Before studying this chapter, you should know or, if necessary, review:

a. What assets, liabilities, stockholders’ equity, retained earnings, dividends, revenues, and expenses are. (Ch. 1, pp. 11–12)

b. Why assets equal liabilities plus stockholders’ equity. (Ch. 1, p. 11)

c. What transactions are and how they affect the basic accounting equation. (Ch. 2, pp. 44–51)

The Navigator is a learning system designed to guide you through each chapter and help you succeed in learning the material. It consists of (1) a checklist at the beginning of the chapter, which outlines text features and study skills you will need, and (2) a series of check boxes that prompt you to use the learning aids in the chapter and set priorities as you study.

The Feature Story helps you picture how the chapter topic relates to the real world of accounting and business. Throughout the chapter, references to the Feature Story will help you put new ideas in context, organize them, and remember them. The problem called A Look Back at Our Feature Story toward the end of the chapter helps you pull together the ideas learned in the chapter. Many Feature Stories end with the URL of the company cited in the story.

The Navigator to this page is shown below.

Before this page, Study Objectives and Concepts for Review were listed.
In Chapter 2 we analyzed business transactions in terms of the accounting equation. The cumulative effect of these transactions were presented in tabular form. Imagine a restaurant and gift shop such as The Mug and Muskot using the same tabular format as Rest Caterers, Inc., to keep track of every one of its transactions. In a single day, this restaurant and gift shop engages in hundreds of business transactions. To record each transaction this way would be impractical, expensive, and unnecessary. Instead, procedures and records are used to keep track of transaction data more easily.

This chapter introduces and illustrates these basic procedures and records. The content and organization of Chapter 3 are as follows:

**The Recording Process**

<table>
<thead>
<tr>
<th>The Account</th>
<th>Steps in the Recording Process</th>
<th>The Recording Process Illustrated</th>
<th>The Trial Balance</th>
<th>Electronic Data Processing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debits and credits</td>
<td>Journalizing, posting, summarizing</td>
<td>Summarized illustration of journalizing and posting</td>
<td>Limitations of a trial balance</td>
<td>Comparative advantages of manual versus computerized systems</td>
</tr>
</tbody>
</table>

**The Account**

An account is an individual accounting record of increases and decreases in a specific asset, liability, or stockholders’ equity item. For example, Rest Caterers, Inc. (the company discussed in Chapter 2), would have separate accounts for Cash, Accounts Receivable, Accounts Payable, Service Revenue, Salaries Expense, and so on. In its simplest form, an account consists of three parts: (1) the title of the account, (2) a left, or debit, side, and (3) a right, or credit, side. Because the alignment of these parts of an account resembles the letter T, it is referred to as a T account. The basic form of an account is shown in Illustration 3-1.

**Study Objective 1**

Explain what an account is and how it helps in the recording process.

**Illustration 3-1**

Basic form of an account

**Steps in the Recording Process**

The basic steps in the recording process occur repeatedly. The analysis of transactions was illustrated in Chapter 1. Further examples will be given in this and later chapters. The other steps in the recording process are explained in the next sections.

**Technology in Action**

Computerized and manual accounting systems basically parallel one another. Most of the procedures are handled by electronic circuitry in computerized systems. They seem to occur instantly. But, to fully comprehend how computerized systems operate, you need to understand manual approaches for processing accounting data.

**THE JOURNAL**

Transactions are recorded initially in chronological order in a journal before being transferred to the accounts. Thus the journal is referred to as the book of original entry. For each transaction, the journal shows the debit and credit effects on specific accounts. Companies may use various kinds of journals, but every company has the most basic form of journal, a general journal. Typically, a general journal has spaces for dates, account titles and explanations, debits and credits, and two amount columns. Whenever we use the term journal in this textbook, without a modifying adjective, we mean the general journal.

The journal makes several significant contributions to the recording process:

1. It discloses in one place the complete effects of a transaction.
2. It provides a chronological record of transactions.
3. It helps to prevent or locate errors because the debit and credit amounts for each entry can be readily compared.

Entering transaction data in the journal is known as journalizing. Separate journal entries are made for each transaction. A complete entry consists of (1) the date of the transaction, (2) the accounts and amounts to be debited and credited, and (3) a brief explanation of the transaction.

**Study Objective 4**

Explain what a journal is and how it helps in the recording process.
Before You Go On sections follow each key topic. Review It questions prompt you to stop and review the key points you have just studied. If you cannot answer these questions, you should go back and read the section again. Review It questions marked with the PepsiCo icon ask you to find information in the PepsiCo 2006 Annual Report, which is excerpted in the Appendix at the end of the text. Brief Do It exercises ask you to put your newly acquired knowledge to work. They outline an Action Plan necessary to complete the exercise, and the accompanying Solution helps you see how the problem should be solved. (The Do It exercises are keyed to similar homework exercises.)

