CHAPTER 2

Accounting for Accruals and Deferrals

LEARNING OBJECTIVES

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

SECTION 1: SHOW HOW ACCRUALS AFFECT FINANCIAL STATEMENTS

LO 2-1 Show how receivables affect financial statements.

LO 2-2 Show how payables affect financial statements.

SECTION 2: SHOW HOW DEFERRALS AFFECT FINANCIAL STATEMENTS

LO 2-3 Show how supplies affect financial statements.

LO 2-4 Show how prepaid items affect financial statements.

LO 2-5 Show how unearned revenues affect financial statements.

LO 2-6 Explain the accounting cycle including adjustments and the closing process.

LO 2-7 Prepare financial statements based on accrual accounting.

LO 2-8 Classify accounting events into one of four categories.

Video lectures and accompanying self-assessment quizzes are available for all learning objectives through McGraw-Hill Connect® Accounting.

SECTION 1:

ACCOUNTING FOR ACCRUALS

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 2014 but collects cash for those services in 2015. In this case, realization occurs in 2015. 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 2015 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 2014 (the period in which it performed the services) even though it does not collect (realize) the cash until 2015.

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 2014 related to cash realized in 2015 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 2014 to purchase office supplies it uses in 2015. In this case the cash payment occurs in 2014 although supplies expense is recognized in 2015. This example is a deferral.

The Curious Accountant

On September 15, 2014, Janet McGeorge purchased a subscription to *Better Homes and Gardens* magazine for her mother's birthday. She paid $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. The company also owns 12 television stations. Janet's mother 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, 2014, financial statements? (Answer on page 64.)

ACCRUAL ACCOUNTING

LO 2-1

Show how receivables affect financial statements.

This 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, 2014, 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 2014 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 2014 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 2014.**

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 2015.**

The $42,000 for consulting services to be performed in 2015 is not recognized in the 2014 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)

LO 2-2

Show how payables affect financial statements.

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 2014 Cato recorded accrued salary expense of $6,000 (the salary expense is for courses the instructor taught in 2014 that Cato will pay cash for in 2015).**

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 (2014) even though Cato will not pay the instructor again until 2015. Cato must also recognize the obligation (liability) it has to pay the instructor. To accurately report all 2014 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 2014, 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 2014 income statement and the amount of cash flow from operating activities Anwar should report on the 2014 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.

Summary of Events and General Ledger

The previous section of this chapter described seven events Cato Consultants experienced during the 2014 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

The financial statements for Cato Consultants' 2014 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.

EXHIBIT 2.1

Transaction Data for 2013 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 2014 advertising costs.
6 Cato signed contracts for $42,000 of consulting services to be performed in 2015.
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	

Income Statement

The income statement reflects accrual accounting. Consulting revenue represents the price Cato charged for all the services it performed in 2014, 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. As of December 31, 2014, Cato Consultants had total assets of $77,000 ($53,000 cash + $24,000 accounts receivable). These assets are equal to the

EXHIBIT 2.2 Vertical Statements Model

CATO CONSULTANTS
Financial Statements*

Income Statement
For the Year Ended December 31, 2014

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, 2014

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, 2014

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, 2014

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.

obligations and commitments Cato has to its creditors and investors. Specifically, Cato has a $6,000 obligation (liability) to creditors, with the remaining $71,000 of assets available to support commitments (stockholders' equity) to stockholders.

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 2014, 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 2014.

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 2014, 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

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 C1.1 transfers the balance in the Consulting Revenue account to the Retained Earnings account. Closing entries C1.2 and C1.3 transfer the balances in the expense accounts to retained earnings.

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.

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 2014. The instructor's teaching produced revenue in 2014. If Cato waited until 2015 (when it paid

EXHIBIT 2.3

General Ledger Accounts for Cato Consultants

Assets = Liabilities + Stockholders' Equity

Assets

Cash

(1)	5,000
(3)	60,000
(4)	(10,000)
(5)	(2,000)
Bal.	53,000

Accounts Receivable

(2)	84,000
(3)	(60,000)
Bal.	24,000

Liabilities

Salaries Payable

(7)	6,000
Bal.	6,000

Stockholders' Equity

Common Stock

(1)	5,000

Retained Earnings

Cl.1	84,000
Cl.2	(16,000)
Cl.3	(2,000)
Bal.	66,000

Consulting Revenue

(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

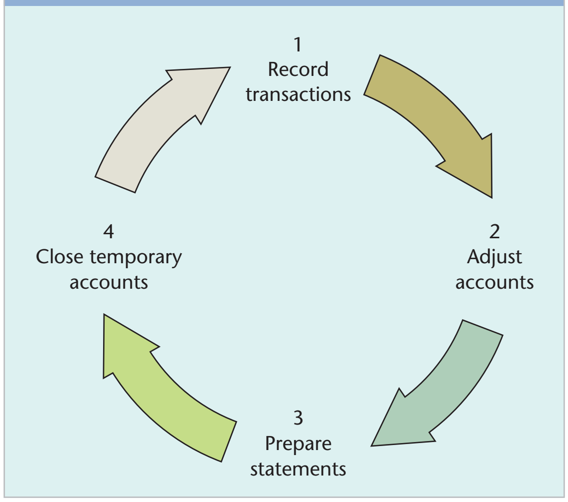
the instructor) to recognize $6,000 of the total $16,000 salary expense, then $6,000 of the expense would not be matched with the revenue it generated. By using accrual accounting, Cato recognized all the salary expense in the same accounting period in which the consulting revenue was recognized. A primary 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 2013 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.

EXHIBIT 2.4

The Accounting Cycle



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 2014 even though some of that cost may generate revenue in future accounting periods.

SECTION 2:

ACCOUNTING FOR DEFERRALS

As previously discussed cash may be exchanged before revenue or expense is recognized. In this case the business defers recognition. This section introduces three common deferrals.

SECOND ACCOUNTING CYCLE

The effects of Cato Consultants' 2015 events are as follows:

EVENT 1 Cato paid $6,000 to the instructor 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 2014 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

LO 2-3

Show how supplies affect financial statements.

