)
Land	0	(r)	8,000
Total assets	$ (f)	$11,200	$10,600
Liabilities	$ (g)	$ 5,000	$ 2,000
Stockholders' equity			
Common stock	(h)	(s)	8,000
Retained earnings	(i)	200	600
Total stockholders' equity	(j)	6,200	8,600
Total liabilities and stockholders' equity	$8,100	$11,200	$10,600
Statements of Cash Flows			
Cash flows from operating activities			
Cash receipts from revenue	$ (k)	$ 1,300	$ (v)
Cash payments for expenses	(l)	(700)	(w)
Net cash flows from operating activities	200	600	700
Cash flows from investing activities			
Cash payments for land	0	(8,000)	0
Cash flows from financing activities			
Cash receipts from loan	3,000	3,000	0
Cash payments to reduce debt	0	(1,000)	(x)
Cash receipts from stock issue	5,000	1,000	(y)
Cash payments for dividends	(100)	(500)	(z)
Net cash flows from financing activities	7,900	2,500	(1,300)
Net change in cash	8,100	(4,900)	(600)
Plus: Beginning cash balance	0	8,100	3,200
Ending cash balance	$8,100	$ 3,200	$ 2,600

ANALYZE, THINK, COMMUNICATE

ATC 2-1 Business Applications Case *Understanding real-world annual reports*

Required

Use the Target Corporation's annual report in Appendix B to answer the following questions. Note that net income and net earnings are synonymous terms.

Target Corporation

a. Which accounts on Target's balance sheet are accural type accounts?

b. Which accounts on Target's balance sheet are deferral type accounts?

c. Compare Target's 2009 *net earnings* to its 2009 *cash provided by operating activities.* Which is larger?

d. First, compare Target's 2008 net earnings to its 2009 net earnings. Next, compare Target's 2008 cash provided by operating activities to its 2009 cash provided by operating activities. Which changed the most from 2008 to 2009, net earnings or cash provided by operating activities?

ATC 2-2 Group Assignment *Financial reporting and market valuation*

The following financial highlights were drawn from the 2009 annual reports of Microsoft Corporation and Apple Inc.

	Microsoft	Apple
Revenue	$58.4 Billion	$42.9 Billion
Net income	$14.6 Billion	$ 5.7 Billion
Cash and short-term investments	$39.7 Billion	$23.1 Billion

Even so, as of May 26, 2010, Wall Street valued Microsoft at $219.19 billion and Apple at $222.12.

Divide the class into groups of four or five students.

Required

Have the members of each group reach a consensus response for each of the following tasks. Each group should elect a spokes person to represent the group.

Group Tasks

(1) Determine the amount of expenses incurred by each company.

(2) Comment on how the concept of conservatism applies to the financial information presented in this case.

(3) Speculate as to why investors would be willing to pay more for Apple than Microsoft.

Class Discussion

Randomly call on the spokes persons to compare their responses for each of the group tasks.

ATC 2-3 Research Assignment *Investigating nonfinancial information in Nike's annual report*

Although most of this course is concerned with the financial statements themselves, all sections of a company's annual report are important. A company must file various reports with the SEC, and one of these, Form 10-K, is essentially the company's annual report. The requirements below ask you to investigate sections of Nike's annual report that explain various nonfinancial aspects of its business operations.

To obtain the Form 10-K you can use either the EDGAR system following the instructions in Appendix A or the company's website.

Required

a. In what year did Nike begin operations?

b. Other than athletic shoes, what products does Nike sell?

c. Does Nike operate businesses under names other than Nike? If so, what are they?

d. How many employees does Nike have?

e. In how many countries other than the United States does Nike sell its products?

ATC 2-4 Writing Assignment *Conservatism and Matching*

Glenn's Cleaning Services Company is experiencing cash flow problems and needs a loan. Glenn has a friend who is willing to lend him the money he needs provided she can be convinced that he will be able to repay the debt. Glenn has assured his friend that his business is viable, but his friend has asked to see the company's financial statements. Glenn's accountant produced the following financial statements.

Income Statement	
Service Revenue	$ 38,000
Operating Expenses	(70,000)
Net Loss	$(32,000)

Balance Sheet	
Assets	$85,000
Liabilities	$35,000
Stockholders' Equity	
Common Stock	82,000
Retained Earnings	(32,000)
Total Liabilities and Stockholders' Equity	$85,000

Glenn made the following adjustments to these statements before showing them to his friend. He recorded $82,000 of revenue on account from Barrymore Manufacturing Company for a contract to clean its headquarters office building that was still being negotiated for the next month. Barrymore had scheduled a meeting to sign a contract the following week, so Glenn was sure that he would get the job. Barrymore was a reputable company, and Glenn was confident that he could ultimately collect the $82,000. Also, he subtracted $30,000 of accrued salaries expense and the corresponding liability. He reasoned that since he had not paid the employees, he had not incurred any expense.

Required

a. Reconstruct the income statement and balance sheet as they would appear after Glenn's adjustments.

b. Write a brief memo explaining how Glenn's treatment of the expected revenue from Barrymore violated the conservatism concept.

c. Write a brief memo explaining how Glenn's treatment of the accrued salaries expense violates the matching concept.