



Accounting Principles, 7<sup>th</sup> Edition

Weygandt • Kieso • Kimmel

## **Chapter 1**

# **Accounting in Action**

Prepared by Naomi Karolinski

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and

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# **CHAPTER 1**

## **ACCOUNTING IN ACTION**

After studying this chapter, you should be able to:

- **1 Explain what accounting is.**
- **2 Identify users and uses of accounting.**
- **3 Understand why ethics is a fundamental business concept.**
- **4 Explain the meaning of generally accepted accounting principles and the cost principle.**

# **CHAPTER 1**

# **ACCOUNTING IN ACTION**

After studying this chapter, you should be able to:

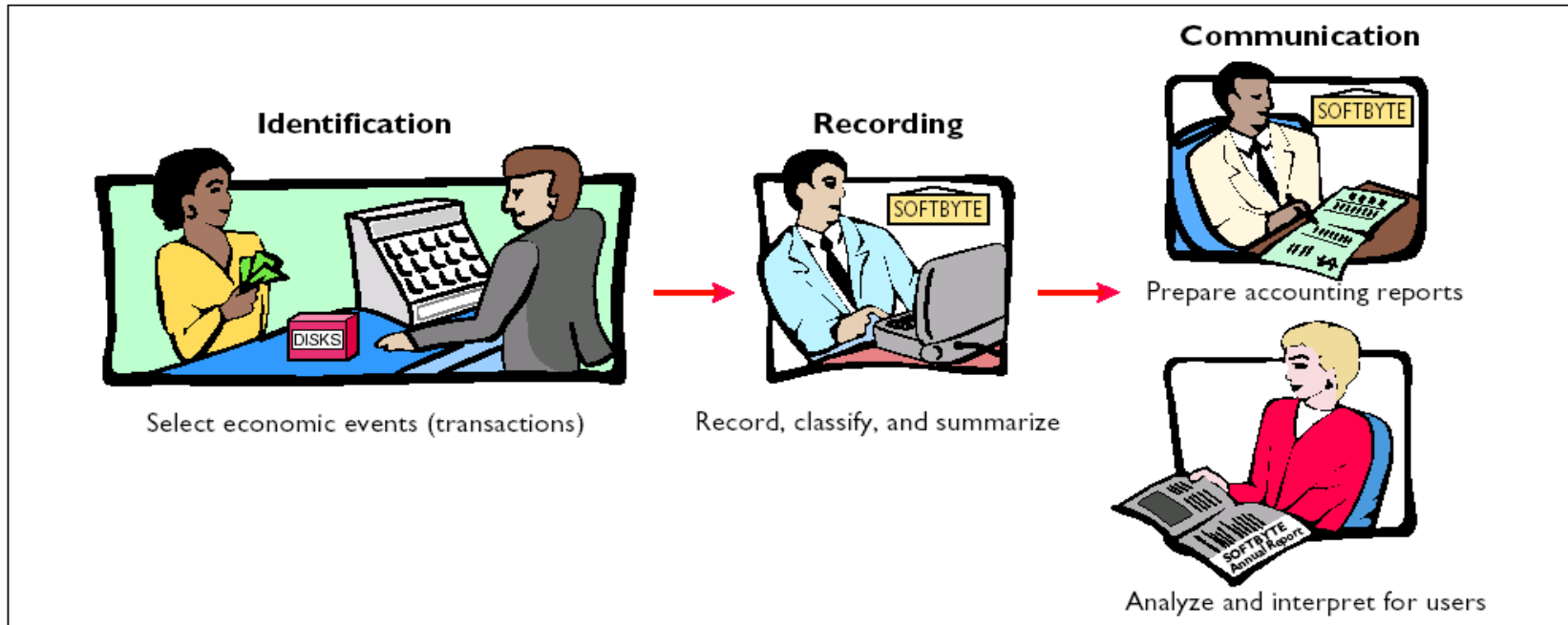
- **5 Explain the meaning of the monetary unit assumption and the economic entity assumption.**
- **6 State the basic accounting equation and explain the meaning of assets, liabilities, and owner's equity.**
- **7 Analyze the effect of business transactions on the basic accounting equation.**
- **8 Understand what the four financial statements are and how they are prepared.**

# WHAT IS ACCOUNTING?

STUDY OBJECTIVE 1

- **Accounting** is an information system that
  - **Identifies**
  - **Records**
  - **Communicates the economic events of an organization to interested users**

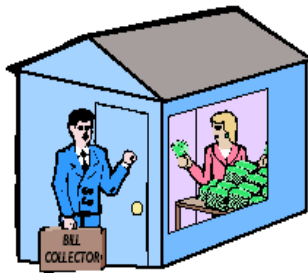
# THE ACCOUNTING PROCESS



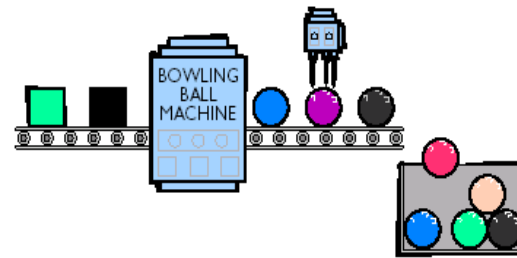
# QUESTIONS ASKED BY INTERNAL USERS

## STUDY OBJECTIVE 2

### Questions Asked by Internal Users



Is cash sufficient to pay bills?



What is the cost of manufacturing each unit of product?



Can we afford to give employee pay raises this year?



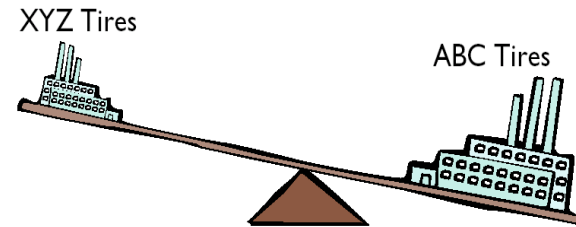
Which product line is the most profitable?

# QUESTIONS ASKED BY EXTERNAL USERS

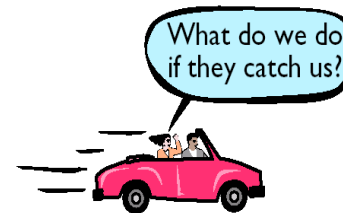
## Questions Asked by External Users



Is the company earning satisfactory income?



How does the company compare in size and profitability with competitors?



Will the company be able to pay its debts as they come due?



# **BOOKKEEPING DISTINGUISHED FROM ACCOUNTING**

- **Accounting**

**Includes bookkeeping**

**Also includes much more**

- **Bookkeeping**

**The recording of economic events**

**One part of accounting**

# **THE ACCOUNTING PROFESSION**

- **Public Accountants**

**Service to the general public through the services they perform.**

- **Private Accountants**

**Individuals in companies involved in activities including cost and tax accounting, systems, and internal auditing.**

- **Not For Profit Accountants**

**Reporting and control for government units, foundations, hospitals, labor unions, colleges/universities, and charities.**

# **THE BUILDING BLOCKS OF ACCOUNTING**

STUDY OBJECTIVES 3, 4 & 5

- **Ethics**

**Standards by which actions are judged as right or wrong, honest or dishonest.**

- **Generally Accepted Accounting Principles**

**Established by the F.A.S.B and the S.E.C.**

- **Assumptions**

- **Monetary Unit**

**Only data that can be expressed in terms of money is included in the accounting records.**

- **Economic Entity**

**Includes any organization or unit in society.**

# **BUSINESS ENTERPRISES**

- **Proprietorship**

**Owned by one person.**

- **Partnership**

**Owned by two or more persons.**

- **Corporation**

**Organized as a separate legal entity under state corporation law and having ownership divided into transferable shares of stock.**

# The accounting process is correctly sequenced as

- identification, recording, communication.
- identification, communication, recording.
- recording, communication, identification.
- communication, recording, identification.

# The accounting process is correctly sequenced as

- identification, communication, recording.
- recording, communication, identification.
- **identification, recording, communication.**
- communication, recording, identification.

# BASIC ACCOUNTING EQUATION

STUDY OBJECTIVE 6



# **ASSETS AS A BUILDING BLOCK**

- **Assets** are resources owned by a business.
- They are used in carrying out such activities as production, consumption and exchange.



# **LIABILITIES AS A BUILDING BLOCK**

- **Liabilities**
  - **are creditor claims against assets**
  - **are existing debts and obligations**

# **OWNER'S EQUITY AS A BUILDING BLOCK**

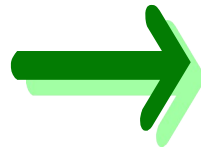
- **Owner's Equity = total assets minus total liabilities. (A - L = O.E.)**
- **Owner's Equity represents the ownership claim to total assets.**
- **Subdivisions of Owner's Equity:**
  - 1 Capital or Investments by Owner (+)**
  - 2 Drawing (-)**
  - 3 Revenues (+)**
  - 4 Expenses (-)**

# **INVESTMENTS BY OWNERS AS A BUILDING BLOCK**

- **Investments**
  - **are the assets the owner puts in the business**
  - **increase owner's equity**

# DRAWINGS AS A BUILDING BLOCK

- **Drawings**
  - are withdrawals of cash or other assets by the owner for personal use
  - decrease owner's equity



# **REVENUES AS A BUILDING BLOCK**

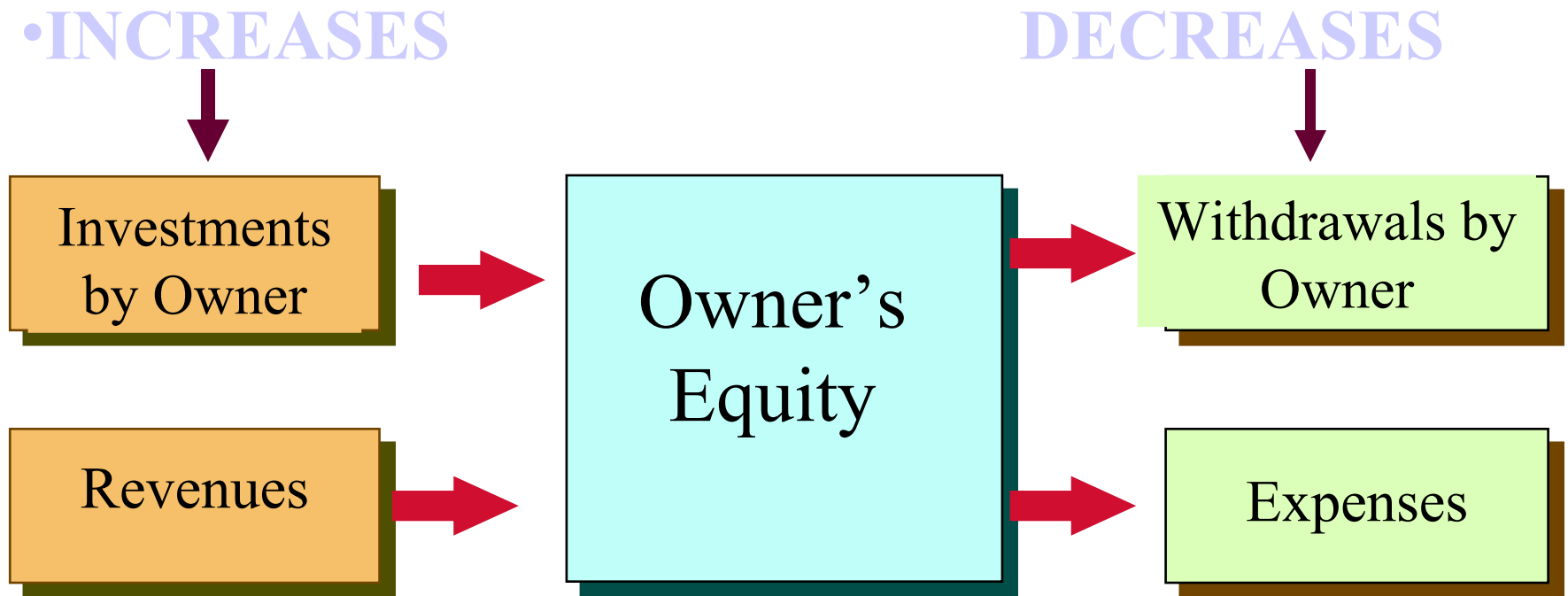
- **Revenues**
  - **gross increases in owner's equity from business activities entered into for the purpose of earning income**
  - **may result from sale of merchandise, services, rental of property, or lending money**
  - **usually result in an increase in an asset**

# **EXPENSES AS A BUILDING BLOCK**

## **Expenses**

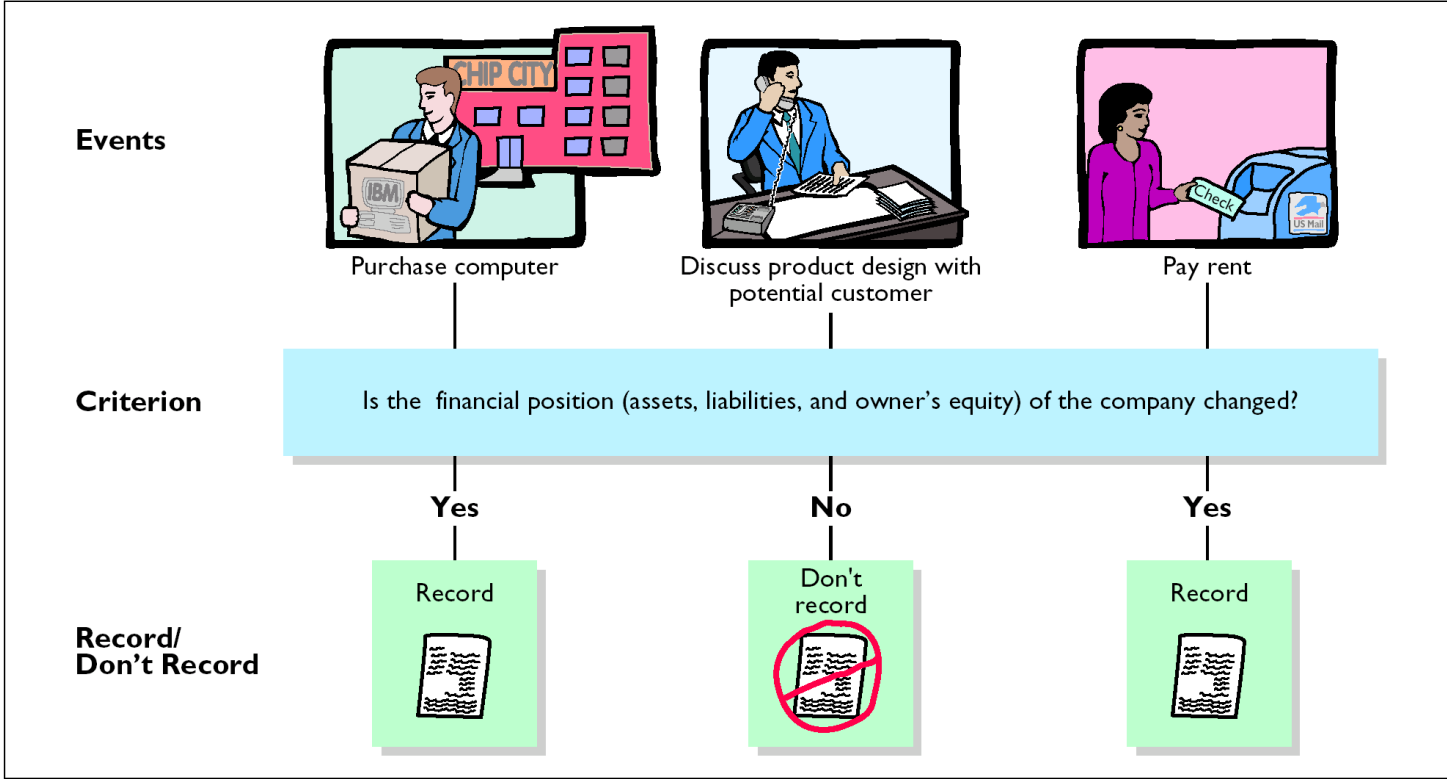
- **decreases in owner's equity that result from operating the business**
- **cost of assets consumed or services used in the process of earning revenue**
- **examples: utility expense, rent expense, supplies expense, and tax expense**

# INCREASES AND DECREASES IN OWNER'S EQUITY



# TRANSACTION IDENTIFICATION PROCESS

## STUDY OBJECTIVE 6

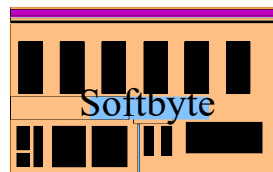




# TRANSACTION ANALYSIS

## TRANSACTION 1

- **Ray Neal** decides to open a computer programming service.
- On September 1, he invests \$15,000 cash in the business, which he names **Softbyte**.



# TRANSACTION ANALYSIS

## TRANSACTION 1 SOLUTION

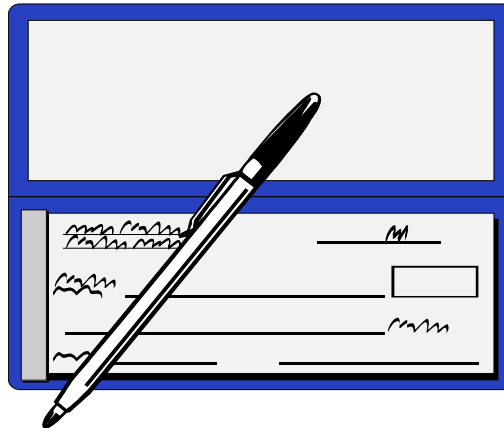
- $$\begin{array}{r} \text{Assets} \\ \hline \text{Cash} \\ \hline \text{+ 15,000} \\ \hline \text{15,000} \end{array} = \begin{array}{r} \text{Liabilities} \\ \hline \text{R. Neal,} \\ \hline \text{Investment} \\ \hline \text{+ 15,000} \\ \hline \text{15,000} \end{array} + \begin{array}{r} \text{Owner's Equity} \\ \hline \text{Capital} \end{array}$$

There is an increase in the asset Cash, \$15,000, and an equal increase in the owner's equity, R. Neal, Capital, \$15,000

# TRANSACTION ANALYSIS

## TRANSACTION 2

- **Softbyte** purchases computer equipment for **\$7,000** cash.



# TRANSACTION ANALYSIS

## TRANSACTION 2 SOLUTION

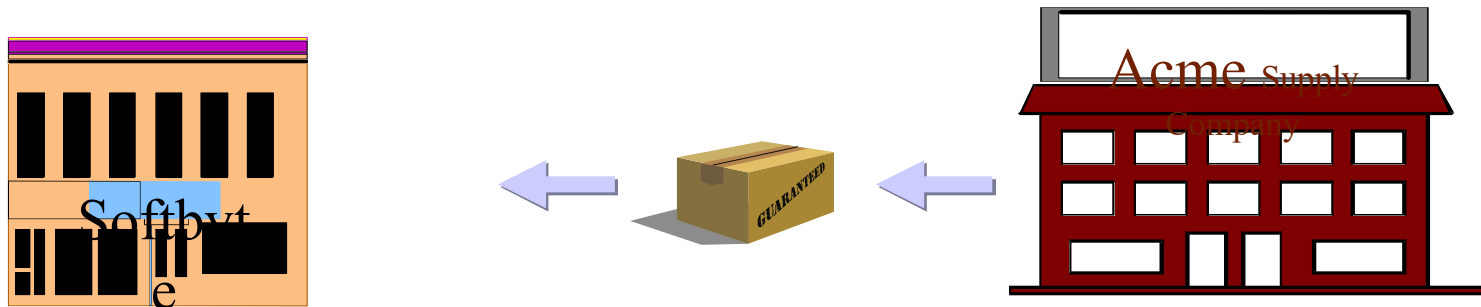
- $$\underline{\text{Assets}} = \underline{\text{Liabilities}} + \underline{\text{Owner's Equity}}$$
- $$\underline{\text{Cash}} + \underline{\text{Equipment}} = \quad + \underline{\text{R. Neal,}}$$
- Capital
- Old
- Bal. \$15,000 = \$15,000
- (2) - 7,000 + 7,000
- New
- Bal. \$8,000 + \$7,000 = \$15,000

Cash is decreased by \$7,000 and the asset  
Equipment is increased by \$7,000

# TRANSACTION ANALYSIS

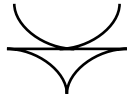

## TRANSACTION 3

- **Softbyte** purchases supplies expected to last for several months for **\$1,600** from **Acme Supply Company**.
- **Acme** agrees to allow **Softbyte** to pay this bill next month, in October.
- This transaction is referred to as a purchase on account or a credit purchase.



# TRANSACTION ANALYSIS

## TRANSACTION 3 SOLUTION

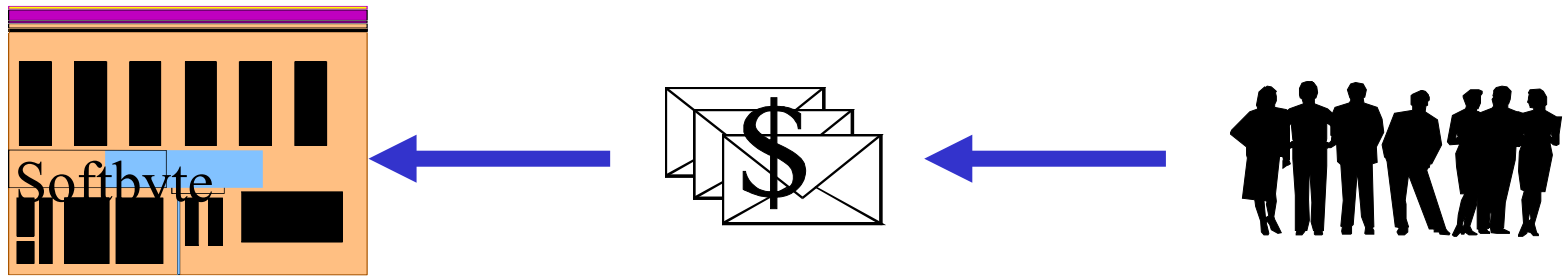
	<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Owner's Equity</u>
	<u>Cash</u> + <u>Supplies</u> + <u>Equip.</u>	=	<u>Accts. Pay.</u>	+	<u>R. Neal, Capital</u>
Old	\$8,000                      + \$7,000	=			\$15,000
(3)	<u>          + \$1,600</u>		<u>          + \$1,600</u>		
New	\$8,000 + \$1,600 + \$7,000	=	+ \$1,600	+	\$15,000
					
	\$16,500		\$16,500		

The asset Supplies is increased by \$1,600, and the liability Accounts Payable is increased by the same amount

# TRANSACTION ANALYSIS

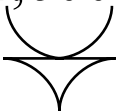
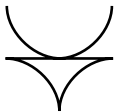
## TRANSACTION 4

- **Softbyte** receives \$1,200 cash from customers for programming services it has provided.
- This transaction represents the **Softbyte's** principal revenue-producing activity.



# TRANSACTION ANALYSIS

## TRANSACTION 4 SOLUTION

•	<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Owner's Equity</u>
•	<u>Cash</u> + <u>Supplies</u> + <u>Equip.</u>	=	<u>Accts. Pay.</u>	+	<u>R. Neal., Capital</u>
•	Old \$8,000 + \$1,600 + \$7,000	=	\$1,600	+	\$15,000
•	(4) <u>+ 1,200</u>				<u>+ 1,200</u>
•	New \$9,200 + \$1,600 + \$7,000	=	\$1,600		\$16,200
					
•	\$17,800				\$17,800

Cash is increased by \$1,200 and R. Neal, Capital is increased by \$1,200

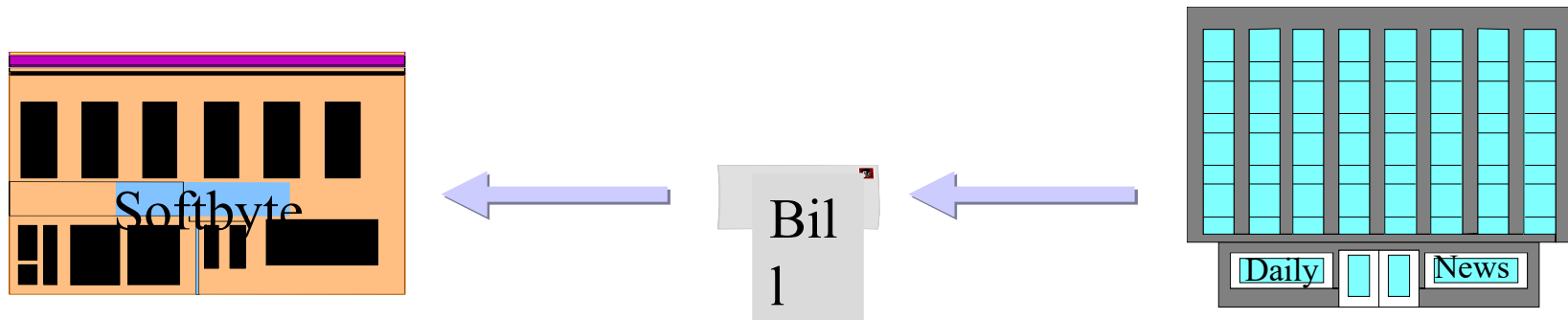


# TRANSACTION ANALYSIS

TRANSACTION

5

- **Softbyte** receives a bill for **\$250** from the **Daily News** for advertising but postpones payment of the bill until a later date.



# TRANSACTION ANALYSIS

## TRANSACTION 5 SOLUTION

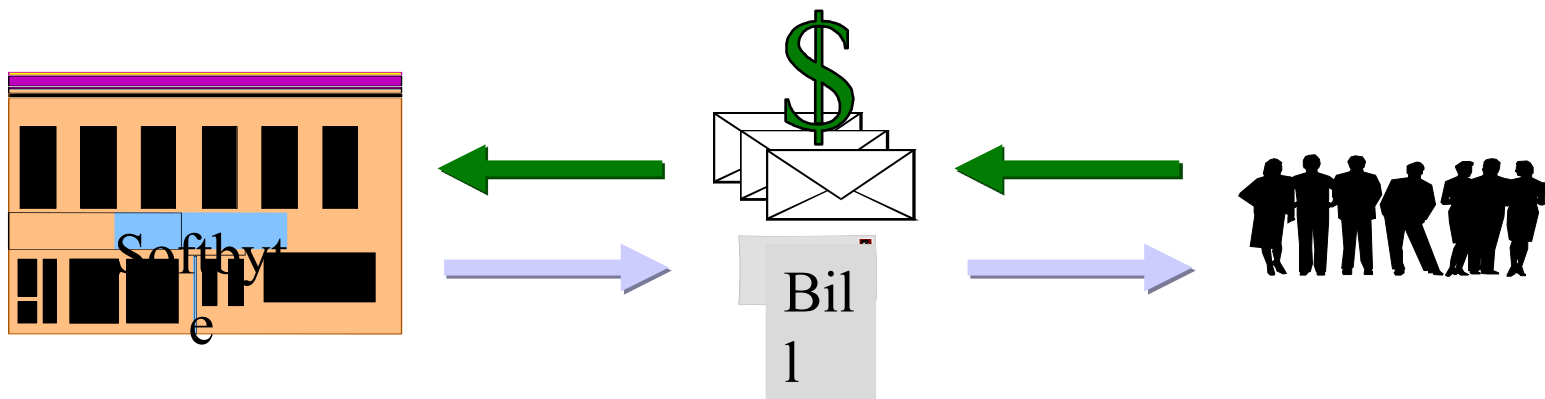
- Assets = Liabilities + Owner's Equity
- Cash + Supplies + Equip. = Accts. Pay. + R. Neal, Capital
- Old \$9,600 + \$1,600 + \$7,000 = \$1,600 + \$16,200
- (5) Advertising Expense + 250 - 250
- New \$9,600 + \$1,600 + \$7,000 = \$1,850 + \$15,950
- \$17,800 \$17,800

Accounts Payable is increased by \$250 and R. Neal, Capital is decreased by \$250

# TRANSACTION ANALYSIS

## TRANSACTION 6

- **Softbyte** provides \$3,500 of programming services for customers.
- Cash of \$1,500 is received from customers, and the balance of \$2,000 is billed on account.