Accounting for Supplies Purchase

EVENT 2 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						
Supplies	=	Accts. Pay.			Rev.	−	Exp.	=	Net Inc.	Cash Flow
800	=	800	+	NA	NA	−	NA	=	NA	NA

Prepaid Items (Cost versus Expense)

EVENT 3 **On March 1, 2015, 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.**

LO 2-4

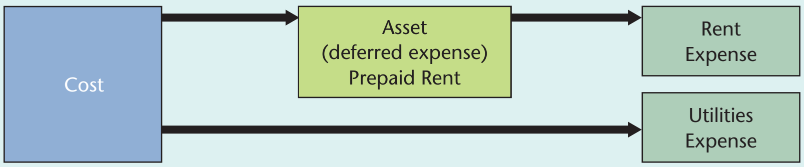
Show how prepaid items affect financial statements.

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

LO 2-5

Show how unearned revenues affect financial statements.

Accounting for Receipt of Unearned Revenue

EVENT 4 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, 2015.

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

Other 2015 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						Cash Flow
Accts. Rec.	=			Ret. Earn.	Rev.	−	Exp.	=	Net Inc.	
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 Flow
Cash	+	Accts. Rec.					Rev.	−	Exp.	=	Net Inc.	
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

LO 2-6

Explain the accounting cycle including adjustments and the closing process.

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, 2015, to rent office space for one year (see Event 3). 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, 2014. Based on this information alone, determine the cash flow from operating activities that Rujoub would report on the 2014 and 2015 statements of cash flows. Also, determine the amount of insurance expense Rujoub would report on the 2014 income statement and the amount of prepaid insurance (an asset) that Rujoub would report on the December 31, 2014, balance sheet.

Answer Since Rujoub paid all of the cash in 2014, the 2014 statement of cash flows would report an $18,000 cash outflow from operating activities. The 2015 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 2014 and therefore would report $3,000 (2 months × $1,500) of insurance expense on the 2014 income statement. Rujoub would report a $15,000 (10 months × $1,500) asset, prepaid insurance, on the December 31, 2014, balance sheet. The $15,000 of prepaid insurance would be recognized as insurance expense in 2015 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, 2015, to May 31, 2016 (see Event 4). 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 2015

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, 2014. Based on this information alone, determine the cash flow from operating activities Sanderson would report on the 2014 and 2015 statements of cash flows. Also determine the amount of revenue Sanderson would report on the 2014 and 2015 income statements.

Answer Since Sanderson collected all of the cash in 2014, the 2014 statement of cash flows would report a $24,000 cash inflow from operating activities. The 2015 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 2014 and nine months in 2015. Sanderson would report $6,000 (3 months × $2,000) of revenue on the 2014 income statement and $18,000 (9 months × $2,000) of revenue on the 2015 income statement.

Answers to The Curious Accountant

Because the **Meredith Corporation** receives cash from customers before actually sending any magazines to them, the company has not earned any revenue when it receives the cash. Meredith has a liability called *unearned revenue.* If Meredith closed its books on December 31, then $3 of Janet's subscription would be recognized as revenue in 2014. The remaining $9 would appear on the balance sheet as a liability.

Meredith actually ends its accounting year on June 30 each year. The actual June 30, 2012, balance sheet for the company is presented in Exhibit 2.6. The liability for unearned revenue was $322.3 million ($180.9 + $141.4)—which represented about 26.4 percent of 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

MEREDITH CORPORATION AND SUBSIDIARIES
Consolidated Balance Sheets
As of June 30 (amounts in thousands)

	2012	2011
Assets		
Current assets		
Cash and cash equivalents	$ 25,820	$ 27,721
Accounts receivable		
(net of allowances of $13,436 in 2012 and $10,823 in 2011)	215,526	212,365
Inventories	22,559	21,529
Current portion of subscription acquisition costs	75,446	54,581
Current portion of broadcast rights	3,408	3,974
Other current assets	16,677	13,568
Total current assets	359,436	333,738
Property, plant, and equipment		
Land	19,517	19,619
Buildings and improvements	129,688	127,916
Machinery and equipment	290,866	289,045
Leasehold improvements	14,816	14,468
Construction in progress	384	8,209
Total property, plant, and equipment	455,271	459,257
Less accumulated depreciation	(260,967)	(272,819)
Net property, plant, and equipment	194,304	186,438
Subscription acquisition costs	75,368	54,286
Broadcast rights	943	1,292
Other assets	66,858	66,940
Intangible assets, net	586,263	545,101
Goodwill	733,127	525,034
Total assets	$2,016,299	$1,712,829
Liabilities and Shareholders' Equity,		
Current liabilities		
Current portion of long-term debt	$ 105,000	$ 50,000
Current portion of long-term broadcast rights payable	6,752	8,548
Accounts payable	72,911	82,878
Accrued expenses		
Compensation and benefits	52,402	53,593
Distribution expenses	12,029	13,937
Other taxes and expenses	52,640	48,205
Total accrued expenses	117,071	115,735
Current portion of unearned subscription revenues	**180,852**	**151,831**
Total current liabilities	482,586	408,992
Long-term debt	275,000	145,000
Long-term broadcast rights payable	3,695	5,431
Unearned subscription revenues	**141,408**	**120,024**
Deferred income taxes	204,054	160,709
Other noncurrent liabilities	112,111	97,688
Total liabilities	1,218,854	937,844
Shareholders' equity		
Series preferred stock, par value $1 per share	—	—
Common stock, par value $1 per share	35,791	36,282
Class B stock, par value $1 per share, convertible to common stock	8,716	8,776
Additional paid-in capital	53,275	58,274
Retained earnings	722,778	687,816
Accumulated other comprehensive income (loss)	(23,115)	(16,163)
Total shareholders' equity	797,445	74,985
Total liabilities and shareholders' equity	$2,016,299	$1,712,829

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 2015 accounting period. These events are summarized in Exhibit 2.7 on page 67. The associated general ledger accounts are also shown in the exhibit. The account balances at the end of 2014, shown in Exhibit 2.3, become the beginning balances for the 2015 accounting period. The 2015 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 68 and 69. Before reading further, trace each event shown in Exhibit 2.7 to the related accounts that are also shown in that exhibit.

Vertical Statements Model

LO 2-7

Prepare financial statements based on accrual accounting.