ACCOUNTING IN ACTION Business Insight

In his autobiography, Sam Walton described the double-entry accounting system with which he began the Wal-Mart empire: “We kept a little pigeonhole on the wall for the cash register and paperwork of each [Wal-Mart] store. I had a blue binder ledger book for each store. When we added a store, we added a pigeonhole. We did this at least up to twenty stores. Then once a month, the bookkeeper and I would enter the merchandise, enter the sales, enter the cash, and balance it.”

Why did Sam Walton keep separate pigeonholes and blue binders for each store?


Infographics, a special type of illustration, pictorially link concepts to the real world and provide visual reminders of key concepts.

Color illustrations visually reinforce important concepts and therefore often contain material that may appear on exams.

ACCOUNTING IN ACTION Business Insight

December 31 is Haugrove’s legal title to both the units sold and the units purchased. If units in transit are ignored, inventory quantities would be understated by 4,000 units (1,500 + 2,500).

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Adjustments for accrued expenses are needed for two purposes: (1) to record the obligations that exist at the balance sheet date and (2) to recognize the expenses that apply to the current accounting period. Prior to adjustment, both liabilities and expenses are understated. Therefore, as shown in Illustration 4-13, the adjusting entry for accrued expenses results in a debit (increase) to an expense account and a credit (increase) to a liability account.

Accrued Interest. Premier Staffing Agency, Inc., signed a $5,000, three-month note payable on October 1. The note requires interest at an annual rate of 12 percent. The amount of the interest accumulation is determined by three factors: (1) the face value of the note; (2) the interest rate, which is always expressed as an annual rate; and (3) the length of time the note is outstanding. In this instance, the total interest due on the $5,000 note at its due date three months hence is $150 ($5,000 × 12% × 3/12; the interest for one month is $50). The formula for computing interest\(^1\) and its application to Premier Staffing Agency, Inc., for the month of October is shown in Illustration 4-14. Note that the time period is expressed as a fraction of a year.

\[ \text{Interest} = \text{Face Value} \times \text{Annual Interest Rate} \times \text{Time in Terms of One Year} \]

\[ \text{Interest} = 5,000 \times 12\% \times \frac{1}{12} = 50 \]

The accrued expense adjusting entry at October 31 is

Oct. 31 Interest Expense 50
Interest Payable 50
(To record interest on notes payable)

After this adjusting entry is posted, the accounts look like Illustration 4-15.

\begin{align*}
\text{Interest Expense} & \quad 50 \\
\text{Interest Payable} & \quad 50
\end{align*}

\(^1\)The computation of interest will be considered in more depth in later chapters.

Helpful Hints in the margins are like having an instructor with you as you read. They further clarify concepts being discussed.

Accounting equation analyses have been inserted in the margin next to key journal entries. They help you understand the impact of an accounting transaction on the financial statements.

Financial statements appear throughout the book. Often, numbers or categories are highlighted in colored type to draw your attention to key information.

**UAL, Inc. (United Airlines)**

**Balance Sheet (partial)**

<table>
<thead>
<tr>
<th>Current assets</th>
<th>(in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,348</td>
</tr>
<tr>
<td>Short-term investments</td>
<td>588</td>
</tr>
<tr>
<td>Receivables</td>
<td>788</td>
</tr>
<tr>
<td>Aircraft fuel, spare parts, and supplies</td>
<td>330</td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>229</td>
</tr>
<tr>
<td>Other current assets</td>
<td>294</td>
</tr>
<tr>
<td>Total current assets</td>
<td>1,337</td>
</tr>
</tbody>
</table>

**Illustration 4-15**

**Adjusting entries for accrued expenses.**

**HELPFUL HINT** Interest is a cost of borrowing money that accumulates with the passage of time.

**Formula for computing interest**

\[ A = L \times S \times E \]

**Illustration 4-16**

**Interest accounts after adjustment**

**Acadia’s Corporation**

**Balance Sheet (partial)**

<table>
<thead>
<tr>
<th>Current assets</th>
<th>(in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,348</td>
</tr>
<tr>
<td>Short-term investments</td>
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</tr>
<tr>
<td>Receivables</td>
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<tr>
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<tr>
<td>Other current assets</td>
<td>294</td>
</tr>
<tr>
<td>Total current assets</td>
<td>1,337</td>
</tr>
</tbody>
</table>

**Illustration 5-17**

**Current assets section**

**HELPFUL HINT** Interest is a cost of borrowing money that accumulates with the passage of time.
Many of the last Before You Go On exercises take you back for a critical look at the chapter-opening Feature Story.

