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SKU: 9781259631122-SOLUTIONS

ANSWERS TO QUESTIONS - CHAPTER 2

1. Accrual accounting attempts to record the effects of accounting events in the period when such events occur, regardless of when cash is received or paid. The goal is to match expenses with the revenues that they produce.

2. Recognition is the act of recording an event in the financial statements. When accruals are used, events are recognized before the associated cash is paid or collected.

3. Deferral is the recognition of revenue or expenses in a period after the cash consequences are realized, i.e., cash is collected in advance of performing the service.

4. If cash is collected in advance for services, the revenue is recognized when the services are rendered.

5. An asset source transaction increases assets and increases either liabilities or equity.

6. The issue of common stock, which is capital acquired from owners, increases business assets (usually cash) and equity (common stock).

7. The recognition of revenue on account increases the corresponding revenue account on the income statement, but does not affect the statement of cash flows. The cash flow statement is affected when the account is collected.

8.

Asset Source Transaction	Effect on Accounting Equation
Issue of Common Stock	Increases Assets Increases Common Stock
Revenue Earned	Increases Assets Increases Retained Earnings
Borrowed Funds	Increases Assets Increases Liabilities

9. **Revenue is recognized under accrual accounting when a revenue-producing event occurs, i.e., when the revenue is *earned*, even if no cash is collected at the time of the transaction.**

10. **The collection of cash for accounts receivable is an asset exchange transaction. Only the asset side of the accounting equation is affected because one asset account increases (cash), and another asset account decreases (accounts receivable). Total assets are unchanged.**

11. **If cash is collected in advance for services, a liability is created (unearned revenue), increasing the claims side of the accounting equation.**

12. **Unearned revenue is cash that has been collected for services that have not yet been performed.**

13. **The recognition of expenses affects the accounting equation by either decreasing assets or increasing liabilities (payables) and by decreasing stockholders' equity (retained earnings).**

14. **A claims exchange transaction is one where the claims of creditors (liabilities) increase and the claims of stockholders (retained earnings) decrease, or vice versa. The total amount of claims is unchanged.**

15. **Cash payments to creditors are <u>asset use</u> transactions. These transactions result in the reduction of an asset account (cash) and the reduction of the corresponding liability account (payables).**

16. **Expenses are recognized under accrual accounting at the time the expense is incurred or resources are consumed, regardless of when cash payment is made.**

17. **Net cash flows from operations on the cash flow statement may be different from net income because of the application of accrual accounting. Revenues and expenses reported on the income statement may be recognized before or after the actual collection or payment of cash that is reported on the cash flow statement.**

18. The income statement reflects the change in net assets associated with operating a business, as shown by revenues and expenses. Expenses may result from a decrease in assets or an increase in liabilities. Revenues may result from an increase in assets or a decrease in liabilities.

19. Net income increases stockholders' claims on business assets by increasing retained earnings.

20. A cost can be either an asset or an expense. If the item acquired has already been used in the process of earning revenue, its cost represents an expense. If the item will be used in the future to generate revenue, its cost represents an asset.

21. A cost is held in the asset account until the item is used to produce revenue. When the revenue is generated, the asset is converted into an expense in order to match revenues with related expenses. Not all costs become expenses. If the value of an asset will not expire in the revenue-generating process, the asset will not become an expense. For example, the cost of land will not become an expense because land does not depreciate.

22. Supplies used during the accounting period are recognized in a single adjusting entry at the end of the period. The amount of supplies used is determined by subtracting the amount of supplies on hand at the end of the period from the amount of supplies that were available for use (beginning supplies balance plus supplies purchased).

23. An expense is a decrease in assets or an increase in liabilities that occurs in the process of generating revenue.

24. Revenue is an increase in assets or a decrease in liabilities that results from the operating activities of the business.

25. The purpose of the statement of changes in stockholders' equity is to display the effects of business operations and stock issued to owners and dividends paid to stockholders. It identifies the ways that an entity's equity increased and decreased as a result of its operations and transactions with its stockholders.

26. **The purpose of the balance sheet is to provide information about an entity's assets, liabilities, and stockholders' equity and their relationships to each other at a particular point in time. It provides a list of the economic resources that the enterprise has available for its operating activities and the claims to those resources.**

27. **The balance sheet is dated as of a specific date because it shows information about an entity's assets, liabilities, and stockholders' equity as of that date, not measured over a time period. The statement of changes in stockholders' equity, the income statement, and the statement of cash flows reflect transactions that occur over a period of time.**

28. **Assets are listed on the balance sheet in accordance with their respective levels of liquidity (how rapidly they can be converted to cash).**

29. **The statement of cash flows explains the change in cash from one accounting period to the next. It is prepared by analyzing the cash account and summarizing where cash came from and how it was used.**

30. **An adjusting entry is an entry that updates account balances prior to preparation of the financial statements. The entry means that there is an item that needs proper measurement on the income statement and an adjustment will reflect the correct time period of earning or usage. Example: entry to recognize accrued interest revenue where the revenue has been earned but not yet collected and therefore revenue had not yet been recorded for the time period.**

31. **Temporary accounts (revenue, expense, and dividends) are closed at the end of the accounting period. It is necessary to close these accounts so that revenue, expense, and dividends can be accumulated from a beginning balance of zero for the next period.**

32. **Period costs are costs that are recognized in an accounting period. Examples of period costs include rent expense, utilities expense, and salaries expense.**

33. Salary of the tax return preparer could be directly matched with the revenue that it produces.

34. The four stages of the accounting cycle: Record transactions; adjust the accounts; prepare statements; and close the temporary accounts. The adjustment and closing processes have been added to the cycle in this chapter. It is necessary to adjust accounts so that the accounts will reflect the correct balances under the accrual basis of accounting. The closing process (transferring the balances of the temporary accounts to retained earnings) is necessary so that the temporary accounts have a zero balance at the beginning of the next accounting cycle.

SOLUTIONS TO EXERCISES - CHAPTER 2

EXERCISE 2-1

Holloway Company
Effect of Events on the 2018 Accounting Equation

	Assets			=	Liabilities	+	Stockholders' Equity		
Event	Cash	+	Accounts Rec.	=		+	Common Stock	+	Retained Earnings
Earned Revenue		+	18,000	=		+		+	18,000
Coll. Acct. Rec.	14,000	+	(14,000)	=		+		+	
Ending Balance	14,000	+	4,000	=	-0-	+	-0-	+	18,000

a. Accounts Receivable: $18,000 – $14,000 = $4,000

b. $18,000 Net Income

c. $14,000 cash collected from accounts receivable.

d. $18,000

e. $18,000 of revenue was earned but only $14,000 of it was collected.

EXERCISE 2-2

a.

Chung Corporation Accounting Equation - 2018							
Event	Assets	=	Liabilities	+	Stockholders' Equity		
	Cash	=	Salaries Payable	+	Common Stock	+	Retained Earnings
Earned Rev.	8,000						8,000
Accrued Sal.			5,000				(5,000)
Ending Bal.	8,000	=	5,000	+	-0-	+	3,000

Chung Corporation Balance Sheet As of December 31, 2018		
Assets		
Cash	$8,000	
Total Assets		$8,000
Liabilities		
Salaries Payable	$5,000	
Total Liabilities		$5,000
Stockholders' Equity		
Retained Earnings	$3,000	
Total Stockholders' Equity		3,000
Total Liab. and Stockholders' Equity		$8,000

b.

Computation of Net Income	
Revenue	$8,000
Less: Expenses	(5,000)
Net Income	$3,000

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EXERCISE 2-2 (cont.)

c.

Cash Flow from Operating Activities	
Cash from Revenue	**$8,000**
Net Cash Flow from Operating Act.	**$8,000**

d. **The salary expense is deducted from revenue in computing net income, but it has not been paid. This creates a difference of $5,000 between net income and cash flow from operating activities. The revenue is the same because it has been earned and collected.**

EXERCISE 2-3

a.

Milea, Inc. General Ledger Accounts For the Year Ended December 31, 2018								
	Assets		=	Liabilities	+	Stockholders' Equity		
Event	Cash	Acct. Rec.	=	Salaries Pay.	+	Common Stock	Retained Earn.	Acct. Title for RE
1.	20,000					20,000		
2.		56,000					56,000	Revenue
3.	(2,500)						(2,500)	Util. Exp.
4.	48,000	(48,000)						
5.				10,000			(10,000)	Sal. Exp.
6.	(2,000)						(2,000)	Dividends
Totals	63,500	8,000	=	10,000	+	20,000	41,500	

b.

Milea, Inc. Income Statement For the Year Ended December 31, 2018		
Revenue		$56,000
Expenses		
Utility Expense	$ 2,500	
Salaries Expense	10,000	
Total Expenses		(12,500)
Net Income		$43,500

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EXERCISE 2-3 b. (cont.)

Milea, Inc. Statement of Changes in Stockholders' Equity For the Year Ended December 31, 2018		
Beginning Common Stock	$ -0-	
Plus: Common Stock Issued	20,000	
Ending Common Stock		$20,000
Beginning Retained Earnings	-0-	
Plus: Net Income	$43,500	
Less: Dividends	(2,000)	
Ending Retained Earnings		41,500
Total Stockholders' Equity		$61,500

Milea, Inc. Balance Sheet As of December 31, 2018		
Assets		
Cash	$63,500	
Accounts Receivable	8,000	
Total Assets		$71,500
Liabilities		
Salaries Payable	$10,000	
Total Liabilities		$10,000
Stockholders' Equity		
Common Stock	$20,000	
Retained Earnings	41,500	
Total Stockholders' Equity		61,500
Total Liab. and Stockholders' Equity		$71,500

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EXERCISE 2-3 b. (cont.)

Milea, Inc. Statement of Cash Flows For the Year Ended December 31, 2018		
Cash Flow From Operating Activities		
Cash Received from Customers	$48,000	
Cash Paid for Expenses	(2,500)	
Net Cash Flow from Operating Act.		$45,500
Cash Flow From Investing Activities		-0-
Cash Flow From Financing Activities		
Issue of Stock	$20,000	
Paid Dividends	(2,000)	
Net Cash Flow from Financing Act.		18,000
Net Change in Cash		63,500
Plus: Beginning Cash Balance		-0-
Ending Cash Balance		$63,500

c. Net income is the difference between services performed and expenses incurred, regardless of the cash collected or paid. Cash flow from operating activities is the difference between cash collected and paid for operating activities. There was $56,000 of income earned, but only $48,000 collected and $12,500 of expenses incurred, but there was only $2,500 paid.

EXERCISE 2-4

a.