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 2014 and 2015 accounting data. To conserve space, we have combined all the expenses for each year into single amounts labeled "Operating Expenses," determined as follows:

	2014	2015
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:

	2014	2015
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

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

EXHIBIT 2.7

Ledger Accounts with 2015 Transaction Data

1. Cato paid $6,000 to the instructor to settle the salaries payable obligation.
2. Cato purchased $800 of supplies on account.
3. On March 1, Cato paid $12,000 cash to lease office space for one year.
4. Cato received $18,000 cash in advance from Westberry Company for consulting services to be performed for one year beginning June 1.
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)
(3)	(12,000)
(4)	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
(2)	800
(13)	(650)
Bal.	150

Prepaid Rent	
Bal.	0
(3)	12,000
(14)	(10,000)
Bal.	2,000

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

Liabilities

Accounts Payable	
Bal.	0
(2)	800
(8)	21,000
(9)	(18,200)
Bal.	3,600

Unearned Revenue	
Bal.	0
(4)	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

	2014	2015
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

	2014	2015
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

	2014	2015
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

	2014	2015
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

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 2014 statement of stockholders' equity to the beginning retained earnings balance on the 2015 statement of stockholders' equity. Also, trace the ending cash balance on the 2014 statement of cash flows to the beginning cash balance on the 2015 statement of cash flows. Finally, confirm that the change in cash between the 2014 and 2015 balance sheets ($53,000 − $9,300 = $43,700 decrease) agrees with the net change in cash reported on the 2014 statement of cash flows.

CHECK YOURSELF 2.4

Treadmore Company started the 2014 accounting period with $580 of supplies on hand. During 2014 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 2014. 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.

REALITY BYTES

REVENUE VERSUS CASH FLOW: THE GAMES PEOPLE PLAY

Most banks have a sign on their door that says "FDIC Insured." The FDIC on the sign refers to the **Federal Deposit Insurance Corporation**. Insurance provided by the FDIC protects the bank's depositors up to $250,000 per account in the event the bank should fail. To pay for this insurance, the FDIC charges participating banks a fee.

After 164 banks failed during the economic and banking crisis of 2007 and 2008 the FDIC was concerned that its reserves available to pay potential claims were running low. To address this, it required banks to prepay three years of premiums in 2009, rather than pay them in 2009, 2010, and 2011. Although such measures improved the FDIC's cash reserves, it does not mean they earned three year's worth of revenue in 2009, and it did not change the fact that cash payments would still have to be made over the next three years with moneys collected in 2009. And, even though the banks paid three years of premiums in 2009, they spread the expense recognition over 2009, 2010, and 2011.

The FDIC was not the first entity to use such tactics. State and local governments have sometimes delayed payments due near the end of their fiscal year into the next year so as not to show a deficit in the current year.

Near the end of their fiscal year, business entities sometimes try to convince customers to buy more goods and services than they need immediately. The company tells the customer that they can always return the goods next year if they do not need them. The goal is to increase this year's revenues, and profits, and executive bonuses. This tactic, called "trade loading" is at best a violation of GAAP, and in some situations may be illegal.

The problems these tactics create are rather obvious. Cash collected in advance in 2009 by the FDIC means less cash will be collected in 2010 and 2011. Expenses deferred into the next fiscal year by a state government means that next year will have higher expenses to pay than it otherwise would have. These schemes are sometimes referred to as, "kicking the can down the road." Such plans are seldom successful in the long run.

Source of FDIC information: *Birmingham Business Journal,* October 2, 2009.

TRANSACTION CLASSIFICATION

LO 2-8

Classify accounting events into one of four categories.

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.

<< A Look Back

This chapter introduced the *accrual accounting* concept. Accrual accounting causes the amount of revenues and expenses reported on the income statement to differ significantly from the amount of cash flow from operating activities reported on the statement of cash flows because of timing differences. These differences are readily apparent when relevant events are recorded in a horizontal financial statements model. To review, study the following transactions and the corresponding statements model. Set up a statements model on a piece of paper and try to record the effects of each event before reading the explanation.

Events

1. Provided $600 of services on account.
2. Collected $400 cash from accounts receivable.
3. Accrued $350 of salary expense.
4. Paid $225 cash in partial settlement of salaries payable.

Event No.	Balance Sheet							Income Statement					Statement of Cash Flows	
	Cash	+	Accts. Rec.	=	Sal. Pay.	+	Ret. Earn.	Rev.	−	Exp.	=	Net Inc.		
1	NA	+	600	=	NA	+	600	600	−	NA	=	600	NA	
2	400	+	(400)	=	NA	+	NA	NA	−	NA	=	NA	400	OA
3	NA	+	NA	=	350	+	(350)	NA	−	350	=	(350)	NA	
4	(225)	+	NA	=	(225)	+	NA	NA	−	NA	=	NA	(225)	OA
Totals	175	+	200	=	125	+	250	600	−	350	=	250	175	NC

Notice the $250 of net income differs from the $175 cash flow from operating activities. The entries in the statements model demonstrate the reasons for the difference. Although $600 of revenue is recognized, only $400 of cash was collected. The remaining $200 will be collected in the future and is currently shown on the balance sheet as Accounts Receivable. Also, although $350 of salary expense is recognized, only $225 was paid in cash. The remaining $125 will be paid in the future. This obligation is shown as Salaries Payable on the balance sheet. Study these relationships carefully to develop a clear understanding of how accrual accounting affects financial reporting.

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 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**, **Radio Shack**, **Office Depot**, and **Lowes**.

Video lectures and accompanying self-assessment quizzes are available for all learning objectives through McGraw-Hill *Connect® Accounting.*

SELF-STUDY REVIEW PROBLEM

Gifford Company experienced the following accounting events during 2014:

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, 2014, 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 2015:

1. Recognized $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, 2015, adjusted the books to recognize the remaining revenue earned by providing services related to the advance described in Event 3 of 2014.
7. On December 31, 2015, Gifford adjusted the books to recognize the amount of the insurance policy used during 2015.

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	+	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 2014 income statement?

c. What amount of cash flow from customers would Gifford report on the 2014 statement of cash flows?

d. What amount of unearned revenue would Gifford report on the 2014 and 2015 year-end balance sheets?

e. What are the 2015 opening balances for the revenue and expense accounts?

f. What amount of total assets would Gifford report on the December 31, 2014 balance sheet?

g. What obligations and commitments would Gifford report on the December 31, 2015 balance sheet?

Solution to Requirement a

The financial statements model follows:

Event No.	Assets					=	Liab.	+	Stockholders' Equity			Rev.	−	Exp.	=	Net Inc.	Cash Flow
	Cash	+	Accts. Rec.	+	Prep. Ins.	=	Unearn. Rev.	+	Com. Stk.	+	Ret. Earn.						
2013																	
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					
2014																	
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 2014 is $30,000 ($3,000 × 10 months). Revenue recognized in 2015 is $6,000 ($3,000 × 2 months).