### BEFORE YOU GO ON...

1. What are the income statement, retained earnings statement, balance sheet, and statement of cash flows?
2. How are the financial statements interrelated?

**A LOOK BACK AT OUR FEATURE STORY**

Refer back to the Feature Story about PepsiCo at the beginning of Chapter 1, and answer the following questions:

1. If you were interested in investing in PepsiCo, what would the balance sheet and income statement tell you?
2. Would you request audited financial statements? Explain.
3. Will the financial statements show the market value of the company? Explain.

**SOLUTION**

1. The balance sheet reports the assets, liabilities, and stockholders’ equity of the company. The income statement presents the revenues and expenses and resulting net income (or net loss) for a specific period of time. The balance sheet is like a snapshot of the company’s financial condition at a point in time. The income statement indicates the profitability of the company. Also, the sources of the company’s revenues and its expenses are provided in the income statement.

2. You should request professional financial statements—statements that a CPA has examined and expressed an opinion as to the fairness of presentation. You should not make decisions without having audited financial statements.

3. The financial statements will not show the market value of the company. One important principle of accounting is the cost principle, which states that assets should be recorded at cost. Cost has an important advantage over other valuations. It is reliable.

### ACTION PLAN

- Remember that assets must equal liabilities plus stockholders’ equity after each transaction.
- Transactions increase assets, decrease stockholders’ equity.
- Dividends and expenses decrease stockholders’ equity.
- The income statement shows revenues and expenses for a period of time.
- The retained earnings statement shows the changes in retained earnings over time.
- The balance sheet reports assets, liabilities, and stockholders’ equity at a specific date.

### DEMONSTRATION PROBLEM

Hospitality Legal Services, Inc., which provides contract services for caterers and their clients, was incorporated on July 1, 2008. During the first month of operations, the following transactions occurred:

- Stockholders invested $10,000 in cash in exchange for shares of stock.
- Paid $800 for July rent on office space.
- Purchased office equipment on account, $3,000.
- Provided legal services to clients for cash, $1,500 (use Service Revenue).
- Borrowed $700 cash from a bank on a note payable.
- Performed legal services for client on account, $2,000.
- Paid monthly expenses: salaries $500, utilities $300, and telephone $100.

**Instructions**

(a) Prepare a tabular summary of the transactions.
(b) Prepare the income statement, retained earnings statement, and balance sheet at July 31 for Hospitality Legal Services, Inc.

#### SOLUTION TO DEMONSTRATION PROBLEM

##### (a) Transaction Analysis

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Assets</th>
<th>Liabilities</th>
<th>Stockholders’ Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>$10,000</td>
<td>$10,000</td>
<td></td>
</tr>
<tr>
<td>(2)</td>
<td>$3,000</td>
<td></td>
<td>$3,000</td>
</tr>
<tr>
<td>(3)</td>
<td>$800</td>
<td>$800</td>
<td></td>
</tr>
<tr>
<td>(4)</td>
<td>$1,500</td>
<td></td>
<td>$1,500</td>
</tr>
<tr>
<td>(5)</td>
<td>$700</td>
<td>$700</td>
<td></td>
</tr>
<tr>
<td>(6)</td>
<td>$2,000</td>
<td></td>
<td>$2,000</td>
</tr>
<tr>
<td>(7)</td>
<td>$500</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### (b) Income Statement

**Hospitality Legal Services, Inc.**

For the Month Ended July 31, 2008

<table>
<thead>
<tr>
<th>Revenue</th>
<th>$3,500</th>
</tr>
</thead>
<tbody>
<tr>
<td>Service revenue</td>
<td></td>
</tr>
<tr>
<td>Expenses</td>
<td>$2,500</td>
</tr>
<tr>
<td>Rent expense</td>
<td>$100</td>
</tr>
<tr>
<td>Salaries expense</td>
<td>$500</td>
</tr>
<tr>
<td>Utilities expense</td>
<td>$300</td>
</tr>
<tr>
<td>Telephone expense</td>
<td>$100</td>
</tr>
<tr>
<td>Total expenses</td>
<td>$1,700</td>
</tr>
<tr>
<td>Net income</td>
<td>$1,800</td>
</tr>
</tbody>
</table>
the chapter are related. Another opportunity to review as well.

The ability of a company to pay obligations that are due within one year or the operating cycle is called current liabilities. Noncurrent liabilities that do not have a physical substance are called long-term liabilities. The economic entity assumption requires that only transactions data capable of being expressed in terms of money be included in the accounting records. The economic entity assumption requires that the activities of each economic entity be kept separate from the activities of its owners and other economic entities.