# TRANSACTION ANALYSIS

## TRANSACTION 6 SOLUTION

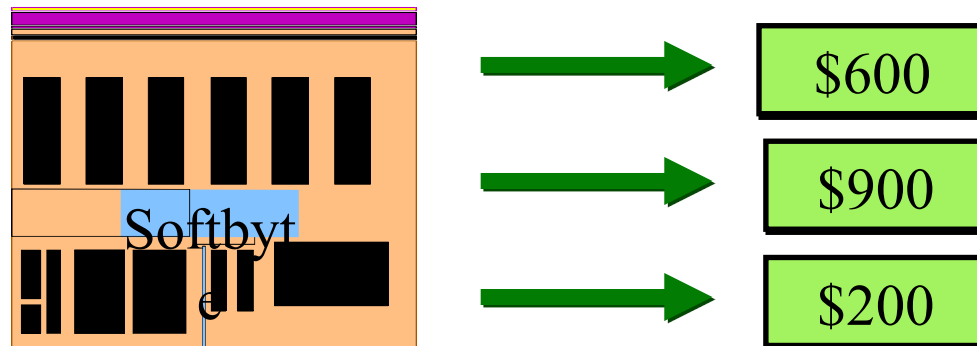
- Assets = Liabilities + Owner's Equity
- Cash + Accts. Rec. + Supplies + Equip. = Accts. Pay. + R. Neal, Capital
- Old
- \$9,600 + \$1,600 + \$7,000 = \$1,850 + \$15,950
- (6)
- + 1,500 + 2,000 + 3,500
- New
- \$10,700 + \$2,000 + \$1,600 + \$7,000 = \$1,850 + \$19,450
- $$\underbrace{\qquad\qquad\qquad}_{\$21,300} \qquad\qquad\qquad \underbrace{\qquad\qquad\qquad}_{\$21,300}$$

Cash is increased by \$1,500; Accounts Receivable is increased by \$2,000, and R. Neal, Capital is increased by \$3,500

# TRANSACTION ANALYSIS

## TRANSACTION 7

- Expenses paid in cash for September are store rent, \$600; employees' salaries, \$900; and utilities, \$200.



# TRANSACTION ANALYSIS

## TRANSACTION 7 SOLUTION

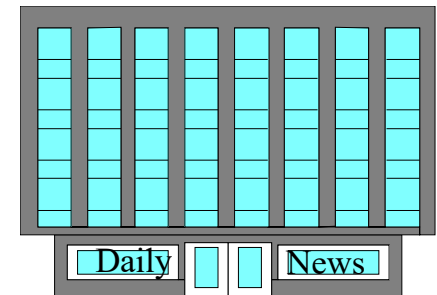
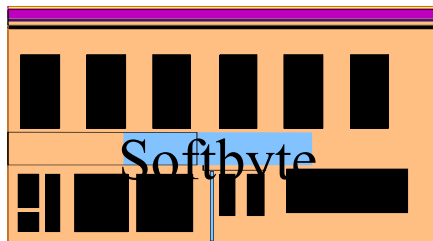
- Assets = Liabilities + Owner's Equity
- Cash + Accts. Rec. + Supplies + Equip. = Accts. Pay. + R. Neal, Capital
- Old
- \$19,450 + \$2,000 + \$1,600 + \$7,000 = \$1,850 + \$19,450
- (7)
- - 1,700
- Rent Expense - 600
- Salaries Expense - 900
- Utilities Expense - 200
- New
- \$9,000 + \$2,000 + \$1,600 + \$7,000 = \$1,850 + \$17,750
- $\underbrace{\hspace{10em}}_{\$19,600}$   $\underbrace{\hspace{10em}}_{\$19,600}$

Cash is decreased by \$1,700 and R. Neal, Capital is decreased by the same amount

# TRANSACTION ANALYSIS

## TRANSACTION 8

- **Softbyte** pays its **\$250 Daily News** advertising bill in **cash**.



# TRANSACTION ANALYSIS

## TRANSACTION 8 SOLUTION

- $$\underline{\text{Assets}} = \underline{\text{Liabilities}} + \underline{\text{Owner's Equity}}$$
- $$\underline{\text{Cash}} + \underline{\text{Accts. Rec.}} + \underline{\text{Supplies}} + \underline{\text{Equip.}} = \underline{\text{Accts. Pay.}} + \underline{\text{R. Neal, Capital}}$$
- Old
- $$\$9,000 + \$2,000 + \$1,600 + \$7,000 = \$1,850 + \$17,750$$
- $$(8) - \underline{250} \qquad \qquad \qquad \underline{- 250}$$
- New
- $$\begin{array}{ccccccccc} \$8,750 & + & \$2,000 & + & \$1,600 & + & \$7,000 & = & \$1,600 & + & \$17,750 \\ & & \underbrace{\hspace{2em}} & & & & & & & & \underbrace{\hspace{2em}} \\ & & \$19,350 & & & & & & & & \$19,350 \end{array}$$

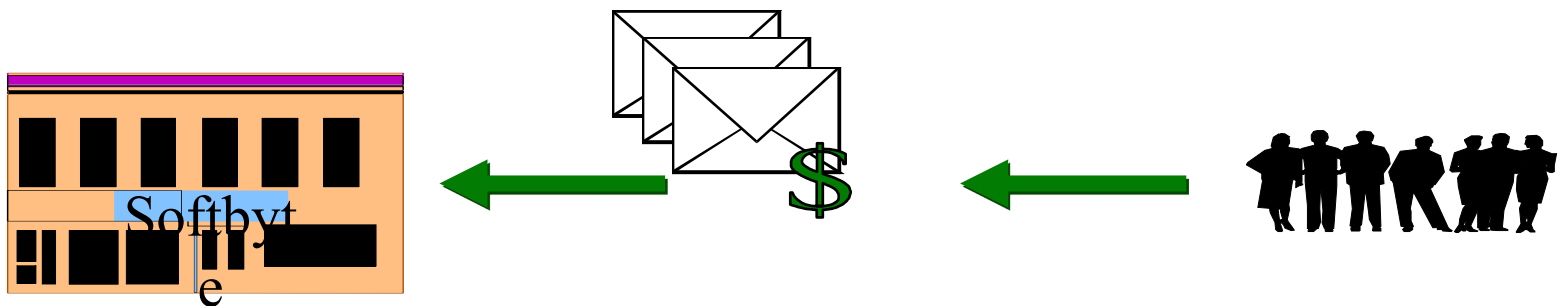
Both Cash and Accounts Payable are decreased by \$250. Since the expense was previously recorded, it is not recorded now.



# TRANSACTION ANALYSIS

## TRANSACTION 9

- The sum of \$600 in cash is received from customers who have previously been billed for services (in Transaction 6).



# TRANSACTION ANALYSIS

## TRANSACTION 9 SOLUTION

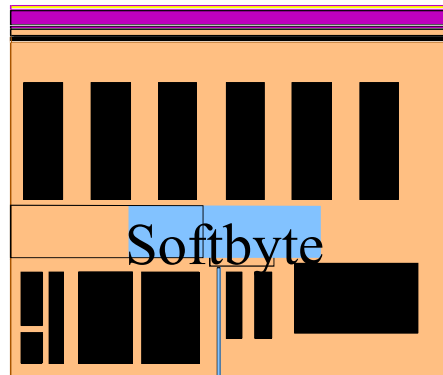
- $$\underline{\text{Assets}} = \underline{\text{Liabilities}} + \underline{\text{Owner's Equity}}$$
- $$\underline{\text{Cash}} + \underline{\text{Accts. Rec.}} + \underline{\text{Supplies}} + \underline{\text{Equip.}} = \underline{\text{Accts. Pay.}} + \underline{\text{R. Neal, Capital}}$$
- Old
- $$\$8,750 + \$2,000 + \$1,600 + \$7,000 = \$1,600 + \$17,750$$
- $$(9) + 600 - 600$$
- $$\$9,350 + \$1,400 + \$1,600 + \$7,000 = \$1,600 + \$17,750$$
- $$\begin{array}{c} \underbrace{\hspace{10em}} \\ \$19,350 \end{array} \qquad \qquad \qquad \begin{array}{c} \underbrace{\hspace{10em}} \\ \$19,350 \end{array}$$

Cash is increased by \$600 and Accounts Receivable is decreased by the same amount. R. Neal, Capital is not increased because the revenue was already recorded.

# TRANSACTION ANALYSIS

## TRANSACTION 10

- **Ray Neal** withdraws \$1,300 in cash from the business for his personal use.



\$1,300



# TRANSACTION ANALYSIS

## TRANSACTION 10 SOLUTION

	Assets				=	Liabilities	+	Owner's Equity			
	Cash	+	Accounts Receivable	+	Supplies	+	Equipment	=	Accounts Payable	+	R. Neal, Capital
Old Bal.	\$9,350		\$1,400		\$1,600		\$7,000		\$1,600		\$17,750
• (10)	-1,300								-1,300	Drawings	
New Bal.	\$8,050	+	\$1,400	+	\$1,600	+	\$7,000	=	\$1,600	+	\$16,450
	\$18,050								\$18,050		

Cash is decreased \$1,300 and R. Neal, Capital is decreased by the same amount.



# FINANCIAL STATEMENTS

## STUDY OBJECTIVE 8

• **Four** financial statements are prepared from the summarized accounting data:

- **Income Statement**

Revenues and expenses and resulting net income or net loss for a specific period of time

- **Owner's Equity Statement**

Changes in owner's equity for a specific period of time

- **Balance Sheet**

assets, liabilities, and owner's equity at a specific date

- **Statement of Cash Flows**

cash inflows (receipts) and outflows (payments) for a specific period of time

## FINANCIAL STATEMENTS AND THEIR INTERRELATIONSHIPS

SOFTBYTE, INC.		
Income Statement		
For the Month Ended September 30, 2005		
Revenues		
Service revenue		\$ 4,700
Expenses		
Salaries expense	\$ 900	
Rent expense	600	
Advertising expense	250	
Utilities expense	<u>200</u>	
Total expenses		<u>1,950</u>
Net income		<u><u>2,750</u></u>

Net income of \$2,750 shown on the income statement is added to the beginning balance of owner's capital in the owner's equity statement.

# FINANCIAL STATEMENTS AND THEIR INTERRELATIONSHIPS

SOFTBYTE, INC.		
Owner's Equity Statement		
For the Month Ended September 30, 2005		
R. Neal, Capital, September 1		\$ -
Add: Investments	\$ 15,000	
Net income	• 2,750	
		<u>17,750</u>
Less: Drawings		<u>1,300</u>
R. Neal, Capital, September 30		<u><u>\$ 16,450</u></u>

Net income of \$2,750 is determined from the information in the owner's equity column of the Summary of Transactions (Illustration 1-8).



# FINANCIAL STATEMENTS AND THEIR INTERRELATIONSHIPS

SOFTBYTE, INC.		
Owner's Equity Statement		
For the Month Ended September 30, 2005		
Retained earnings, September 1		\$ -
Add: Investments	\$ 15,000	
Net income	<u>2,750</u>	<u>17,750</u>
		17,750
Less: Drawings		<u>1,300</u>
Retained earnings, September 30, 2005		<u><u>•\$16,450</u></u>

Net income of \$2,750 carried forward from the income statement to the owner's equity statement. The owner's capital of \$16,450 at the end of the reporting period is shown as the final total of the owner's equity column of the Summary of

# FINANCIAL STATEMENTS AND THEIR INTERRELATIONSHIPS

SOFTBYTE, INC. Balance Sheet September 30, 2005		
Assets		
Cash		\$ 8,050
Accounts receivable		1,400
Supplies		1,600
Equipment		7,000
Total assets		<u>\$ 18,050</u>
Liabilities and Owner's Equity		
Liabilities		
Accounts payable		\$ 1,600
Owner's equity		
R. Neal, capital		<u>•16,450</u>
Total liabilities and owner's equity		<u>\$ 18,050</u>

Owner's capital of \$16,450 at the end of the reporting period shown in the owner's equity statement is shown on the balance sheet.

# FINANCIAL STATEMENTS AND THEIR INTERRELATIONSHIPS

SOFTBYTE, INC. Balance Sheet September 30, 2005		
Assets		
Cash		• \$ 8,050
Accounts receivable		1,400
Supplies		1,600
Equipment		7,000
Total assets		<u>\$ 18,050</u>
Liabilities and Owner's Equity		
Liabilities		
Accounts payable		\$ 1,600
Owner's equity		
R. Neal, capital		16,450
Total liabilities and owner's equity		<u>\$ 18,050</u>

Cash of \$8,050 on the balance sheet is reported on the statement of cash flows.

# FINANCIAL STATEMENTS AND THEIR INTERRELATIONSHIPS

SOFTBYTE, INC.		
Statement of Cash Flows		
For the Month Ended September 30, 2005		
Cash flows from operating activities		
Cash receipts from revenues		\$ 3,300
Cash payments for expenses		(1,950)
Net cash provided by operating activities		<u>1,350</u>
Cash flows from investing activities		
Purchase of equipment		(7,000)
Cash flows from financing activities		
Sale of common stock	\$ 15,000	
Payment of cash dividends	(1,300)	
Net cash provided by financing activities		<u>13,700</u>
Net increase in cash		8,050
Cash at the beginning of the period		<u>-0-</u>
Cash at the end of the period		<u><u>•\$ 8,050</u></u>

Cash of **\$8,050** on the balance sheet and statement of cash flows is shown as the final total of the cash column of the Summary of

Which of the following is not an advantage of the corporate form of business organization?

- Limited liability of stockholders
- Transferability of ownership
- Unlimited personal liability for stockholders
- Unlimited life

Which of the following is not an advantage of the corporate form of business organization?

- Limited liability of stockholders
- Transferability of ownership
- Unlimited personal liability for stockholders
- Unlimited life

Accounting Principles, 7<sup>th</sup> Edition

Weygandt • Kieso • Kimmel

## **Chapter 2**

# **The Recording Process**

Prepared by Naomi Karolinski

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and

Marianne Bradford

Bryant College

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# **CHAPTER 2**

## **THE RECORDING**

After studying this chapter, you should be able to:

## **PROCESS**

- 1 Explain what an account is and how it helps in the recording process**
- 2 Define debits and credits and explain how they are used to record business transactions**
- 3 Identify the basic steps in the recording process**
- 4 Explain what a journal is and how it helps in the recording process**



# **CHAPTER 2**

## **THE RECORDING**

After studying this chapter, you should be able to:

### **PROCESS**

- 5** Explain what a ledger is and how it helps in the recording process
- 6** Explain what posting is and how it helps in the recording process
- 7** Prepare a trial balance and explain its purpose

# THE ACCOUNT

## STUDY OBJECTIVE 1

- An **account** is an individual accounting record of increases and decreases in a specific asset, liability, or owner's equity item.
- There are separate accounts for the items we used in transactions such as **cash, salaries expense, accounts payable, etc.**

# BASIC FORM OF ACCOUNT

## STUDY OBJECTIVE 2

- The simplest form an account consists of
  - 1 the title of the account
  - 2 a left or debit side
  - 3 a right or credit side
- The alignment of these parts resembles the letter T = **T account**

Title of Account	
Left or debit side	Right or credit side
Debit balance	Credit balance

# DEBITS AND CREDITS

- **Debit** indicates left and **Credit** indicates right
- Recording \$s on the **left** side of an account is debiting the account
- Recording \$s on the **right** side is crediting the account
- If the total of debit amounts is bigger than credits, the account has a **debit** balance
- If the total of credit amounts is bigger than debits, the account has a **credit** balance

# TABULAR SUMMARY COMPARED TO ACCOUNT FORM

Tabular Summary

Cash
\$15,000
-7,000
1,200
1,500
-1,700
-250
600
-1,300
<u>\$ 8,050</u>

Account Form

Cash			
(Debits)	15,000	(Credits)	7,000
	1,200		1,700
	1,500		250
	600		1,300
Balance	8,050		
(Debit)			

# DEBITING AN ACCOUNT

Cash	
Debits	Credits
15,000	

**Example:** The owner makes an initial investment of **\$15,000** to start the business. **Cash** is debited as the owner's **Capital** is credited.

# CREDITING AN ACCOUNT

Cash	
Debits	Credits
	7,000

**Example:** Monthly rent of \$7,000 is paid.

**Cash** is credited as **Rent Expense** is debited.

# DEBITING / CREDITING AN ACCOUNT

Cash	
Debits	Credits
15,000	7,000
8,000	

**Example:** Cash is debited for \$15,000 and credited for \$7,000, leaving a debit balance of \$8,000.



# **DOUBLE-ENTRY SYSTEM**

- **equal debits and credits made accounts for each transaction**
- **total debits always equal the total credits**
- **accounting equation always stays in balance**

**Assets**



**Liabilities**



**Equity**

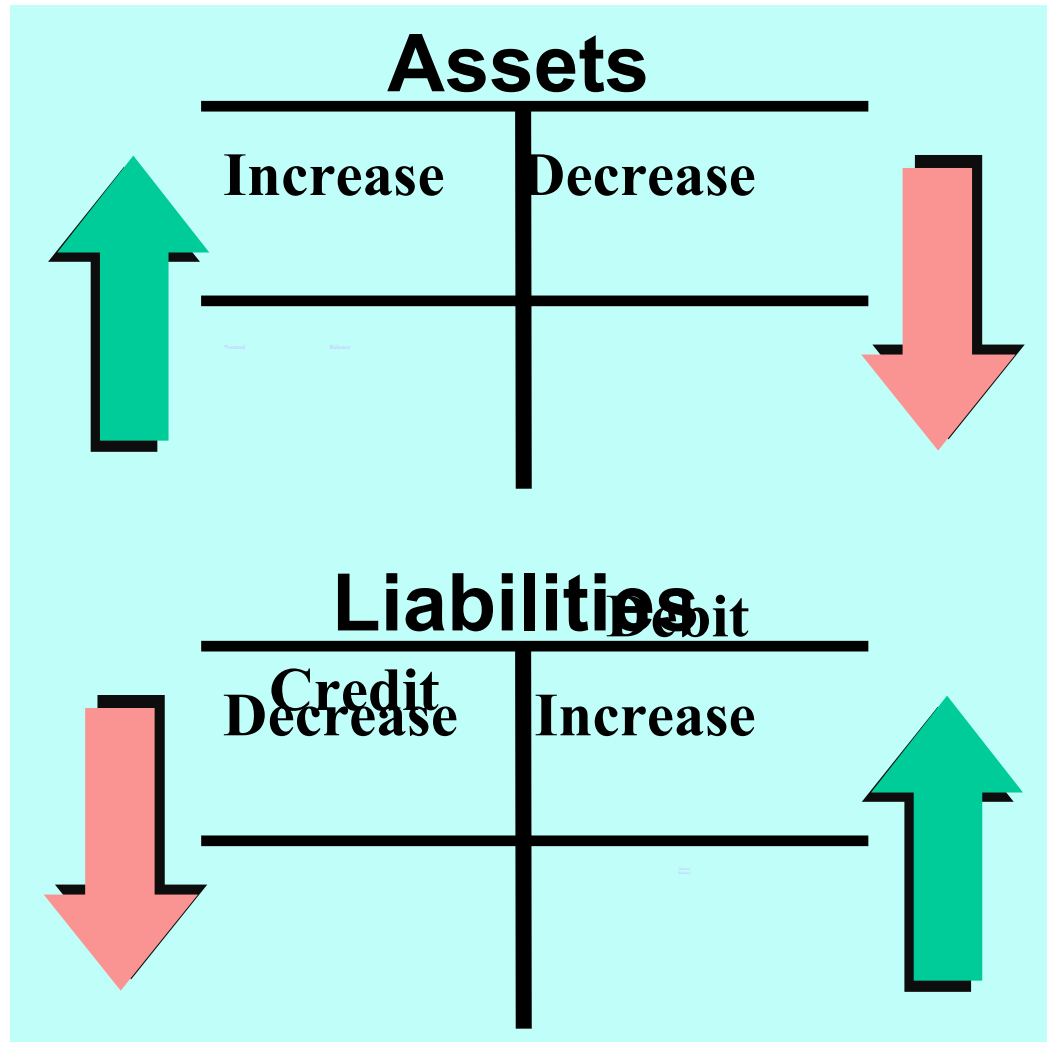
# **DEBIT AND CREDIT EFFECTS — ASSETS AND LIABILITIES**

<b>Debits</b>	<b>Credits</b>
<b>Increase assets</b>	<b>Decrease assets</b>
<b>Decrease liabilities</b>	<b>Increase liabilities</b>

# NORMAL BALANCE

- every account has a designated **normal** balance.
  - It is either a debit or credit.
- accounts rarely have an abnormal balance.

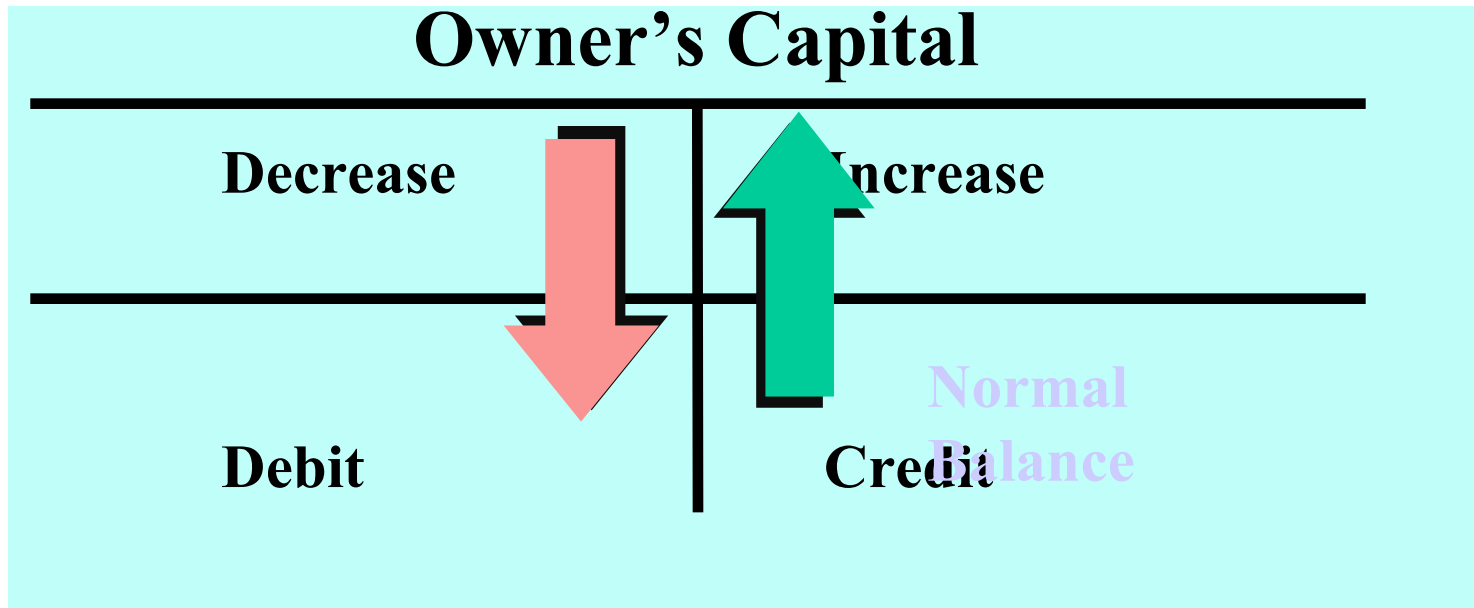
# NORMAL BALANCES — ASSETS AND LIABILITIES



# **DEBIT AND CREDIT EFFECTS — OWNER'S CAPITAL**

<b>Debits</b>	<b>Credits</b>
<b>Decrease owner's capital</b>	<b>Increase owner's capital</b>

# NORMAL BALANCE — OWNER'S CAPITAL

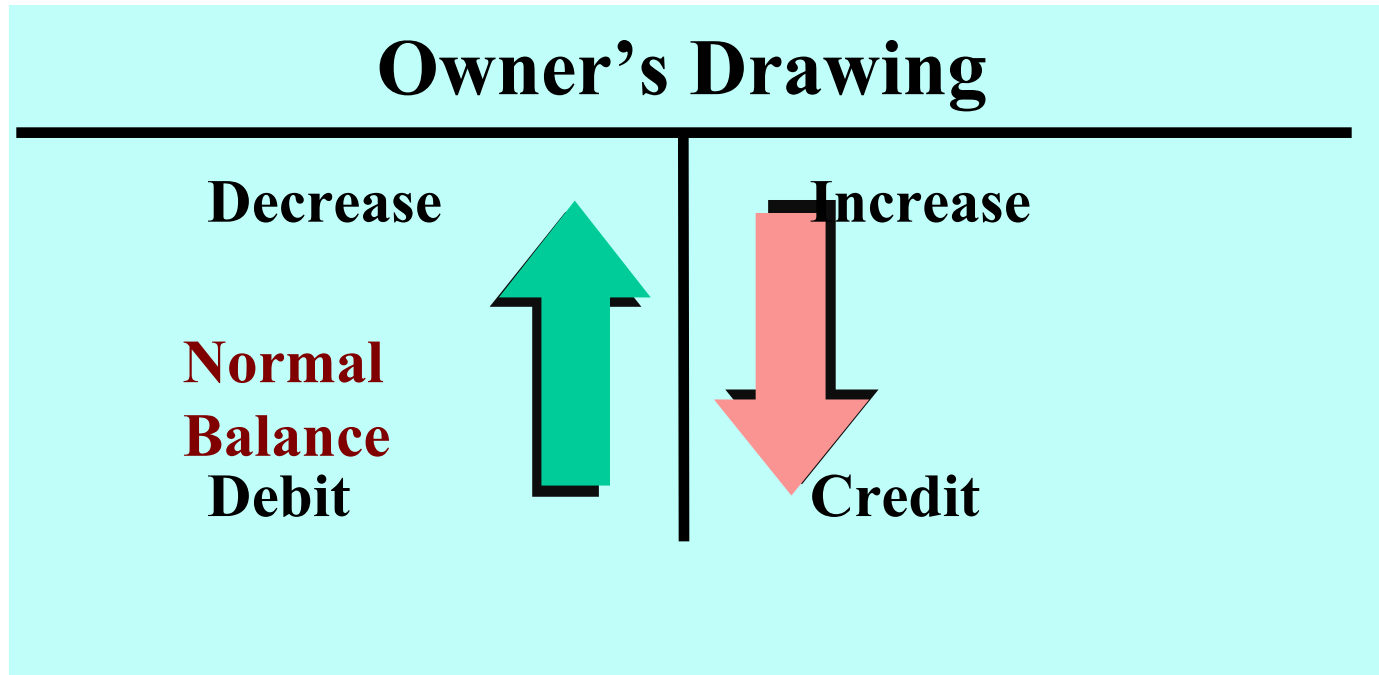


# DEBIT AND CREDIT EFFECTS — OWNER'S DRAWING

Debits	Credits
Increase owner's drawing	Decrease owner's drawing

Remember, **Drawing** is a **contra-account** – an account that is backwards from the account it accompanies (the **Capital** account).