†Rent expense is incurred at the rate of $1,000 ($12,000 ÷ 12 months) per month. Rent expense recognized in 2015 is $9,000 ($1,000 × 9 months).

Solutions to Requirements b–g

b. Gifford would report $48,000 of revenue in 2014 ($18,000 revenue on account plus $30,000 of the $36,000 of unearned revenue).

c. The cash inflow from customers in 2014 is $51,000 ($36,000 when the unearned revenue was received plus $15,000 collection of accounts receivable).

d. The December 31, 2014, balance sheet will report $6,000 of unearned revenue, which is the amount of the cash advance less the amount of revenue recognized in 2014 ($36,000 − $30,000). The December 31, 2015, 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, 2014, 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 2015, there would be no liabilities on the 2015 balance sheet. In this case, all of the assets are committed to the investors.

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 right 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/edmondssurvey4e.

SECTION 1 EXERCISES

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

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

LO 2-1

Exercise 2-1 *Effect of collecting accounts receivable on the accounting equation and financial statements*

Burke Company earned $12,000 of service revenue on account during 2014. The company collected $9,800 cash from accounts receivable during 2014.

Required

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

a. The balance of the accounts receivable that Burke would report on the December 31, 2014, balance sheet.

b. The amount of net income that Burke would report on the 2014 income statement.

c. The amount of net cash flow from operating activities that would be reported on the 2014 statement of cash flows.

d. The amount of retained earnings that would be reported on the 2014 balance sheet.

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

Exercise 2-2 *Effect of accrued expenses on the accounting equation and financial statements* LO 2-2

During 2014, Crest Corporation earned $5,000 of cash revenue and accrued $3,000 of salaries expense.

Required

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

a. Prepare the December 31, 2014, balance sheet.

b. Determine the amount of net income that Crest would report on the 2014 income statement.

c. Determine the amount of net cash flow from operating activities that Crest would report on the 2014 statement of cash flows.

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

Exercise 2-3 *Effect of accruals on the financial statements* LO 2-1, 2-2

Coates Inc. experienced the following events in 2014, in its first year of operation:

1. Received $20,000 cash from the issue of common stock.

2. Performed services on account for $38,000.

3. Paid the utility expense of $2,500.

4. Collected $21,000 of the accounts receivable.

5. Recorded $15,000 of accrued salaries at the end of the year.

6. Paid a $2,000 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.

COATES INC.
General Ledger Accounts

Event	Assets		=	Liabilities	+	Stockholders' Equity		Acct. Titles for Ret. Earn.
	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 2014 accounting period.

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

Exercise 2-4 *Effect of accounts receivable and accounts payable transactions on financial statements* LO 2-1, 2-2

The following events apply to Brown and Birgin, a public accounting firm, for the 2014 accounting period:

1. Performed $96,000 of services for clients on account.

2. Performed $65,000 of services for cash.

3. Incurred $45,000 of other operating expenses on account.
4. Paid $26,000 cash to an employee for salary.
5. Collected $70,000 cash from accounts receivable.
6. Paid $38,000 cash on accounts payable.
7. Paid a $10,000 cash dividend to the stockholders.
8. Accrued salaries were $3,000 at the end of 2014.

Required

a. 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 OA to designate operating activity, IA for investment activity, FA for financing activity, and NC for net change in cash. Use NA to indicate the element is not affected by the event. The first event is recorded as an example.

Event No.	Assets			=	Liabilities			+	Equity						
	Cash	+	Accts. Rec.	=	Accts. Pay.	+	Sal. Pay	+	Ret. Earn.	Rev.	−	Exp.	=	Net Inc.	Cash Flow
1	NA	+	96,000	=	NA	+	NA	+	96,000	96,000	−	NA	=	96,000	NA

b. What is the amount of total assets at the end of 2014?
c. What is the balance of accounts receivable at the end of 2014?
d. What is the balance of accounts payable at the end of 2014?
e. What is the difference between accounts receivable and accounts payable?
f. What is net income for 2014?
g. What is the amount of net cash flow from operating activities for 2014?

LO 2-1, 2-2

Exercise 2-5 *Missing information related to accruals*

Panoramic Inc. had a beginning balance of $2,000 in its Accounts Receivable account. The ending balance of Accounts Receivable was $2,400. During the period, Panoramic recognized $40,000 of revenue on account. Panoramic's Salaries Payable account has a beginning balance of $1,300 and an ending balance of $900. During the period, the company recognized $35,000 of accrued salaries expense.

Required

a. Based on the information provided, determine the amount of net income.
b. Based on the information provided, determine the amount of net cash flow from operating activities.

LO 2-1, 2-2, 2-6

Exercise 2-6 *Effect of accruals on the financial statements*

Valmont Inc. experienced the following events in 2014, its first year of operation:

1. Received $50,000 cash from the issue of common stock.
2. Performed services on account for $67,000.
3. Paid a $5,000 cash dividend to the stockholders.
4. Collected $45,000 of the accounts receivable.
5. Paid $49,000 cash for other operating expenses.
6. Performed services for $10,000 cash.
7. Recognized $2,000 of accrued utilities expense at the end of the year.

Required

a. Identify the events that result in revenue or expense recognition.
b. Based on your response to Requirement *a*, determine the amount of net income reported on the 2014 income statement.
c. Identify the events that affect the statement of cash flows.

d. Based on your response to Requirement *c*, determine the amount of cash flow from operating activities reported on the 2014 statement of cash flows.

e. What is the before- and after-closing balance in the service revenue account? What other accounts would be closed at the end of the accounting cycle?

f. What is the balance of the retained earnings account that appears on the 2014 balance sheet?

Exercise 2-7 *Net income versus changes in cash* LO 2-1, 2-2

In 2014, Zoe Inc. billed its customers $62,000 for services performed. The company collected $51,000 of the amount billed. Zoe incurred $39,000 of other operating expenses on account. Zoe paid $31,000 of the accounts payable. Zoe acquired $40,000 cash from the issue of common stock. The company invested $21,000 cash in the purchase of land.

Required

(*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.) Use the preceding information to answer the following questions:

a. What amount of revenue will Zoe report on the 2014 income statement?

b. What amount of cash flow from revenue will Zoe 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 Zoe report on the year-end balance sheet?