Lewis and Harper Statements Model for 2018																
	Balance Sheet									Income Statement					Statement of	
	Assets			=	Liabilities			+	S. Equity	Rev.	–	Exp.	=	Net Inc.	Cash Flows	
Event No.	Cash	+	Accts. Rec.	=	Acct. Payable	+	Sal. Pay.	+	Retained Earn.							
1.	NA		70,000		NA		NA		70,000	70,000		NA		70,000	NA	
2.	40,000		NA		NA		NA		40,000	40,000		NA		40,000	40,000	OA
3.	NA		NA		36,000		NA		(36,000)	NA		36,000		(36,000)	NA	
4.	(10,000)		NA		NA		NA		(10,000)	NA		10,000		(10,000)	(10,000)	OA
5.	47,000		(47,000)		NA		NA		NA	NA		NA		NA	47,000	OA
6.	(16,000)		NA		(16,000)		NA		NA	NA		NA		NA	(16,000)	OA
7.	(8,000)		NA		NA		NA		(8,000)	NA		NA		NA	(8,000)	FA
8.	NA		NA		NA		2,000		(2,000)	NA		2,000		(2,000)	NA	
Totals	53,000	+	23,000	=	20,000	+	2,000	+	54,000	110,000	–	48,000	=	62,000	53,000	NC

b. Total assets: $76,000 ($53,000 + $23,000)

c. $23,000

d. $20,000

e. Accounts Receivable (an asset) is an amount owed to Lewis and Harper: $23,000;
Accounts Payable (a liability) is an amount that Lewis and Harper owes: $20,000

f. $62,000

g. $61,000 ($40,000 – $10,000 + $47,000 – $16,000)

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EXERCISE 2-5

a.

Computation of Net Income	
Revenue recognized on account	$68,000
Less accrued salary expense	(46,000)
Net Income	$22,000

b.

Computation of Cash Collected from Accounts Receivable	
Beginning balance of Accounts Receivable	$ 4,000
Add revenue recognized on account	68,000
Less ending balance of Accounts Receivable	(4,500)
Cash collected from accounts receivable	$67,500

Computation of Cash Paid for Salaries Expense	
Beginning balance of Salaries Payable	$ 2,600
Add accrued salary expense recognized	46,000
Less ending balance of Salaries Payable	(1,500)
Cash paid for Salary Expense	$47,100

Cash Flow from Operating Activities	
Cash from Accounts Receivable	$67,500
Cash paid for Salary Expense	(47,100)
Net Cash Flow from Operating Act.	$20,400

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EXERCISE 2-6

a. & c.

Event	Revenue	Expense	Statement of Cash Flows	
1.	NA	NA	$40,000	FA
2.	$82,000	NA		NA
3.	NA	NA	(6,000)	FA
4.	NA	NA	76,000	OA
5.	NA	$53,000	(53,000)	OA
6.	19,000	NA	19,000	OA
7.	NA	3,500		NA

b.

Computation of Net Income	
Revenue	$101,000
Less: Expenses	(56,500)
Net Income	$44,500

d.

Cash Flow from Operating Activities	
Cash from Revenue	$95,000
Cash paid for expenses	(53,000)
Net Cash Flow from Operating Act.	$42,000

e. The before-closing balance in the Revenue account is $101,000. After it is closed to Retained Earnings the balance will be zero. Other accounts that are closed at the end of the period include any other revenue accounts, the expense accounts, and the dividends account.

f. The balance of Retained Earnings on the 2018 Balance Sheet will be the amount of Net Income, $44,500 minus $6,000 of dividends that were paid during the year = $38,500. There was no beginning balance in Retained Earnings.

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EXERCISE 2-7

Lee Inc. Effect of Events on the General Ledger Accounts									
	Assets			=	Liabilities	+	Stockholders' Equity		
Event	Cash	Accounts Receivable	Land	=	Accounts Payable	+	Com. Stock	+	Retained Earnings
1. Sales on Account		62,000							62,000
2. Coll. Accts. Rec.	51,000	(51,000)							
3. Incurred Expense					39,000				(39,000)
4. Pd. Acc. Pay.	(31,000)				(31,000)				
5. Issue of Stock	40,000						40,000		
6. Purchase Land	(21,000)		21,000						
Totals	39,000	11,000	21,000	=	8,000	+	40,000	+	23,000

a. Revenue recognized, $62,000.

b. Cash flow from revenue, $51,000.

c. Revenue, $62,000, less operating expenses, $39,000 = $23,000 net income.

d. Accounts receivable collected, $51,000, less cash paid for expenses, $31,000 = $20,000 cash flow from operating activities.

e. Income of $62,000 was earned, but only $51,000 was collected (a difference of $11,000); operating expenses incurred were $39,000 but only $31,000 was paid during the period (a difference of $8,000). Consequently, net income is $3,000 more than cash flow from operating activities.

f. $21,000 cash outflow for the purchase of land.

g. $40,000 cash inflow from the issue of common stock.

h. Total assets = $71,000 ($39,000 + $11,000 + $21,000)
Total liabilities = $8,000
Total equity = $63,000 ($40,000 + $23,000)

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EXERCISE 2-8

a.

Pizza Express Inc. Effect of Events on Financial Statements for 2018																
	Assets			=	Liab.	+	Stockholders' Equity			Income Statement						Statement of Cash Flows
Event No.	Cash	+	Supplies	=	Accts. Pay.	+	Com. Stock	+	Ret. Earn.	Rev.	–	Exp.	=	Net Income		
Beg. Bal	2,500	+	-0-	=	-0-	+	1,400	+	1,100	-0-	–	-0-	=	-0-		-0-
1.	NA	+	3,600	=	3,600	+	NA	+	NA	NA	–	NA	=	NA		NA
2.	12,300	+	NA	=	NA	+	NA	+	12,300	12,300	–	NA	=	12,300		12,300 OA
3.	(2,700)	+	NA	=	(2,700)	+	NA	+	NA	NA	–	NA	=	NA		(2,700) OA
4.	NA	+	(3,350)	=	NA	+	NA	+	(3,350)	NA	–	3,350	=	(3,350)		NA
Totals	12,100	+	250	=	900	+	1,400	+	10,050	12,300	–	3,350	=	8,950		9,600 NC

b. The difference in net income and cash flow from operating activities of $650 ($8,950 – $9,600) is attributed to recognizing supplies expense of $3,350 in the income statement, whereas the cash payment on accounts payable (for supplies) was only $2,700.

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EXERCISE 2-9

Yard Professionals Inc. Effect of Events on the Accounting Equation						
	Assets		=	Liab.	+	Stk. Equity
Event	Cash	Supplies	=	Accounts Payable		Retained Earnings
1. Provided Service	35,000					35,000
2. Purchased Supplies		6,000		6,000		
3. Used Supplies		(4,200)				(4,200)
Totals	35,000	1,800	=	6,000		30,800

b.

Yard Professionals Inc. Income Statement For the Year Ended December 31, 2018	
Revenue	$35,000
Expense	(4,200)
Net Income	$30,800

Yard Professionals Inc. Balance Sheet As of December 31, 2018		
Assets		
Cash	$35,000	
Supplies	1,800	
Total Assets		$36,800
Liabilities		
Accounts Payable	$ 6,000	
Total Liabilities		$ 6,000
Stockholders' Equity		
Retained Earnings	30,800	
Total Stockholders' Equity		30,800
Total Liab. and Stockholders' Equity		$36,800

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EXERCISE 2-9 b. (cont.)

Yard Professionals Inc. Statement of Cash Flows For the Year Ended December 31, 2018		
Cash Flows From Operating Activities:		
Cash Receipt from Revenue	$35,000	
Net Cash Flow from Operating Activities		$35,000
Cash Flows From Investing Activities		-0-
Cash Flows From Financing Activities:		-0-
Net Change in Cash		35,000
Plus: Beginning Cash Balance		-0-
Ending Cash Balance		$35,000

c. The balance of the Supplies account on January 1, 2019 is $1,800, the same as the December 31, 2018 balance.

d. The balance of the Supplies Expense account on January 1, 2019 is zero because the expense account was closed to Retained Earnings at December 31, 2018.

EXERCISE 2-10

a. A cost that is an asset is the cost of resources that are given up in acquiring some type of asset, such as an automobile, office equipment, or land. A cost that is an expense is the use of assets (depreciation) or the payment for an expense that is incurred in the current period (utilities, salaries, etc.).

b. Examples of costs that are assets:
   1. Purchased land.
   2. Paid for 12 months rent in advance.
   3. Purchased supplies for future use.

c. Examples of costs that are expenses:
   1. Recorded rent that has expired.
   2. Paid monthly utilities expense.
   3. Used supplies that had been previously purchased.

EXERCISE 2-11

a.

Life, Inc. Effect of Events on the Accounting Equation				
	Assets		=	Stockholders' Equity
Event	Cash	Prepaid Rent	=	Retained Earnings
1. Performed Services	36,000			36,000
2. Prepaid Rent	(18,000)	18,000		
3. Used Rent		(16,500)*		(16,500)
Totals	18,000	1,500	=	19,500

*$18,000 x 11/12 = $16,500

b.

Life, Inc. Income Statement For the Year Ended December 31, 2018	
Revenue	$36,000
Expense	(16,500)
Net Income	$19,500

Life, Inc. Balance Sheet As of December 31, 2018		
Assets		
Cash	$18,000	
Prepaid Rent	1,500	
Total Assets		$19,500
Liabilities		-0-
Stockholders' Equity		
Retained Earnings	19,500	
Total Stockholders' Equity		19,500
Total Liab. and Stockholders' Equity		$19,500

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EXERCISE 2-11 b. (cont.)

Life, Inc. Statement of Cash Flows For the Year Ended December 31, 2018		
Cash Flows From Operating Activities:		
Cash Receipt from Revenue	$36,000	
Cash Payment for Rent	(18,000)	
Net Cash Flow from Operating Activities		$18,000
Cash Flows From Investing Activities		-0-
Cash Flows From Financing Activities:		-0-
Net Change in Cash		18,000
Plus: Beginning Cash Balance		-0-
Ending Cash Balance		$18,000

c. The balance of the Prepaid Rent will be expensed in 2019, $1,500.

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EXERCISE 2-12

a.

Maine Corporation Accounting Equation 2018								
	Assets		=	Liab.	+	Stockholders' Equity		
Event	Cash	Prepaid Rent	=		+	Com. Stock	+	Retained Earnings
Paid rent in advance	(18,000)	18,000						
Adj. Rent exp.		(13,500)*						(13,500)
Totals	(18,000)	4,500	=	-0-	+	-0-	+	(13,500)

*$18,000 x 9/12 = $13,500

b. The required entry would decrease assets by $13,500 [($18,000 ÷ 12) x 9] and decrease stockholders' equity by $13,500 (retained earnings). If this entry is not made, assets and stockholders' equity would both be overstated on the balance sheet by $13,500. On the income statement, expenses would be understated causing net income to be overstated by $13,500.

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EXERCISE 2-13

a.