# **NORMAL BALANCE — OWNER'S DRAWING**

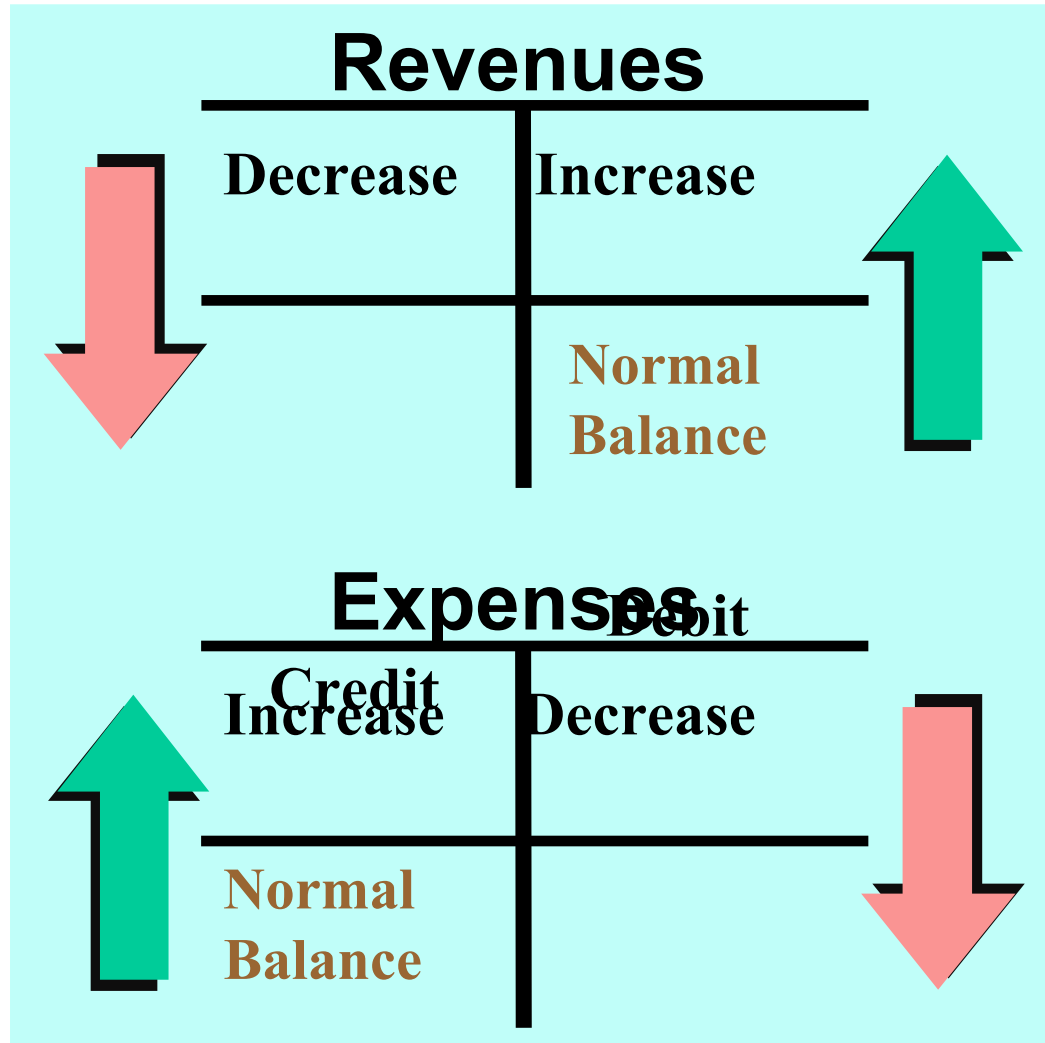




# **DEBIT AND CREDIT EFFECTS — REVENUES AND EXPENSES**

<b>Debits</b>	<b>Credits</b>
<b>Decrease revenues Increase expenses</b>	<b>Increase revenues Decrease expenses</b>

# NORMAL BALANCES — REVENUES AND EXPENSES



# EXPANDED BASIC EQUATION AND DEBIT/CREDIT RULES AND EFFECTS

<b>Assets</b>	=	<b>Liabilities</b>	+	<b>Owner's Equity</b>
---------------	---	--------------------	---	-----------------------

<b>Assets</b>	=	<b>Liabilities</b>	+	<b>Owner's Capital</b>	-	<b>Owner's Drawing</b>																
<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%; text-align: center; padding: 5px;"><b>Dr.</b></td> <td style="width: 50%; text-align: center; padding: 5px;"><b>Cr.</b></td> </tr> <tr> <td style="text-align: center; padding: 5px;">+</td> <td style="text-align: center; padding: 5px;">-</td> </tr> </table>	<b>Dr.</b>	<b>Cr.</b>	+	-		<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%; text-align: center; padding: 5px;"><b>Dr.</b></td> <td style="width: 50%; text-align: center; padding: 5px;"><b>Cr.</b></td> </tr> <tr> <td style="text-align: center; padding: 5px;">-</td> <td style="text-align: center; padding: 5px;">+</td> </tr> </table>	<b>Dr.</b>	<b>Cr.</b>	-	+		<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%; text-align: center; padding: 5px;"><b>Dr.</b></td> <td style="width: 50%; text-align: center; padding: 5px;"><b>Cr.</b></td> </tr> <tr> <td style="text-align: center; padding: 5px;">-</td> <td style="text-align: center; padding: 5px;">+</td> </tr> </table>	<b>Dr.</b>	<b>Cr.</b>	-	+		<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%; text-align: center; padding: 5px;"><b>Dr.</b></td> <td style="width: 50%; text-align: center; padding: 5px;"><b>Cr.</b></td> </tr> <tr> <td style="text-align: center; padding: 5px;">+</td> <td style="text-align: center; padding: 5px;">-</td> </tr> </table>	<b>Dr.</b>	<b>Cr.</b>	+	-
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+	-																					

+	<b>Revenues</b>	-	<b>Expenses</b>								
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<b>Dr.</b>	<b>Cr.</b>										
-	+										
<b>Dr.</b>	<b>Cr.</b>										
+	-										

Which of the following is not true of the terms **debit** and **credit**.

- a. They can be abbreviated as Dr. and Cr.
- b. They can be interpreted to mean increase and decrease.
- c. They can be used to describe the balance of an account.
- d. They can be interpreted to mean left and right.

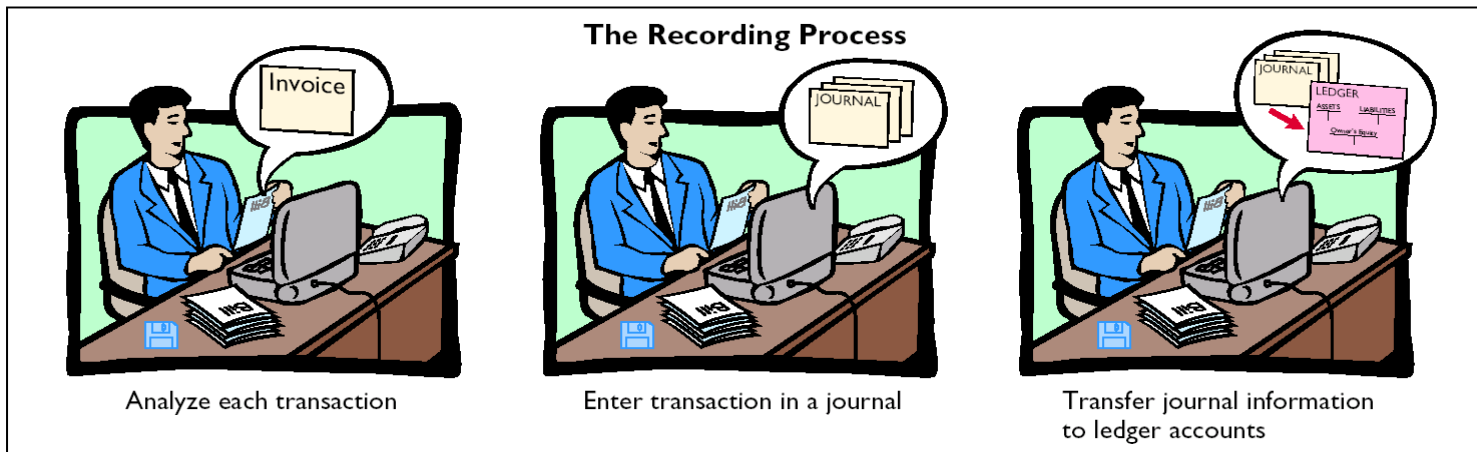
Which of the following is not true of the terms **debit** and **credit**.

- They can be abbreviated as Dr. and Cr.
- They can be interpreted to mean increase and decrease.
- They can be used to describe the balance of an account.
- They can be interpreted to mean left and right.

# THE RECORDING PROCESS

## STUDY OBJECTIVE 3

- 1 analyze each transaction (+, -)
- 2 enter transaction in a journal
- 3 transfer journal information to ledger accounts



# THE JOURNAL

## STUDY OBJECTIVE 4

- **Transactions**
  - Are initially recorded in chronological order before they are transferred to the ledger accounts.
- A **general journal** has
  - 1 spaces for dates
  - 2 account titles and explanations
  - 3 references
  - 4 two amount columns

# THE JOURNAL

A **journal** makes several contributions to recording process:

- 1** discloses in one place the complete effect of a transaction
- 2** provides a chronological record of transactions
- 3** helps to prevent or locate errors as debit and credit amounts for each entry can be compared



# JOURNALIZIN G

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

# TECHNIQUE OF JOURNALIZING

The date of the transaction is entered into the date column.

GENERAL JOURNAL					J1
Date	Account Titles and Explanation	Ref.	Debit	Credit	
2005 Sept. 1	Cash R. Neal, Capital (Invested cash in business)		15,000		15,000
1	Computer Equipment Cash (Purchased equipment for cash)		7,000		7,000

# TECHNIQUE OF JOURNALIZING

The **debit** account title is entered at the extreme left margin of the Account Titles and Explanation column. The **credit** account title is indented on the next line.

GENERAL JOURNAL					J1
Date	Account Titles and Explanation	Ref.	Debit	Credit	
2005 Sept. 1	Cash R. Neal, Capital (Invested cash in business)		15,000	15,000	
1	Computer Equipment Cash (Purchased equipment for cash)		7,000	7,000	

# TECHNIQUE OF JOURNALIZING

The amounts for the **debits** are recorded in the Debit column and the amounts for the **credits** are recorded in the Credit column.

GENERAL JOURNAL					J1
Date	Account Titles and Explanation	Ref.	Debit	Credit	
2005 Sept. 1	Cash R. Neal, Capital (Invested cash in business)		15,000	15,000	
1	Computer Equipment Cash (Purchased equipment for cash)		7,000	7,000	

# TECHNIQUE OF JOURNALIZING

A brief explanation of the transaction is given.

GENERAL JOURNAL					J1
Date	Account Titles and Explanation	Ref.	Debit	Credit	
2005 Sept. 1	Cash R. Neal, Capital (Invested cash in business)		15,000	15,000	
1	Computer Equipment Cash (Purchased equipment for cash)		7,000	7,000	

# TECHNIQUE OF JOURNALIZING

A space is left between journal entries. The blank space separates individual journal entries and makes the entire journal easier to read.

GENERAL JOURNAL					J1
Date	Account Titles and Explanation	Ref.	Debit	Credit	
2005 Sept. 1	Cash R. Neal, Capital (Paid for business)		15,000		15,000
1	Computer Equipment Cash (Purchased equipment for cash)		7,000		7,000

# TECHNIQUE OF JOURNALIZING

The column entitled Ref. is left blank at the time journal entry is made and is used later when the journal entries are transferred to the ledger accounts.

GENERAL JOURNAL					J1
Date	Account Titles and Explanation	Ref.	Debit	Credit	
2005 Sept. 1	Cash R. Neal, Capital (Invested cash in business)		15,000	15,000	
1	Computer Equipment Cash (Purchased equipment for cash)		7,000	7,000	

# SIMPLE AND COMPOUND JOURNAL ENTRIES

If an entry involves only two accounts, one debit and one credit, it is considered a **simple entry**.

GENERAL JOURNAL					J1
Date	Account Titles and Explanation	Ref.	Debit	Credit	
2005 July 1	Cash K. Browne, Capital (Invested cash in the business)		20,000	20,000	



# COMPOUND JOURNAL ENTRY

When three or more accounts are required in one journal entry, the entry is referred to as a **compound entry**.

GENERAL JOURNAL					J1
Date	Account Titles and Explanation	Ref.	Debit	Credit	
2005 July 1	Delivery Equipment		14,000		
	Cash			8,000	
	Accounts Payable			6,000	
	(Purchased truck for cash with balance on account)				

1

2

3

# COMPOUND JOURNAL ENTRY

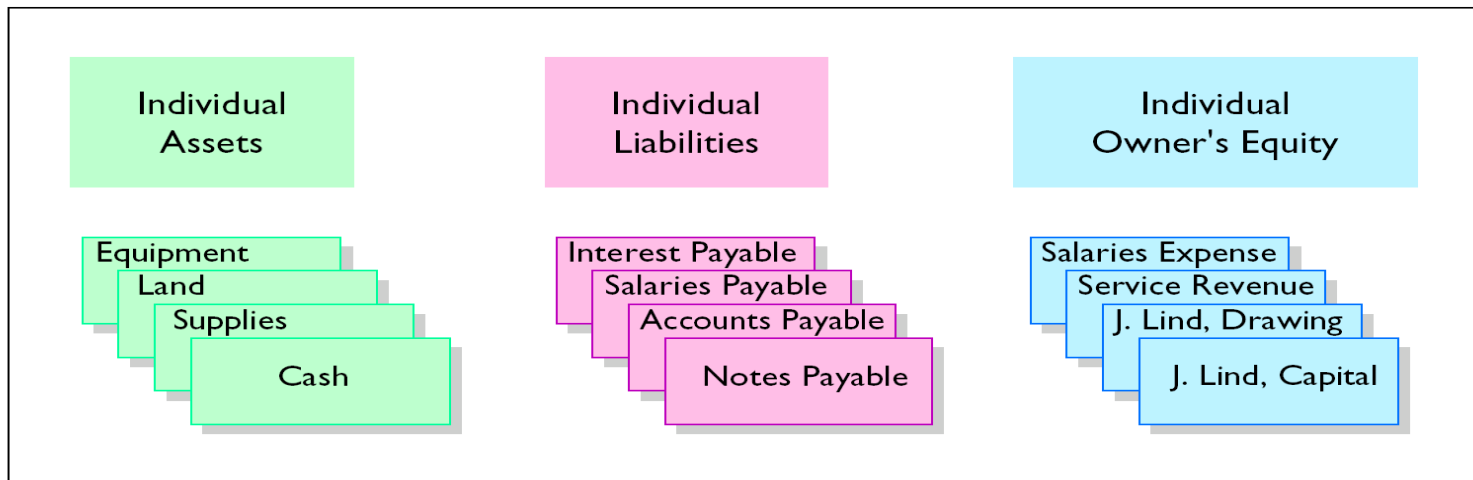
This is the wrong format; all debits must be listed before the credits are listed.

GENERAL JOURNAL				J1
Date	Account Titles and Explanation	Ref.	Debit	Credit
2005 July 1	Cash			8,000
	Delivery Equipment		14,000	
	Accounts Payable			6,000
	(Purchased truck for cash with balance on account)			

# THE LEDGER

A Group of accounts maintained by a company is called the ledger.

A **general ledger** contains all the assets, liabilities, and owner's equity accounts



# POSTING A JOURNAL ENTRY

## STUDY OBJECTIVE 6

GENERAL JOURNAL					J1
Date	Account Titles and Explanation	Ref.	Debit	Credit	
2005					
Sept. 1	Cash	10	15,000		
	R. Neal, Capital (invested cash in business)	25		15,000	

## GENERAL LEDGER

CASH						NO. 10
Date	Explanation	Ref.	Debit	Credit	Balance	
2005						
Sept. 1		J1	15,000		15,000	

R. NEAL, CAPITAL						NO. 25
Date	Explanation	Ref.	Debit	Credit	Balance	
2005						
Sept. 1		J1		15,000	15,000	

In the ledger, enter in the appropriate columns of the account(s) debited the **date**, **journal page**, and **debit amount** shown in the journal.

# POSTING A JOURNAL ENTRY

GENERAL JOURNAL						J1
Date	Account Titles and Explanation	Ref.	Debit	Credit		
2005 Sept. 1	Cash	10	15,000			
	R. Neal, Capital (invested cash in business)	25		15,000		
GENERAL LEDGER						
CASH						NO. 10
Date	Explanation	Ref.	Debit	Credit	Balance	
2005 Sept. 1		J1	15,000		15,000	
R. NEAL, CAPITAL						NO. 25
Date	Explanation	Ref.	Debit	Credit	Balance	
2005 Sept. 1		J1		15,000	15,000	

In the ledger, enter in the appropriate columns of the account(s) debited the **date**, **journal page**, and **debit amount** shown in the journal.

# POSTING A JOURNAL ENTRY

GENERAL JOURNAL						J1
Date	Account Titles and Explanation	Ref.	Debit	Credit		
2005 Sept. 1	Cash R. Neal, Capital (invested cash in business)	10 <del>25</del>	15,000		15,000	

GENERAL LEDGER						
CASH						NO. 10
Date	Explanation	Ref.	Debit	Credit	Balance	
2005 Sept. 1		J1	15,000		15,000	
R. NEAL, CAPITAL						NO. 25
Date	Explanation	Ref.	Debit	Credit	Balance	
2005 Sept. 1		J1		15,000	15,000	

In the reference column of the journal, write the **account number** to which the debit amount was posted.

# POSTING A JOURNAL ENTRY

GENERAL JOURNAL						J1
Date	Account Titles and Explanation	Ref.	Debit	Credit		
2005 Sept. 1	Cash R. Neal, Capital (invested cash in business)	10 25	15,000	15,000		

## GENERAL LEDGER

CASH						NO. 10
Date	Explanation	Ref.	Debit	Credit	Balance	
2005 Sept. 1		J1	15,000		15,000	

R. NEAL, CAPITAL						NO. 25
Date	Explanation	Ref.	Debit	Credit	Balance	
2005 Sept. 1		J1		15,000	15,000	

In the ledger, enter in the appropriate columns of the account(s) credited the **date**, **journal page**, and **credit amount** shown in the journal.

# POSTING A JOURNAL ENTRY

GENERAL JOURNAL					J1
Date	Account Titles and Explanation	Ref.	Debit	Credit	
2002 Sept. 1	Cash R. Neal, Capital (Invested cash in business)	10 25	15,000	15,000	

## GENERAL LEDGER

CASH					NO. 10
Date	Explanation	Ref.	Debit	Credit	Balance
2002 Sept. 1		J1	15,000		15,000

R. NEAL, CAPITAL					NO. 25
Date	Explanation	Ref.	Debit	Credit	Balance
2002 Sept. 1		J1		15,000	15,000

In the reference column of the journal, write the **account number** to which the credit amount was posted.



# CHART OF ACCOUNTS

A **Chart of Accounts** lists the accounts and the account numbers which identify their location in the ledger.

## PIONEER ADVERTISING AGENCY

### Chart of Accounts

#### Assets

---

**101 Cash**  
112 Accounts Receivable  
**126 Advertising Supplies**  
**130 Prepaid Insurance**  
**157 Office Equipment**  
158 Accumulated Depreciation—Office Equipment

#### Liabilities

---

**200 Notes Payable**  
**201 Accounts Payable**  
**209 Unearned Revenue**  
212 Salaries Payable  
230 Interest Payable

#### Owner's Equity

---

**301 C. R. Byrd, Capital**  
**306 C. R. Byrd, Drawing**  
350 Income Summary

#### Revenues

---

**400 Service Revenue**

#### Expenses

---

631 Advertising Supplies Expense  
711 Depreciation Expense  
722 Insurance Expense  
**726 Salaries Expense**  
**729 Rent Expense**  
905 Interest Expense

# INVESTMENT OF CASH BY OWNER

## Transaction

October 1, C.R. Byrd invests \$10,000 cash in an advertising business known as:  
The Pioneer Advertising Agency.

## Basic Analysis

- The asset Cash is increased \$10,000
- Owner's equity, C. R. Byrd, Capital is increased \$10,000.

## Debit-Credit Analysis

Debits increase assets: debit Cash **\$10,000**.  
Credits increase owner's equity: credit C.R. Byrd, Capital **\$10,000**.

# PURCHASE OF OFFICE EQUIPMENT

## JOURNAL ENTRY

Date	Account Titles and Explanation	Ref.	Debit	Credit
Oct. 1	Office Equipment Notes Payable (Issued 3-month, 12% note for office equipment)	157 200	5,000	5,000

## POSTING

	Office Equipment	157
Oct. 1	5,000	

Notes Payable	200
Oct. 1	5,000

# RECEIPT OF CASH FOR FUTURE SERVICE

## Transaction

October 2, a \$1,200 cash advance is received from a client, for advertising services expected to be completed by December 31.

## Basic Analysis

Asset Cash is increased \$1,200

Liability Unearned Fees is increased \$1,200

•Service has not been rendered yet.

Liabilities often have the word “payable” in their title, Unearned fees are a liability.

## Debit-Credit Analysis

Debits increase assets: debit Cash **\$1,200**.

Credits increase liabilities: credit Unearned Fees **\$1,200**.

# RECEIPT OF CASH FOR FUTURE SERVICE

## JOURNAL ENTRY

Date	Account Titles and Explanation	Ref.	Debit	Credit
Oct. 2	Cash	101	1,200	
	Unearned Fees	209		1,200
	(Received advance from R. Knox for future services)			

## POSTING

Cash		101
Oct. 1	10,000	
2	1,200	

Unearned Fees		209
	Oct. 2	1,200

# **PAYMENT OF MONTHLY RENT**

## **Transaction**

**October 3, office rent for October is paid in cash, \$900.**

## **Basic Analysis**

**The expense Rent is increased \$900  
Payment pertains only to the current month  
Asset Cash is decreased \$900.**

## **Debit-Credit Analysis**

**Debits increase expenses: debit Rent Expense \$900.  
Credits decrease assets: credit Cash \$900.**

# PAYMENT OF MONTHLY RENT

## JOURNAL ENTRY

Date	Account Titles and Explanation	Ref.	Debit	Credit
Oct. 3	Rent Expense	729	900	
	Cash	101		900
	(Paid October rent)			

## POSTING

Cash		101
Oct. 1	10,000	
2	1,200	
		900

Rent Expense		729
Oct 3	900	

# PAYMENT FOR INSURANCE

## Transaction

October 4, \$600 Paid one-year insurance policy- expires next year on September 30.

## Basic Analysis

- Asset Prepaid Insurance increases \$600
- Payment extends to more than the current month
- Asset Cash is decreased \$600.
- Payments of expenses benefiting more than one period are prepaid expenses or prepayments.

## Debit-Credit Analysis

Debits increase assets: debit Prepaid Insurance \$600. Credits decrease assets: credit Cash \$600.



# PAYMENT FOR INSURANCE

## JOURNAL ENTRY

Date	Account Titles and Explanation	Ref.	Debit	Credit
Oct. 4	Prepaid Insurance	130	600	
	Cash	101		600
	(Paid one-year policy; effective date October 1)			

## POSTING

Cash		101
Oct. 1	10,000	900
2	1,200	600

Prepaid Insurance		130
Oct. 4	600	

# **PURCHASE OF SUPPLIES ON CREDIT**

## **Transaction**

**October 5, an estimated 3-month supply of advertising materials is purchased on account from Aero Supply for \$2,500.**

## **Basic Analysis**

**The asset Advertising Supplies is increased \$2,500; the liability Accounts Payable is increased \$2,500.**

## **Debit-Credit Analysis**

**Debits increase assets: debit Advertising Supplies \$2,500. Credits increase liabilities: credit Accounts Payable \$2,500.**

# PURCHASE OF SUPPLIES ON CREDIT

## JOURNAL ENTRY

Date	Account Titles and Explanation	Ref.	Debit	Credit
Oct. 5	Advertising Supplies Accounts Payable (Purchased supplies on account from Aero Supply)	126 201	2,500	2,500

## POSTING

	Advertising Supplies	126
Oct. 5	2,500	

Accounts Payable	201
Oct. 5	2,500

# **HIRING OF EMPLOYEES**

## **Transaction**

**October 9, hire four employees to begin work on October 15. Each employee is to receive a weekly salary of \$500 for a 5-day work week, payable every 2 weeks -- first payment made on October 26.**

## **Basic Analysis**

**A business transaction has not occurred only an agreement between the employer and the employees to enter into a business transaction beginning on October 15.**

## **Debit-Credit Analysis**

**A debit-credit analysis is not needed because there is no accounting entry.**

# WITHDRAWAL OF CASH BY OWNER

## Transaction

October 20, C. R. Byrd withdraws \$500 cash for personal use.

## Basic Analysis

The owner's equity account C. R. Byrd, Drawing is increased \$50  
The asset Cash is decreased \$500.

## Debit-Credit Analysis

Debits increase drawings: debit C. R. Byrd, Drawing **\$500**. Credits decrease assets: credit Cash **\$500**.

# WITHDRAWAL OF CASH BY OWNER

## JOURNAL ENTRY

Date	Account Titles and Explanation	Ref.	Debit	Credit
Oct. 20	C. R. Byrd, Drawing Cash (Withdrew cash for personal use)	306 101	500	500

## POSTING

Cash		101	
Oct. 1	10,000	Oct. 3	900
2	1,200	4	600
		20	500

C. R. Byrd, Drawing		306	
Oct. 20	500		

# PAYMENT OF SALARIES

## Transaction

October 26, employee salaries of \$4,000 are owed and paid in cash. (See October 9 transaction.)

## Basic Analysis

The expense account Salaries Expense is increased \$4,000; the asset Cash is decreased \$4,000.

## Debit-Credit Analysis

Debits increase expenses: debit Salaries Expense **\$4,000**. Credits decrease assets: credit Cash **\$4,000**.

# PAYMENT OF SALARIES

## JOURNAL ENTRY

Date	Account Titles and Explanation	Ref.	Debit	Credit
Oct. 26	Salaries Expense	726	4,000	
	Cash	101		4,000
	(Paid salaries to date)			

## POSTING

Cash		101	
Oct. 1	10,000	Oct. 3	900
2	1,200	4	600
		20	500
		26	4,000

Salaries Expense		726	
Oct. 26	4,000		



# RECEIPT OF CASH FOR FEES EARNED

## Transaction

October 31, received \$10,000 in cash from Copa Company for advertising services rendered in October.

## Basic Analysis

The asset Cash is increased \$10,000; the revenue Fees Earned is increased \$10,000.

## Debit-Credit Analysis

Debits increase assets: debit Cash **\$10,000**. Credits increase revenues: credit Fees Earned **\$10,000**.

# RECEIPT OF CASH FOR FEES EARNED

## JOURNAL ENTRY

Date	Account Titles and Explanation	Ref.	Debit	Credit
Oct. 31	Cash	101	10,000	
	Fees Earned	400		10,000
	(Received cash for fees earned)			

## POSTING

Cash		101	Fees Earned		400
Oct. 1	10,000	Oct. 3	900	Oct. 31	10,000
2	1,200	4	600		
31	10,000	20	500		
		26	4,000		

# THE TRIAL BALANCE

## STUDY OBJECTIVE 7

- The **trial balance** is a list of accounts and their balances at a given time.
- The primary purpose of a trial balance is to prove debits = credits after posting.
- If debits and credits do not agree, the trial balance can be used to uncover errors in journalizing and posting.

# THE TRIAL BALANCE

The Steps in preparing the Trial Balance are:

1. List the account titles and balances
2. Total the debit and credit columns
3. Prove the equality of the two columns

# A TRIAL BALANCE

## PIONEER ADVERTISING AGENCY

Trial Balance

October 31, 2005

	Debit	Credit
Cash	\$ 15,200	
Advertising Supplies	2,500	
Prepaid Insurance	600	
Office Equipment	5,000	
Notes Payable		\$ 5,000
Accounts Payable		2,500
Unearned Fees		1,200
C. R. Byrd, Capital		10,000
C. R. Byrd, Drawing	500	
Fees Earned		10,000
Salaries Expense	4,000	
Rent Expense	900	
	<u>\$ 28,700</u>	<u>\$ 28,700</u>

The total debits  
must equal the  
total credits.

# **LIMITATIONS OF A TRIAL BALANCE**

- **A trial balance does not prove all transactions have been recorded or the ledger is correct.**
- **Numerous errors may exist even though the trial balance columns agree. For example, the trial balance may balance even when:**
  - **a transaction is not journalized**
  - **a correct journal entry is not posted**
  - **a journal entry is posted twice**
  - **incorrect accounts used in journalizing or posting**
  - **offsetting errors are made in recording**

Which one of the following represents the expanded basic accounting equation?

- $\text{Assets} = \text{Liabilities} + \text{Owner's Capital} + \text{Owner's Drawings} - \text{Revenue} - \text{Expenses}.$
- $\text{Assets} + \text{Owner's Drawings} + \text{Expenses} = \text{Liabilities} + \text{Owner's Capital} + \text{Revenue}.$
- $\text{Assets} - \text{Liabilities} - \text{Owner's Drawings} = \text{Owner's Capital} + \text{Revenue} - \text{Expenses}.$
- $\text{Assets} = \text{Revenue} + \text{Expenses} - \text{Liabilities}.$

Which one of the following represents the expanded basic accounting equation?

- Assets = Liabilities + Owner's Capital + Owner's Drawings – Revenue - Expenses.
- Assets + Owner's Drawings + Expenses = Liabilities + Owner's Capital + Revenue.
- Assets – Liabilities – Owner's Drawings = Owner's Capital + Revenue – Expenses.
- Assets = Revenue + Expenses – Liabilities.



Accounting Principles, 7<sup>th</sup> Edition

Weygandt • Kieso • Kimmel

## **Chapter 3**

# **Adjusting the Accounts**

Prepared by Naomi Karolinski

Monroe Community College

and

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Bryant College

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# **CHAPTER 3**

## **ADJUSTING THE ACCOUNTS**

**After studying this chapter, you should be able to:**

- 1 Explain the time period assumption**
- 2 Explain the accrual basis of accounting**
- 3 Explain why adjusting entries are needed**
- 4 Identify the major types of adjusting entries**
- 5 Prepare adjusting entries for prepayments**
- 6 Prepare adjusting entries for accruals**
- 7 Describe the nature and purpose of an adjusted trial balance**

# TIME-PERIOD ASSUMPTION

## STUDY OBJECTIVE 1

- The **time period** (or periodicity) **assumption**
  - assumes the economic life of a business can be divided into artificial time periods
- **Accounting time periods**
  - generally month, a quarter, or a year
- **Accounting time period of one year in length**
  - referred to as a **fiscal year**

# ACCRUAL BASIS OF ACCOUNTING

## STUDY OBJECTIVE 2

- Revenue recognition and matching principles
  - Used under the **accrual basis of accounting**
- **Cash basis accounting**
  - revenue is recorded when cash is received
  - expenses are recorded when cash is paid
- GAAP requires accrual basis accounting
  - cash basis often causes misleading financial statements.