SECTION 2 EXERCISES

Exercise 2-8 *Supplies and the financial statements model* LO 2-2, 2-3

Copy Express Inc. began the 2014 accounting period with $9,000 cash, $5,000 of common stock, and $4,000 of retained earnings. Copy Express was affected by the following accounting events during 2014:

1. Purchased $9,500 of paper and other supplies on account.
2. Earned and collected $32,500 of cash revenue.
3. Paid $7,200 cash on accounts payable.
4. Adjusted the records to reflect the use of supplies. A physical count indicated that $1,700 of supplies was still on hand on December 31, 2014.

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								
	Cash	+	Supplies	=	Accts. Pay.	+	Com. Stk.	+	Ret. Earn.	Rev.	−	Exp.	=	Net Inc.	Cash Flows
Beg. bal.	9,000	+	0	=	0	+	5,000	+	4,000	0	−	0	=	0	0

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

LO 2-3, 2-6

Exercise 2-9 *Supplies on financial statements*

Accounting Professionals Inc. experienced the following events in 2014, its first year of operation:

1. Performed services for $20,000 cash.
2. Purchased $4,000 of supplies on account.
3. A physical count on December 31, 2014, found that there was $1,000 of supplies on hand.

Required

Based on this information alone

a. Record the events under an accounting equation.
b. Prepare an income statement, balance sheet, and statement of cash flows for the 2013 accounting period.
c. What is the balance in the Supplies account as of January 1, 2015?
d. What is the balance in the Supplies Expense account as of January 1, 2015?

LO 2-3, 2-4

Exercise 2-10 *Asset versus expense*

A cost can be either an asset or an expense.

Required

a. Distinguish between a cost that is an asset and a cost that is an expense.
b. List three costs that are assets.
c. List three costs that are expenses.

LO 2-4

Exercise 2-11 *Prepaid items on financial statements*

Therapy Inc. experienced the following events in 2014, its first year of operation:

1. Performed counseling services for $18,000 cash.
2. On February 1, 2014, paid $12,000 cash to rent office space for the coming year.
3. Adjusted the accounts to reflect the amount of rent used during the year.

Required

Based on this information alone

a. Record the events under an accounting equation.
b. Prepare an income statement, balance sheet, and statement of cash flows for the 2014 accounting period.
c. Ignoring all other future events, what is the amount of rent expense that would be recognized in 2015?

LO 2-4, 2-6

Exercise 2-12 *Effect of an error on financial statements*

On June 1, 2014, Cole Corporation paid $8,400 to purchase a 24-month insurance policy. Assume that Cole records the purchase as an asset and that the books are closed on December 31.

Required

a. Show the purchase of the insurance policy and the related adjusting entry to recognize insurance expense in the accounting equation.
b. Assume that Cole Corporation failed to record the adjusting entry to reflect the expiration of insurance. How would the error affect the company's 2014 income statement and balance sheet?

LO 2-5

Exercise 2-13 *Unearned items on financial statements*

Interior Design Consultants (IDC) experienced the following events in 2014, its first year of operation:

1. On October 1, 2014, IDC collected $24,000 for consulting services it agreed to provide during the coming year.
2. Adjusted the accounts to reflect the amount of consulting service revenue recognized in 2014.

Required

Based on this information alone

a. Record the events under an accounting equation.

b. Prepare an income statement, balance sheet, and statement of cash flows for the 2014 accounting period.

c. Ignoring all other future events, what is the amount of service revenue that would be recognized in 2015?

Exercise 2-14 *Unearned revenue defined as a liability* LO 2-5

Kim Wong received $800 in advance for tutoring fees when she agreed to help Joe Pratt with his introductory accounting course. Upon receiving the cash, Kim mentioned that she would have to record the transaction as a liability on her books. Joe asked, "Why a liability? You don't owe me any money, do you?"

Required

Respond to Joe's question regarding Wong's liability.

Exercise 2-15 *Supplies, unearned revenue, and the financial statements model* LO 2-3, 2-5

Ross, Attorney at Law, experienced the following transactions in 2014, the first year of operations:

1. Purchased $1,500 of office supplies on account.
2. Accepted $36,000 on February 1, 2014, as a retainer for services to be performed evenly over the next 12 months.
3. Performed legal services for cash of $84,000.
4. Paid cash for salaries expense of $32,000.
5. Paid a cash dividend to the stockholders of $8,000.
6. Paid $1,200 of the amount due on accounts payable.
7. Determined that at the end of the accounting period, $150 of office supplies remained on hand.
8. On December 31, 2014, 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						
	Cash	+	Supplies	=	Accts. Pay.	+	Unearn. Rev.	+	Ret. Earn.	Rev.	−	Exp.	=	Net Inc.	Cash Flow
1	NA	+	1,500	=	1,500	+	NA	+	NA	NA	−	NA	=	NA	NA

Exercise 2-16 *Unearned revenue and the financial statements model* LO 2-5

Ed Arnold started a personal financial planning business when he accepted $120,000 cash as advance payment for managing the financial assets of a large estate. Arnold agreed to manage the estate for a one-year period beginning May 1, 2014.

Required

a. Show the effects of the advance payment and revenue recognition on the 2014 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	Assets	=	Liab.	+	Stockholders' Equity	Rev.	−	Exp.	=	Net Inc.	Cash Flows
	Cash	=	Unearn. Rev.	+	Ret. Earn.						

b. How much revenue would Ed recognize on the 2015 income statement?

c. What is the amount of cash flow from operating activities in 2015?

LO 2-4, 2-5

Exercise 2-17 *Prepaid vs. unearned, the entity concept*

On October 1, 2014, Caldonia Company paid East Alabama Rentals $4,800 for a 12-month lease on warehouse space.

Required

a. Record the deferral and the related December 31, 2014, adjustment for Caldonia Company in the accounting equation.

b. Record the deferral and the related December 31, 2014, adjustment for East Alabama Rentals in the accounting equation.

LO 2-1, 2-2, 2-3, 2-4, 2-5

Exercise 2-18 *Identifying deferral and accrual events*

Required

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

a. Incurred other operating expenses on account.

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

c. Paid a cash dividend to the stockholders.

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

e. Paid cash to purchase land.

f. Provided services on account.

g. Collected accounts receivable.

h. Paid one year's rent in advance.

i. Paid cash for utilities expense.

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

k. Recorded interest revenue earned for the period.