Yard Designs 2018					
Event	Assets	=	Liabilities	+	Stockholders' Equity
	Cash	=	Unearned Revenue	+	Retained Earnings
event	54,000		54,000		
Adj.			(13,500)*		13,500
	54,000	=	40,500		13,500

*$54,000 x 3/12 = $13,500

b.

Yard Designs Income Statement For the Year Ended December 31, 2018	
Revenue	$13,500
Expense	-0-
Net Income	$13,500

Yard Designs Balance Sheet As of December 31, 2018		
Assets		
Cash	$54,000	
Total Assets		$54,000
Liabilities		-0-
Unearned Revenue	$40,500	
Total Liabilities		$40,500
Stockholders' Equity		
Retained Earnings	13,500	
Total Stockholders' Equity		13,500
Total Liab. and Stockholders' Equity		$54,000

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EXERCISE 2-13 b. (cont.)

Yard Designs Statement of Cash Flows For the Year Ended December 31, 2018		
Cash Flows From Operating Activities:		
Cash Receipt from Revenue	$54,000	
Net Cash Flow from Operating Activities		$54,000
Cash Flows From Investing Activities		-0-
Cash Flows From Financing Activities:		-0-
Net Change in Cash		54,000
Plus: Beginning Cash Balance		-0-
Ending Cash Balance		$54,000

c. Nine months of unearned revenue from 2018 will be recognized in 2019: $54,000 x 9/12 = $40,500

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EXERCISE 2-14

Note: This exercise can be used to assess writing skills.

The fee that Matlock receives in advance is a liability at the time of receipt. Matlock has the duty to either perform the service or return the money received in advance. When Matlock performs the service, the liability will be satisfied and the revenue will be recognized.

EXERCISE 2-15

Hart, Attorney At Law
Effect of Transactions on the Financial Statements for 2018

	Balance Sheet									Income Statement					Statement of
	Assets			=	Liabilities			+	S. Equity	Rev	–	Exp.	=	Net Inc.	Cash Flows
No.	Cash	+	Supplies	=	Accts. Payable	+	Unearn. Rev.	+	Retained Earnings						
1.	36,000	+	NA	=	NA	+	36,000	+	NA	NA	–	NA	=	NA	36,000 OA
2.	54,000	+	NA	=	NA	+	NA	+	54,000	54,000	–	NA	=	54,000	54,000 OA
3.	NA	+	2,800	=	2,800	+	NA	+	NA	NA	–	NA	=	NA	NA
4.	(2,400)	+	NA	=	(2,400)	+	NA	+	NA	NA	–	NA	=	NA	(2,400) OA
5.	(5,000)	+	NA	=	NA	+	NA	+	(5,000)	NA	–	NA	=	NA	(5,000) FA
6.	(31,000)	+	NA	=	NA	+	NA	+	(31,000)	NA	–	31,000	=	(31,000)	(31,000) OA
7.	NA	+	(2,600)	=	NA	+	NA	+	(2,600)	NA	–	2,600	=	(2,600)	NA
8.	NA	+	NA	=	NA	+	(27,000)*	+	27,000	27,000	–	NA	=	27,000	NA
Totals	51,600	+	200	=	400	+	9,000	+	42,400	81,000	–	33,600	=	47,400	51,600 NC

*$36,000 x 9/12 = $27,000

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EXERCISE 2-16

a.

Bell Personal Financial Planning Horizontal Statements Model for 2018												
	Assets	=	Liabilities	+	Stk. Equity	Income Statement					Statement of Cash Flows	
Event	Cash	=	Unearned Revenue	+	Retained Earnings	Rev.	–	Exp.	=	Net Income		
1. Advance Payment	36,000		36,000		NA	NA		NA		NA	36,000	OA
2. Revenue Earned	NA		(21,000)*		21,000	21,000		NA		21,000	NA	
Totals	36,000	=	15,000	+	21,000	21,000	–	-0-	=	21,000	36,000	NC

*$36,000 x 7/12 = $21,000

b. Revenue that will be recognized in 2019 is $15,000, the remainder of the unearned revenue from 2018.

c. $-0-, no cash is received. All cash was received in 2018.

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EXERCISE 2-17

a.

Stokes Company Accounting Equation - 2018								
Event	Assets		=	Liab.	+	Stockholders' Equity		
	Cash	Prepaid Rent	=		+	Common Stock	+	Retained Earnings
Paid 12 months rent	(4,800)	4,800						
Adj. for 3 months used		(1,200)*						(1,200)

*$4,800 x 3/12 = $1,200

b.

Eastport Rentals Accounting Equation - 2018							
Event	Assets	=	Liabilities	+	Stockholders' Equity		
	Cash	=	Unearned Revenue	+	Common Stock	+	Retained Earnings
Recd. 12 months rent	4,800		4,800				
Earned 3 months rent			(1,200)*				1,200

*$4,800 x 3/12 = $1,200

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EXERCISE 2-18

a. deferral

b. neither

c. neither

d. neither

e. deferral

f. accrual

g. neither

h. neither

i. accrual

j. neither

k. accrual

l. deferral

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EXERCISE 2-19

Note: There are many examples of events that illustrate the required effects. An example is given of each event.

a. Recognized accrued salaries expense.

b. Paid rent expense.

c. Recognized revenue for which cash had been received in advance (unearned revenue).

d. Provided service for cash.

EXERCISE 2-20

a. Retained Earnings is a permanent account, meaning that one period's ending balance becomes the next period's beginning balance. Since the December 31, 2018 balance is $42,100, this was also the balance on January 1, 2019.

b. The balance in the temporary accounts will be zero on January 1, 2018. The temporary accounts would have been closed to Retained Earnings on December 31, 2017, thus leaving a zero balance.

c. The December 31, 2017 balance in the Retained Earnings account is the same balance as the January 1, 2018 balance, computed as follows:

Beginning Retained Earnings Balance, January 1, 2018	$?
+ Net Income, 2018 (Revenue $19,400 – Expenses $9,800)	9,600
– Dividends paid 2018	(500)
= Ending Retained Earnings Balance, December 31, 2018	$42,100

Working backwards:
End. Retained Earnings + Dividends – Net Income = Beg. Retained Earnings; and January 1, 2018 = December 31, 2017
= $42,100 + $500 – $9,600 = $33,000 = January 1, 2018 Retained Earnings
Therefore:
December 31, 2017 Retained Earnings = $33,000

d. The revenue and expense data are recorded in Revenue and Expense accounts and do not affect retained earnings at the time of recognition. The balance in the Retained Earnings account on June 30, 2018 is the same as it was on January 1, 2018 which is $33,000 (see answer (c) for calculation).

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EXERCISE 2-21

a.

Event	Requires year-end adjusting entry?
1.	No
2.	No
3.	No
4.	Yes
5.	No
6.	Yes
7.	No
8.	No
9.	No
10.	No

b. Adjusting entries are required to update accounting records for income that has been earned or expenses that have been incurred. Revenue and expenses are recognized in the period that they are earned or incurred, not necessarily when the cash is received or paid. After the adjusting entries are made at the end of the accounting period, the revenue, expense and dividends accounts are closed to Retained Earnings.

EXERCISE 2-22

a.

Permanent Accounts
Cash
Notes Payable
Land
Common Stock
Retained Earnings

Temporary (Nominal) Accounts
Revenue
Expenses
Dividends

b.

Beginning Retained Earnings	$2,500
Add: Revenue	7,500
Less: Expenses	(3,400)
Less: Dividends	(1,000)
Ending Retained Earnings	$5,600

c.

Computation of Net Income	
Revenue	$7,500
Less: Expenses	(3,400)
Net Income	$4,100

d. Net income is only the current year's net income. Retained Earnings is an accumulation of net income over the life of the business less any dividends that have been paid over the years.

e. All revenue, expense, and dividend accounts will have a zero balance because they have been closed to retained earnings.

EXERCISE 2-23

a.

Account	Classification
1. Other Operating Expenses	T
2. Utilities Expense	T
3. Retained Earnings	P
4. Salaries Expense	T
5. Land	P
6. Dividends	T
7. Service Revenue	T
8. Cash	P
9. Salaries Payable	P
10. Common Stock	P

b. The four stages of the accounting cycle are:
recording transactions
adjusting the accounts
preparing financial statements
closing temporary accounts.

The first stage of the cycle must be recording accounting data in accounts to put it into usable form. Once the accounting data is summarized in the accounts, adjustments are made to reflect any unrecorded transactions. The account balances are then used to prepare the financial statements. After the financial statements are prepared, the temporary accounts (revenue, expenses, and dividends) must be closed to prepare these accounts for the next accounting period.

EXERCISE 2-24

a. Examples of expenses that would be matched directly with revenue:

Sales commissions
Salaries expense

b. An example of a period cost that is difficult to match with revenue:

Advertising expense - A company can not be certain when dollars spent for advertising will produce benefits.

EXERCISE 2-25

a.

Event	Classification
1.	FA
2.	NA
3.	OA
4.	OA
5.	OA
6.	NA
7.	OA
8.	FA
9.	OA
10.	NA

b.

Ewing Company Statement of Cash Flows For the Year Ended December 31, 2018		
Cash Flows From Operating Activities:		
Cash from the collection of accts. rec.	$51,000	
Cash from service revenue	8,000	
Cash payment for supplies	(1,200)	
Cash payment on accounts payable	(22,000)	
Cash payment for rent	(6,500)	
Net Cash Flow from Operating Activities		$29,300
Cash Flows From Investing Activities		-0-
Cash Flows From Financing Activities:		
Cash receipt from stock issue	$30,000	
Cash payment for dividends	(4,000)	
Net Cash Flow from Financing Activities		26,000
Net Change in Cash		$55,300
Plus: Beginning Cash Balance		-0-
Ending Cash Balance		$55,300

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EXERCISE 2-26

Item/Account	Statement		Item/Account	Statement
a. Supplies	BS		u. Rent Exp.	IS
b. Cash Flow from Financing Act.	CF		v. P/E Ratio	NA
c. "As of" Date Notation	BS		w. Taxes Payable	BS
d. End Retained Earn.	BS/SE		x. Unearned Revenue	BS
e. Net Income	IS/SE		y. Service Revenue	IS
e. Dividends	SE/CF		z. Cash Flow from Investing Activities	CF
g. Net Change in Cash	CF		aa. Consulting Revenue	IS
h. "For the Period Ended"	IS/CF/SE		bb. Utilities Expense	IS
i. Land	BS		cc. End. Common Stock	BS/SE
j. Ending Common Stock	BS/SE		dd. Total Liabilities	BS
k. Salaries Expense	IS		ee. Operating Cycle	NA
l. Prepaid Rent	BS		ff. Cash Flow from Operating Activities	CF
m. Accounts Payable	BS		gg. Operating Expenses	IS
n. Total Assets	BS		hh. Supplies Expense	IS
o. Salaries Payable	BS		ii. Beg. Retained Earn.	SE
p. Insurance Expense	IS		jj. Beg. Common Stock	SE
q. Notes Payable	BS		kk. Prepaid Insurance	BS
r. Accounts Receivable	BS		ll. Salary Expense	IS
s. Interest Receivable	BS		mm. Beginning Cash	CF
t. Interest Revenue	IS		nn. Ending Cash	BS/CF