# REVENUE RECOGNITION PRINCIPLE

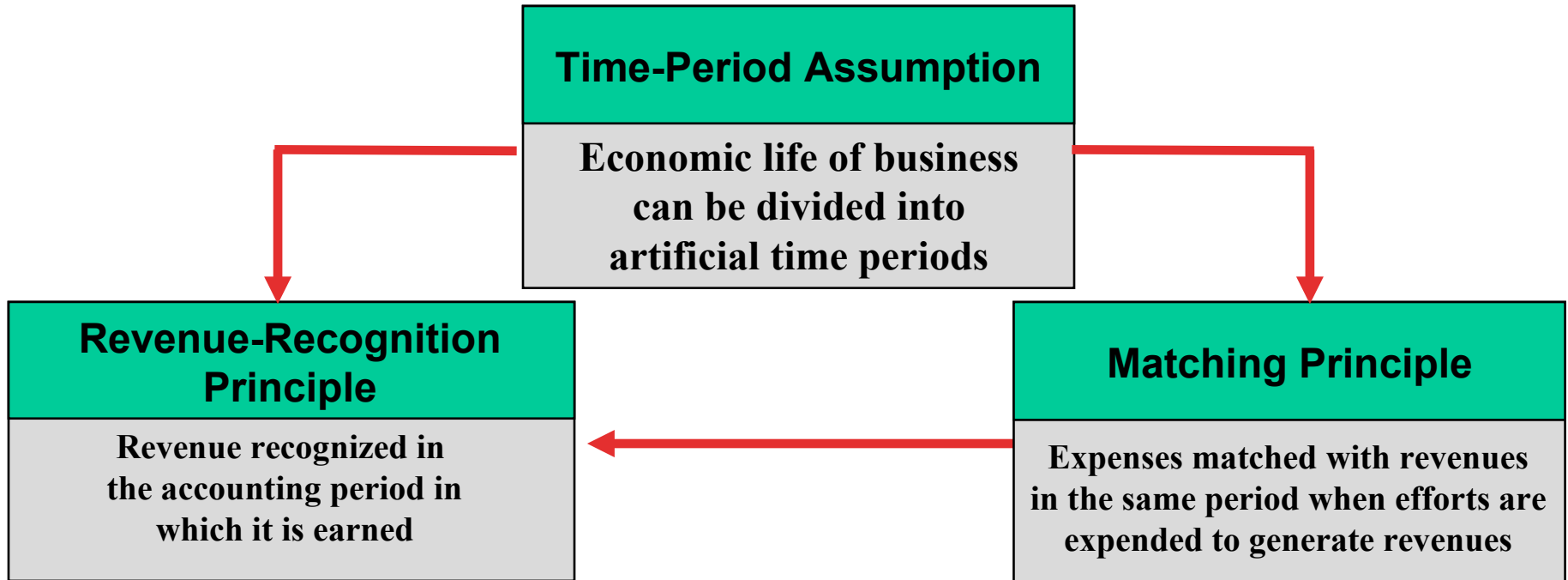
- **Revenue recognition principle**
  - Revenue must be recognized in the accounting period in which it is earned, not just when money is exchanged.
  - In a service business, revenue is earned at the time the service is performed.

# THE MATCHING PRINCIPLE

- Expense recognition is the **matching principle**.
- Efforts (expenses) must be matched with accomplishments (revenues).



# GAAP RELATIONSHIPS IN REVENUE AND EXPENSE RECOGNITION

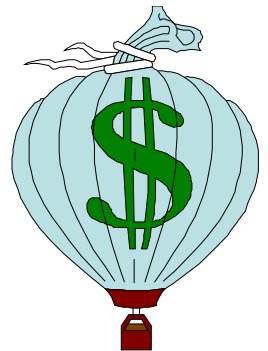


# ADJUSTING ENTRIES

## STUDY OBJECTIVE 3

**Adjusting entries** are made in order for:

- revenues to be recorded in the period in which they are *earned*
- expenses to be recognized in the period in which they are *incurred*





# ADJUSTING ENTRIES

## STUDY OBJECTIVE 4

### Adjusting entries

- required each time financial statements are prepared
- Adjusting entries are classified as
  - Prepayments (*prepaid expenses* and *unearned revenues*) OR
  - Accruals (*accrued revenues* and *accrued expenses*)

# TYPES OF ADJUSTING ENTRIES

## Prepayments

- **Prepaid Expenses**

Expenses paid in cash - recorded as assets before used or consumed

- **Unearned Revenues**

Cash received - recorded as liabilities before the revenue is earned

# TYPES OF ADJUSTING ENTRIES

## Accruals

- **Accrued Revenues**

revenues earned but not yet received in cash or recorded

- **Accrued Expenses**

expenses incurred but not yet paid in cash or recorded

# TRIAL BALANCE

## PIONEER ADVERTISING AGENCY

### Trial Balance

October 31, 2005

	Debit	Credit
Cash	\$ 15,200	
Advertising Supplies	2,500	
Prepaid Insurance	600	
Office Equipment	5,000	
Notes Payable		\$ 5,000
Accounts Payable		2,500
Unearned Revenue		1,200
C. R. Byrd, Capital		10,000
C. R. Byrd, Drawing	500	
Service Revenue		10,000
Salaries Expense	4,000	
Rent Expense	900	
	<u>\$ 28,700</u>	<u>\$ 28,700</u>

**The Trial Balance  
is the starting place  
for adjusting  
entries.**

# PREPAYMENTS

## STUDY OBJECTIVE 5

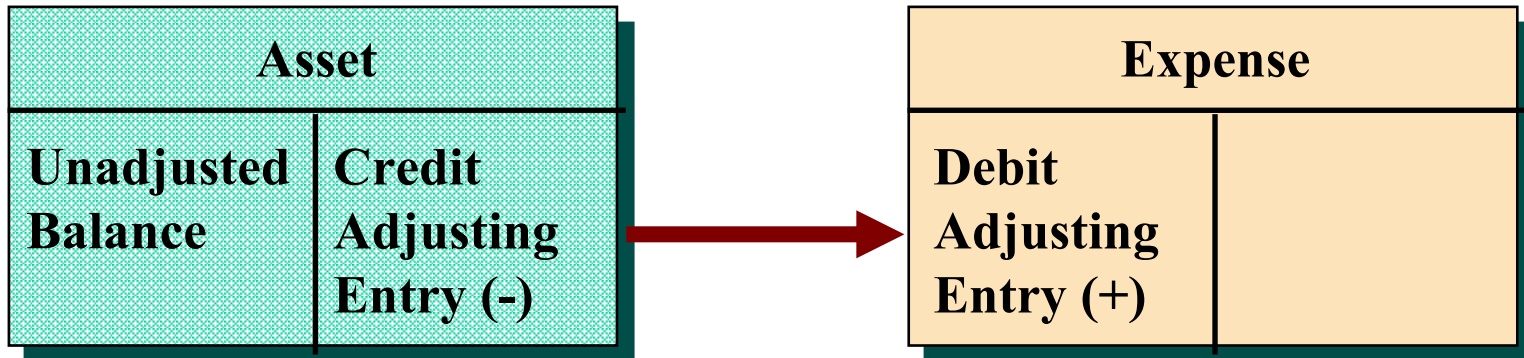
### Prepayments

- The first category of adjusting entry is prepayments.
- Required to record revenues earned and expenses incurred
  - Also ensures that assets and liabilities are not overstated
- The adjusting entry for prepayments:
  - Increases an income statement account
  - Decreases a balance sheet account

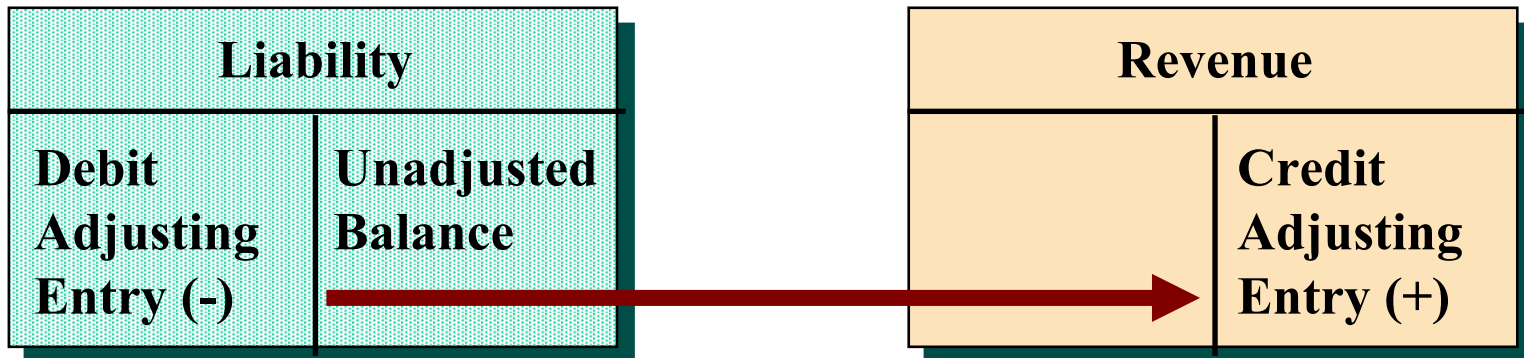
# ADJUSTING ENTRIES FOR PREPAYMENTS

## Adjusting Entries

### Prepaid Expenses



### Unearned Revenues



# PREPAID EXPENSES

- **Prepaid expenses**
  - expenses paid in cash and recorded as assets before they are used or consumed
  - Prepaid expenses expire with the passage of time or through use and consumption
- **An asset-expense account relationship** exists with prepaid expenses

# PREPAID EXPENSES

- **Prior to adjustment**
  - assets are **overstated** and expenses are **understated**
- **Adjusting entry**
  - debit expense account
  - credit asset account
- **Examples**
  - prepaid expenses include supplies, insurance depreciation



# ADJUSTING ENTRIES FOR PREPAYMENTS SUPPLIES

## ADJUSTMENT

October 31, an inventory count reveals that \$1,000 of \$2,500 of supplies are still on hand.

## JOURNAL ENTRY

Date	Account Titles and Explanation	Debit	Credit
Oct. 31	Advertising Supplies Expense Advertising Supplies (To record supplies used)	1,500	1,500

## POSTING

Advertising Supplies		Advertising Supplies Expense	
Oct. 5	2,500	Oct. 31	1,500
31	1,000	Oct. 31	1,500

# ADJUSTING ENTRIES FOR PREPAYMENTS INSURANCE

## ADJUSTMENT

October 31, an analysis of the policy reveals that \$50 of insurance expires each month.

## JOURNAL ENTRY

Date	Account Titles and Explanation	Debit	Credit
Oct. 31	Insurance Expense Prepaid Insurance (To record insurance expired)	50	50

## POSTING

Prepaid Insurance		Insurance Expense	
	10		63
Oct. 4	600	Oct. 31	50
	31		50
	550		

# DEPRECIATION

## Depreciation

- **the allocation of the cost of an asset to expense over its useful life in a rational and systematic manner**
- **Equipment or a building**
  - **viewed as a long-term prepayment of services**
  - **allocated in the same manner as other prepaid expenses**

# DEPRECIATION

- **Depreciation**
  - is an estimate rather than a factual measurement of the cost that has expired
- **Recording depreciation**
  - Debit *Depreciation Expense*
  - Credit *Accumulated Depreciation (contra asset)*

Depreciation Expense	
XXX	

Accumulated Depreciation	
	XXX

# DEPRECIATION

- **Balance Sheet**
  - Accumulated Depreciation is offset against the asset account
- **Book Value**
  - difference between the cost of any depreciable asset and its related accumulated depreciation is the **book value** of the asset
  - not market value

# ADJUSTING ENTRIES FOR PREPAYMENTS

## DEPRECIATION

### ADJUSTMENT

October 31, depreciation on the office equipment is estimated to be \$480 a year, or \$40 per month.

### JOURNAL ENTRY

Date	Account Titles and Explanation	Debit	Credit
Oct. 31	Depreciation Expense Accumulated Depreciation - Office Equipment (To record monthly depreciation)	40	40

### POSTING

Accumulated Depreciation - Office Equipment		Depreciation Expense	
	Oct. 31	40	40

# UNEARNED REVENUES

- **Unearned revenues**
  - revenues received and recorded as liabilities before they are earned
- **Unearned revenues**
  - earned by rendering a service to a customer
- A *liability-revenue* account relationship exists with unearned revenues

# UNEARNED REVENUES

- **Prior to adjustment**
  - liabilities are **overstated** and revenues are **understated**
- **Adjusting entry**
  - debit to a liability account
  - credit to a revenue account
- **Examples**
  - rent, magazine subscriptions and customer deposits for future services



# ADJUSTING ENTRIES FOR PREPAYMENTS UNEARNED REVENUES

## ADJUSTMENT

October 31, analysis reveals that, of \$1,200 in fees, \$400 has been earned in October.

## JOURNAL ENTRY

Date	Account Titles and Explanation	Debit	Credit
Oct. 31	Unearned Revenue Service Revenue (To record revenue for services provided)	400	400

## POSTING

Unearned Revenue			
Oct. 31	400	Oct. 2	1,200
		31	800

Service Revenue			
		Oct. 31	10,000
		31	400

# ACCRUALS

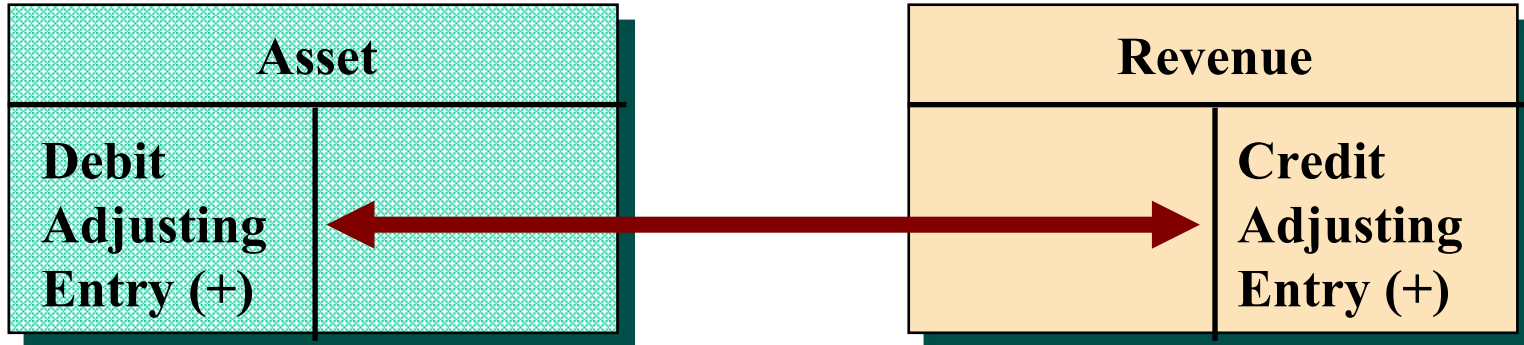
## STUDY OBJECTIVE 6

- **Second category of adjusting entries is accruals**
- **Adjusting entries**
  - required to record revenues earned and expenses incurred in the current period
- **Adjusting entry for accruals**
  - increase both a balance sheet and an income statement account

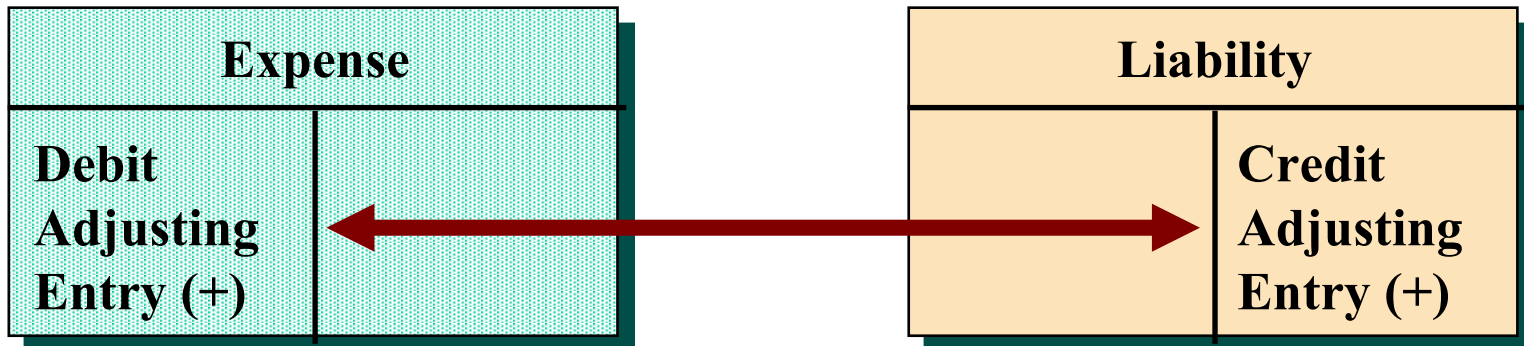
# ADJUSTING ENTRIES FOR ACCRUALS

## Adjusting Entries

### Accrued Revenues



### Accrued Expenses



# ACCRUED REVENUES

- **Accrued revenues**
  - accumulate with the passing of time or through services performed but not billed or collected
  - An asset-revenue account relationship exists
  - Prior to adjustment, assets and revenues are understated
- **Adjusting entry**
  - a debit an asset account
  - credit a revenue account

# ADJUSTING ENTRIES FOR ACCRUALS

## ACCRUED REVENUES

### ADJUSTMENT

October 31, the agency earned \$200 for advertising services that were not billed to clients before October 31.

### JOURNAL ENTRY

Date	Account Titles and Explanation	Debit	Credit
Oct. 31	Accounts Receivable Service Revenue (To accrue revenue for services provided)	200	200

### POSTING

Accounts Receivable	
Oct. 31	200

Service Revenue		
	Oct. 31	10,000
	31	400
	31	200
	31	10,600

# ACCRUED EXPENSES

- **Accrued expenses**
  - Expenses incurred but not paid yet
  - A liability-expense account relationship exists
  - Prior to adjustment, liabilities and expenses are understated
- **Adjusting Entry**
  - debit an expense account
  - credit a liability account

# ADJUSTING ENTRIES FOR ACCRUALS

## ACCRUED INTEREST

### ADJUSTMENT

October 31, the portion of the interest to be accrued on a 3-month note payable is calculated to be \$50.

### JOURNAL ENTRY

Date	Account Titles and Explanation	Debit	Credit
Oct. 31	Interest Expense Interest Payable (To accrue interest on notes payable)	50	50

### POSTING

Interest Expense	
Oct. 31	50

Interest Payable	
Oct. 31	50

# ADJUSTING ENTRIES FOR ACCRUALS

## ACCRUED SALARIES

### ADJUSTMENT

October 31, accrued salaries are calculated to be \$1,200.

### JOURNAL ENTRY

Date	Account Titles and Explanation	Debit	Credit
Oct. 31	Salaries Expense Salaries Payable (To record accrued salaries)	1,200	1,200

### POSTING

Salaries Expense	
Oct. 26	4,000
31	1,200
31	5,200

Salaries Payable	
Oct. 31	1,200



# SUMMARY OF ADJUSTING ENTRIES

<u>Type of Adjustment</u>	<u>Account Relationship</u>	<u>Accounts before Adjustment</u>	<u>Adjusting Entry</u>
---------------------------	-----------------------------	-----------------------------------	------------------------

<b>Assets and expenses</b>	<b>Assets overstated Expenses understated</b>	<b>Dr. Expenses Cr. Assets</b>	<b>1 Prepaid expenses</b>
<b>2 Unearned revenues</b>	<b>Liabilities and revenues</b>	<b>Liabilities overstated Revenues understated</b>	<b>Dr. Liabilities Cr. Revenues</b>
<b>3 Accrued revenues</b>	<b>Assets and revenues</b>	<b>Assets understated Revenues understated</b>	<b>Dr. Assets Cr. Revenues</b>
<b>4 Accrued expenses</b>	<b>Expenses and liabilities</b>	<b>Expenses understated Liabilities understated</b>	<b>Dr. Expenses Cr. Liabilities</b>

Which of the following statements concerning accrual-basis accounting is incorrect?

- a. Accrual-basis accounting follows the revenue recognition principle.
- b. Accrual-basis accounting is the method required by generally accepted accounting principles.
- c. Accrual-basis accounting recognizes expenses when they are paid.
- d. Accrual-basis accounting follows the matching principle.

Which of the following statements concerning accrual-basis accounting is incorrect?

- a. Accrual-basis accounting follows the revenue recognition principle.
- b. Accrual-basis accounting is the method required by generally accepted accounting principles.
- c. Accrual-basis accounting recognizes expenses when  
• they are paid.
- d. Accrual-basis accounting follows the matching principle.

# ADJUSTED TRIAL BALANCE

## STUDY OBJECTIVE 7

- **Adjusted Trial Balance**
  - prepared after all adjusting entries have been journalized and posted
  - purpose is to prove equality of the total debit and credit balances in the ledger after adjustments have been made
- **Financial statements**
  - prepared directly from the adjusted trial balance

# TRIAL BALANCE AND ADJUSTED TRIAL BALANCE COMPARED

<b>PIONEER ADVERTISING AGENCY</b>				
<b>Adjusted Trial Balance</b>				
<b>October 31, 2005</b>				
	Before Adjustment		After Adjustment	
	Debit	Credit	Debit	Credit
Cash	\$ 15,200		\$ 15,200	
Accounts Receivable			200	
Advertising Supplies	2,500		1,000	
Prepaid Insurance	600		550	
Office Equipment	5,000		5,000	
Accumulated Depreciation - Office Equipment				\$ 40
Notes Payable		\$ 5,000		5,000
Accounts Payable		2,500		2,500
Interest Payable				50
Unearned Revenue		1,200		800
Salaries Payable				1,200
C. R. Byrd, Capital		10,000		10,000
C. R. Byrd, Drawing	500		500	
Service Revenue		10,000		10,600
Salaries Expense	4,000		5,200	
Advertising Supplies Expense			1,500	
Rent Expense	900		900	
Insurance Expense			50	
Interest Expense			50	
Depreciation Expense			40	
	<u>\$ 28,700</u>	<u>\$ 28,700</u>	<u>\$ 30,190</u>	<u>\$ 30,190</u>

# PREPARING FINANCIAL STATEMENTS

**Financial statements** are prepared directly from the **adjusted trial balance**

- **Income statement**
  - use the revenue and expense accounts
- **Owner's Equity Statement**
  - use the owner's capital and drawing accounts and the net income (or net loss) from the Income Statement
- **Balance sheet**
  - use asset and liability accounts and ending owner's capital balance reported in Owner's Equity Statement

# PREPARATION OF THE INCOME STATEMENT AND THE OWNER'S EQUITY STATEMENT FROM THE ADJUSTED TRIAL BALANCE

PIONEER ADVERTISING AGENCY		
Adjusted Trial Balance		
October 31, 2005		
	Debit	Credit
Cash	\$ 15,200	
Accounts Receivable	200	
Advertising Supplies	1,000	
Prepaid Insurance	550	
Office Equipment	5,000	
Accumulated Depreciation - Office Equipment		\$ 40
Notes Payable		5,000
Accounts Payable		2,500
Interest Payable		50
Unearned Revenue		800
Salaries Payable		1,200
C. R. Byrd, Capital		10,000
C. R. Byrd, Drawing	500	
Service Revenue		10,600
Salaries Expense	5,200	
Advertising Supplies Expense	1,500	
Rent Expense	900	
Insurance Expense	50	
Interest Expense	50	
Depreciation Expense	40	
	\$ 30,190	\$ 30,190

# PREPARATION OF THE INCOME STATEMENT AND THE OWNER'S EQUITY STATEMENT FROM THE ADJUSTED TRIAL BALANCE

## PIONEER ADVERTISING AGENCY Income Statement For the Month Ended October 31, 2005

<b>Revenues</b>	
Fees earned	<b>\$ 10,600</b>
<b>Expenses</b>	
Salaries expense	<b>\$ 5,200</b>
Advertising supplies expense	<b>1,500</b>
Rent expense	<b>900</b>
Insurance expense	<b>50</b>
Interest expense	<b>50</b>
Depreciation expense	<b>40</b>
Total expenses	<b>7,740</b>
Net income	<b>\$ 2,860</b>

The income statement is prepared from the **revenue and expense accounts**.



# PREPARATION OF THE INCOME STATEMENT AND THE OWNER'S EQUITY STATEMENT FROM THE ADJUSTED TRIAL BALANCE

<b>PIONEER ADVERTISING AGENCY</b> <b>Adjusted Trial Balance</b> <b>October 31, 2005</b>		
	Debit	Credit
Cash	\$ 15,200	
Accounts Receivable	200	
Advertising Supplies	1,000	
Prepaid Insurance	550	
Office Equipment	5,000	
Accumulated Depreciation – Office Equipment		\$ 40
Notes Payable		5,000
Accounts Payable		2,500
Interest Payable		50
Unearned Revenue		800
Salaries Payable		1,200
C. R. Byrd, Capital		10,000
C. R. Byrd, Drawing	500	
Service Revenue		10,600
Salaries Expense	5,200	
Advertising Supplies Expense	1,500	
Rent Expense	900	
Insurance Expense	50	
Interest Expense	50	
Depreciation Expense	40	
	\$ 30,190	\$ 30,190

**PREPARATION OF THE INCOME STATEMENT AND THE  
OWNER'S EQUITY STATEMENT FROM THE ADJUSTED TRIAL  
BALANCE**

**PIONEER ADVERTISING AGENCY  
Owner's Equity Statement  
For the Month Ended October 31, 2005**

C.R. Byrd, Capital, October 1		\$	-0-
Add: Investments	<b>\$ 10,000</b>		
Net income	<u>2,860</u>		<u>12,860</u>
			12,860
Less: Drawings			<u>500</u>
C.R. Byrd, Capital, October 31			<u><u>\$ 12,360</u></u>

The owner's equity statement is prepared from the **owner's capital and drawing accounts** and the **net income** (or **net loss**) shown in the income statement.

# PREPARATION OF THE BALANCE SHEET FROM THE ADJUSTED TRIAL BALANCE

<b>PIONEER ADVERTISING AGENCY</b> <b>Adjusted Trial Balance</b> <b>October 31, 2005</b>		
	Debit	Credit
Cash	\$ 15,200	
Accounts Receivable	200	
Advertising Supplies	1,000	
Prepaid Insurance	550	
Office Equipment	5,000	
Accumulated Depreciation – Office Equipment		\$ 40
Notes Payable		5,000
Accounts Payable		2,500
Interest Payable		50
Unearned Revenue		800
Salaries Payable		1,200
C. R. Byrd, Capital		10,000
C. R. Byrd, Drawing	500	
Service Revenue		10,600
Salaries Expense	5,200	
Advertising Supplies Expense	1,500	
Rent Expense	900	
Insurance Expense	50	
Interest Expense	50	
Depreciation Expense	40	
	\$ 30,190	\$ 30,190

# PREPARATION OF THE BALANCE SHEET FROM THE ADJUSTED TRIAL BALANCE

PIONEER ADVERTISING AGENCY				
Balance Sheet				
October 31,				
2005				
<u>Assets</u>		<u>Liabilities and Owner's Equity</u>		
Cash		\$ 15,200	Liabilities	
Accounts receivable		200	Notes payable	\$ 5,000
Advertising supplies		1,000	Accounts payable	2,500
Prepaid insurance		550	Interest payable	50
Office equipment	\$ 5,000		Unearned fees	800
Less: Accumulated depreciation	40	<u>4,960</u>	Salaries payable	<u>1,200</u>
			Total liabilities	9,550
			Owner's equity	
			C.R. Byrd, Capital	<u>12,360</u>
			Total liabilities and owner's equity	<u>\$ 21,910</u>
Total assets		<u>\$ 21,910</u>		

The balance sheet is then prepared from the **asset** and **liability** accounts and the **ending owner's capital balance** as reported in the owner's equity statement.

# **ALTERNATIVE TREATMENT OF PREPAID EXPENSES AND UNEARNED REVENUES**

- **Alternative treatment uses Income Statement Accounts Initially**
  - **Debit the expense for prepaid expenses when cash is paid**
  - **Credit the revenue at the time cash is received**
- **After adjustments, alternative treatment of prepaid expenses and unearned revenues will result in the same effect to financial statements as the initial entries to the balance sheet accounts and then adjusting entries**

# ALTERNATIVE ADJUSTMENTS FOR PREPAYMENTS SUPPLIES

## ADJUSTMENT

October 31, an inventory count reveals that \$1,000 of \$2,500 of supplies are still on hand.