LO 2-1, 2-2, 2-3, 2-4, 2-5

Exercise 2-19 *Revenue and expense recognition*

Required

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

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

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

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

LO 2-6

Exercise 2-20 *Closing entries*

Rollins Company's accounting records show an after-closing balance of $19,400 in its Retained Earnings account on December 31, 2014. During the 2014 accounting cycle, Rollins earned $15,100 of revenue, incurred $9,200 of expense, and paid $1,500 of dividends. Revenues and expenses were recognized evenly throughout the accounting period.

Required

a. Determine the balance in the Retained Earnings account as of January 1, 2015.

b. Determine the balance in the temporary accounts as of January 1, 2014.

c. Determine the after-closing balance in the Retained Earnings account as of December 31, 2013.

d. Determine the balance in the Retained Earnings account as of June 30, 2014.

LO 2-6

Exercise 2-21 *Adjusting the accounts*

Mikita Inc. experienced the following accounting events during its 2014 accounting period:

1. Paid cash to settle an account payable.
2. Collected a cash advance for services that will be provided during the coming year.
3. Paid a cash dividend to the stockholders.

4. Paid cash for a one-year lease to rent office space.
5. Collected cash from accounts receivable.
6. Recognized cash revenue.
7. Issued common stock.
8. Paid cash to purchase land.
9. Paid cash to purchase supplies.
10. Recognized operating expenses on account.

Required

a. Identify the events that would require a year-end adjusting entry.
b. Are adjusting or closing entries recorded first? Why?

Exercise 2-22 *Closing the accounts* LO 2-6

The following information was drawn from the accounting records of Swanson Company as of December 31, 2014, before the temporary accounts had been closed. The Cash balance was $6,000, and Notes Payable amounted to $3,000. The company had revenues of $7,000 and expenses of $4,200. The company's Land account had a $4,000 balance. Dividends amounted to $1,000. There was $2,000 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 Swanson's beginning balance (as of January 1, 2014) in the Retained Earnings account was $5,200, determine its balance after the temporary accounts were closed at the end of 2014.
c. What amount of net income would Swanson Company report on its 2014 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, 2015?

Exercise 2-23 *Closing accounts and the accounting cycle* LO 2-6

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) Service Revenue
   (2) Dividends
   (3) Common Stock
   (4) Notes Payable
   (5) Cash
   (6) Rent Expense
   (7) Accounts Receivable
   (8) Utilities Expense
   (9) Prepaid Insurance
   (10) Retained Earnings
b. List and explain the four stages of the accounting cycle. Which stage must be first? Which stage is last?

Exercise 2-24 *Matching concept* LO 2-7

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. Advertising expense.
c. Supplies.
d. The cost of land that has been sold.

LO 2-7

Exercise 2-25 *Classifying events on the statement of cash flows*

The following transactions pertain to the operations of Blair Company for 2014:

1. Acquired $30,000 cash from the issue of common stock.
2. Performed services for $12,000 cash.
3. Paid a $7,200 cash advance for a one-year contract to rent equipment.
4. Recognized $15,000 of accrued salary expense.
5. Accepted a $21,000 cash advance for services to be performed in the future.
6. Provided $60,000 of services on account.
7. Incurred $28,000 of other operating expenses on account.
8. Collected $51,000 cash from accounts receivable.
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.)

LO 2-7

CHECK FIGURES
a. IS
z. IS

Exercise 2-26 *Relationship of accounts 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. Consulting Revenue
b. Market Value of Land
c. Supplies Expense
d. Salaries Payable
e. Notes Payable
f. Ending Common Stock
g. Beginning Cash Balance
h. Prepaid Rent
i. Net Change in Cash
j. Land
k. Operating Expenses
l. Total Liabilities
m. "As of" Date Notation
n. Salaries Expense
o. Net Income
p. Service Revenue
q. Cash Flow from Operating Activities
r. Operating Income
s. Interest Receivable
t. Interest Revenue
u. Rent Expense
v. Salary Expense
w. Total Stockholders' Equity
x. Unearned Revenue
y. Cash Flow from Investing Activities
z. Insurance Expense
aa. Ending Retained Earnings
bb. Interest Revenue
cc. Supplies
dd. Beginning Retained Earnings
ee. Utilities Payable
ff. Cash Flow from Financing Activities
gg. Accounts Receivable
hh. Prepaid Insurance
ii. Ending Cash Balance
jj. Utilities Expense
kk. Accounts Payable
ll. Beginning Common Stock
mm. Dividends
nn. Total Assets

Exercise 2-27 *Identifying transaction type and effect on the financial statements* LO 2-7, 2-8

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	AE	I/D		NA		NA		NA	NA		NA		NA	D IA
b	AS	I		NA		I		NA	NA		NA		NA	I FA

a. Purchased land for cash.
b. Acquired cash from the issue of common stock.
c. Collected cash from accounts receivable.
d. Paid cash for operating expenses.
e. Recorded accrued salaries.
f. Purchased supplies on account.
g. Performed services on account.
h. Paid cash in advance for rent on office space.
i. Adjusted the books to record supplies used during the period.
j. Performed services for cash.
k. Paid cash for salaries accrued at the end of a prior period.
l. Paid a cash dividend to the stockholders.
m. Adjusted books to reflect the amount of prepaid rent expired during the period.
n. Incurred operating expenses on account.
o. Paid cash on accounts payable.
p. Received cash advance for services to be provided in the future.
q. Recorded accrued interest revenue earned at the end of the accounting period.

Exercise 2-28 *Effect of accounting events on the income statement and statement of cash flows* LO 2-1, 2-2, 2-3, 2-4, 2-5, 2-6, 2-7

Required

Explain how each of the following events or series of 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.

	Net Income		Cash Flows from Operating Activities	
Event	Direction of Change	Amount of Change	Direction of Change	Amount of Change
a	NA	NA	NA	NA

a. Acquired $60,000 cash from the issue of common stock.
b. Earned $20,000 of revenue on account. Collected $15,000 cash from accounts receivable.
c. Paid $4,800 cash on October 1 to purchase a one-year insurance policy.

d. Collected $12,000 in advance for services to be performed in the future. The contract called for services to start on August 1 and to continue for one year.
e. Accrued salaries amounting to $5,000.
f. Sold land that cost $15,000 for $15,000 cash.
g. Provided services for $9,200 cash.
h. Purchased $2,000 of supplies on account. Paid $1,500 cash on accounts payable. The ending balance in the Supplies account, after adjustment, was $800.
i. Paid cash for other operating expenses of $2,200.