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EXERCISE 2-27

Horizontal Statements Model															
						Stock. Equity			Income Statement					Statement of Cash Flows	
Event	Type of Event	Assets	=	Liab.	+	Com. Stock	+	Ret. Earn	Rev.	–	Exp	=	Net Inc.		
a.	AS	I		NA		NA		I	I		NA		I	I	OA
b.	AS	I		I		NA		NA	NA		NA		NA	NA	
c.	AE	I/D		NA		NA		NA	NA		NA		NA	D	OA
d.	AE	I/D		NA		NA		NA	NA		NA		NA	D	IA
e.	AU	D		NA		NA		D	NA		NA		NA	D	FA
f.	AS	I		NA		I		NA	NA		NA		NA	I	FA
g.	AU	D		D		NA		NA	NA		NA		NA	D	OA
h.	AE	I/D		NA		NA		NA	NA		NA		NA	I	OA
i.	AS	I		I		NA		NA	NA		NA		NA	I	OA
j.	CE	NA		I		NA		D	NA		I		D	NA	
k.	AS	I		NA		NA		I	I		NA		I	NA	
l.	AU	D		NA		NA		D	NA		I		D	NA	
m.	AU	D		NA		NA		D	NA		I		D	D	OA
n.	AU	D		NA		NA		D	NA		I		D	NA	
o.	CE	NA		I		NA		D	NA		I		D	NA	
p.	AU	D		D		NA		NA	NA		NA		NA	D	OA
q.	AS	I		NA		NA		I	I		NA		I	NA	

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EXERCISE 2-28

	Net Income		Cash Flow from Operating Activities	
Event/Adj.	Direction of Change	Amount of Change	Direction of Change	Amount of Change
a. Event	NA	NA	Decrease	$9,000
Adj.	Decrease	$2,250[1]	NA	NA
b. Event	NA	NA	Decrease	500
Adj.	Decrease	$1,700[2]	NA	NA
c. Event No adj.	Increase	$10,000	Increase	$10,000
d. Event	NA	NA	Increase	$2,400
Adj.	Increase	$1,600[3]	NA	NA
e. Event No adj.	Decrease	$5,600	NA	NA
f. Event No adj.	NA	NA	NA	NA
g. Event No adj.	NA	NA	NA	NA
h. Event No adj.	Increase	$12,000	Increase	$8,000
i. Event No adj.	Decrease	$4,500	Decrease	$4,500

[1]$9,000 x 3/12 = $2,250
[2]$2,000 – $300 = $1,700
[3]$2,400 x 8/12 = $1,600

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EXERCISE 2-29

The following are only example transactions. There are also other transactions that would cause the desired effect.

a. The business acquired cash by issuing stock to its owners.

Cash revenue is earned.

b. Paid cash dividends to stockholders.

Paid an expense with cash.

c. The business invested cash by purchasing a building.

Collected accounts receivable.

d. Unearned revenue is earned and recognized.

e. Recorded accrued salaries.

Recorded the expense for the utility bill received at the end of the month, but not due until next month.

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

Borrowed cash from the bank.

g. Paid cash for operating expenses previously purchased on account.

Repaid a loan with cash.

EXERCISE 2-30

a.	AS	Asset Source
b.	AU	Asset Use
c.	AU	Asset Use
d.	CE	Claims Exchange
e.	AU	Asset Use
f.	AS	Asset Source
g.	AS	Asset Source
h.	AE	Asset Exchange
i.	AS	Asset Source
j.	AE	Asset Exchange

EXERCISE 2-31

Note: These are only sample transactions. Other similar transactions will satisfy the requirements of this exercise.

a. Payment of a bank loan; payment of accounts payable.

b. Collection of accounts receivable; purchase of Land.

c. Borrowed cash from the bank; issued stock for cash.

d. Provide service on account.

e. Provide service for cash; provide service on account.

SOLUTIONS TO PROBLEMS - CHAPTER 2

PROBLEM 2-32

Super Cleaning Company
Effect of Events on the Financial Statements

	Balance Sheet													Income Statement					Stmt. of Cash Flows
	Assets					=	Liabilities			+	Stockholders' Equity			Rev.	–	Exp.	=	Net Inc.	
Event No.	Cash	+	Accts Rec.	+	Pp. Rent	=	Accts. Pay.	+	Unearn Rev.	+	Com. Stock	+	Ret. Earn.						
1.	10,000	+	NA	+	NA	=	NA	+	NA	+	10,000	+	NA	NA	–	NA	=	NA	10,000 FA
2.	NA	+	15,000	+	NA	=	NA	+	NA	+	NA	+	15,000	15,000	–	NA	=	15,000	NA
3.	5,000	+	NA	+	NA	=	NA	+	NA	+	NA	+	5,000	5,000	–	NA	=	5,000	5,000 OA
4.	2,800	+	NA	+	NA	=	NA	+	2,800	+	NA	+	NA	NA	–	NA	=	NA	2,800 OA
5.	12,200	+	(12,200)	+	NA	=	NA	+	NA	+	NA	+	NA	NA	–	NA	=	NA	12,200 OA
6.	(1,900)	+	NA	+	NA	=	NA	+	NA	+	NA	+	(1,900)	NA	–	1,900	=	(1,900)	(1,900) OA
7.	NA	+	NA	+	NA	=	NA	+	(1,400)	+	NA	+	1,400	1,400	–	NA	=	1,400	NA
8.	NA	+	NA	+	NA	=	3,600	+	NA	+	NA	+	(3,600)	NA	–	3,600	=	(3,600)	NA
9.	(4,800)	+	NA	+	4,800	=	NA	+	NA	+	NA	+	NA	NA	–	NA	=	NA	(4,800) OA
10.	(2,800)	+	NA	+	NA	=	(2,800)	+	NA	+	NA	+	NA	NA	–	NA	=	NA	(2,800) OA
11.	(1,500)	+	NA	+	NA	=	NA	+	NA	+	NA	+	(1,500)	NA	–	NA	=	NA	(1,500) FA
12.	NA	+	NA	+	(3,600)*	=	NA	+	NA	+	NA	+	(3,600)	NA	–	3,600	=	(3,600)	NA
Bal.	19,000	+	2,800	+	1,200	=	800	+	1,400	+	10,000	+	10,800	21,400	–	9,100	=	12,300	19,000 NC

*$4,800 x 9/12 = $3,600

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PROBLEM 2-33

The Accounting Equation									
	Total Assets			=	Liabilities	+	Stockholders' Equity		
Event/ Adjust.	Cash	+	Other Assets	=		+	Common Stock	+	Retained Earnings
a.	(4,800)		+4,800		NA		NA		NA
a. Adj.	NA		(1,200)[1]		NA		NA		(1,200)
b.	+3,600		NA		+3,600		NA		NA
b. Adj.	NA		NA		(2,700)[2]		NA		+2,700
c.	NA		+1,200		+1,200		NA		NA
c. Adj.	NA		(1,025)		NA		NA		(1,025)
d.	(9,600)		+9,600		NA		NA		NA
d. Adj.	NA		(4,000)[4]		NA		NA		(4,000)

[1]$4,800 x 3/12 = $1,200
[2]$3,600 x 9/12 = $2,700
[3]$1,200 – $175 = $1,025
[4]$9,600 x 5/12 = $4,000

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PROBLEM 2-34

Nowell Company Income Statement For the Year Ended December 31, 2018		
Consulting Revenue		$18,200
Expenses		
Travel Expense	$2,100	
Rent Expense	3,500	
Salary Expense	7,200	
Other Operating Expenses	2,300	
Total Expenses		(15,100)
Net Income		$3,100

b.

Accounts to be Closed:
Consulting Revenue
Travel Expense
Dividends
Rent Expense
Salary Expense
Other Operating Expenses

c.

Computation of Retained Earnings:	
Beginning Retained Earnings	$16,200
Add: Net Income	3,100
Less: Dividends	(4,000)
Ending Retained Earnings	$15,300

Net income only includes revenues and expenses for the current year. Retained earnings not only includes current year net income, but also the balance from previous years and reductions for dividends.

d. The balances are zero; they were closed to Retained Earnings on December 31, 2018. The December 31 closing balance of one year is the opening balance on January 1 of the next year.

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PROBLEM 2-35

Accounting Equation (Prepared for Instructor's Use)

Waddell Company Accounting Equation											
	Assets						Liabilities			Stk. Equity	
Date	Cash	Acc Rec.	Pp. Rent	Supp.	Int. Rec.	Land	Acc. Pay.	Sal. Pay.	Unear. Rev.	Com. Stock	Ret. Earn
Bal.	35,000	9,000				51,000	7,500			40,000	47,500
1/1	20,000									20,000	
2/1	(6,000)		6,000								
3/1	(2,000)										(2,000)
4/1	(15,000)					15,000					
5/1	(5,500)						(5,500)				
7/1	9,600								9,600		
9/1	30,000					(30,000)					
10/1				2,500			2,500				
12/31		58,000									58,000
12/31	46,000	(46,000)									
12/31							28,000				(28,000)
12/31								6,500			(6,500)
12/31				(2,450)							(2,450)
12/31[1]											
12/31[2]					500						500
12/31a			(5,500)[3]								(5,500)
12/31a									(4,800)[4]		4,800
Bal.	112,100	21,000	500	50	500	36,000	32,500	6,500	4,800	60,000	66,350

[1] 12/31 No entry required for the change in the value of the land.
[2] 12/31 This assumes that part of the cash was invested in an interest-bearing account.
[3] 12/31a Expired Rent $6,000 x 11/12 = $5,500.
[4] 12/31a Unearned Revenue earned $9,600 x 6/12 = $4,800.