## JOURNAL ENTRY

Date	Account Titles and Explanation	Debit	Credit
Oct. 31	Advertising Supplies	1,000	
	Advertising Supplies Expense (To record supplies inventory)		1,000

## POSTING

Advertising Supplies	
Oct. 31	1,000

Advertising Supplies Expense			
Oct. 5	2,500	Oct. 31	1,000
31	1,500		

# ALTERNATIVE ADJUSTMENTS FOR PREPAYMENTS UNEARNED REVENUES

## ADJUSTMENT

October 31, analysis reveals that, of \$1,200 in fees, \$400 has been earned in October.

## JOURNAL ENTRY

Date	Account Titles and Explanation	Debit	Credit
Oct. 31	Service Revenue Unearned Revenue (To record unearned revenue)	800	800

## POSTING

Unearned Revenue		Service Revenue	
	Oct. 31	800	
			Oct. 2 1,200
			31 400

# SUMMARY OF BASIC RELATIONSHIPS FOR PREPAYMENTS

<u>Type of Adjustment</u>	<u>Account Relationship</u>	<u>Reason for Adjustment</u>	<u>Account Balances before Adjustment</u>	<u>Adjusting Entry</u>
---------------------------	-----------------------------	------------------------------	---	------------------------

**1 Prepaid Expenses**    **Assets and Expenses**    **a Prepaid expenses initially recorded in Expenses**    **Assets overstated**    **Dr Expenses**  
**Expenses**    **Expenses**    **initially recorded in Expenses**    **Cr Assets**    **asset accounts have been used.**

**b Prepaid expenses overstated**    **Assets understated**    **Dr Assets**    **initially recorded in Expenses**  
**Cr Expenses**    **expense accounts**    **have not been used.**

**2 Unearned Revenues**    **Liabilities and Revenues**    **a Unearned revenues initially recorded in Revenues**    **Liabilities overstated**    **Dr Liabilities**  
**Revenues**    **Revenues**    **initially recorded in Revenues**    **Cr Revenues**    **liability accounts have been earned.**

**b Unearned revenues**    **Liabilities understated**    **Dr Revenues**    **initially recorded in Revenues**  
**Cr Liabilities**    **revenue accounts**    **have not been earned.**



# Which of the statements below is not true?

- 1. An adjusted trial balance should show ledger account balances.
- 2. An adjusted trial balance can be used to prepare financial statements.
- 3. An adjusted trial balance proves the mathematical equality of debits and credits in the ledger
- 4. An adjusted trial balance is prepared before all transactions have been posted from the journal.

# Which of the statements below is not true?

- 1. An adjusted trial balance should show ledger account balances.
- 2. An adjusted trial balance can be used to prepare financial statements.
- 3. An adjusted trial balance proves the mathematical equality of debits and credits in the ledger
- 4. An adjusted trial balance is prepared before all transactions have been posted from the journal.

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## **Chapter 4**

# **Completion of the Accounting Cycle**

Prepared by Naomi Karolinski

Monroe Community College

and

Marianne Bradford

Bryant College

After studying this chapter, you should be able to:

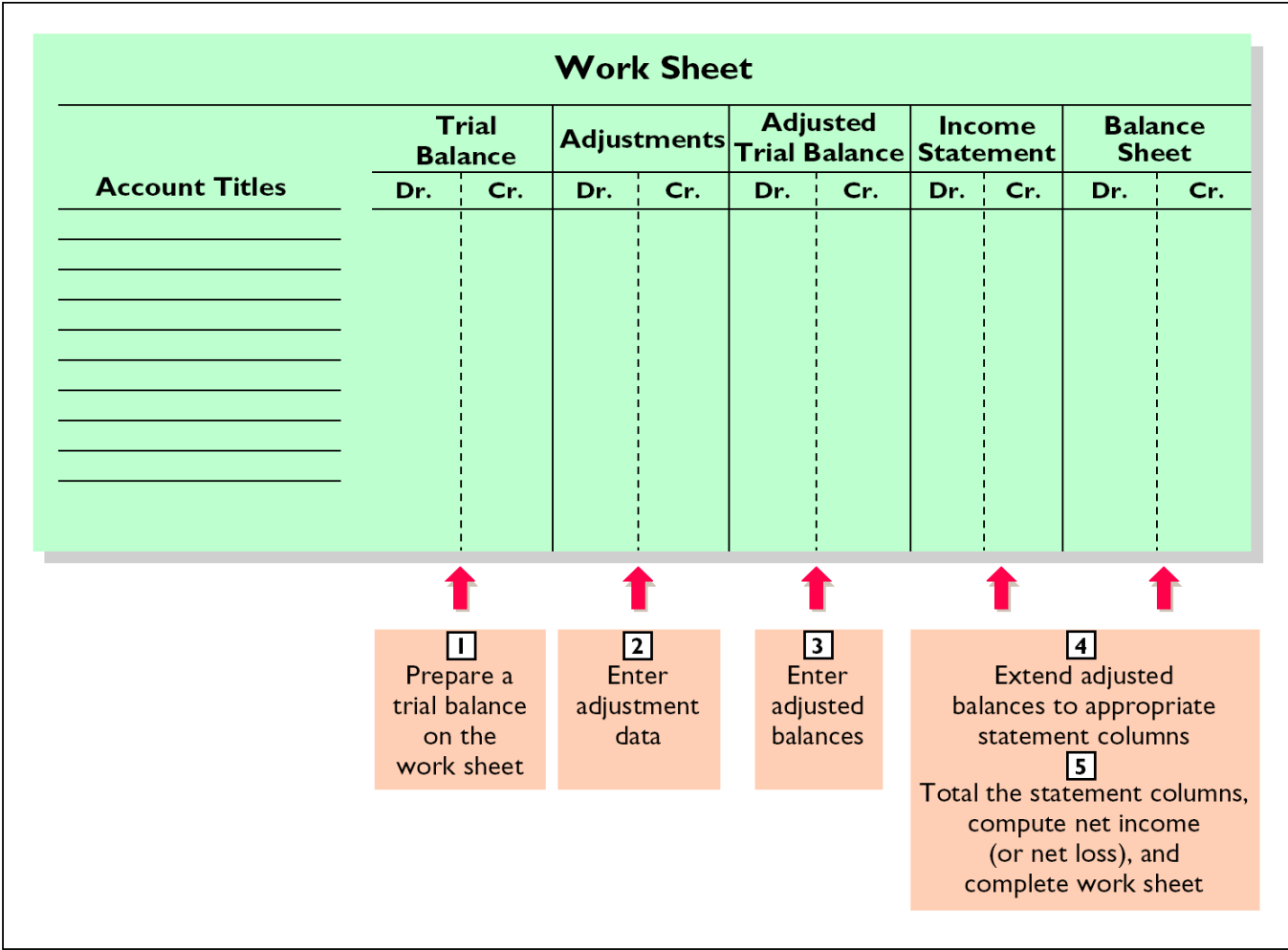
- 1** prepare a work sheet
- 2** explain the process of closing the books
- 3** describe the content and purpose of a post-closing trial balance
- 4** state the required steps in the accounting cycle
- 5** explain the approaches to preparing correcting entries
- 6** identify the sections of a classified balance sheet

# WORK SHEET

## STUDY OBJECTIVE 1

- **Work Sheet**
  - multiple-column form used for the adjustment process and preparing financial statements
  - a **working tool** for the accountant
  - not a permanent accounting record
- **Work Sheet**
  - makes preparation of adjusting entries and financial statements easier

# FORM AND PROCEDURE FOR A WORK SHEET



# **WORK SHEET**

- **Work sheet**
  - **is not a permanent accounting record**
- **When used**
  - **financial statements are prepared from the work sheet**
  - **adjustments are journalized and posted from the work sheet after financial statements**

# **STEPS IN PREPARING A WORK SHEET**

- 1 prepare trial balance**
- 2 enter adjustments in the adjustments columns**
- 3 enter adjusted balances in adjusted trial balance columns**
- 4 extend adjusted trial balance amounts to appropriate financial statement columns**
- 5 total the statement columns, compute net income (loss), and complete the work sheet**



# PREPARING A WORK SHEET

## 1 PREPARING A TRIAL BALANCE

PIONEER ADVERTISING AGENCY						
Work Sheet						
For the Month Ended October 31, 2005						
Account Titles	Trial Balance		Adjustments		Adjusted Trial Balance	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	15,200					
Advertising Supplies		600				
Prepaid Insurance		5,000				
Office Equipment	5,000					
Notes Payable						
Accounts Payable	2,500					
Unearned Revenue		1,200				
C.R. Byrd, Capital						
C.R. Byrd, Drawing		10,000				
Service Revenue		500				
Salaries Expense	10,000					
Rent Expense	4,000					
Totals	36,700	36,700				

# PREPARING A WORK SHEET

## 2 ENTER THE ADJUSTMENTS

PIONEER ADVERTISING AGENCY						
Work Sheet						
For the Month Ended October 31, 2005						
Account Titles	Trial Balance		Adjustments		Adjusted Trial Balance	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	15,200					
Advertising Supplies	2,500		a 1,500			
Prepaid Insurance	600		b 50			
Office Equipment	5,000					
Notes Payable		5,000				
Accounts Payable		2,500				
Unearned Revenue		1,200				
C.R. Byrd, Capital		10,000				
C.R. Byrd, Drawing	500		d 400			
Service Revenue		10,000	d 400			g
			e 200			
Salaries Expense	4,000		1,200			
Rent Expense	900					
<b>Totals</b>	<b>28,700</b>	<b>28,700</b>				
Advertising Supplies Expense						a 1,500
Insurance Expense						b 50
Accum. Depr —Off Equip						
Depreciation Expense			c 40			c
Accounts Receivable			40			e
Interest Expense			200			
Interest Payable			50			f
Salaries Payable			f 50			
<b>Totals</b>			<b>3,440</b>	<b>g 1,200 3,440</b>		

# PREPARING A WORK SHEET

## 3 ENTER ADJUSTED BALANCES

PIONEER ADVERTISING AGENCY						
Work Sheet						
For the Month Ended October 31, 2005						
Account Titles	Trial Balance		Adjustments		Adjusted Trial Balance	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	15,200				15,200	
Advertising Supplies	2,500			a 1,500	1,000	
Prepaid Insurance	600			b 50	550	
Office Equipment	5,000				5,000	
Notes Payable		5,000				5,000
Accounts Payable		2,500				2,500
Unearned Revenue		1,200	d 400			800
C.R. Byrd, Capital		10,000				10,000
C.R. Byrd, Drawing	500				500	
Service Revenue		10,000		d 400 e 200		10,600
Salaries Expense	4,000		g 1,200		5,200	
Rent Expense	900				900	
Totals	28,700	28,700				
Advertising Supplies Expense			a 1,500		1,500	
Insurance Expense			b 50		50	
Accum. Depr —Off Equip				c 40		40
Depreciation Expense			c 40		40	
Interest Expense			f 50		50	
Accounts Receivable			e 200		200	
Interest Payable				f 50		50
Salaries Payable				g 1,200		1,200
Totals			3,440	3,440	30,190	30,190

# PREPARING A WORK SHEET

## 4 EXTEND ADJUSTED BALANCES

PIONEER ADVERTISING AGENCY						
Work Sheet						
For the Month Ended October 31, 200 5						
Account Titles	Adjusted Trial Balance		Income Statement		Balance Sheet	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	15,200					
Advertising Supplies	1,000					
Prepaid Insurance	550					
Office Equipment	5,000					
Notes Payable		5,000				
Accounts Payable		2,500	10,600			
Unearned Revenue		800				
C.R. Byrd, Capital		10,000	5,200			
C.R. Byrd, Drawing	500					
Service Revenue		10,600	900			
Salaries Expense	5,200					
Rent Expense	900				1,500	
Advertising Supplies Expense	1,500				50	
Insurance Expense	50					
Accum. Depr. — Office Equip.		40				
Depreciation Expense	40					
Interest Expense	50					
Accounts Receivable	200		40			
Interest Payable		50			50	
Salaries Payable		1,200				
Totals	30,190	30,190	7,740	10,600		
Net Income			2,860			
Totals			10,600	10,600		

# PREPARING A WORK SHEET

## 4 EXTEND ADJUSTED BALANCES

PIONEER ADVERTISING AGENCY						
Work Sheet						
For the Month Ended October 31, 2005						
Account Titles	Adjusted Trial Balance		Income Statement		Balance Sheet	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	15,200				15,200	
Advertising Supplies	1,000					1,000
Prepaid Insurance	550				550	
Office Equipment	5,000					
Notes Payable		5,000				5,000
Accounts Payable		2,500				
Unearned Revenue		800				800
C.R. Byrd, Capital		10,000				
C.R. Byrd, Drawing	500				500	
Service Revenue		10,600		10,600		10,600
Salaries Expense	5,200		5,200			
Rent Expense	900		900		900	
Advertising Supplies Expense	1,500		1,500			1,500
Insurance Expense	50		50			50
Accum. Depr. — Office Equip.		40				
Depreciation Expense	40		40		40	
Interest Expense	50		50		50	
Accounts Receivable	200				200	
Interest Payable		50				50
Salaries Payable		1,200				1,200
Totals	30,190	30,190	7,740	10,600	22,450	19,590
Net Income			2,860			2,860
Totals			10,600	10,600	22,450	22,450

# ADJUSTING ENTRIES JOURNALIZED

GENERAL JOURNAL				
Date	Account Titles and Explanation	Ref.	Debit	Credit
2005 Oct. 31	<sup>a</sup> Advertising Supplies Expense Advertising Supplies		1,500	
31	<sup>b</sup> 1,500 Insurance Expense			50
31	<sup>c</sup> Prepaid Insurance 50			
31	<sup>d</sup> Depreciation Expense Accumulated Expense			40
31	<sup>e</sup> 40 Unearned Fees			400
31	<sup>f</sup> Fees Earned 400			
31	<sup>g</sup> Accounts Receivable Fees Earned			200
	200			

# PREPARATION OF FINANCIAL STATEMENTS

## INCOME STATEMENT

<b>PIONEER ADVERTISING AGENCY</b> <b>Income Statement</b> <b>For the Month Ended October 31, 2005</b>		
<b>Revenues</b>		
Service revenue		\$10,600
<b>Expenses</b>		<b>\$5,200</b>
Salaries expense		1,500
Advertising supplies expense	<b>The income statement is prepared from the income statement columns of the work sheet.</b>	900
Rent expense		50
Insurance expense		50
Interest expense		40
Depreciation expense		<u>40</u>
<b>Total expenses</b>		
<b>Net income</b>		<b><u><u>\$ 2,860</u></u></b>

# PREPARATION OF FINANCIAL STATEMENTS

## OWNER'S EQUITY STATEMENT

<b>PIONEER ADVERTISING AGENCY</b> <b>Owner's Equity Statement</b> <b>For the Month Ended October 31, 2005</b>			
C.R. Byrd, Capital, October 1		\$	-0-
Add: Investments		\$10,000	
Net income		2,860	12,860
Less: Drawings		<u>          </u>	<u>12,860</u>
C.R. Byrd, Capital, October 31			<u>500</u>
			<u><b>\$12,360</b></u>

The owner's equity statement is prepared from the balance sheet columns of the work sheet.



# PREPARATION OF FINANCIAL STATEMENTS

## BALANCE SHEET

PIONEER ADVERTISING AGENCY			
Balance Sheet			
October 31, 2005			
<u>Assets</u>		<u>Liabilities and Owner's Equity</u>	
Cash	\$ 15,200	<b>Liabilities</b>	
Accounts receivable	200	Notes payable	\$ 5,000
Advertising supplies	1,000	Accounts payable	2,500
Prepaid insurance	550	Interest payable	50
Office equipment	\$5,000	Unearned revenue	800
Less: Accumulated depreciation	40	Salaries payable	1,200
	4,960	<b>Total liabilities</b>	9,550
		<b>Owner's equity</b>	12,360
		C.R. Byrd, Capital	12,360
		<b>Total liabilities and owner's equity</b>	\$21,910
<b>Total assets</b>	\$21,910		

The balance sheet is prepared from the balance sheet columns of the work sheet.

A work sheet can be thought of  
as a(n)

- permanent accounting record
- optional device used by accountants
- part of the general ledger
- part of the journal

A work sheet can be thought of as a(n)

- permanent accounting record
- optional device used by accountants
- part of the general ledger
- part of the journal

# TEMPORARY VERSUS PERMANENT ACCOUNTS

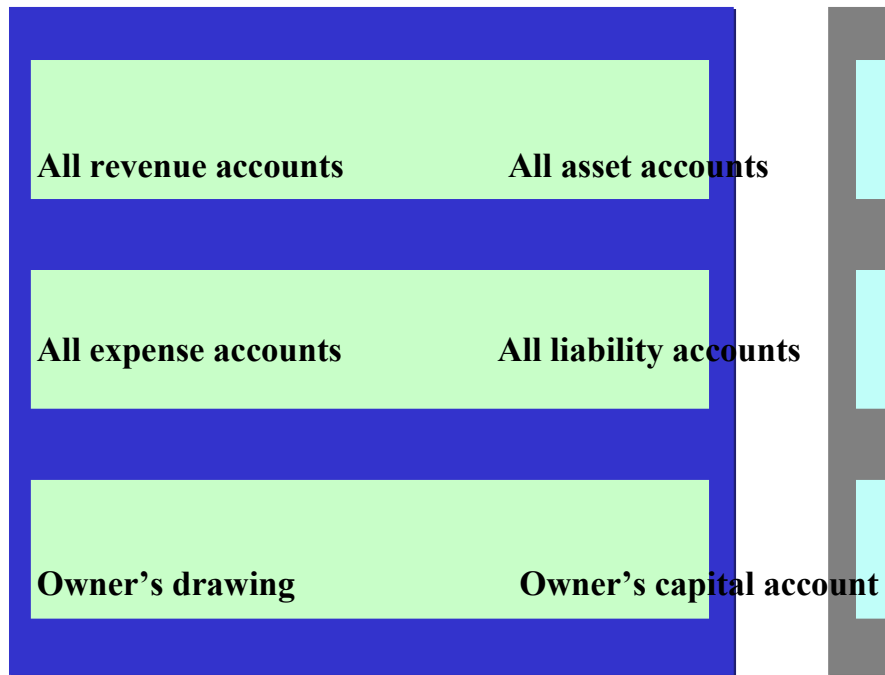
## STUDY OBJECTIVE 2

**TEMPORARY (NOMINAL)**

**PERMANENT (REAL)**

**These accounts are closed**

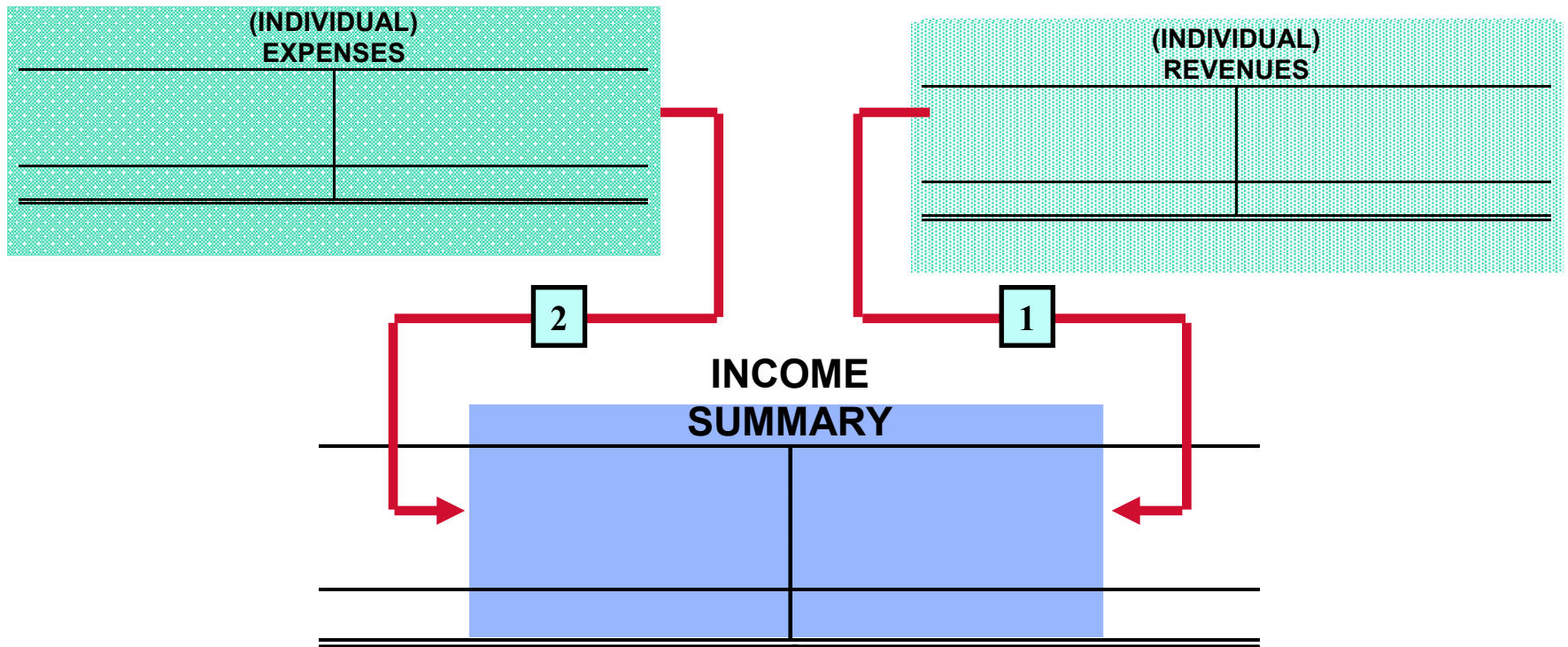
**These accounts are not closed**



# CLOSING ENTRIES

- **Closing entries**
  - Formally transfers net income (loss) and owner's drawings to owner's capital
  - Journalizing and posting is a required step in the **accounting cycle**
- **Income Summary**
  - A temporary account
  - Used in closing revenue and expense accounts
  - Minimizes the details in the permanent owner's capital account

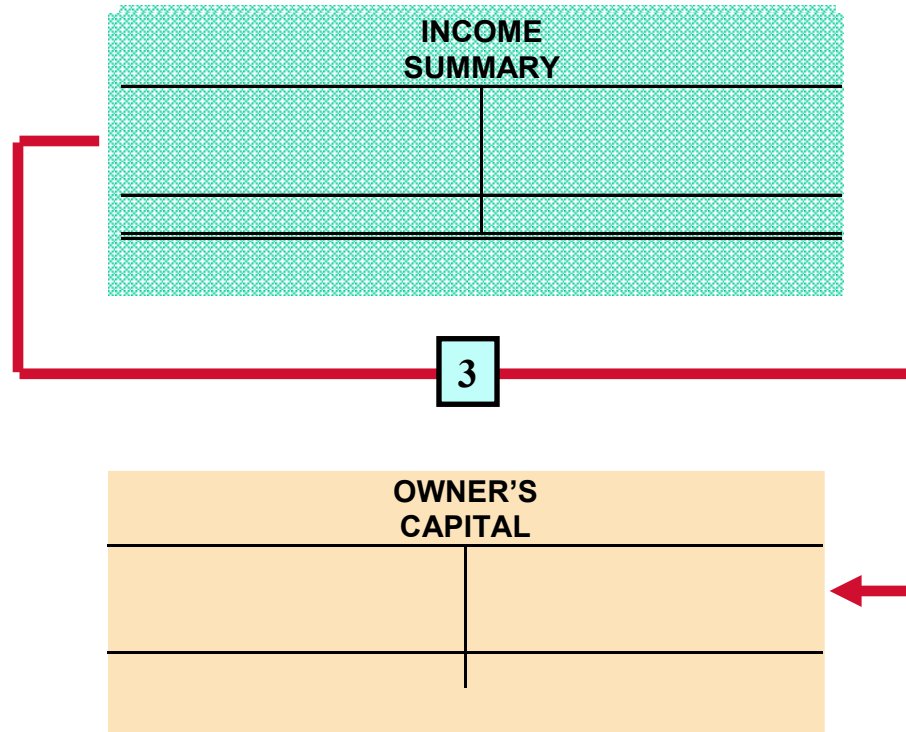
# DIAGRAM OF CLOSING PROCESS PROPRIETORSHIP



**1** Debit each revenue account for its balance, and credit Income Summary for total revenues.

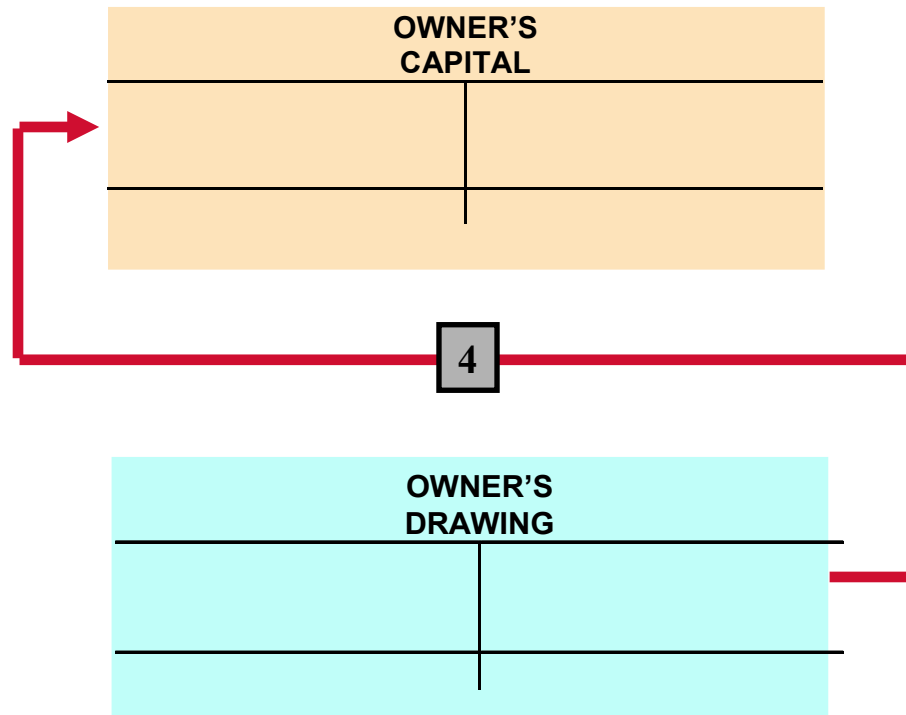
**2** Debit Income Summary for total expenses, and credit each expense account for its balance.