The basic accounting equation is:

Assets = Liabilities + Stockholders' Equity

Assets are resources owned by the business. Liabilities are creditor claims on total assets. Stockholders' equity is the owners' claim on total assets.

Exercises 163

5-4 Indicate which of the following statements are true or false regarding the work sheet:

a. The work sheet is essentially a working tool of the accounting department.

b. The work sheet cannot be used as a basis for posting to ledgers.

c. The work sheet is distributed to management and other interested parties.

d. Financial statements can be prepared directly from the work sheet before journalizing and posting the adjusting entries.

5-2 The ledger of W. S. Juice Bar includes the following unadjusted balances: Service Revenue $80,500; Salaries Expense $28,950; and Prepaid Rent $6,000. Adapting entries are required for the services provided for $9,300 for the current month, the expiration of a contract for prepaid rent of $2,000, and the expiration of prepaid rent of $1,350; and the payment of current liabilities of $6,950. Prepare the adjusting entries and post to the ledger accounts.

5-4 Using the data in Exercise 5-3, prepare a classified balance sheet and a work sheet. Prepare the closing entries, complete the closing process for these accounts using the three-column form of account.
Group Decision Cases require teams of students to evaluate a manager’s decision or choose from among alternative courses of action. They help prepare you for the business world by giving you practice in solving problems with colleagues.

<table>
<thead>
<tr>
<th>Months</th>
<th>Number</th>
<th>Days per Month</th>
</tr>
</thead>
<tbody>
<tr>
<td>January–March</td>
<td>2</td>
<td>20</td>
</tr>
<tr>
<td>April–May</td>
<td>3</td>
<td>25</td>
</tr>
<tr>
<td>June–October</td>
<td>2</td>
<td>18</td>
</tr>
<tr>
<td>November–December</td>
<td>3</td>
<td>23</td>
</tr>
</tbody>
</table>

Instructions

With the class divided into groups, answer the following:

(a) Prepare a report showing the comparative payroll expense of continuing to employ permanent workers compared to adopting the Harrington Services, Inc., plan.

(b) What other factors should Martha consider before finalizing her decision?

ETHICS CASE

11-13 Harry Smith owns and manages Harry’s Restaurant, a twenty-four-hour restaurant near the city’s medical complex. Harry employs ten full-time employees and sixteen part-time employees.

FINANCIAL REPORTING PROBLEM: PepsiCo

6-14 Refer to the financial statements of PepsiCo, presented in Appendix A, and answer the following questions:

(a) What was the amount of net cash provided by operating activities for the year ended December 30, 2006? For the year ended December 31, 2005?

(b) What was the amount of increase or decrease in cash and cash equivalents for the year ended December 30, 2006? For the year ended December 31, 2005?

(c) Which method of computing net cash provided by operating activities does PepsiCo use?

EXPLORING THE WEB

9-11 A company’s annual report usually will identify the inventory method used. Knowing that, you can analyze the effects of the inventory method on the income statement and its balance sheet.

Address: [www.darden.com](http://www.darden.com)

Steps

1. From Darden Restaurants’ home page, choose Investor Relations.
4. Click on Financial Overview under the Table of Contents.
5. Click on Consolidated Balance Sheets.

Instructions

Answer the following questions based on the 2006 Annual Report:

(a) At Darden’s fiscal year-end, what was the net inventory on the balance sheet?

(b) How has this changed from the previous fiscal year-end?

(c) What inventory method does Darden use (See notes to Consolidated Financial Statements)?

ETHICS CASE

9-12 J. K. Leask Wholesale Corp. uses the LIFO method of inventory costing. In the current year, profit at J. K. Leask is running unusually high. The corporate tax rate is also high this year, but is scheduled to decline significantly next year. In an effort to lower the current year’s net income and to take advantage of the changing income tax rates, the president of J. K. Leask Wholesale instructs the accountant to recommend to the purchasing department a large purchase of inventory for delivery three days before the end of the year. The price of the inventory to be purchased has increased significantly during the year, and the purchases will represent a major portion of the ending inventory value.

Instructions

(a) What is the effect of this transaction on this year’s and next year’s income statement and income tax expenses? Why?

(b) If J. K. Leask Wholesale had been using the FIFO method of inventory costing, would the president give the same directive?

(c) Should the plant accountant order the inventory purchase to lower income? What are the ethical implications of this order?

After you complete your homework assignments, it’s a good idea to go back to The Navigator checklist at the start of the chapter to see if you have used all the study aids of the chapter.