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PROBLEM 2-35 (cont.)

a. The two transactions that need adjusting entries are as follows:
   1. Feb. 1, prepaid rent.
   2. July 1, unearned revenue; cash was received in advance.

b. $36,000; its historical cost.

c. $46,000 + $9,600 – $6,000 – $5,500 = $44,100

d. $6,000 X 11/12 = $5,500

e. $32,500 + $6,500 + $4,800 = $43,800

f. $2,500 – $50 = $2,450

g. $9,600 – $4,800 ($9,600 x 6/12) = $4,800

h. –$15,000 + $30,000 = $15,000

i. $28,000 + $6,500 + $2,450 + $5,500 = $42,450

j. $58,000 + $4,800 = $62,800

k. $20,000 – $2,000 = $18,000

l. (j) $62,800 + $500 – (i) $42,450 = $20,850

m. Beg. RE $47,500 + NI $20,850 – Div. $2,000 = Ending retained earnings $66,350

PROBLEM 2-36

Barker Company Financial Statements For the Year Ended December 31, 2018		
Income Statement		
Revenue		
Service Revenue	$65,200	
Total Revenue		$65,200
Expenses		
Other Operating Expenses	$41,000	
Supplies Expense	1,100	
Rent Expense	2,500	
Insurance Expense	2,100	
Total Expenses		(46,700)
Net Income		$18,500
Statement of Changes in Stockholders' Equity		
Beginning Common Stock	$40,000	
Plus: Stock Issued	5,000	
Ending Common Stock		$45,000
Beginning Retained Earnings	$ 9,300	
Plus: Net Income	18,500	
Less: Dividends	(3,000)	
Ending Retained Earnings		24,800
Total Stockholders' Equity		$69,800

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PROBLEM 2-36 (cont.)

Barker Company Balance Sheet As of December 31, 2018		
Assets		
Cash		$ 48,000
Accounts Receivable		14,200
Supplies		1,000
Prepaid Insurance		1,200
Prepaid Rent		4,800
Land		24,000
Total Assets		$93,200
Liabilities		
Accounts Payable	$17,000	
Unearned Revenue	6,400	
Total Liabilities		$23,400
Stockholders' Equity		
Common Stock	$45,000	
Retained Earnings	24,800	
Total Stockholders' Equity		69,800
Total Liab. and Stockholders' Equity		$93,200

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PROBLEM 2-36 (cont.)

Barker Company Statement of Cash Flows For the Year Ended December 31, 2018	
Cash Flow From Operating Activities	$15,600
Cash Flow From Investing Activities	(5,200)
Cash Flow From Financing Activities	(5,000)
Net Change in Cash	5,400
Plus: Beginning Cash Balance	42,600*
Ending Cash Balance	$48,000

*Not given in the problem.

Ending Cash Balance – Increase in Cash = Beginning Cash Balance
$48,000 – $5,400 = $42,600

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PROBLEM 2-37

FOR THE YEARS	2018	2019	2020
Income Statements			
Revenue (cash)	$ 700	$1,300	$ 2,000
Expense (cash)	(a) (500)	(700)	(1,300)
Net Income (Loss)	$ 200	(m) $ 600	$ 700
Statements of Changes in Stockholders' Equity			
Beginning Common Stock	$ -0-	(n) $5,000	$6,000
Plus: Common Stock Issued	5,000	1,000	2,000
Ending Common Stock	5,000	6,000	(t) 8,000
Beginning Retained Earnings	-0-	100	200
Plus: Net Income (Loss)	(b) 200	(o) 600	700
Less: Dividends	(c) (100)	(500)	(300)
Ending Retained Earnings	100	(p) 200	600
Total Stockholders' Equity	(d) $5,100	$6,200	$8,600
Balance Sheets			
Assets			
Cash	(e) $8,100	(q) $3,200	(u)$ 2,600
Land	-0-	(r) 8,000	8,000
Total Assets	(f) $8,100	$11,200	$10,600
Liabilities	(g) $3,000	$ 5,000	$ 2,000
Stockholders' Equity			
Common Stock	(h) 5,000	(s) 6,000	8,000
Retained Earnings	(i) 100	200	600
Total Stockholders' Equity	(j) 5,100	6,200	8,600
Total Liab. and Stk. Equity	$8,100	$11,200	$10,600

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PROBLEM 2-37 (cont.)

FOR THE YEARS	2018	2019	2020
Statements of Cash Flows			
Cash Flows From Oper. Activities:			
Cash Receipts from Customers	(k)$ 700	$ 1,300	(v) $ 2,000
Cash Payments for Expenses	(l) (500)	(700)	(w) (1,300)
Net Cash Flows from Oper. Act.	200	600	700
Cash Flows From Invest. Activities:			
Cash Payments for Land	-0-	(8,000)	-0-
Cash Flows From Fin. Activities:			
Cash Receipts from Loan	3,000	3,000	-0-
Cash Payments to Reduce Debt	-0-	(1,000)	(x) (3,000)
Cash Receipts from Stock Issue	5,000	1,000	(y) 2,000
Cash Payments for Dividends	(100)	(500)	(z) (300)
Net Cash Flows from Fin. Activities	7,900	2,500	(1,300)
Net Change in Cash	8,100	(4,900)	(600)
Plus: Beginning Cash Balance	-0-	8,100	3,200
Ending Cash Balance	$8,100	$3,200	$2,600

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PROBLEM 2-37 (cont.)

Computations of amounts:

a. $500 Expense = $700 Revenue – $200 Net Income.
b. $200 Net Income = $200 Net Income from Income Statement.
c. $100 Dividends = $200 Net Income – $100 Ending Ret. Earnings.
d. $5,100 Total Stk. Equity = $5,000 Ending Common Stock + $100 Ending Retained Earnings.
e. $8,100 Cash = $8,100 Total Assets – $-0- Land.
f. $8,100 Total Assets = $8,100 Liabilities and Stockholders' Equity.
g. $3,000 Liabilities = $3,000 Cash Receipts from Loan from Statement of Cash Flows.
h. $5,000 Common Stock = $5,000 Com. Stock from Statement of Changes in Stockholders' Equity.
i. $100 Retained Earnings = $100 Ret. Earnings from Statement of Changes in Stockholders' Equity.
j. $5,100 Total Stockholders' Equity = $5,000 Common Stock + $100 Retained Earnings or $5,100 Total Stk. Equity from Statement of Changes in Stk. Equity.
k. $700 Cash Receipts from Revenue = $700 Revenue from Income Statement.
l. $500 Cash Payment for Expenses = $500 Expense from Income Statement.
m. $600 Net Income = $1,300 Revenue – $700 Expense.
n. $5,000 Beginning Common Stock = $5,000 Ending Common Stock 2018.
o. $600 Net Income = $600 Net Income from Income Statement.
p. $200 Ending Retained Earnings = $100 Beginning Ret. Earnings + $600 Net Income – $500 Dividends.
q. $3,200 Cash = Ending Cash Balance from Statement of Cash Flows.
r. $8,000 Land = $8,000 Cash Payment for Land from Statement of Cash Flows.
s. $6,000 Common Stock = $6,000 Ending Common Stock from Statement of Changes in Equity.
t. $8,000 Ending Common Stock = $6,000 Beginning Common Stock + $2,000 Common Stock Issued.
u. $2,600 Cash = $2,600 Ending Cash Balance from Statement of Cash Flows.
v. $2,000 Cash Receipts from Revenue = $2,000 Revenue from Income Statement.
w. $1,300 Cash Payments for Expenses = $1,300 Expense from Income Statement.
x. $3,000 Cash Payment to Reduce Debt = $5,000 Balance of Liabilities, 2019 – $2,000 Balance of Liabilities, 2020.
y. $2,000 Cash Receipts from Stock Issue = $2,000 Stock Issued from Statement of Changes in Stockholders' Equity.
z. $300 Cash Payment for Dividends = $300 Dividends from Statement of Changes in Stockholders' Equity

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PROBLEM 2-38

a.

Alcorn Service Company
Accounting Equation for 2018

		Assets					=	Liabilities			+	Stk. Equity	
Event	Type of Event	Cash	Accts. Rec.	Supp.	Prepd. Rent	Land	=	Accts. Pay.	Salaries Payable	Unearn. Rev.	+	Com. Stock	Ret. Earn.
1.	AS	20,000										20,000	
2.	AS			800				800					
3.	AE	(14,000)				14,000							
4.	AU	(800)						(800)					
5.	AS		10,500										10,500
6.	AU	(3,800)											(3,800)
7.	AE	7,000	(7,000)										
8.	CE								3,600				(3,600)
9.	AU			(700)									(700)
Totals		8,400	3,500	100	-0-	14,000	=	-0-	3,600	-0-	+	20,000	2,400

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PROBLEM 2-38 a. (cont.)

Alcorn Service Company
Accounting Equation for 2019

		Assets						=	Liabilities			+	Stk. Equity	
Event	Type of Event	Cash	Accts. Rec.	Supp.	Prepd. Rent	Land	Int. Rec.	=	Accts. Pay.	Salaries Payable	Unearn Rev.	+	Com. Stock	Ret. Earn.
Bal.		8,400	3,500	100	-0-	14,000			-0-	3,600	-0-		20,000	2,400
1.	AS	15,000											15,000	
2.	AU	(3,600)								(3,600)				
3.	AE	(9,000)			9,000									
4.	AE	14,000				(14,000)								
5.	AS	6,000									6,000			
6.	AS			2,400					2,400					
7.	AS		24,500											24,500
8.	AE	12,600	(12,600)											
9.	AU	(2,000)												(2,000)
10.	AU	(2,850)												(2,850)
11.	AU				(7,500)[1]									(7,500)
12.	CE										(1,500)[2]			1,500
13.	AU			(2,200)[3]										(2,200)
14.	CE									4,800				(4,800)
15.	AS						500							500
Totals		38,550	15,400	300	1,500	-0-	500		2,400	4,800	4,500	+	35,000	9,550

[1]$9,000 x 10/12 = $7,500
[2]$6,000 x 3/12 = $1,500
[3]$100 + $2,400 – $300 = $2,200

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PROBLEM 2-38 (cont.)

b.

Alcorn Service Company Financial Statements For the Years Ended December 31, 2018 and 2019		
Income Statements		
	2018	2019
Service Revenue	$10,500	$26,000
Interest Revenue	-0-	500
Total Revenue	10,500	26,500
Expenses		
Operating Expenses	(3,800)	(2,850)
Supplies Expense	(700)	(2,200)
Salaries Expense	(3,600)	(4,800)
Rent Expense	-0-	(7,500)
Total Expenses	(8,100)	(17,350)
Net Income (Loss)	$2,400	$ 9,150
Statements of Changes in Stockholders' Equity		
Beginning Common Stock	$ -0-	$20,000
Plus: Stock Issued	20,000	15,000
Ending Common Stock	20,000	35,000
Beginning Retained Earnings	-0-	2,400
Plus/Less: Net Income (Loss)	2,400	9,150
Less: Dividends	-0-	(2,000)
Ending Retained Earnings	2,400	9,550
Total Stockholders' Equity	$22,400	$44,550

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PROBLEM 2-38 b. (cont.)

Alcorn Service Company Balance Sheets As of December 31, 2018 and 2019		
	2018	2019
Assets		
Cash	$ 8,400	$38,550
Accounts Receivable	3,500	15,400
Interest Receivable	-0-	500
Supplies	100	300
Prepaid Rent	-0-	1,500
Land	14,000	-0-
Total Assets	$26,000	$56,250
Liabilities		
Accounts Payable	$ -0-	$ 2,400
Salaries Payable	3,600	4,800
Unearned Revenue	-0-	4,500
Total Liabilities	3,600	11,700
Stockholders' Equity		
Common Stock	20,000	35,000
Retained Earnings	2,400	9,550
Total Stockholders' Equity	22,400	44,550
Total Liab. and Stock. Equity	$26,000	$56,250

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PROBLEM 2-38 b. (cont.)