# DIAGRAM OF CLOSING PROCESS



**3 Debit (credit) Income Summary and credit (debit) owner's capital for the amount of net income (loss).**

# DIAGRAM OF CLOSING PROCESS



**4 Debit owner's capital for the balance in the owner's drawing account and credit owner's drawing for the same amount.**



# CLOSING ENTRIES JOURNALIZED

<b>GENERAL JOURNAL</b>				
Date	Account Titles and Explanation	Ref.	Debit	Credit
Oct. 1	<b>Service Revenue</b> <b>Income Summary</b> (To close revenue account)	<b>400</b> <b>350</b>	10,600	10,600

<b>INCOME SUMMARY</b>				No. 400
Date	Explanation	Debit	Credit	Balance
Oct. 31			10,600	10,600

<b>SERVICE REVENUE</b>				No. 350
Date	Explanation	Debit	Credit	Balance
Oct. 31		10,600		10,600 -0-

# CLOSING ENTRIES JOURNALIZED

<b>GENERAL JOURNAL</b>				
Date	Account Titles and Explanation	Ref.	Debit	Credit
<b>2005</b> <b>Oct. 31</b>	<b>Income Summary</b>	<b>350</b>	7,740	
	<b>Salaries Expense</b>	<b>726</b>		5,200
	<b>Advertising Supplies Expense</b>	<b>631</b>		1,500
	<b>Rent Expense</b>	<b>729</b>		900
	<b>Insurance Expense</b>	<b>722</b>		50
	<b>Interest Expense</b>	<b>905</b>		50
	<b>Depreciation Expense</b>	<b>911</b>		40
	<b>(To close expense</b> <b>accounts)</b>			

<b>INCOME SUMMARY</b>				<b>No. 350</b>
Date	Explanation	Debit	Credit	Balance
Oct. 31			10,600	10,600
31		7,740		2,860

# CLOSING ENTRIES JOURNALIZED

<b>GENERAL JOURNAL</b>				
Date	Account Titles and Explanation	Ref.	Debit	Credit
2005 Oct. 31	(3) Income Summary C. R. Byrd, Capital (To close net income to capital)	350 301	2,860	2,860

<b>INCOME SUMMARY</b>				<b>No. 350</b>
Date	Explanation	Debit	Credit	Balance
2005				
Oct. 31			10,600	10,600
31		7,740	2,860	2,860
				-0-

<b>C. R. BYRD, CAPITAL</b>				<b>No. 301</b>
Date	Explanation	Debit	Credit	Balance
Oct. 31			10,000	10,000
31			2,860	12,860

# CLOSING ENTRIES JOURNALIZED

<b>GENERAL JOURNAL</b>				
Date	Account Titles and Explanation	Ref.	Debit	Credit
2005 Oct. 31	<b>(4)</b> <b>C. R. Byrd, Capital</b> <b>C. R. Byrd, Drawing</b> <b>(To close net income to capital)</b>	 <b>350</b> <b>301</b>	 <b>500</b>	  <b>500</b>

C. R. BYRD, DRAWING				No. 350
Date	Explanation	Debit	Credit	Balance
2005 Oct. 31		500		500
31			500	-0-

C. R. BYRD, CAPITAL				No. 301
Date	Explanation	Debit	Credit	Balance
Oct. 31			10,000	10,000
31				12,860
31		500		12,360

## **CAUTIONS RELATING TO CLOSING ENTRIES**

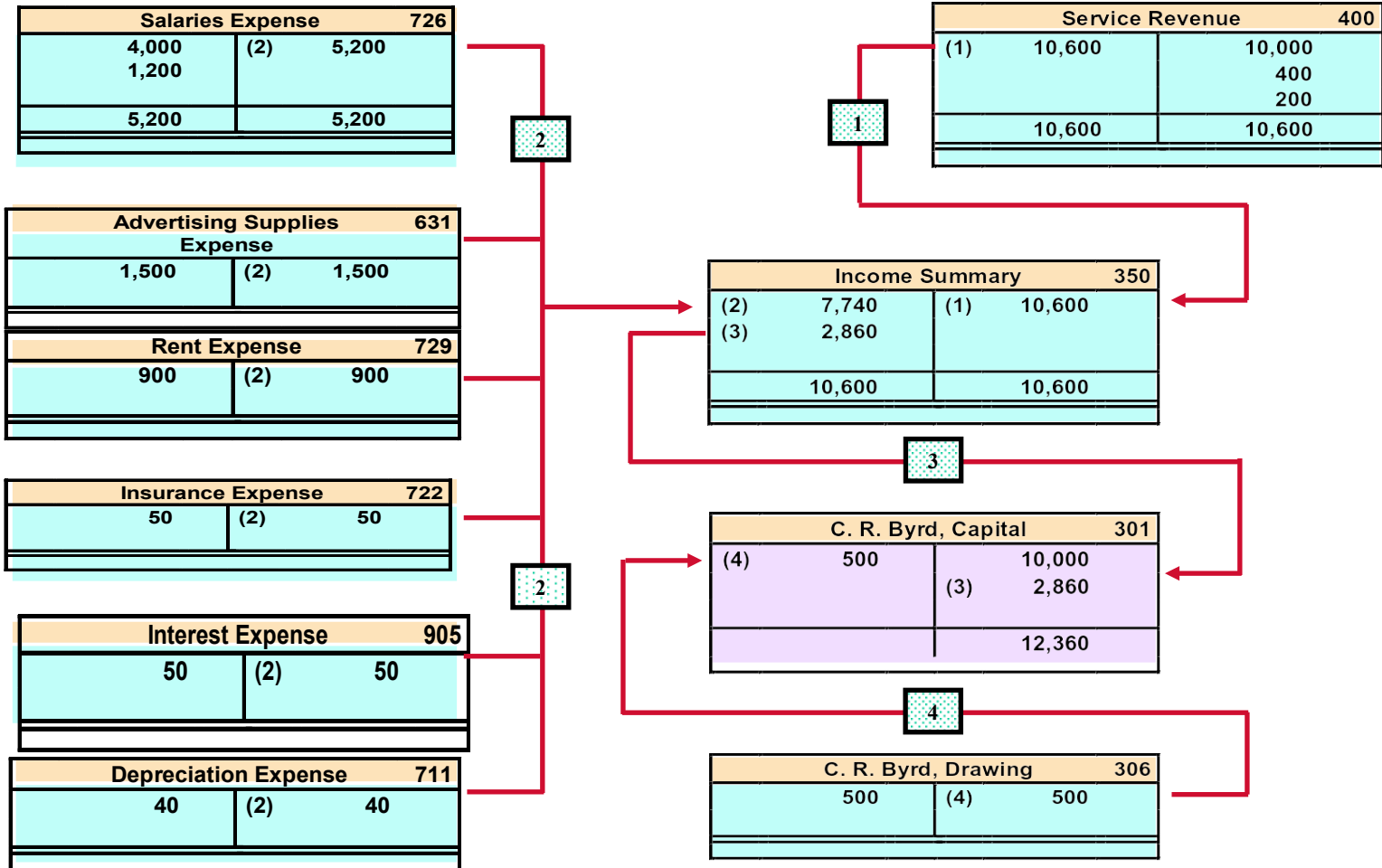
### **Caution:**

- **Avoid doubling revenue and expense balances**
- **Owner's Drawing does not move to the Income Summary account. Owner's drawing is not an expense and it is not a factor in determining net income.**

## **POSTING CLOSING ENTRIES**

- **Temporary accounts**
  - All temporary accounts will have zero balances after posting the closing entries
  - Temporary accounts (revenues and expenses) are totaled, balanced and double ruled
- **Owner's capital**
  - Total equity of the owner at the end of the accounting period
  - No entries are journalized and posted to owner's capital during the year
- **Permanent accounts (assets, liabilities, and owner's capital) not closed**

# POSTING OF CLOSING ENTRIES



# POST-CLOSING TRIAL BALANCE

## STUDY OBJECTIVE 3

After all closing entries have been journalized the **post-closing trial balance** is prepared from the ledger.

**The purpose of this trial balance** is to prove the equality of the permanent account balances that are carried forward into the next accounting period.



# POST-CLOSING TRIAL BALANCE

## PIONEER ADVERTISING AGENCY

Post-Closing Trial Balance

October 31, 2005

	<u>Debit</u>	<u>Credit</u>
Cash	\$15,200	
Accounts Receivable	200	
Advertising Supplies	1,000	
Prepaid Insurance	550	
Office Equipment	5,000	
Accumulated Depreciation—Office Equipment		\$ 40
Notes Payable		5,000
Accounts Payable		2,500
Unearned Revenue		800
Salaries Payable		1,200
Interest Payable		50
C. R. Byrd, Capital		12,360
	<u>\$21,950</u>	<u>\$21,950</u>

# STEPS IN THE ACCOUNTING CYCLE

## STUDY OBJECTIVE 4

- 1 Analyze business transactions**
- 2 Journalize the transactions**
- 3 Post to ledger accounts**
- 4 Prepare a trial balance**
- 5 Journalize and post adjusting entries**

# **STEPS IN THE ACCOUNTING CYCLE**

- 6 Prepare an adjusted trial balance**
- 7 Prepare financial statements:  
Income Statement, Owner's  
Equity Statement, Balance Sheet**
- 8 Journalize and post closing entries**
- 9 Prepare a post-closing trial balance**

# REVERSING ENTRIES

- **Reversing entry**
  - Made at the beginning of the next accounting period
  - Purpose is to simplify the recording of a subsequent transaction related to an adjusting entry
  - Most often used to reverse two types of adjusting entries: **accrued revenues** and **accrued expenses**

# ILLUSTRATIVE EXAMPLE OF REVERSING ENTRY

When Reversing Entries Are Not Used (per chapter)				When Reversing Entries Are Used (per appendix)			
<u>Initial Salary Entry</u>				<u>Initial Salary Entry</u>			
Oct. 26	Salaries Expense	4,000		<b>Oct. 26</b>	<b>Salaries Expense</b>	<b>4,000</b>	
	Cash		4,000		<b>Cash</b>		<b>4,000</b>
<u>Adjusting Entry</u>				<u>Adjusting Entry</u>			
Oct. 31	Salaries Expense	1,200		<b>Oct. 31</b>	<b>Salaries Expense</b>	<b>1,200</b>	
	Salaries Payable		1,200		<b>Salaries Payable</b>		<b>1,200</b>
<u>Closing Entry</u>				<u>Closing Entry</u>			
Oct. 31	Income Summary	5,200		<b>Oct. 31</b>	<b>Income Summary</b>	<b>5,200</b>	
	Salaries Expense		5,200		<b>Salaries Expense</b>		<b>5,200</b>
<u>Reversing Entry</u>				<u>Reversing Entry</u>			
Nov. 1	No reversing entry is made.			<b>Nov. 1</b>	<b>Salaries Payable</b>	<b>1,200</b>	
					<b>Salaries Expense</b>		<b>1,200</b>
<u>Subsequent Salary Entry</u>				<u>Subsequent Salary Entry</u>			
Nov. 9	Salaries Payable	1,200		<b>Nov. 9</b>	<b>Salaries Expense</b>	<b>4,000</b>	
	Salaries Expense	2,800			<b>Cash</b>		<b>4,000</b>
	Cash		4,000				

# CORRECTING ENTRIES

## STUDY OBJECTIVE 5

- **Correcting Entries**
  - errors should be corrected as soon as discovered
  - correcting entries are unnecessary if records are free of errors
  - can be journalized and posted whenever an error is discovered
  - involve any combination of balance sheet and income statement accounts

ILLUSTRATIVE EXAMPLE OF

# CORRECTING ENTRY 1

<b>May 10</b>	<p><b><u>Incorrect Entry</u></b></p> <p>Cash</p> <p style="padding-left: 20px;">Service Revenue</p> <p>50 <b>(To record collection from customer on account)</b></p>		50	
<b>10</b>	<p><b><u>Correct Entry</u></b></p> <p>Cash</p> <p style="padding-left: 20px;">Accounts Receivable</p> <p>50 <b>(To record collection from customer on account)</b></p>		50	
<b>20</b>	<p><b><u>Correcting Entry</u></b></p> <p style="padding-left: 20px;">Service Revenue</p> <p style="padding-left: 40px;"><b>(To correct entry of May 10)</b></p> <p>Accounts Receivable</p>		50	

ILLUSTRATIVE EXAMPLE OF  
**CORRECTING ENTRY 2**

<b>May 18</b>	<p><b><u>Incorrect Entry</u></b></p> <p>Delivery Equipment</p> <p style="padding-left: 40px;">Accounts Payable</p> <p>45 <b>(To record purchase of equipment on account)</b></p>		45	
<b>18</b>	<p><b><u>Correct Entry</u></b></p> <p>Office Equipment</p> <p style="padding-left: 40px;">Accounts Payable</p> <p>450 <b>(To record purchase of equipment on account)</b></p>	450		
<b>June 3</b>	<p><b><u>Correcting Entry</u></b></p> <p>Office Equipment</p> <p style="padding-left: 40px;">Delivery Equipment</p> <p>45 <b>(To correct entry of May 18)</b></p>	450		
	<p>Accounts Payable</p>			



# The closing entry process consists of closing

- all asset and liability accounts
- out the owner's capital account
- all permanent accounts
- all temporary accounts

# The closing entry process consists of closing

- all asset and liability accounts
- out the owner's capital account
- all permanent accounts
- all temporary accounts

# STANDARD BALANCE SHEET CLASSIFICATIONS

## STUDY OBJECTIVE 6

- Financial statements become more useful when the elements are classified into significant subgroups.
- A **classified balance sheet** generally has the following standard classifications:

<b>Assets</b>		<b>Liabilities and Owner's Equity</b>	
Assets	Current Liabilities		Current
Long-Term Investments		Long-Term Liabilities	
Property, Plant and		Owner's (Stockholders') Equity	
Equipment			
Intangible Assets			

# CURRENT ASSETS

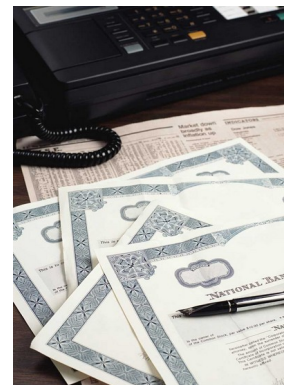
- **Current assets**
  - Cash and other resources that are reasonably expected to be realized in cash or sold or consumed in the business within one year of the balance sheet date or the company's operating cycle, whichever is longer
  - Current assets are listed in the order of their liquidity
- **Operating cycle of a company**
  - This is the average time required to go from cash to cash in producing revenues
- **Examples**
  - Inventory, accounts receivable and cash



# LONG-TERM INVESTMENTS

- **Long-term investments**
  - Resources which can be realized in cash
  - Their conversion into cash is not expected within one year or the operating cycle, whichever is longer
- **Examples**
  - Investments in bonds of another company or investment in land held for resale

**XYZ stock**



# PROPERTY, PLANT, AND EQUIPMENT

- **Property, plant, and equipment**
  - Tangible resources, relatively permanent nature, used in the business, and not intended for sale
- **Examples**
  - Land, buildings, and machinery



# INTANGIBLE ASSETS

- **Intangible assets**
  - **Non-current resources that do not have physical substance**
- **Examples**
  - **Includes patents, copyrights, trademarks, or trade names, gives the holder exclusive right of use for a specified period of time**

AOL TIME WARNER, INC.  
Balance Sheet (partial)  
(in millions)

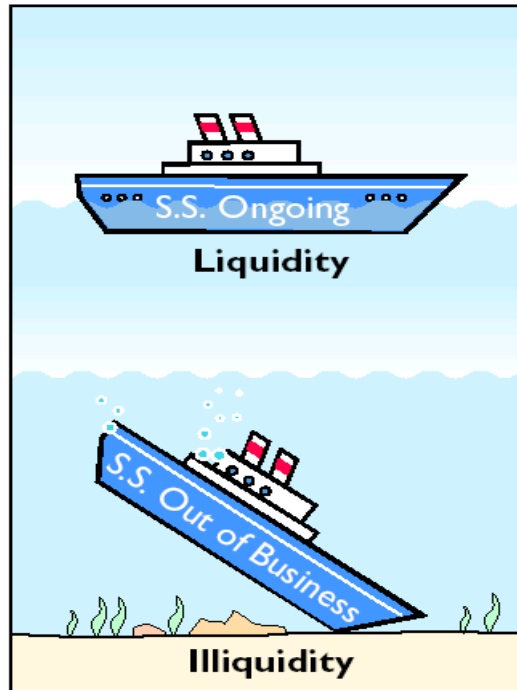
<b>Intangible assets</b>	
Music catalogues and copyrights	\$ 2,935
Cable television and sports franchises	27,371
Brands and trademarks	10,650
Goodwill and other intangible assets	126,942

# CURRENT LIABILITIES

- **Current liabilities**
  - Obligations reasonably expected to be paid from existing current assets or through the creation of other current liabilities within one year or the operating cycle, whichever is longer
- **Examples**
  - Accounts payable, wages payable, interest payable and current maturities of long-term debt



# CURRENT LIABILITIES



**Liquidity** is the ability of a company to pay obligations that are expected to become due within the next year or operating cycle

# LONG-TERM LIABILITIES

- **Long-term liabilities**  
Obligations expected to be paid after one year
- **Examples**
  - Long-term notes payable, bonds payable, mortgages payable, and lease liabilities

# OWNER'S EQUITY

- **The content of the owner's equity section**
  - Varies with the form of business organization
- **Proprietorship**
  - A single owner's equity account called (Owner's Name), Capital
- **Partnership**
  - Separate capital accounts for each partner
- **Corporation**
  - Called stockholders' equity, and it consists of two accounts: **Capital Stock and Retained Earnings**

# CLASSIFIED BALANCE SHEET IN ACCOUNT FORM

<b>PIONEER ADVERTISING AGENCY</b> Balance Sheet October 31, 2005		
<u>Assets</u>		
Current assets		\$
Cash	15,200	
Accounts receivable		200
Advertising supplies		1,000
Prepaid insurance		550
Total current assets		16,950
Property, plant, and equipment		
Office equipment	\$5,000	
Less: Accumulated depreciation	40	4,960
Total assets		\$21,910

**A classified balance sheet**

**1 availability of assets to meet debts**

**2 claims of short- and long-term creditors on total assets**

# CLASSIFIED BALANCE SHEET IN REPORT FORM

		<u>Liabilities and Owner's Equity</u>	
<b>Current liabilities</b>			<b>\$ 1,000</b>
Notes payable			<b>2,500</b>
Accounts payable			<b>50</b>
Interest payable			<b>800</b>
Unearned revenue			<b>1,200</b>
Salaries payable			<b>1,200</b>
<b>Total current liabilities</b>			<b>5,550</b>
<b>Long-term liabilities</b>			<b>4,000</b>
Notes payable			<b>4,000</b>
<b>Total liabilities</b>			<b>9,550</b>
<b>Owner's equity</b>			<b>12,360</b>
C. R. Byrd, Capital			<b>\$21,910</b>
<b>Total liabilities and owner's equity</b>			<b>\$21,910</b>

The balance sheet is most often presented in the report form, with the assets above liabilities and owner's equity.

# A current asset is

- the last asset purchased by a business
- an asset which is currently being used to produce a product or service
- usually found as a separate classification in the income statement
- expected to be realized in cash, sold or consumed within one year of the balance sheet or the company's operating cycle, whichever is longer

# A current asset is

- the last asset purchased by a business
- an asset which is currently being used to produce a product or service
- usually found as a separate classification in the income statement
- expected to be realized in cash, sold or consumed within one year of the balance sheet or the company's operating cycle, whichever is longer

Accounting Principles, 7<sup>th</sup> Edition

Weygandt • Kieso • Kimmel

## **Chapter 5**

# **Accounting for Merchandising Operations**

Prepared by Naomi Karolinski

Monroe Community College

and

Marianne Bradford

Bryant College

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# **CHAPTER 5**

## **ACCOUNTING FOR MERCHANDISING OPERATIONS**

**After studying this chapter, you should be able to:**

- 1 identify the differences between a service enterprise and a merchandising company**
- 2 explain the entries for purchases under a perpetual inventory system**
- 3 explain the entries for sales revenues under a perpetual inventory system**
- 4 explain the steps in the accounting cycle for a merchandising company**

# **CHAPTER 5**

## **ACCOUNTING FOR MERCHANDISING OPERATIONS**

**After studying this chapter, you should be able to:**

- 5 distinguish between a multiple-step and a single-step income statement**
- 6 explain the computation and importance of gross profit**
- 7 determine the cost of goods sold under a periodic system**

# MERCHANDISING COMPANY

A **merchandising company** buys and sells goods to earn a profit.

1) **Wholesalers** sell to **retailers**

2) **Retailers** sell to **consumers**

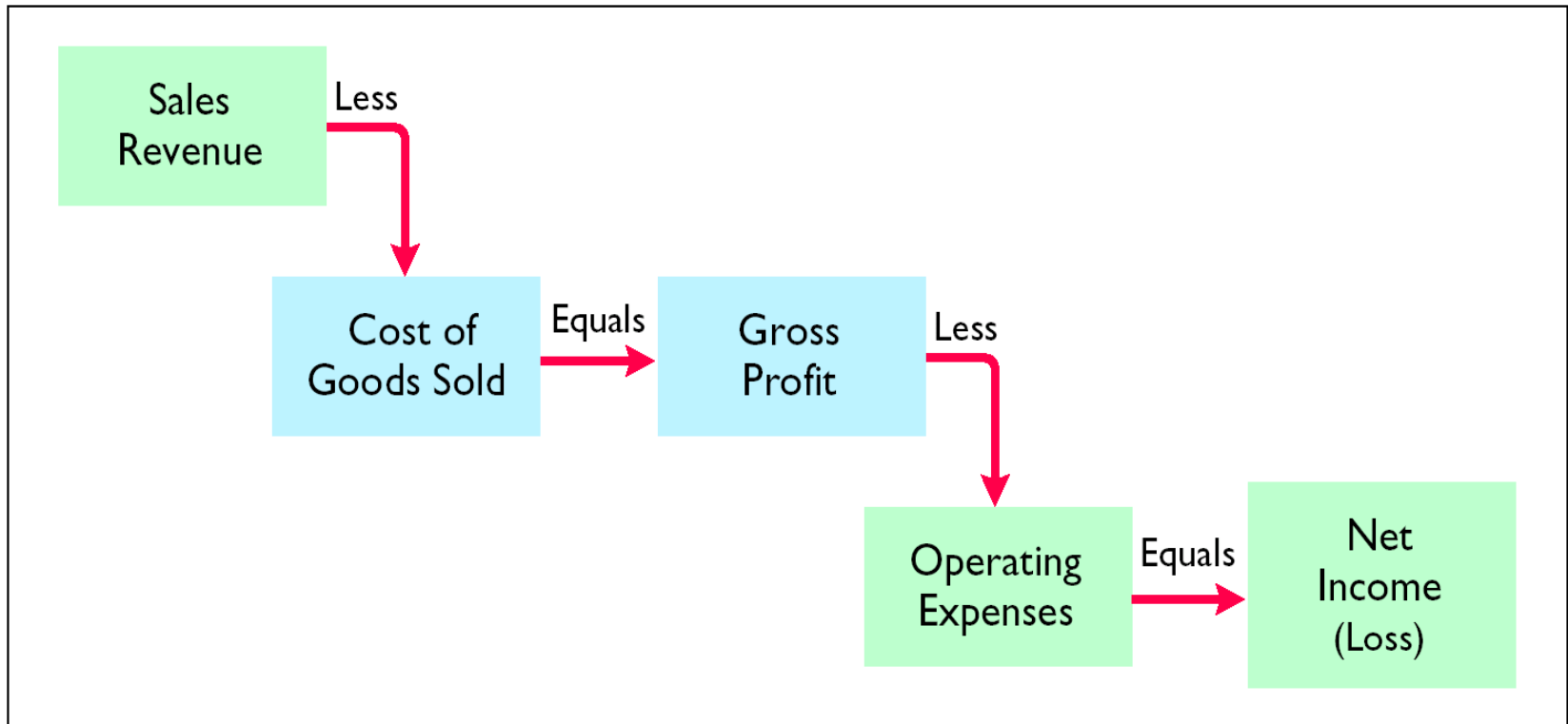
Primary source of revenue is **Sales**



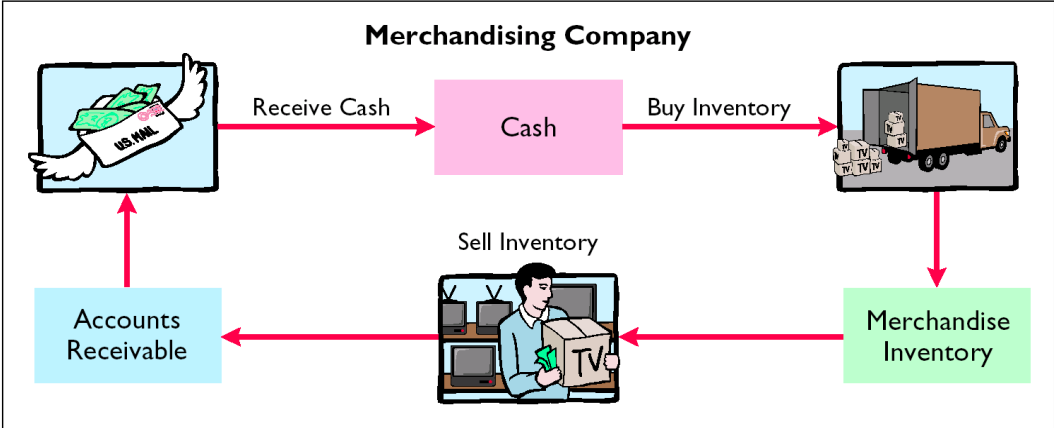
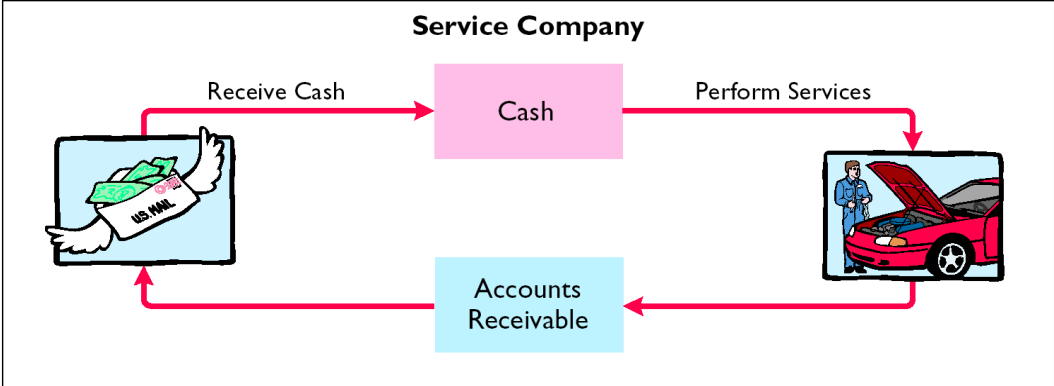
# MEASURING NET INCOME

- **Expenses for a merchandiser** are divided into two categories:
  - 1 **Cost of goods sold**
    - The total cost of merchandise sold during the period
  - 2 **Operating expenses**
    - Expenses incurred in the process of earning sales revenue (Examples: sales salaries and insurance expense)
- **Gross profit** is equal to Sales Revenue less Cost of Goods Sold

# INCOME MEASUREMENT PROCESS FOR A MERCHANDISING COMPANY



# OPERATING CYCLES FOR A SERVICE COMPANY AND A MERCHANDISING COMPANY



# INVENTORY SYSTEMS

**Merchandising entities may use either:**

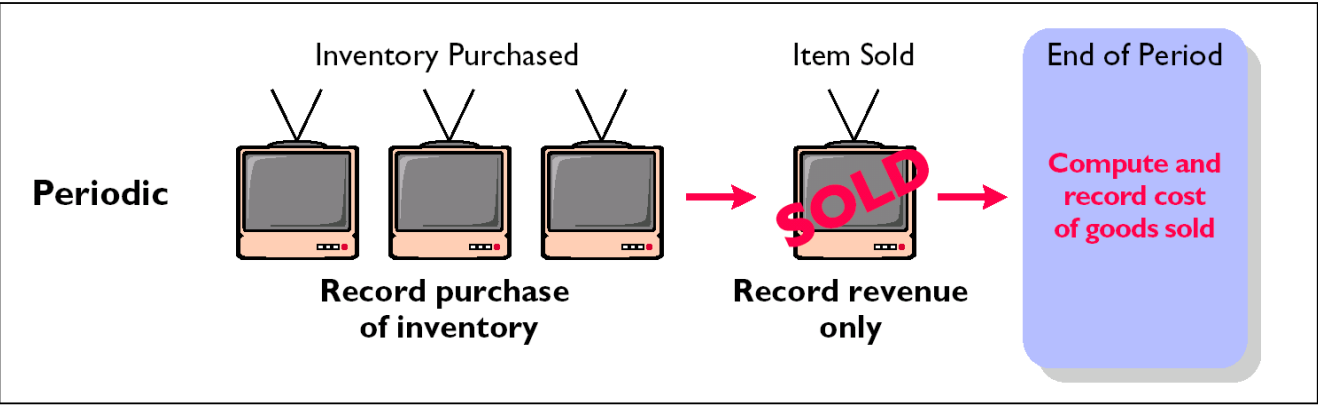
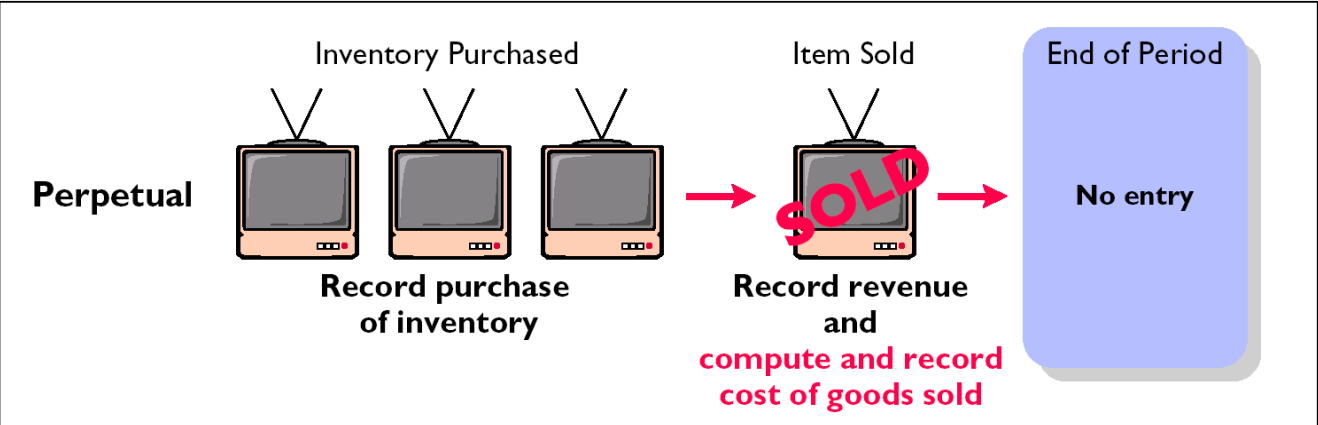
## **1) Perpetual Inventory**

**Detailed records of the cost of each item are maintained, and the cost of each item sold is determined from records **when the sale occurs.****

## **2) Periodic Inventory**

**Cost of goods sold is determined only at the **end of an accounting period.****

# PERPETUAL VS. PERIODIC





# **COST OF GOODS SOLD**

**To determine the cost of goods sold under a **periodic inventory system**:**

- 1) Determine the cost of goods on hand at the beginning of the accounting period,**
- 2) Add to it the cost of goods purchased,  
and**
- 3) Subtract the cost of goods on hand at the end of the accounting period.**

# PURCHASES OF MERCHANDISE

## STUDY OBJECTIVE 2

- Merchandise is purchased for resale to customers, the account
  - **Merchandise Inventory** is debited for the cost of goods.
- Like sales, purchases may be made for cash or on account (credit).
- The purchase is normally recorded by the purchaser when the goods **received** from the seller.
- Each credit purchase should be supported by a **purchase invoice**.