LO 2-8

Exercise 2-29 *Transactions that affect the elements of financial statements*

Required

Give an example of a transaction that will

a. Increase an asset and decrease another asset (asset exchange event).
b. Increase an asset and increase a liability (asset source event).
c. Decrease an asset and decrease a liability (asset use event).
d. Decrease an asset and decrease equity (asset use event).
e. Increase a liability and decrease equity (claims exchange event).
f. Increase an asset and increase equity (asset source event).
g. Decrease a liability and increase equity (claims exchange event).

LO 2-8

Exercise 2-30 *Identifying source, use, and exchange transactions*

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

LO 2-8

Exercise 2-31 *Identifying asset source, use, and exchange transactions*

Required

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

SECTIONS 1 AND 2 PROBLEMS

LO 2-1, 2-2, 2-3, 2-4, 2-5

Problem 2-32 *Recording events in a horizontal statements model*

CHECK FIGURES
Net Income: $15,200
Ending Cash Balance: $24,600

The following events pertain to James Cleaning Company:

1. Acquired $15,000 cash from the issue of common stock.
2. Provided services for $6,000 cash.

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 $100 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 $6,500 for salaries expense.
10. Incurred $2,800 of other operating expenses on account.
11. Paid $2,100 cash on the account payable created in Event 10.
12. Paid a $1,000 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							
Event No.	Cash	+	Accts. Rec.	+	Supp.	=	Accts. Pay.	+	Unearn. Rev.	+	Com. Stk.	+	Ret. Earn.	Rev.	−	Exp.	=	Net Inc.	Cash Flows
1	15,000	+	NA	+	NA	=	NA	+	NA	+	15,000	+	NA	NA	−	NA	=	NA	15,000 FA

Problem 2-33 *Effect of adjusting entries on the accounting equation*

LO 2-1, 2-2, 2-3, 2-4, 2-5, 2-6

CHECK FIGURE

b. adjustment amount: $2,200

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.

	Total Assets						Stockholders Equity		
Event/ Adjustment	Cash	+	Other Assets	=	Liabilities	+	Common Stock	+	Retained Earnings
a	−6,000		+6,000		NA		NA		NA
Adj.	NA		−4,500		NA		NA		−4,500

a. Paid $6,000 cash in advance on April 1 for a one-year insurance policy.
b. Purchased $2,400 of supplies on account. At year's end, $200 of supplies remained on hand.
c. Paid $7,200 cash in advance on March 1 for a one-year lease on office space.
d. Received an $18,000 cash advance for a contract to provide services in the future. The contract required a one-year commitment starting September 1.

Problem 2-34 *Closing the accounts*

LO 2-6

The following selected accounts and account balances were taken from the records of Bates Company. Except as otherwise indicated, all balances are as of December 31, 2014, before the closing entries were recorded.

CHECK FIGURES
Net Income: $1,600
Ending Retained Earnings: $20,300

Cash received from common stock issued during 2013	$ 4,500
Cash	10,500
Revenue	18,000
Salary expense	13,000
Cash flow from operating activities	4,500
Notes payable	6,000
Utility expense	1,800
Dividends	1,000
Cash flow from financing activities	5,000
Rent expense	1,600
Land	25,000
Retained earnings, January 1, 2014	19,700
Common stock, December 31, 2014	20,000

Required

a. Prepare the income statement Black would include in its 2014 annual report.
b. Identify the accounts that should be closed to the Retained Earnings account.
c. Determine the Retained Earnings account balance at December 31, 2014. Identify the reasons for the difference between net income and the ending balance in Retained Earnings.
d. What are the balances in the Revenue, Expense, and Dividend accounts on January 1, 2015? Explain.

LO 2-1, 2-2, 2-3, 2-4, 2-5, 2-6

CHECK FIGURES
b. $55,000
h. $(20,000)

Problem 2-35 *Effect of events on financial statements*

Davis Company had the following balances in its accounting records as of December 31, 2013:

Assets		Liabilities and Equity	
Cash	$ 60,000	Accounts Payable	$ 32,000
Accounts Receivable	45,000	Common Stock	60,000
Land	35,000	Retained Earnings	48,000
Totals	$140,000		$140,000

The following accounting events apply to Davis for 2014:

Jan.	1	Acquired an additional $30,000 cash from the issue of common stock.
April	1	Paid $7,200 cash in advance for a one-year lease for office space.
June	1	Paid a $5,000 cash dividend to the stockholders.
July	1	Purchased additional land that cost $40,000 cash.
Aug.	1	Made a cash payment on accounts payable of $21,000.
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 $20,000 cash that had originally cost $20,000.
Oct.	1	Purchased $1,200 of supplies on account.
Dec.	31	Earned $75,000 of service revenue on account during the year.
	31	Received $62,000 cash collections from accounts receivable.
	31	Incurred $27,000 other operating expenses on account during the year.
	31	Recognized accrued salaries expense of $18,000.
	31	Had $100 of supplies on hand at the end of the period.
	31	The land purchased on July 1 had a market value of $56,000.
	31	Recognized $120 of accrued interest revenue.

Required

Based on the preceding information for Davis Company answer the following questions. All questions pertain to the 2014 financial statements. (*Hint:* Record the events in general ledger accounts under an accounting equation before answering the questions.)

a. What two additional adjusting entries need to be made 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 be reported 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 revenue 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 2-36 *Identifying and arranging elements on financial statements*

LO 2-7

The following accounts and balances were drawn from the records of Dawkins Company at December 31, 2014:

CHECK FIGURES
a. Total Assets $91,700
b. Net Income $20,000

Cash	$22,100	Accounts receivable	$21,000
Land	43,000	Cash flow from operating act.	8,600
Insurance expense	2,500	Beginning retained earnings	47,200
Dividends	5,000	Beginning common stock	5,500
Prepaid insurance	3,500	Service revenue	86,000
Accounts payable	15,000	Cash flow from financing act.	9,000
Supplies	2,100	Ending common stock	14,500
Supplies expense	1,000	Cash flow from investing act.	(6,000)
Rent expense	3,500	Other operating expenses	59,000

Required

Use the accounts and balances from Dawkins Company 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).

Problem 2-37 *Missing information in financial statements*

LO 2-7

excel

Required

Fill in the blanks (indicated by the alphabetic letters in parentheses) in the following financial statements. Assume the company started operations January 1, 2014, and all transactions involve cash.