Alcorn Service Company Statements of Cash Flows For the Years Ended December 31, 2018 and 2019		
	2018	2019
Cash Flows From Operating Activities:		
Cash Receipts from Customers	$7,000	$18,600[1]
Cash Payments for Expense[2]	(4,600)	(15,450)
Net Cash Flow from Operating Activities	2,400	3,150
Cash Flows From Investing Activities:		
Cash Payment for Land	(14,000)	-0-
Cash Proceeds from Sale of Land	-0-	14,000
Net Cash Flow From Investing Activities	(14,000)	14,000
Cash Flows From Financing Activities:		
Cash Receipts from Stock Issue	20,000	15,000
Cash Payment for Dividends	-0-	(2,000)
Net Cash Flow From Financing Activities	20,000	13,000
Net Change in Cash	8,400	30,150
Plus: Beginning Cash Balance	-0-	8,400
Ending Cash Balance	$8,400	$38,550

[1]2019: $6,000 + $12,600 = $18,600
[2]2018: $3,800 + $800 = $4,600
2019: $3,600 + $9,000 + $2,850 = $15,450

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SOLUTIONS TO ANALYZE, THINK, COMMUNICATE – CHAPTER 2

ATC 2-1

All dollar amounts are in millions.

a. **Target's accrual accounts are: Accounts payable and Accrued and other current liabilities. The Deferred income taxes account shown under Liabilities is probably best classified as an accrual account, but students will probably think it is a deferral account.**

b. **Target's deferral accounts are: Inventories, Buildings and improvements, Fixtures and equipment, Computer hardware and software, and construction in progress. Students might also list the Deferred income taxes account shown under Liabilities.**

c.

Net income for 2015 was	**$3,363**
Cash provided by operating activities for 2015 was	**$5,844**

Thus, cash flow from operating activities exceeded net income by $2,481.

d. **Net income increased by $4,999 from 2014 to 2015 ($3,363 - ($1,636)). Cash provided by operating activities increased by $1,405 from 2014 to 2015 ($5,844 - $4,439). Therefore, the change in net earnings was the greatest.**

e. **The large increase in net earnings was due to discontinued operations reported in 2014, which were the result of Target's plan to exit the Canadian market. Net earnings from continuing operations also increased from 2014 to 2015, but by a much smaller amount, $872 ($3,321 - $2,449).**

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ATC 2-2

Group Task (1)

	Exxon	%	Apple	%
Computation of Expenses				
Revenue (in billions)	$411.9	100.0	$182.8	100.0
Less, Net Income	32.5	7.9	39.5	21.6
Expenses (in billions)	$379.4	92.1	$114.3	78.4

Group Task (2)

The conservatism principle guides accountants to select the alternative that produces the lowest amount of net income. The conservatism principle holds that it is better to understate income than to overstate it. If this holds true, Apple may be expensing more of its cost than Exxon Mobil.

Group Task (3)

Investors may believe there is more growth opportunity in the technology field, where Apple operates than there is in the petroleum field, where Exxon Mobil operates. Additionally, if Apple's net income, as a percentage of sales, is higher, this would likely indicate a higher profit.

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ATC 2-3

This solution is based on Netflix's 2015 financial report.

a. Netflix's accrual accounts are:

Accounts payable
Accrued expenses
Current content liabilities*

***Students probably will miss this one, as a careful reading of the Note 3 is needed to understand it.**

b. Netflix's deferral accounts are:

Content assets, (short-term and long-term)
Property, plant and equipment, net
Other current assets
Other noncurrent assets (possibly, depending on the nature of the asset)
Deferred revenues

ATC 2-4

a.

Income Statement		Balance Sheet	
Service Revenue	$120,000	Assets:	$167,000
Operating Exp.	(40,000)		
Net Income	$ 80,000	Liabilities:	$ 5,000
		Stockholders' Equity:	
		Common Stock	82,000
		Retained Earnings	80,000
		Total Stk. Equity	162,000
		Total Liab. and Stk. Equity	$167,000

Computations for Income Statement Items:

Revenue: $38,000 + $82,000 = $120,000
Operating Expense: $70,000 – $30,000 = $40,000

Computations for Balance Sheet Items:

Assets: $85,000 + $82,000 = $167,000
Liabilities: $35,000 – $30,000 = $5,000
Retained Earnings: ($32,000) + $82,000 + $30,000 = $80,000

b. **The conservatism principal requires that revenue not be recognized before it is actually earned. Glenn actually recorded an amount that not only had not been earned, but the contract had not been finalized. Glenn has overstated his income by the $82,000.**

c. **The accrued salaries are an expense that has already been accrued and is owed and these salary expense should be matched against the respective year's revenue. By removing these expenses from net income computation, Glenn is overstating net income.**

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General Comments for Chapter 2

Accounting for Accruals and Deferrals

This chapter introduces accrual accounting. A key concept in this chapter is for the student to understand that revenues earned must be matched with expenses incurred to earn those revenues, regardless of when the cash exchange occurs. You can introduce the subject simply by using a single accounting event in which a business provides services on account. Chapter 1 assumed that all transactions were cash-based, but we all know that reality in the business world includes products and services purchased and sold 'on credit' or 'on account'. Show students the effect of this accrual by having them prepare an income statement, a statement of retained earnings, a balance sheet, and a statement of cash flows. Students will often stumble on the concept of Unearned Revenue, thinking that it's actually a revenue account when in fact it's a liability. Explain how customer payments that are received before goods or services are provided must be refunded to the customer if those promised goods or services are never actually delivered. Encourage students to record transactions using the horizontal financial statements model, even when problems do not require them to do so. Developing the habit of recording transactions using the model will help students see the impact of each transaction on the financial statements as well as help students identify their errors if the accounting equation is not in balance. Specific examples are provided in the detailed lesson plan outline. If you would like to begin the chapter with a problem-based learning exercise, see the notes below.

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Problem-Based Learning Case: Accrual Accounting

(We describe problem-based learning in the introduction to this manual.)

Instructions: The case appears on the following page in a format you can copy or display. Distribute copies of the case to the class before explaining accrual accounting. Ask students to individually develop answers. After allowing students time to develop their individual answers, put them into groups to reach consensus on an answer. Also, ask each group to select a spokesperson. Allow groups time to develop answers, and then call on some of the spokespersons to share their solutions. As you respond to the student solutions, explain the basic concepts of accrual accounting with respect to revenues earned and expenses incurred on account.

The final result is:

Net income: revenue of $145,000 less expenses of $80,000 = $65,000.

Total assets: cash, $45,000 plus accounts receivable, $25,000 = $70,000.

Total liabilities: salaries payable: $5,000.

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Chapter 2 Problem-Based Learning Case: Accrual Accounting

Professional Headhunters, Inc. (PHI), a job placement company, operates in the northeastern United States. During 2018, the company earned $145,000 in revenue by providing services to customers. However, it collected only $120,000 of the revenue in cash. PHI expected to collect the remaining $25,000 in 2019. In addition, PHI incurred $80,000 of expenses. However, by the end of 2018, PHI had paid only $75,000 of the cash owed for expenses because it had not yet paid $5,000 to employees who had worked during 2018 but had not been paid by the end of the year. PHI expected to pay the $5,000 in cash to the employees during 2019. Based on this information alone, determine the amount of net income, total assets, and total liabilities PHI should report on its 2018 financial statements.

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Detailed Outline of a Lesson Plan for Chapter 2

I. Distribute copies of Demonstration Problem 2-1, found near the back of this chapter of the Instructor's Manual.

A. Explain the phrase "***on account.***" Tell students this means Packard recognizes the revenue when it is earned, which may be before it collects the cash. Packard's customers created charge accounts and purchased goods or services by charging the purchases to their accounts. Revenue is recognized in the accounting period in which the services are provided regardless of when cash changes hands. This discussion should lead to defining the term accrual. In general, transactions in which a revenue or expense is recognized before cash changes hands are called ***accruals***. Demonstrate this point by recording the revenue recognition for Packard using the horizontal financial statements model. Next, have your students prepare an income statement, a statement of retained earnings, a balance sheet, and a statement of cash flows. To minimize the time required to prepare these financial statements, you may provide students with copies of the workpaper for Demonstration Problem 2-1. The workpaper is near the back of this chapter of the Instructor's Manual.

B. Since Packard did not issue any stock, the statement of changes in stockholders' equity becomes a statement of retained earnings. Although the text does not cover a statement of retained earnings, students should be able to infer the format from their experience with the statement of changes in stockholders' equity. Use the exercise to discuss diversity in reporting practice. Although there is general consistency in financial reporting, there is also variety. Students should learn to understand different reporting formats.

C. After accounting for the 2018 revenue, assume Packard collects the $5,000 account receivable in 2019. This is the only 2019 transaction. Have students record the event using the horizontal financial statements model and prepare the four basic financial statements for the 2019 accounting period. Encourage students to analyze the difference between the amount of net income and the amount of cash flow from operating activities. This single transaction clearly illustrates differences between the income statement and the statement of cash flows.

D. Introduce the term ***unearned revenue b***efore starting part B of this problem. Explain that ***unearned revenue is a liability*** because it represents ***an obligation to provide future services***. Make the point that businesses can be ***obligated*** to provide services as well as to pay cash. Show your stu-

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dents how to record the liability using the horizontal financial statements model.

E. Explain the year-end adjustment necessary to recognize three months of earned revenue on December 31. Emphasize the difference between the amount of cash collected and the amount of revenue recognized. Highlight that Jackson earned and recognized the revenue *after* it collected the cash. Draw a general definition of deferrals from this illustration. ***Transactions in which a revenue or expense is recognized after cash changes hands are termed deferrals.*** Contrast deferrals with accruals which were presented in part A of Demonstration Problem 2-1. For emphasis, reiterate the explanation of an accrual. ***Transactions in which a revenue or expense is recognized before cash changes hands are termed accruals.*** Although these are not precise definitions, they describe the basic concepts in terms students can understand. Explain that accrual accounting uses both accruals and deferrals.

F. Also note the connection between reducing the liability account (unearned revenue) and recognizing revenue, reinforcing that ***revenue is an <u>increase</u> in assets or a <u>decrease</u> in liabilities from providing services or products to customers***. Similarly, an ***expense is a <u>decrease</u> in assets or an <u>increase</u> in liabilities that occurs in efforts to produce revenue***. ***Net income is a change in wealth*** (increase in net assets). It is not enough to orally define terms. You must repeatedly demonstrate the definitions within the context of problems. Gradually, students will understand fundamental accounting interrelationships.