# PURCHASES OF MERCHANDISE

## SALES INVOICE

SELLERS ELECTRONIX					
27 CIRCLE DRIVE					
HARDING, MICHIGAN 48281					
INVOICE NO. 731					
<b>S O L D T O</b>	Firm Name <u>Beyer Video</u>				
	Attention of <u>James Hoover, Purchasing Agent</u>				
	Address <u>125 Main Street</u>				
	<u>Chelsea</u>		<u>Illinois</u>		<u>60915</u>
	City	State	Zip		
Date	Salesperson	Terms	Freight Paid by Buyer		
5/4/05	Malone	2/10, n/30			
Catalog No.	Description	Quantity	Price	Amount	
X572Y9820	Printed Circuit Board-prototype	1	2,300	\$2,300	
A2547Z45	Production Model Circuits	5	300	1,500	
<b>IMPORTANT: ALL RETURNS MUST BE MADE WITHIN 10 DAYS</b>			<b>TOTAL</b>	<b>\$3,800</b>	

# PURCHASES OF MERCHANDISE

GENERAL JOURNAL			
Date	Account Titles and Explanation	Dr.	Cr.
May 4	Merchandise Inventory Accounts Payable (To record goods purchased on account, terms 2/10, n/30, from Sellers Electronix)	3,800 3,800	

For purchases on account, **Merchandise Inventory** is debited and **Accounts Payable** is credited.

# PURCHASE RETURNS AND ALLOWANCES

- A purchaser may be dissatisfied with merchandise received because the goods:
  - 1) are damaged or defective,
  - 2) of inferior quality, or
  - 3) not in accord with the purchaser's specifications.
- The purchaser initiates the request for a reduction of the balance due through the issuance of a **debit memorandum** (purchaser's debit decreases A/P!).
- The **debit memorandum** is a document issued by a buyer to inform a seller that the seller's account has been debited because of unsatisfactory merchandise.

# PURCHASE RETURNS AND ALLOWANCES

GENERAL JOURNAL			
Date	Account Titles and Explanation	Dr.	Cr.
May 8	Accounts Payable Merchandise Inventory (To record return of inoperable goods received from Sellers Electronix, DM No. 126)	300	300

For purchases returns and allowances, **Accounts Payable** is debited and **Merchandise Inventory** is credited.

# FREE ON BOARD

A sales agreement should indicate whether the seller or the buyer is to pay the cost of transporting the goods to the buyer's place of business.

- **FOB Shipping Point**

- 1) Goods placed free on board the carrier by seller

- 2) **Buyer** pays freight costs

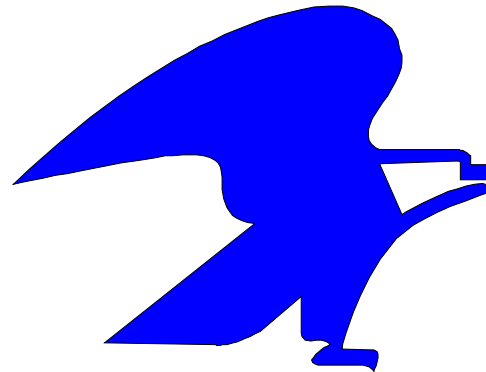
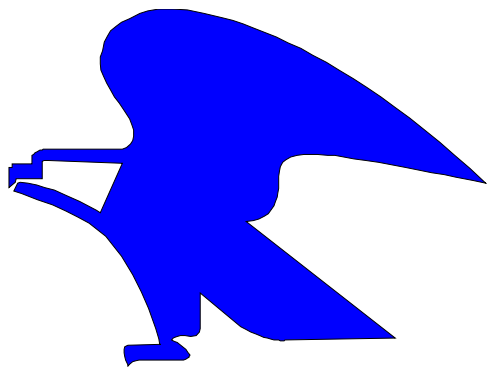
- **FOB Destination**

- 1) Goods placed free on board at buyer's business

- 2) **Seller** pays freight costs

# ACCOUNTING FOR FREIGHT COSTS

- **Merchandise Inventory** is debited if buyer pays freight.
- **Freight-out (or Delivery Expense)** is debited if seller pays freight.





# ACCOUNTING FOR FREIGHT COSTS

GENERAL JOURNAL			
Date	Account Titles and Explanation	Dr.	Cr.
May 6	Merchandise Inventory Cash (To record payment of freight, terms FOB shipping point)	150	150

When the purchaser directly incurs the freight costs, the account **Merchandise Inventory** is debited and **Cash** is credited.

# ACCOUNTING FOR FREIGHT COSTS

GENERAL JOURNAL			
Date	Account Titles and Explanation	Dr.	Cr.
May 4	Freight-out (Delivery Expense) Cash (To record payment of freight on goods sold FOB destination)	150	150

Freight costs incurred by the seller on outgoing merchandise are debited to **Freight-out** (or **Delivery Expense**) and **Cash** is credited.

# PURCHASE DISCOUNTS

- Credit terms may permit the buyer to claim a cash discount for the prompt payment of a balance due.
- The buyer calls this discount a **purchase discount**.
- Like a sales discount, a purchase discount is based on the invoice cost less returns and allowances, if any.



# PURCHASE DISCOUNTS

GENERAL JOURNAL			
Date	Account Titles and Explanation	Dr.	Cr.
May 14	Accounts Payable	3,500	
	Cash		
	Merchandise Inventory	3,430	
	(To record payment within discount period)		
		70	

If payment is made within the discount period, **Accounts Payable** is debited, **Cash** is credited, and **Merchandise inventory** is credited for the discount taken.

# PURCHASE DISCOUNTS

GENERAL JOURNAL			
Date	Account Titles and Explanation	Debit	Credit
June 3	Accounts Payable	3,500	
	Cash (To record payment with no discount taken)	3,500	

If payment is made after the discount period, **Accounts Payable** is debited and **Cash** is credited for the full amount.

# SAVINGS OBTAINED BY TAKING PURCHASE DISCOUNT

A buyer should usually take all available discounts.

If Beyer Video takes the discount, it pays **\$70** less in cash.

If it forgoes the discount and invests the **\$3,500** for **20 days** at **10%** interest, it will earn only **\$19.06** in interest.

The savings obtained by taking the discount is calculated as follows:

Discount of 2% on \$3,500	\$ 70.00
Interest received on \$3,430 (for 20 days at 10%)	<u>( 19.06)</u>
Savings by taking the discount	<u><u>\$ 50.94</u></u>

# SALES TRANSACTIONS

## STUDY OBJECTIVE 3

- **Revenues – (Revenue recognition principle)**
  - **Earned when the goods are transferred from seller to buyer**
- **All sales should be supported by a document such as a cash register tape or sales invoice.**

# RECORDING CASH SALES

GENERAL JOURNAL			
Date	Account Titles and Explanation	Dr.	Cr.
May 4	Cash Sales (To record daily cash sales)	2,200	
		2,200	
4	Cost of Goods Sold Merchandise Inventory (To record cost of merchandise sold for cash)	1,400	
		1,400	

- For cash sales, **Cash** is debited and **Sales** is credited.
- For the cost of goods sold for cash, **Cost of Goods Sold** is debited and **Merchandise Inventory** is credited.



# RECORDING CREDIT SALES

GENERAL JOURNAL			
Date	Account Titles and Explanation	Dr.	Cr.
May 4	Accounts Receivable Sales (To record credit sales to Beyer Video per invoice #731)	3,800	3,800
4	Cost of Goods Sold Merchandise Inventory (To record cost of merchandise sold on invoice #731 to Beyer Video)	2,400	2,400

- For credit sales, **Accounts Receivable** is debited and **Sales** is credited.
- For the cost of goods sold on account, **Cost of Goods Sold** is debited and **Merchandise Inventory** is credited.

# SALES RETURNS AND ALLOWANCES

- **Sales Returns**
  - Customers dissatisfied with merchandise and are allowed to return the goods to the seller for credit or a refund.
- **Sales Allowances**
  - Result when customers are dissatisfied and the seller allows a deduction from the selling price.



# SALES RETURNS AND ALLOWANCES

- **Credit memorandum**
  - the seller prepares a form to inform the customer that a credit has been made to the customer's account receivable
- **Sales Returns and Allowances**
  - Contra revenue account to the Sales account
- The normal balance of Sales Returns and Allowances is a **debit**

# RECORDING SALES RETURNS AND ALLOWANCES

GENERAL JOURNAL			
Date	Account Titles and Explanation	Dr.	Cr.
May 8	Sales Returns and Allowances Accounts Receivable (To record return of inoperable goods delivered to Beyer Video, per credit memorandum)	300	300
8	Merchandise Inventory Cost of Goods Sold (To record cost of goods returned per credit memorandum)	140	140

The seller's entry to record a credit memorandum involves a debit to the **Sales Returns and Allowances** account and a credit to **Accounts Receivable**. The entry to record the cost of the returned goods involves a debit to **Merchandise Inventory** and a credit to **Cost Goods Sold**.

# SALES DISCOUNTS

- **Sales discount**
  - Offer of a cash discount to a customer for the prompt payment of a balance due
  - Is a **contra revenue account** with a normal debit balance
- **Example:** Credit sale has the terms 3/10, n/30, a 3% discount is allowed if payment is made within 10 days. After 10 days there is no discount, and the balance is due in 30 days.

# CREDIT TERMS

**Credit terms** specify the amount and time period for the cash discount

- Indicates the length of time in which the purchaser is expected to pay the full invoice price

<b>T E R M S</b>	<b>E X P L A N A T I O N</b>
<b>2/10, n/30</b>	<b>A 2% discount may be taken if payment is made within 10 days of the invoice date.</b>
<b>1/10 EOM</b>	<b>A 1% discount is available if payment is made by the 10<sup>th</sup> of the next month.</b>

# RECORDING SALES DISCOUNTS

GENERAL JOURNAL			
Date	Account Titles and Explanation	Dr.	Cr.
May 14	Cash	3,430	
	Sales Discounts	70	
	Accounts Receivable		
	(To record collection within 2/10, n/30 discount period from Beyer Video)	3,500	

When cash discounts are taken by customers, the seller debits **Sales Discounts**.

# CLOSING ENTRIES

## STUDY OBJECTIVE 4

- Adjusting entries are journalized from the **adjustment columns** of the work sheet.
- All accounts that affect the determination of net income are closed to **Income Summary**.
- Data for the preparation of closing entries may be obtained from the **income statement columns** of the work sheet.

GENERAL JOURNAL			
Date	Account Titles and Explanation	Debit	Credit
2005 Dec. 31	(1) Sales Income Summary (To close income statement accounts with credit balances)	480,000	480,000



# CLOSING ENTRIES

**Cost of Goods Sold** is a new account that must be closed to **Income Summary**.

GENERAL JOURNAL			
Date	Account Titles and Explanation	Debit	Credit
2005	(2)		
Dec. 31	Income Summary		
	Sales Returns and Allowances	140,000	
	Sales Discounts		
	Cost of goods sold	12,000	
	Store Salaries Expense		
	Rent Expense	8,000	
	Freight-out		316,000
	Advertising Expense	45,000	
	Utilities Expense		
	Depreciation Expense	19,000	
	Insurance Expense		
	(To close income statement	7,000	
	accounts with debit balances)		
		16,000	

# CLOSING ENTRIES

GENERAL JOURNAL			
Date	Account Titles and Explanation	Debit	Credit
2005 Dec. 31	(3) Income Summary R. A. Lamb, Capital (To close net income to capital)	30,000	30,000
31	(4) R. A. Lamb, Capital R. A. Lamb, Drawing (To close drawings to capital)	15,000	15,000

- After the closing entries are posted, all temporary accounts have **zero balances**
- In addition, **R. A. Lamb, Capital** has a credit balance of **\$98,000** ( $\$83,000 + \$30,000 - \$15,000$ ).

Under a perpetual inventory system,  
acquisition of merchandise for  
resale is debited to the

- purchases account
- supplies account
- merchandise Inventory account
- cost of Goods Sold account

Under a perpetual inventory system,  
acquisition of merchandise for  
resale is debited to the

- purchases account
- supplies account
- **merchandise Inventory account**
- cost of Goods Sold account

# **MULTIPLE-STEP INCOME STATEMENT**

## **STUDY OBJECTIVE 5**

- **Includes sales revenue, cost of goods sold, and gross profit sections**
- **Additional nonoperating sections may be added for:**
  - 1) revenues and expenses resulting from secondary or auxiliary operations**
  - 2) gains and losses unrelated too operations**

# MULTIPLE-STEP INCOME STATEMENT

**Operating expenses** may be subdivided into:

- a) Selling expenses**
- b) Administrative expenses**

**Nonoperating sections** are reported after income from operations and are classified as:

- a) Other revenues and gains**
- b) Other expenses and losses**

# SINGLE-STEP INCOME STATEMENT

## SELLERS ELECTRONIX Income Statement For the Year Ended December 31, 2005

### Revenues

Net sales

Interest revenue

Gain on sale of equipment

Total revenues

### Expenses

Cost of goods sold

Selling expenses

Administrative expenses

Interest expense

Casualty loss from vandalism

Total expenses

Net income

All data are classified under  
two categories: **1**

Revenues

**2** Expenses

Only one step is required in  
determining net income or net  
loss.

\$ 460,000

3,000

600

463,600

316,000

76,000

38,000

1,800

200

432,000

\$ 31,600

# COMPUTATION OF GROSS PROFIT

## STUDY OBJECTIVE 6

Gross profit is determined as follows:

Net sales	\$ 460,000
Cost of goods sold	<u>316,000</u>
<b>Gross profit</b>	<b>\$ 144,000</b>



# OPERATING EXPENSES IN COMPUTING NET INCOME

Net income is determined as follows:

Gross profit	\$ 144,000
--------------	------------

Operating expenses	<u>114,000</u>
--------------------	----------------

Net income	<u>\$ 30,000</u>
------------	------------------

Gross profit for a merchandiser is  
net sales minus

- operating expenses
- cost of goods sold
- sales discounts
- cost of goods available for sale

Gross profit for a merchandiser is  
net sales minus

- operating expenses
- **cost of goods sold**
- sales discounts
- cost of goods available for sale

# PERIODIC INVENTORY SYSTEMS

Appendix 5A

- **Revenues from the sale of merchandise are recorded when sales are made in the same way as in a perpetual system**
- **No attempt is made on the date of sale to record the cost of merchandise sold**
- **Physical inventories are taken at end of period to determine:**
  - **The cost of merchandise on hand**
  - **The cost of the goods sold during the period**

# Determining Cost of Goods Sold

## Periodic

### STUDY OBJECTIVE 7

<b>SELLERS ELECTRONIX</b>			
Cost of Goods Sold			
For the Year Ended December 31, 2005			
Cost of goods sold			
<b>Inventory, January 1</b>			<b>\$36,000</b>
Purchases		\$325,000	
Less: Purchase returns and allowances	\$10,400		
Purchase discounts	<u>6,800</u>	<u>17,200</u>	
Net purchases		307,800	
Add: Freight-in		<u>12,200</u>	
<b>Cost of goods purchased</b>			<b><u>320,000</u></b>
Cost of goods available for sale			356,000
<b>Inventory, December 31</b>			<b><u>40,000</u></b>
<b>Cost of goods sold</b>			<b>316,000</b>

# RECORDING MERCHANDISE TRANSACTIONS UNDER A PERIODIC INVENTORY SYSTEM

- **Purchases**

- Merchandise purchased for resale to customers
- May be made for cash or on account (credit)
- Normally recorded by the purchaser when the goods are **received** from the seller
- Credit purchase should be supported by a **purchase invoice**



# RECORDING PURCHASES OF MERCHANDISE

General Journal			
Date	Account Titles	Debit	Credit
May 4	Purchases	3,800	
	Accounts Payable	3,800	

To illustrate the recording of merchandise transactions under a periodic system, we will use the purchase/sale transactions between Seller and Buyer. For purchases on account, **Purchases** is debited and **Accounts Payable** is credited for merchandise ordered from Seller.

# PURCHASE RETURNS AND ALLOWANCES

- A sales return and allowance on the seller's books is recorded as a **purchase return and allowance** on the books of the purchaser.
- **Purchase Returns and Allowances**
  - **contra account** to Purchases
  - Normal credit balance
- **Debit memorandum**
  - Purchaser initiates the request for a reduction of the balance due through the issuance of a the debit memorandum
  - A document issued by a buyer to inform a seller that the seller's account has been debited because of unsatisfactory merchandise





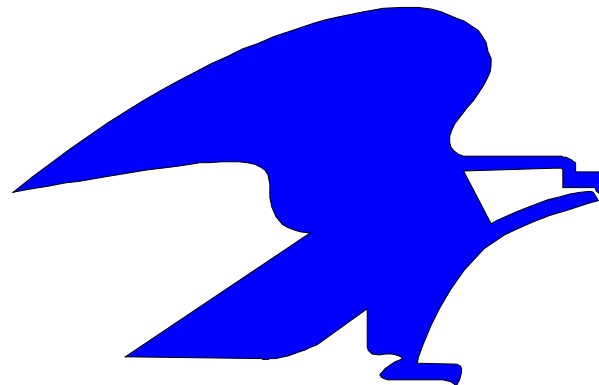
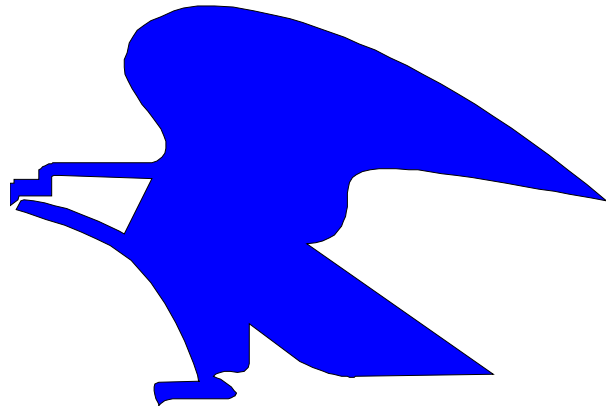
# RECORDING PURCHASE RETURNS AND ALLOWANCES

General Journal			
Date	Account Titles	Debit	Credit
May 8	Accounts Payable	300	
	Purchase Returns and Allowances	300	

For purchases returns and allowances, **Accounts Payable** is debited and **Purchase Returns and Allowances** is credited. Because \$300 of merchandise received from Seller is inoperable, Buyer returns the goods and issues a debit memo

# ACCOUNTING FOR FREIGHT COSTS

- **Freight-in** is debited if buyer pays freight
- **Freight-out** (or **Delivery Expense**) is debited if seller pays freight



# ACCOUNTING FOR FREIGHT COSTS

General Journal			
Date	Account Titles	Debit	Credit
<b>May 9</b>	<b>Freight-in</b>	<b>150</b>	
	<b>Cash</b>	<b>150</b>	

When the purchaser directly incurs the freight costs, the account **Freight-in** (or **Transportation-in**) is debited and **Cash** is credited. In this example, Buyer pays Acme Freight Company \$150 for freight charges on its purchase from Seller.

# PURCHASE DISCOUNTS

- **Credit terms may permit the buyer to claim a cash discount for the prompt payment of a balance due.**
- **The buyer calls this discount a **purchase discount**.**
- **Like a sales discount, a purchase discount is based on the invoice cost less returns and allowances, if any.**

# PURCHASE DISCOUNTS

General Journal			
Date	Account Titles	Debit	Credit
May 14	Accounts Payable	3,500	
	Purchase Discounts	70	
	Cash	3,430	

If payment is made within the discount period, **Accounts Payable** is debited, **Purchase Discounts** is credited for the discount taken, and **Cash** is credited. On May 14 Buyer pays the balance due on account to Seller taking the 2% cash discount allowed by Seller for payment within 10 days.

# RECORDING SALES OF MERCHANDISE

General Journal			
Date	Account Titles	Debit	Credit
May 4	Accounts Receivable	3,800	
	Sales		3,800

For credit sales, **Accounts Receivable** is debited and **Sales** is credited. In this illustration, the sale of \$3,800 of merchandise to Buyer on May 4 is recorded by the Seller.

# RECORDING SALES RETURNS AND ALLOWANCES

General Journal			
Date	Account Titles	Debit	Credit
May 8	Sales Returns and Allowances	300	
	Accounts Receivable		300

The seller's entry to record a credit memorandum involves a debit to the **Sales Returns and Allowances** account and a credit to **Accounts Receivable**. Based on the debit memo received from Buyer on May 8 for returned goods, Seller records the \$300 sales returns above.

# RECORDING SALES DISCOUNTS

General Journal			
Date	Account Titles	Debit	Credit
<b>May 15</b>	<b>Cash</b>	<b>3,430</b>	
	<b>Sales Discounts</b>	<b>70</b>	
	<b>Accounts Receivable</b>	<b>3,500</b>	

When cash discounts are taken by customers, the seller debits **Sales Discounts**. On May 15, Seller receives payment of \$3,430 on account from Buyer. Seller honors the 2% discount and records the payment of Buyer's accounts receivable.



# WORK SHEET FOR A MERCHANDISING COMPANY

## SELLERS ELECTRONIX

Work Sheet

For the Year Ended December 31, 2005

	Trial Balance		Adjustments		Adjusted Trial Balance		Income Statement		Balance Sheet	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	9,500				9,500				9,500	
Accounts Receivable	16,100				16,100				16,100	
<b>MERCHANDISE INVENTORY</b>	<b>40,500</b>			(a) 500	<b>40,000</b>				<b>40,000</b>	
Prepaid Insurance	3,800			(b) 2,000	1,800				1,800	
Store Equipment	80,000				80,000				80,000	
Accumulated Depreciation		16,000		(c) 8,000		24,000				24,000
Accounts Payable		20,400				20,400				20,400
R.A. Lamb, Capital		83,000				83,000				83,000
R.A. Lamb, Drawing	15,000				15,000				15,000	
<b>SALES</b>		<b>480,000</b>				<b>480,000</b>	<b>480,000</b>			
<b>SALES RETURNS AND ALLOWANCES</b>	<b>12,000</b>				<b>12,000</b>		<b>12,000</b>			
<b>SALES DISCOUNTS</b>	<b>8,000</b>				<b>8,000</b>		<b>8,000</b>			
<b>COST OF GOODS SOLD</b>	<b>315,500</b>		(a) 500		<b>316,000</b>		<b>316,000</b>			
Freight-out	7,000				7,000		7,000			
Advertising Expense	16,000				16,000		16,000			
Admin. Sal. Exp.	19,000				19,000		19,000			
Store Salaries Expense	40,000		(d) 5,000		45,000		45,000			
Utilities Expense	17,000				17,000		17,000			
Totals	<u>599,400</u>	<u>599,400</u>								
Insurance Expense			(b) 2,000		2,000		2,000			
Depreciation Expense			(c) 8,000		8,000		8,000			
Salaries Payable				(d) 5,000		5,000				5,000
Totals			<u>15,500</u>	<u>15,500</u>	<u>612,400</u>	<u>612,400</u>	450,000	480,000	162,400	132,400
Net Income							30,000			30,000
Totals							<u>480,000</u>	<u>480,000</u>	<u>162,400</u>	<u>162,400</u>

Key: (a) Adjustment to inventory on hand, (b) Insurance expired, (c) Depreciation expense, (d) Salaries accrued.

# USING A WORK SHEET

## Appendix 5B

### **Trial Balance Columns**

- 1 Data from the trial balance are obtained from the ledger balances of Sellers Electronix at December 31**
- 2 The amount shown for Merchandise Inventory, \$40,500, is the year-end inventory amount which results from the application of a perpetual inventory system**

# USING A WORK SHEET

## Adjustments Columns

**1** A merchandising company usually has the same types of adjustments as a service company

**2** Work sheet adjustments **b**, **c**, and **d** are for insurance, depreciation, and salaries

**Adjusted Trial Balance** - The **adjusted trial balance** shows the balance of all accounts after adjustment at the end of the accounting period

# USING A WORK SHEET

## Income Statement Columns

- 1** The accounts and balances that affect the **income statement** are transferred from the **adjusted trial balance columns** to the income statement columns for Sellers Electronix at December 31
- 2** All of the amounts in the **income statement credit column** should be totaled and compared to the total of the amounts in the **income statement debit column**

# USING A WORK SHEET

## Balance Sheet Columns

- 1** The major difference between the balance sheets of a service company and a merchandising company is **inventory**
- 2** For Sellers Electronix, the ending **Merchandise Inventory** amount of **\$40,000** is shown in the **balance sheet debit column**
- 3** The information to prepare the **owner's equity statement** is also found in these columns

Accounting Principles, 7<sup>th</sup> Edition

Weygandt • Kieso • Kimmel

## **Chapter 8**

# **Internal Control and Cash**

Prepared by Naomi Karolinski

Monroe Community College

and

Marianne Bradford

Bryant College

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# **CHAPTER 8**

## **INTERNAL CONTROL AND CASH**

After studying this chapter, you should be able to:

- 1 Define internal control.**
- 2 Identify the principles of internal control.**
- 3 Explain the applications of internal control principles to cash receipts.**
- 4 Explain the applications of internal control principles to cash disbursements.**
- 5 Describe the operation of a petty cash fund.**
- 6 Indicate the control features of a bank account.**
- 7 Prepare a bank reconciliation.**
- 8 Explain the reporting of cash.**

# **INTERNAL CONTROL**

STUDY OBJECTIVE **1**

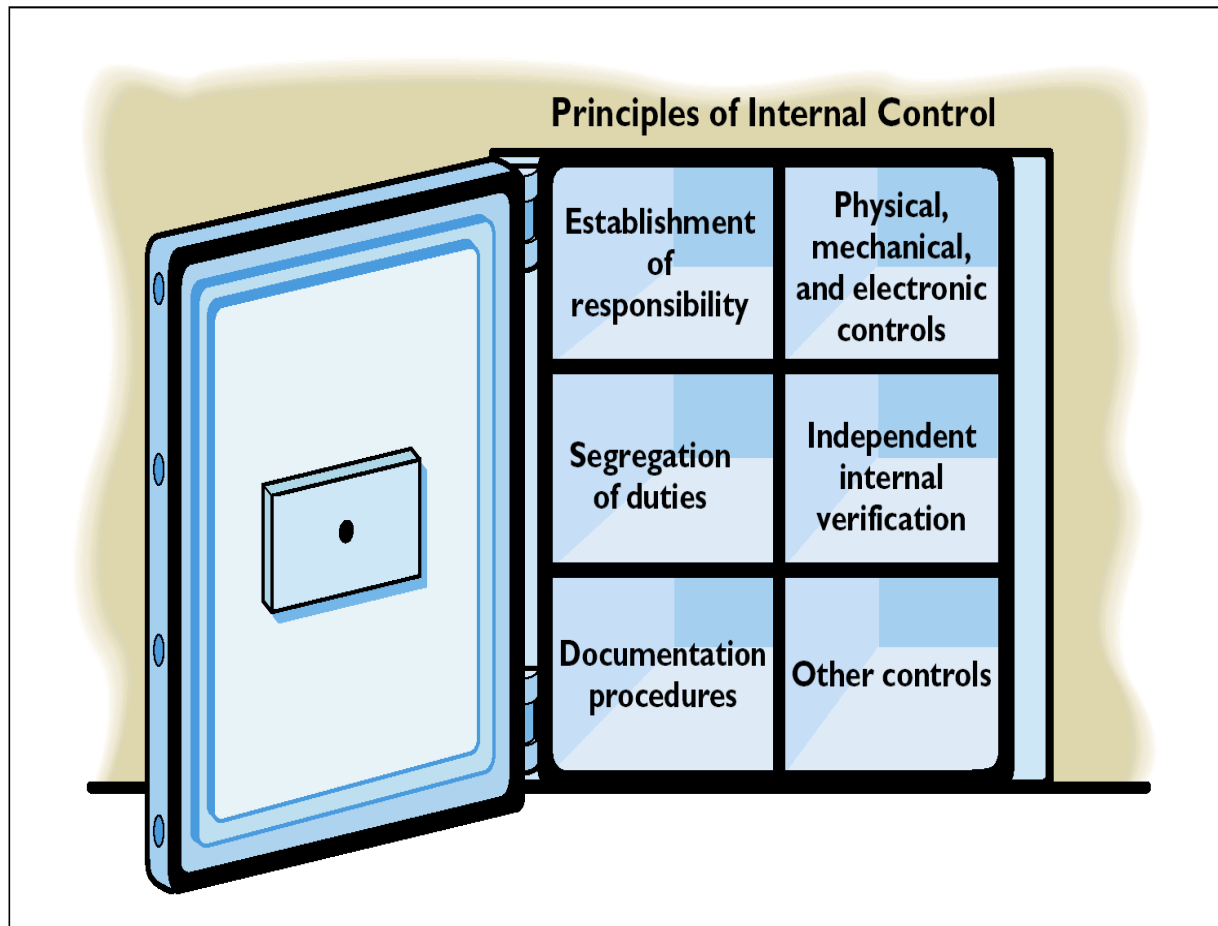
## **Internal Control**

- 1. Safeguards an organization's assets**
- 2. Enhances the accuracy and reliability of accounting records**



# PRINCIPLES OF INTERNAL CONTROL

## STUDY OBJECTIVE 2



# **PRINCIPLES OF INTERNAL CONTROL**

- **Establishment of responsibility:**
  - most effective when only one person is responsible for a given task
- **Segregation of duties:**
  - the work of one employee should provide a reliable basis for evaluating the work of another employee
- **Documentation procedures:**
  - documents provide evidence that transactions and events have occurred

# **PRINCIPLES OF INTERNAL CONTROL**

- **Physical, mechanical, and electronic controls:**  
safeguarding of assets and enhancing accuracy and reliability of the accounting records.
- **Independent internal verification:**  
the review, comparison, and reconciliation of information from two sources.
- **Other controls:**  
bonding of employees who handle cash, rotating employee's duties, and requiring employees to take vacations.