	For the Years		
	2014	2015	2016
Income Statements			
Revenue	$ 400	$ 500	$ 800
Expense	(250)	(l)	(425)
Net income	$ (a)	$ 100	$ 375
Statement of Changes in Stockholders' Equity			
Beginning common stock	$ 0	$ (m)	$ 9,100
Plus: Common stock issued	(b)	1,100	310
Ending common stock	$8,000	9,100	(s)
Beginning retained earnings	0	25	75
Plus: Net income	(c)	100	375
Less: Dividends	(d)	(50)	(150)
Ending retained earnings	25	(n)	300
Total stockholders' equity	$ (e)	$ 9,175	$ (t)

continued

Balance Sheets			
Assets			
Cash	$ (f)	$ (o)	$ (u)
Land	0	(p)	2,500
Total assets	$11,000	$11,650	$10,550
Liabilities	$ (g)	$ (q)	$ 840
Stockholders' equity			
Common stock	(h)	(r)	9,410
Retained earnings	(i)	75	300
Total stockholders' equity	8,025	9,175	9,710
Total liabilities and stockholders' equity	$11,000	$11,650	$10,550

Statements of Cash Flows			
Cash flows from operating activities			
Cash receipts from customers	$ (j)	$ 500	$ (v)
Cash payments for expenses	(k)	(400)	(w)
Net cash flows from operating activities	150	100	375
Cash flows from investing activities			
Cash payments for land	0	(5,000)	0
Cash receipt from sale of land	0	0	2,500
Net cash flows from investing activities	0	(5,000)	2,500
Cash flows from financing activities			
Cash receipts from borrowed funds	2,975	0	0
Cash payments to reduce debt	0	(500)	(x)
Cash receipts from stock issue	8,000	1,100	(y)
Cash payments for dividends	(125)	(50)	(z)
Net cash flows from financing activities	10,850	550	(1,475)
Net change in cash	11,000	(4,350)	1,400
Plus: Beginning cash balance	0	11,000	6,650
Ending cash balance	$11,000	$ 6,650	$ 8,050

LO 2-1, 2-2, 2-3, 2-4, 2-5, 2-6, 2-7, 2-8

eXcel

CHECK FIGURES

Net Income, 2014: $16,800
Net Income, 2015: $6,300

Problem 2-38 *Events for two complete accounting cycles*

Alabama Service Company was formed on January 1, 2014.

Events Affecting the 2014 Accounting Period

1. Acquired cash of $60,000 from the issue of common stock.
2. Purchased $1,200 of supplies on account.
3. Purchased land that cost $18,000 cash.
4. Paid $800 cash to settle accounts payable created in Event 2.
5. Recognized revenue on account of $42,000.
6. Paid $21,000 cash for other operating expenses.
7. Collected $38,000 cash from accounts receivable.

Information for 2014 Adjusting Entries

8. Recognized accrued salaries of $3,200 on December 31, 2014.
9. Had $200 of supplies on hand at the end of the accounting period.

Events Affecting the 2015 Accounting Period

1. Acquired an additional $20,000 cash from the issue of common stock.
2. Paid $3,200 cash to settle the salaries payable obligation.

3. Paid $3,600 cash in advance for a lease on office facilities.
4. Sold land that had cost $15,000 for $15,000 cash.
5. Received $4,800 cash in advance for services to be performed in the future.
6. Purchased $1,000 of supplies on account during the year.
7. Provided services on account of $32,000.
8. Collected $33,000 cash from accounts receivable.
9. Paid a cash dividend of $5,000 to the stockholders.
10. Paid other operating expenses of $19,500.

Information for 2015 Adjusting Entries

11. The advance payment for rental of the office facilities (see Event 3) was made on March 1 for a one-year lease term.
12. The cash advance for services to be provided in the future was collected on October 1 (see Event 5). The one-year contract started October 1.
13. Had $300 of supplies on hand at the end of the period.
14. Recognized accrued salaries of $3,900 at the end of the accounting period.
15. Recognized $400 of accrued interest revenue.

Required

a. Identify each event affecting the 2014 and 2015 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 2014 and 2015, using the vertical statements model.

ANALYZE, THINK, COMMUNICATE

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

Required

Use the Target Corporation's Form 10-K to answer the following questions related to Target's 2012 fiscal year (year ended February 2, 2013). Target's Form 10-K is available on the company's website or through the SEC's EDGAR database. Appendix A provides instructions for using the EDGAR database.

Target Corporation

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

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

c. Compare Target's 2012 *net earnings* (the year ended February 2, 2013) to its 2012 *cash provided by operating activities.* Which is larger?

d. First, compare Target's 2011 net income to its 2012 net income. Next, compare Target's 2011 cash provided by operating activities to its 2012 cash provided by operating activities. Which changed the most from 2011 to 2012, net earnings or cash provided by operating activities?

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

The following financial highlights were drawn from the 2012 annual reports of Exxon Mobil Corporation and Apple Inc.

	Exxon	Apple
Revenue	$482.3 Billion	$156.5 Billion
Net income	$ 44.9 Billion	$ 41.7 Billion
Cash and short-term investments	$ 38.1 Billion	$ 29.1 Billion

Even so, as of February 28, 2013, Wall Street valued Exxon Mobil at $402.9 billion and Apple at $418.6 billion.

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 spokesperson 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 information presented in this case.

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

ATC 2-3 Research Assignment *Identifying accruals and deferrals at Netflix*

This chapter defined and discussed accrual and deferral transactions. Complete the requirements below using the most recent financial statements available on the Internet for **Netflix, Inc.** Obtain the statements by following the steps below. (Be aware that the formatting of the company's website may have changed since these instructions were written.)

1. Go to www.netflix.com.
2. Click on "Investor Relations," which is at the bottom of the page in very small print.
3. Click on the "Annual Reports and Proxies" link at the left side of the page.
4. Click on the "20xx Annual Report." Use the pdf. version of the annual report.
5. Find the company's balance sheet and complete the requirements below. In recent years this has been shown toward the end of the Form 10-K section of the company's annual report, on page 48. The "Index" near the beginning of the report can help you locate the financial statements.

Required

a. Make a list of all the accounts on the balance sheet that you believe are accrual-type accounts.

b. Make a list of all the accounts on the balance sheet that you believe are deferral-type accounts.

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.