II. Use separate examples to introduce other types of deferrals (prepaid assets and supplies). You can use exercises 2-8, 2-9 or 2-11 in the textbook as demonstration problems, or create your own. We often make up demonstration problems like these in the classroom. Encourage students to think by asking them to attempt to record the effects of events before you discuss them. For example, instead of defining prepaid assets, simply give the students an event involving a prepaid asset. Say, "On October 1, 2018, ABC Company paid $1,200 in advance for one year of property insurance protection." Without having ever discussed prepaid insurance, ask the students to record the event using the horizontal financial statements model. Make them write down an answer. Don't be concerned with accuracy. Be concerned with involvement. Walk around the room and look at what they are doing. Occasionally collect these exercises from the students as in-class assignments. Give them credit regardless of their answers. The grade is for participation, not accuracy. Your objective is to motivate them to think about the problem before you offer a solution. At this stage, you are not evaluating their performance.

III. Time considerations and homework assignments. Completing Demonstration Problems 2-1A & B should require approximately one hour of class time. Have the students work

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along with you as you explain the problems. Exercises 2-3, 2-15, 2-16, and 2-17 parallel the Demonstration Problems and can be considered for homework assignments.

IV. Use Demonstration Problem 2-2 as a comprehensive summary problem. This is a two-cycle problem. Explain the first cycle (2018) and then use the second cycle as an in-class assignment. Allot approximately one hour to complete this assignment. Students needing additional time can finish the problem as homework. Problem 2-38 mirrors the demonstration problem and can be used as a homework assignment.

V. Use the horizontal financial statements model to highlight the differences between accrual and cash basis accounting. For example, suppose a company provides $5,000 of services on account and later collects $3,000 of the account receivable. The effect of these two events on the financial statements is shown below.

Event	Balance Sheet							Income Statement					Statement of
No.	Cash	+	Acct. Rec.	=	Liab.	+	Equity	Rev.	−	Exp.	=	Net Inc.	Cash Flows
1	NA	+	5,000	=	NA	+	5,000	5,000	−	NA	=	5,000	NA
2	3,000	+	(3,000)	=	NA	+	NA	NA	−	NA	=	NA	+3,000 OA

Include other events you deem appropriate. By this point students have a sufficient background to use the horizontal financial statements model. It is critically important to establish a firm foundation in the basics before progressing to more advanced representations. Introduce the model gradually.

VI. Hand out the official answers to any of the Demonstration Problems that you covered in class. Doing so allows the students to focus more on understanding the material than on taking notes for later reference. If they know that they will have access to the official answers to the problems worked in class, then they will not be as concerned about recording those answers during the discussion.

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Demonstration Problem 2-1A: Revenue Earned on Account

Part A
Packard Consultants was started in 2018. During that year the company earned $5,000 of consulting revenue ***on account***. Assume this is the only event experienced by Packard during 2018.

Required
1. Record the event using the horizontal financial statements model.
2. Prepare an income statement, a statement of retained earnings, a balance sheet, and a statement of cash flows for 2018.

Part B
During 2019, Packard Consultants collected $5,000 cash from the account receivable it established in Part A.

Required
1. Record the event under using the horizontal financial statements model.
2. Prepare an income statement, a statement of retained earnings, a balance sheet, and a statement of cash flows for 2019.

Demonstration Problem 2-1B: Unearned Revenue

Jackson Legal Services was started when a client paid the firm a $12,000 cash retainer on October 1, 2018. Jackson agreed to provide legal advice to the client for a one-year period beginning on the date of the cash receipt. The closing date for the law practice is December 31.

Required

1. Record the events for 2018 and 2019 using the horizontal financial statements model.
2. Prepare an income statement, a statement of retained earnings, a balance sheet, and a statement of cash flows for 2018 and 2019.

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Demonstration Problem 2-2: Accruals and Deferrals

Part A Smith Company experienced the following accounting events during 2018:

1. Smith Company was started on January 1 when it issued common stock for $2,000 cash.
2. During the year, the company recognized $1,500 of consulting revenue on account.
3. The company collected $1,200 cash from accounts receivable.
4. Smith accrued salary expense during the year of $900.
5. Paid $700 of the salaries payable liability.
6. Paid dividends of $100 to the stockholders.
7. Paid $360 cash for an insurance policy that covered the company for one year beginning March 1, 2018.
8. On November 1, 2018, Smith collected $2,880 cash in advance for consulting services to be provided under a one-year contract.
9. Recognized insurance expense (Policy in event 7) for ten months.
10. Recognized income earned under the one-year contract at December 31, 2018.

Part B Smith Company experienced the following accounting events during 2019:

1. Smith Company issued additional common stock for $3,000 cash.
2. During the period, Smith recognized $2,700 of consulting revenue earned on account.
3. Smith collected $2,800 cash from accounts receivable.
4. Smith accrued salary expense of $1,500.
5. The company paid $1,350 of the salaries payable liability.
6. Smith paid dividends of $300 to the stockholders.
7. Paid $420 cash to renew the insurance policy for another one-year term.
8. Smith adjusted the books to reflect the insurance expense that had been incurred in 2019 (described in event 7 of 2018).
9. Smith adjusted the books to reflect the revenue earned in 2019 under the one-year consulting contract that began in 2018 (event 8 in 2018).

Required

1. Record the events using the horizontal financial statements model.
2. For 2018 and 2019, prepare an income statement, a statement of retained earnings, a balance sheet, and a statement of cash flows.

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Demonstration Problem 2-1A: Solution, part 1.

	Assets		=	Liabilities	+	Equity		
Part A, 2018	**Cash**	**Accounts Receivable**	**=**	**Liabilities**	**+**	**Common Stock**	**+**	**Retained Earnings**
Beginning balances	**$ 0**	**$ 0**		**$ 0**		**$ 0**		**$ 0**
Effect of recognizing revenue		**5,000**						**5,000**
Part B, 2019								
Effect of collecting cash	**5,000**	**(5,000)**						
Ending balances	**$5,000**	**$ 0**	**=**	**$ 0**	**+**	**$ 0**	**+**	**$5,000**

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Demonstration Problem 2-1A: Solution, part 2. Financial Statements

Packard Consultants		
Income Statements		
For the Years Ended December 31,	2018	2019
Consulting revenue	$5,000	$ 0
Expenses	0	0
Net income	$5,000	$ 0
Statements of Retained Earnings		
Beginning retained earnings	$ 0	$5,000
Plus: Net income	5,000	0
Less: Dividends	0	0
Ending retained earnings	$5,000	$5,000
Balance Sheets at December 31		
Assets		
Cash	$ 0	$5,000
Accounts receivable	5,000	0
Total assets	$5,000	$5,000
Equity		
Retained earnings	$5,000	$5,000
Statements of Cash Flows		
Cash flows from operating activities	$ 0	$5,000
Cash flows from investing activities	0	0
Cash flows from financing activities	0	0
Net change in cash	0	5,000
Beginning cash balance	0	0
Ending cash balance	$ 0	$5,000

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Demonstration Problem 2-1B: Solution, part 1.

	Assets	=	Liabilities	+	Equity		
2018	**Cash**	**=**	**Unearned Revenue**	**+**	**Com. Stock**	**+**	**Ret. Earn.**
Beginning balances	**$ 0**		**$ 0**		**$ 0**		**$ 0**
1. Recognize liability	**12,000**		**12,000**				
2. Adjustment for earned revenue			**(3,000)**				**3,000**
Ending/beginning balances	**$12,000**	**=**	**$ 9,000**	**+**	**$ 0**	**+**	**$3,000**
2019							
1. Adjustment for earned revenue			**(9,000)**				**9,000**
Ending balances	**$12,000**		**$ 0**		**$ 0**		**$12,000**

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Demonstration Problem 2-1B: Solution, part 2. Financial Statements

Jackson Legal Services Financial Statements		
Income Statements		
For the Years Ended December 31,	2018	2019
Fees revenue	$ 3,000	$ 9,000
Expenses	0	0
Net income	$ 3,000	$ 9,000
Statements of Retained Earnings		
Beginning retained earnings	$ 0	$ 3,000
Plus: Net income	3,000	9,000
Less: Dividends	0	0
Ending retained earnings	$ 3,000	$12,000
Balance Sheets as of December 31		
Assets		
Cash	$12,000	$12,000
Liabilities		
Unearned revenue	$ 9,000	$ 0
Equity		
Retained earnings	3,000	12,000
Total liabilities and equity	$12,000	$12,000
Statements of Cash Flows		
Cash flows from operating activities	$12,000	$ 0
Cash flows from investing activities	0	0
Cash flows from financing activities	0	0
Net change in cash	12,000	0
Beginning cash balance	0	12,000
Ending cash balance	$12,000	$12,000

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Demonstration Problem 2-2: Solution, parts A and B.

Horizontal Financial Statements Model for 2018 and 2019

A spreadsheet is embedded to reflect the solution to this question. This spreadsheet covers both 2018 and 2019. The workpaper for students' use in answering this question would basically be the solution with the amounts deleted for all events except for the 2018 beginning balance.

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	Assets			=	Liabilities		+	Equity					
Event	Cash	Accts Receiv	Prepaid Insurance	=	Salaries Payable	Unearned Revenue	+	Com Stock	Retained Earnings	Revenue	Expense	Cash Flow	Activity Type
2014													
Beg. Bal	$- 0	$- 0			$- 0			$- 0	$- 0	$- 0	$- 0		
1													
2													
3													
4													
5													
6													
7													
8													
9													
10													
End. Bal.													
2015													
Beg. Bal													
1													
2													
3													
4													
5													
6													
7													
9													
End. Bal.	$- 0	$- 0	$- 0		$- 0	$- 0		$- 0	$- 0				

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	Assets			=	Liabilities		+	Equity					
Event	Cash	Accts Receiv	Prepaid Insurance	=	Salaries Payable	Unearned Revenue	+	Com Stock	Retained Earnings	Revenue	Expense	Cash Flow	Activity Type
2018													
Beg. Bal	$ - 0	$ - 0			$ - 0			$ - 0	$ - 0	$ - 0	$ - 0		
1	$ 2,000							$ 2,000				$ 2,000	FA
2		$ 1,500							$ 1,500	$ 1,500			
3	$ 1,200	$ (1,200)										$ 1,200	OA
4					$ 900				$ (900)		$ 900		
5	$ (700)				$ (700)							$ (700)	OA
6	$ (100)								$ (100)			$ (100)	FA
7	$ (360)		$ 360									$(360)	OA
8	$ 2,880					$2,880						$ 2,880	OA
9			$ (300)						$ (300)		$ 300		
10						$(480)			$480	$ 480			
End. Bal.	$ 4,920	$ 300	$ 60		$ 200	$2,400		$ 2,000	$680	$ 1,980	$ 1,200	$ 4,920	
2019													
Beg. Bal	$ 4,920	$ 300	$ 60		$ 200	$2,400		$ 2,000	$ 680			$ 4,920	
1	$ 3,000							$ 3,000				$ 3,000	FA
2		$ 2,700							$ 2,700	$ 2,700			
3	$ 2,800	$(2,800)										$ 2,800	OA
4					$ 1,500				$ (1,500)		$ 1,500		
5	$ (1,350)				$ (1,350)							$ (1,350)	OA
6	$(300)								$ (300)			$ (300)	FA
7	$(420)		$ 420									$ (420)	OA
8			$ (410)						$ (410)		$ 410		
9						$(2,400)			$ 2,400	$ 2,400			
End. Bal.	$ 8,650	$ 200	$ 70		$ 350	$- 0		$ 5,000	$ 3,570	$ 5,100	$ 1,910	$ 8,650	