# PHYSICAL, MECHANICAL, AND ELECTRONIC CONTROLS

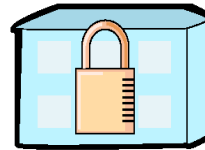
- ◆ Locked warehouses and storage cabinets for inventories and records
- ◆ Safes, vaults, and safety deposit boxes for cash and business papers
- ◆ Time clocks for recording time worked
- ◆ Computer facilities with pass key access
- ◆ Alarms to prevent break-ins
- ◆ Television monitors and garment sensors to deter theft

# PHYSICAL, MECHANICAL, AND ELECTRONIC CONTROLS



Safes, vaults, and safety deposit boxes for cash and business papers

## Physical Controls

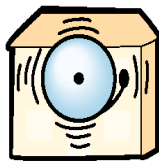


Locked warehouses and storage cabinets for inventories and records



Computer facilities with pass key access or fingerprint or eyeball scans

## Mechanical and Electronic Controls



Alarms to prevent break-ins



Television monitors and garment sensors to deter theft



Time clocks for recording time worked

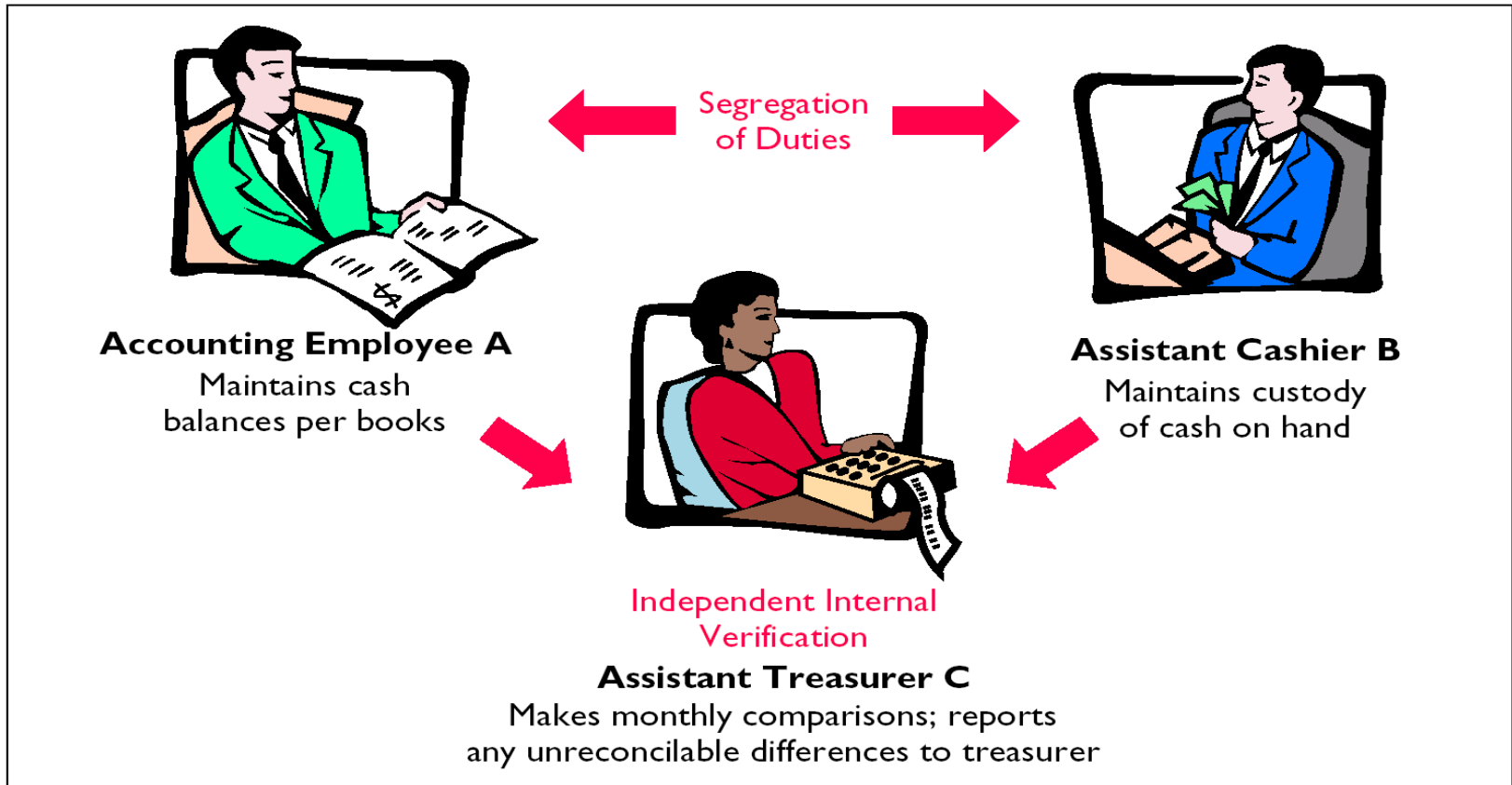
# **INDEPENDENT INTERNAL VERIFICATION**

**Maximum benefit**

**Independent internal verification:**

- 1 Made on periodic or surprise basis**
- 2 Should be done by someone who is independent of the employee responsible for the information**
- 3 Report discrepancies and exceptions to a management level that can take appropriate corrective action**

# COMPARISON OF SEGREGATION OF DUTIES PRINCIPLE WITH INDEPENDENT INTERNAL VERIFICATION PRINCIPLE



# LIMITATIONS OF INTERNAL CONTROL

- ◆ **Costs of establishing control procedures** should not exceed their expected benefits
- ◆ **The human element** is an important factor in every system of internal control.
  - A good system can become ineffective through employee fatigue, carelessness, or indifference.
- ◆ **Collusion** may result.
  - Two or more individuals work together to get around prescribed controls and may significantly impair the effectiveness of a system.





# CASH

## ◆ Cash

- **Coins, currency, checks, money orders, and money on hand or on deposit at a bank or similar depository**

## ◆ **Internal control over cash is imperative**

- **Safeguards cash and assure the accuracy of the accounting records for cash**

# **CONTROL OVER CASH RECEIPTS**

## **STUDY OBJECTIVE 3**

- **Only designated personnel should be authorized to handle or have access to cash receipts.**
- **Different individuals should:**
  - 1 receive cash**
  - 2 record cash receipt transactions**
  - 3 have custody of cash**



# **CONTROL OVER CASH RECEIPTS**

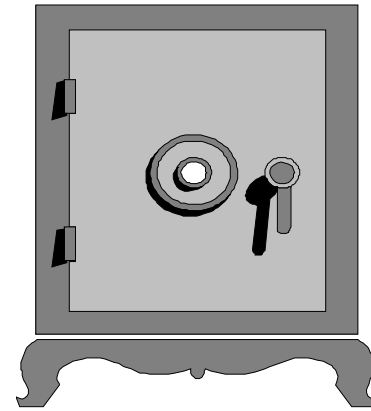
- **Documents should include:**

- 1 Remittance advices**

- 2 Cash register tapes**

- 3 Deposit slips**

- **Cash should be stored in safes and bank vaults**
- **Access to storage areas should be limited to authorized personnel**
- **Cash registers should be used in executing over-the-counter receipts**



# Review

---

Internal control is used in a business to enhance the accuracy and reliability of its accounting records and to:

- a. safeguard its assets.
- b. prevent fraud.
- c. produce correct financial statements.
- d. deter employee dishonesty.

# Review

---

Internal control is used in a business to enhance the accuracy and reliability of its accounting records and to:

- a. **safeguard its assets.**
- b. prevent fraud.
- c. produce correct financial statements.
- d. deter employee dishonesty.

# CONTROL OVER CASH RECEIPTS

Store No. <u>  8  </u>	Date <u>March 8, 2005</u>
1. Opening cash balance	\$ 50.00
2. Cash sales per tape (attached)	<u>6,956.20</u>
3. Total cash to be accounted for	7,006.20
4. Cash on hand (see list)	<u>6,996.10</u>
5. Cash (short) or over	\$ <u>(10.10)</u>
6. Ending cash balance	<u>\$ 50.00</u>
7. Cash for deposit (Line 4 – Line 6)	<u>\$6,946.10</u>
Cashier <u>J. Cruise</u>	Supervisor <u>M. Braun</u>

- **Daily cash counts and daily comparisons of total receipts.**
- **All personnel who handle cash receipts should be bonded and required to take vacations.**
- **Control of over-the-counter receipts is centered on cash registers that are visible to customers.**

## Internal Control over Cash Receipts

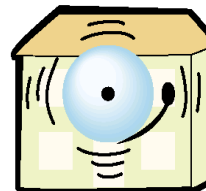
### Establishment of Responsibility

Only designated personnel are authorized to handle cash receipts (cashiers)



### Physical, Mechanical, and Electronic Controls

Store cash in safes and bank vaults; limit access to storage areas; use cash registers



### Segregation of Duties

Different individuals receive cash, record cash receipts, and hold the cash



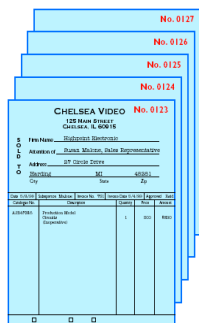
### Independent Internal Verification

Supervisors count cash receipts daily; treasurer compares total receipts to bank deposits daily



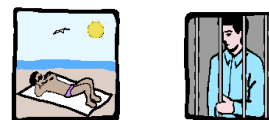
### Documentation Procedures

Use remittance advice (mail receipts), cash register tapes, and deposit slips

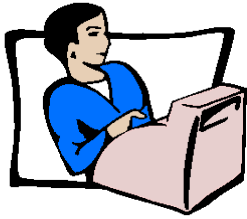


### Other Controls

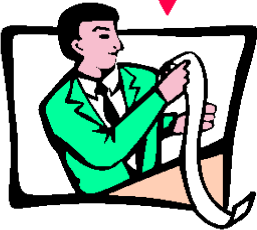
Bond personnel who handle cash; require employees to take vacations; deposit all cash in bank daily



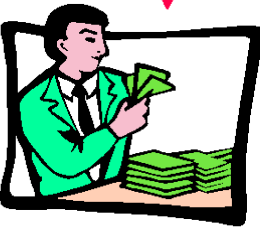
## Store Sales Departments



Cashiers ring up sales on registers



Supervisor reads register totals

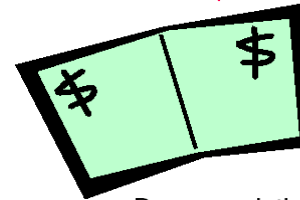
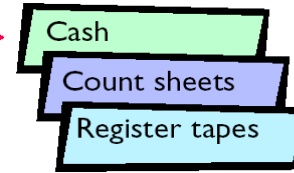


Supervisor makes cash counts



Supervisor prepares cash count sheets

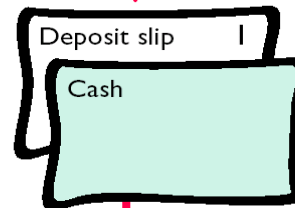
## Cashier's Department



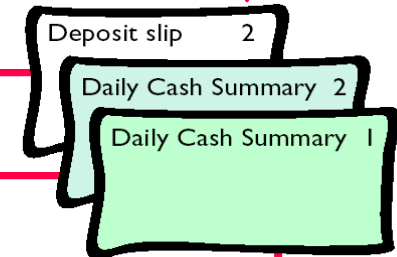
Prepare daily cash summary



Prepare deposit slip



To bank  
(for deposit)



To treasurer  
(for verification)

To accounting  
(for recording)



# **CONTROL OVER CASH DISBURSEMENTS**

## **STUDY OBJECTIVE 4**

- **Payments are made by check rather than by cash, except for petty cash transactions.**
- **Only specified individuals should be authorized to sign checks.**
- **Different departments or individuals should be assigned the duties of approving an item for payment and paying it.**

# **CONTROL OVER CASH DISBURSEMENTS**

- ◆ **Prenumbered checks should be used and each check should be supported by an approved invoice or other document.**
- ◆ **Blank checks should be stored in a safe.**
  - 1 Access should be restricted to authorized personnel.**
  - 2 A check writer machine should be used to imprint the amount on the check in indelible ink.**

# CONTROL OVER CASH DISBURSEMENTS

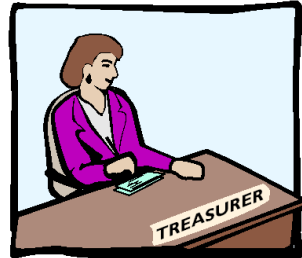
- ◆ Each check should be compared with the approved invoice before it is issued.
- ◆ Following payment, the approved invoice should be stamped “**PAID**”.



## Internal Control over Cash Disbursements

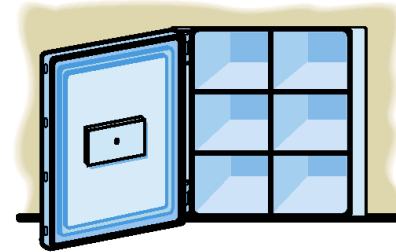
### Establishment of Responsibility

Only designated personnel are authorized to sign checks (treasurer)



### Physical, Mechanical, and Electronic Controls

Store blank checks in safes, with limited access; print check amounts by machine in indelible ink



### Segregation of Duties

Different individuals approve and make payments; check signers do not record disbursements



### Independent Internal Verification

Compare checks to invoices; reconcile bank statement monthly



### Documentation Procedures

Use prenumbered checks and account for them in sequence; each check must have approved invoice



### Other Controls

Stamp invoices  
PAID

CHelsea VIDEO		No. 0404	
125 Main Street Chelsea, IL 60915			
S	Firm Name	Highpoint Electronics	
O	Attention of	Susan Makson, Sales Representative	
T	Address	27 Circle Drive	
O	Handling	MI	48221
	City	State	Zip
Date: 01/10/91	Quantity: 1000	Invoice No.: 991	Invoice Date: 01/10/91
Company No.:	Customer:	Quantity:	Price:
ADDRESS:	Product/Model Description:	1	300 800
<b>PAID</b>			

# VOUCHER SYSTEM

- ◆ **The voucher system**
  - ◆ Is often used to enhance the internal control over cash disbursements.
  - ◆ Is an extensive network of approvals by authorized individuals acting independently to ensure that all disbursements by check are proper.
- ◆ A **voucher** is an authorization form prepared for each expenditure.
- ◆ Vouchers are recorded in a journal called the **voucher register**.

# **ELECTRONIC FUNDS TRANSFER SYSTEM**



- **Checks processing is expensive**
  - **New methods are being developed to transfer funds among parties without the use of paper**
- **Electronic Funds Transfer (EFT) System**

**A disbursement system that uses wire, telephone, telegraph, or computer to transfer cash from one location to another**

# PETTY CASH FUND

## STUDY OBJECTIVE 5

- ◆ A **petty cash fund** is used to pay relatively small amounts
- ◆ Operation of the fund, often called an **imprest system**, involves:
  - 1 Establishing the fund
  - 2 Making payments from the fund
  - 3 Replenishing the fund
- ◆ Accounting entries are required when:
  - 1 The fund is established
  - 2 The fund is replenished
  - 3 The amount of the fund is changed

# **ESTABLISHING THE FUND**

- **Two essential steps in establishing a petty cash fund are:**
  - 1 appointing a petty cash custodian who will be responsible for the fund and**
  - 2 determining the size of the fund.**
- **Ordinarily, the amount is expected to cover anticipated disbursements for a 3 to 4 week period.**



# ESTABLISHING THE FUND

GENERAL JOURNAL			
Date	Account Titles and Explanation	Debit	Credit
Mar. 1	Petty Cash Cash (To establish a petty cash fund)	100	100

When the fund is established, a check payable to the petty cash custodian is issued for the stipulated amount.

# **REPLENISHING THE FUND**

- ◆ **When the money in the petty cash fund reaches a minimum level, the fund is replenished.**
- ◆ **The request for reimbursement is initiated by the petty cash custodian.**
- ◆ **The petty cash custodian prepares a schedule of the payments that have been made and sends the schedule, with supporting documentation, to the treasurer's office.**

# REPLENISHING THE FUND

GENERAL JOURNAL			
Date	Account Titles and Explanation	Debit	Credit
Mar. 15	Postage Expense	44	
	Freight-out	38	
	Miscellaneous Expense	5	
	Cash		
	(To replenish petty cash fund)		87

On March 15 the petty cash custodian requests a check for \$87. The fund contains \$13 cash and petty cash receipts for postage, \$44, freight-out, \$38, and miscellaneous expenses, \$5.

# REPLENISHING THE FUND

GENERAL JOURNAL			
Date	Account Titles and Explanation	Debit	Credit
Mar. 15	Postage Expense	44	
	Freight-out	38	
	Miscellaneous Expense	5	
	Cash Over and Short	1	
	Cash		
	(To replenish petty cash fund)		88

On March 15 the petty cash custodian requests a check for \$88. The fund contains \$12 cash and petty cash receipts for postage, \$44, freight-out, \$38, and miscellaneous expenses, \$5.

# USE OF A BANK

## STUDY OBJECTIVE 6

- ◆ **The use of a bank minimizes the amount of currency that must be kept on hand and contributes significantly to good internal control over cash.**
- ◆ **A company can safeguard its cash by using a bank as a depository and as a clearing house for checks received and checks written.**



# WRITING CHECKS

- ◆ A **check** is a written order signed by the depositor directing the bank to pay a specified sum of money to a designated recipient.
- ◆ Three parties to a check are:
  - 1 **Maker (drawer) issues the check**
  - 2 **Bank (payer) on which check is drawn**
  - 3 **Payee to whom check is payable**

# WRITING CHECKS

## Check

Maker

**W.A. LAIRD COMPANY**  
77 West Central Avenue,  
Midland, Michigan 48654

No. **448**

April 16 2005 74-102724

Payee

Pay to the order of Watkins Wholesale Supply, \$ 1525.00  
Fifteen hundred twenty-five and 00/100 Dollars

Payer

**NT** National Bank & Trust  
Midland, Michigan 48654

W.F. Faine

Memo \_\_\_\_\_  
⑆012410497⑆457923⑈02 448

## Remittance Advice

Detach this portion before cashing.

Date	Description	Gross Amount	Discount	Net Amount
4-16-05	Invoice No. 27662	1525.00	---	1525.00

W. A. Laird Company, Midland, MI

# **BANK STATEMENTS**

**A bank statement shows:**

- 1 Checks paid and other debits charged against the account**
- 2 Deposits and other credits made to the account**
- 3 Account balance after each day's transactions**



# MEMORANDA

## ◆ Bank debit memoranda

- Indicate charges against the depositor's account.

Example: ATM service charges

## ◆ Bank credit memoranda

- Indicate amounts that will increase the depositor's account.

Example: interest income on account  
balance

# RECONCILING THE BANK ACCOUNT

STUDY OBJECTIVE 7

## ◆ Reconciliation

- Necessary as the balance per bank and balance per books are seldom in agreement due to time lags and errors.

## ◆ A bank reconciliation

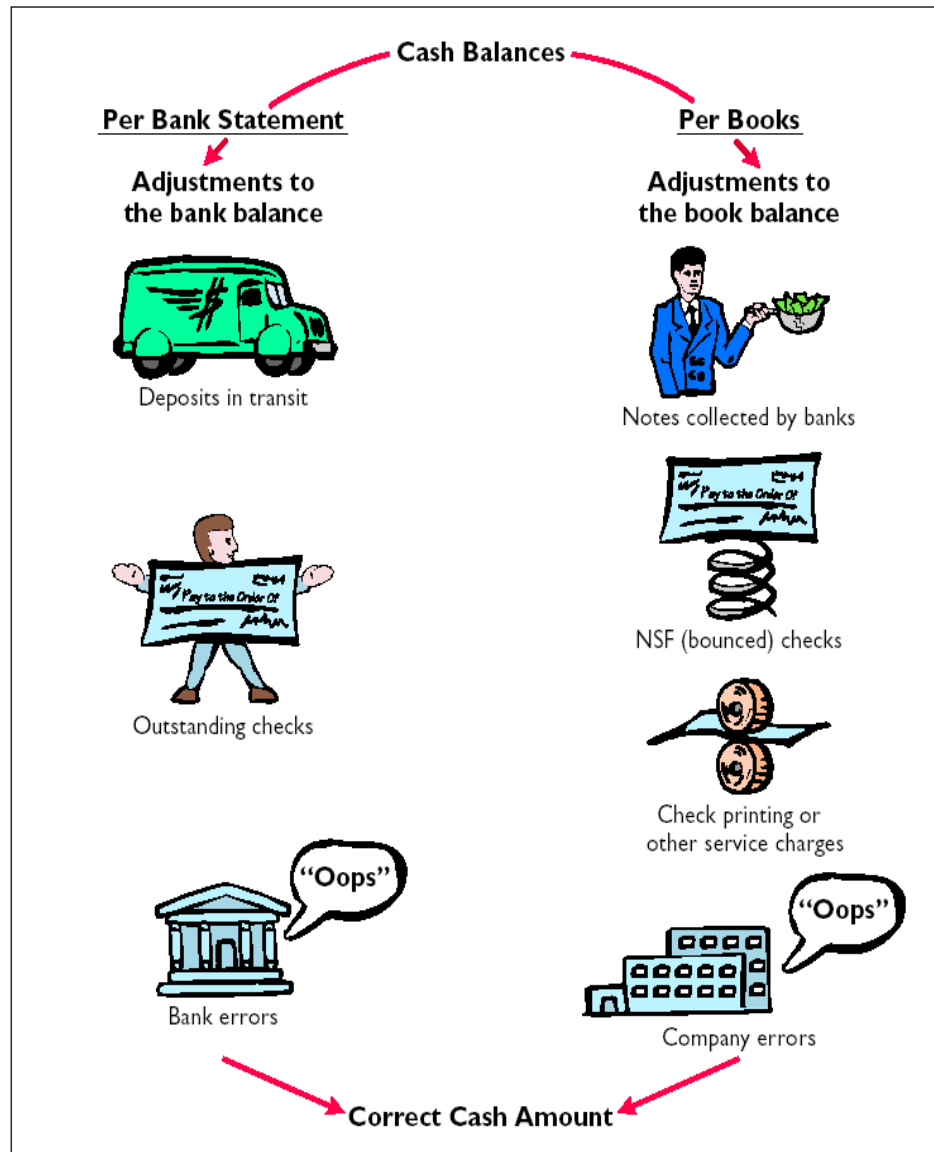
- Should be prepared by an employee who has no other responsibilities pertaining to cash.



# **RECONCILING THE BANK ACCOUNT**

- ◆ **Steps in preparing a bank reconciliation:**
  - 1 Determine deposits in transit**
  - 2 Determine outstanding checks**
  - 3 Note any errors discovered**
  - 4 Trace bank memoranda to the records**
- ◆ **Each reconciling item used in determining the adjusted cash balance per books should be recorded by the depositor.**

# BANK RECONCILIATION



# BANK RECONCILIATION

## W. A. LAIRD COMPANY Bank Reconciliation April 30, 2005

Cash balance per bank statement			\$ 15,907.45
Add: Deposits in transit			<u>2,201.40</u>
			18,108.85
Less: Outstanding checks	The bank statement for the Laird Company shows a balance per bank of \$15,907.45 on April 30, 2005.		
No. 453		\$ 3,000.00	
No. 457		1,401.30	
No. 460		<u>1,502.70</u>	<u>5,904.00</u>
Adjusted cash balance per bank		\$ 12,204.85	<u><u>                    </u></u>
Cash balance per books			\$ 11,589.45
Add: Collection of \$1,000 note receivable plus interest earned			
\$50, less collection fee \$15		\$ 1,035.00	
Error in recording check 443		<u>36.00</u>	<u>1,071.00</u>
			12,660.45
Less: NSF check	On this date the balance of cash per books is \$11,589.45.	425.60	
Bank service charge		<u>30.00</u>	<u>455.60</u>
Adjusted cash balance per books		\$ 12,204.85	<u><u>                    </u></u>

# ENTRIES FROM BANK RECONCILIATION

GENERAL JOURNAL			
Date	Account Titles and Explanation	Debit	Credit
Apr. 30	Cash	1035	
	Miscellaneous Expense	15	
	Notes Receivable		
	Interest Revenue		
	(To record collection of notes receivable by bank)	1000	

50

**Collection of Note Receivable** This entry involves four accounts. Interest of \$50 has not been accrued and the collection fee is charged to Miscellaneous Expense.

# ENTRIES FROM BANK RECONCILIATION

GENERAL JOURNAL			
Date	Account Titles and Explanation	Debit	Credit
Apr. 30	Cash Accounts Payable — Andrea Company (To correct error in recording check No. 443)	36	36

**Book Error** An examination of the cash disbursements journal shows that check No. 443 was a payment on account to Andrea Company, a supplier. The check, with a correct amount of \$1,226.00, was recorded at \$1,262.00.

# ENTRIES FROM BANK RECONCILIATION

GENERAL JOURNAL			
Date	Account Titles and Explanation	Debit	Credit
Apr. 30	Accounts Receivable — J. R. Baron		
	Cash	425.60	
	(To record NSF check)		
		425.60	

**NSF Check** An NSF check becomes an accounts receivable to the depositor.



# ENTRIES FROM BANK RECONCILIATION

GENERAL JOURNAL			
Date	Account Titles and Explanation	Debit	Credit
Apr. 30	Miscellaneous Expense Cash (To record charge for printing company checks)	30	30

**Bank Service Charges** Check printing charges (DM) and other bank service charges (SC) are debited to Miscellaneous Expense because they are usually nominal in amount.

# REPORTING CASH

## STUDY OBJECTIVE 8

- ◆ **Cash reported on the Balance Sheet includes:**
  - 1 Cash on hand**
  - 2 Cash in banks**
  - 3 Petty cash**
- ◆ **Cash is listed first in the balance sheet under the title **cash and cash equivalents** because it is the most liquid asset.**



# CASH EQUIVALENTS

## ◆ Cash equivalents

- Are highly liquid investments that can be converted into a specific amount of cash
- Typically have maturities of 3 months or less when purchased

**Examples: Money market funds, bank certificates of deposit, and U.S. Treasury bills and notes**

# Review

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The statement that correctly describes the reporting of cash is:

- a. Cash cannot be combined with cash equivalents.
- b. Restricted cash funds may be combined with Cash.
- c. Cash is listed first in the current assets.
- d. Restricted cash funds cannot be reported as a current asset.

# Review

---

The statement that correctly describes the reporting of cash is:

- a. Cash cannot be combined with cash equivalents.
- b. Restricted cash funds may be combined with Cash.
- c. Cash is listed first in the current assets.
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