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Demonstration Problem 2-2: Solution, parts A & B. Financial Statements

Income Statements for the Years Ended 12/31	2018	2019
Consulting revenue	$ 1,980	$ 5,100
Total revenue	1,980	5,100
Salary expense	(900)	(1,500)
Insurance expense	(300)	(410)
Net income	780	$ 3,190
Statements of Changes in Stockholders' Equity		
Beginning common stock	$ 0	$ 2,000
Plus: Common stock issued	2,000	3,000
Ending common stock	2,000	5,000
Beginning retained earnings	0	680
Plus: Net income	780	3,190
Less: Dividends	(100)	(300)
Ending retained earnings	680	2,890
Total stockholders' equity	$ 2,680	$ 8,570
Balance Sheets as of December 31		
Cash	$ 4,920	$ 8,650
Accounts receivable	300	200
Prepaid insurance	60	70
Total assets	$ 5,280	$ 8,920
Salaries payable	$ 200	$ 350
Unearned revenue	2,400	0
Total liabilities	2,600	350
Common stock	2,000	5,000
Retained earnings	680	3,570
Total stockholders' equity	2,680	8,570
Total liabilities and stockholders' equity	$ 5,280	$ 8,920
Statements of Cash Flows		
Cash flows from operating activities		
Cash receipts from consulting revenue	$ 4,080	$ 2,800
Cash payments for salaries	(700)	(1,350)
Cash payments for insurance	(360)	(420)
Net cash inflow from operating activities	3,020	1,030
Cash flows from investing activities		
Net cash outflow for investing activities	0	0
Cash flows from financing activities		
Cash receipt from common stock issue	2,000	3,000
Cash payment for dividends	(100)	(300)
Net cash inflow from financing activities	1,900	2,700
Net change in cash	4,920	3,730
Beginning cash balance	0	4,920
Ending cash balance	$ 4,920	$ 8,650

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Demonstration Problem 2-1: Workpaper, part 1.

	Assets			=	Liabilities	+	Equity		
Part A, 2018	Cash	+	Accounts Receivable	=	Liabilities	+	Common Stock	+	Retained Earnings
Beginning balances	$ 0		$ 0		$ 0		$ 0		$ 0
Effect of recognizing revenue									
Part B, 2019									
Effect of collecting cash									
Ending balances	$5,000	+	$ 0	=	$ 0	+	$ 0	+	$5,000

Demonstration Problem 2-1: Workpaper, part 2. Financial Statements

Packard Consultants		
Income Statements		
For the Years Ended December 31,	2018	2019
Consulting revenue	$	$
Expenses		
Net income	$ 5,000	$ 0
Statements of Retained Earnings		
Beginning retained earnings	$ 0	$
Plus: Net income		
Less: Dividends		
Ending retained earnings	$5,000	$5,000
Balance Sheets at December 31		
Assets		
Cash	$	$
Accounts receivable		
Total assets	$	$
Equity		
Retained earnings	$5,000	$5,000
Statements of Cash Flows		
Cash flows from operating activities	$	$
Cash flows from investing activities	0	0
Cash flows from financing activities	0	0
Net change in cash		
Beginning cash balance		
Ending cash balance	$ 0	$5,000

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Demonstration Problem 2-1B: Workpaper, part 2

Jackson Legal Services Financial Statements		
Income Statements		
For the Years Ended December 31,	**2018**	**2019**
Fees revenue		
Expenses		
Net income	$ 3,000	$ 9,000
Statements of Retained Earnings		
Beginning retained earnings	$ 0	$ 3,000
Plus: Net income		
Less: Dividends		
Ending retained earnings	$ 3,000	$12,000
Balance Sheets as of December 31		
Assets		
Cash		
Liabilities		
Unearned revenue		
Equity		
Retained earnings	3,000	12,000
Total liabilities and equity		
Statements of Cash Flows		
Cash flows from operating activities		
Cash flows from investing activities		
Cash flows from financing activities		
Net change in cash		
Beginning cash balance	0	
Ending cash balance	$12,000	$12,000

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Demonstration Problem 2-2: Workpaper, parts A & B. Financial Statements

Income Statements for the Years Ended 12/31	2018	2019
Consulting revenue	$	$
Total revenue		
Salary expense		
Insurance expense		
Net income	780	$ 3,190
Statements of Changes in Stockholders' Equity		
Beginning common stock	$	$
Plus: Common stock issued		
Ending common stock	2,000	5,000
Beginning retained earnings		
Plus: Net income		
Less: Dividends		
Ending retained earnings	680	2,890
Total stockholders' equity	$	$
Balance Sheets as of December 31		
Cash	$	$
Accounts receivable		
Prepaid insurance		
Total assets	$	
Salaries payable	$	$
Unearned income		
Total liabilities	2,600	2,425
Common stock		
Retained earnings		
Total stockholders' equity		
Total liabilities and stockholders' equity	$ 5,280	$10,980
Statements of Cash Flows		
Cash flows from operating activities		
Cash receipts from consulting revenue	$	$
Cash payments for salaries		
Cash payments for insurance		
Net cash inflow from operating activities	3,020	1,030
Cash flows from investing activities		
Net cash outflow for investing activities	0	0
Cash flows from financing activities		
Cash receipt from common stock issue		
Cash payment for dividends		
Net cash inflow from financing activities	1,900	2,700
Net change in cash		
Beginning cash balance		
Ending cash balance	$ 4,920	$ 8,650

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Quiz Questions for Chapter 2

1. X Company recognized $500 of revenue on account and realized $400 of cash collections. The company had accrued salary expense of $300 and invested $200 in a certificate of deposit. Based on this information alone, the amount of cash flow from operating activities would be
   a. $100.
   b. $500.
   c. $200.
   d. $400.

2. On January 1, 2018, West Company had accounts receivable of $500. During 2018 West earned $2,500 of service revenue on account. If the accounts receivable balance as of December 31, 2018, was $400, what was the amount of cash flow from operating activities?
   a. $2,000.
   b. $3,000.
   c. $2,400.
   d. $2,600.

3. The entry to record revenue on account
   a. increases liabilities.
   b. decreases equity.
   c. decreases assets.
   d. none of the above.

4. K Company collected $500 cash on an account receivable that was due from L Company. Based on this information, which of the following statements is true?
   a. K Company's total assets would increase.
   b. L Company's total assets would not change.
   c. K Company's equity would decrease.
   d. None of the above.

5. On April 1, Flavin Co. paid $12,000 cash for an insurance policy that provides coverage for one year beginning immediately. On December 31, Flavin adjusted the books to recognize the amount of the insurance policy used during the year. The amount of the adjustment would be:
   a. $8,000
   b. $9,000
   c. $12,000
   d. $0

6. Which of the following illustrates the recognition of revenue earned on account?

	Balance Sheet				Income Statement				Statement of
	Assets	=	Liab.	+ Equity	Rev.	− Exp.	= Net Inc.		Cash Flow
a.	+		NA	+	NA	NA	NA		NA
b.	+		NA	+	+	NA	+		NA
c.	−		NA	−	NA	+	−		− OA
d.	+		NA	+	+	NA	+		+ OA

Use the following information to answer the next two questions. BBC Company received $9,900 cash on February 1, 2018, from XYZ Company as advance payment for services BBC promised to perform for XYZ over the next three years on a continuous basis. Assume that BBC Company's year-end is December 31.

7. On its 2018 income statement, BBC would report revenue of
   a. $3,300

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b. $9,900
c. $3,025
d. $2,750

8. On its December 31, 2019 balance sheet BBC would report liabilities of
a. $3,575
b. $3,300
c. $9,900
d. $6,875

9. Which of the following illustrates purchasing supplies on account?

	Balance Sheet			Income Statement			Statement of
	Assets =	Liab. +	Equity	Rev. −	Exp. =	Net Inc.	Cash Flow
a.	+	NA	+	NA	NA	NA	NA
b.	+	+	NA	NA	NA	NA	NA
c.	+	+	NA	NA	NA	NA	+ OA
d.	+	NA	+	+	NA	+	+ OA

10. Which of the following illustrates receiving cash as an advance payment for future services?

	Balance Sheet			Income Statement			Statement of
	Assets =	Liab. +	Equity	Rev. −	Exp. =	Net Inc.	Cash Flow
a.	+	NA	+	NA	NA	NA	NA
b.	+	+	NA	+	NA	+	NA
c.	+	+	NA	NA	NA	NA	+ OA
d.	+	NA	+	+	NA	+	+ OA

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Solutions to Quiz Questions

Question	Answer
1	D
2	D
3	D
4	B
5	B
6	B
7	C
8	A
9	B
10	C

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Summary Outline of a Lesson Plan for Chapter 2

I. **Use Demonstration Problem 2-1** to define and illustrate the concept of accrual accounting. This problem includes both an accrual (part A) and a deferral (part B) example.

II. **Use separate examples to further illustrate accrual and deferral concepts.**

III. **Use Demonstration Problem 2-2 as a comprehensive summary problem.** Explain the first cycle to the class and use the second cycle as an in-class assignment. Allot one hour for this assignment. Have slower students finish the problem as homework. Use parallel problem 2-38 in the textbook as a homework assignment.

IV. **Time considerations and homework assignments.** Demonstration Problems 2-1 and 2-2 require approximately one hour of class time. Consider assigning exercises 2-11, 2-15, 2-18, 2-21, and Problem 2-28 from the textbook as homework.

V. **Use a financial statements model to highlight the differences between accrual and cash basis accounting.**

VI. **Hand out official answers to the Demonstration Problems worked in class.**

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Chapter 2 – Accounting for Accruals and Deferrals

		Click on links
Exercise 2-3	Effect of accruals on the financial statements	Exercise 2-3
Exercise 2-4	Effect of accounts receivable and accounts payable transactions on financial statements	Exercise 2-4
Exercise 2-6	Effect of accruals on the financial statements	Exercise 2-6
Exercise 2-9	Supplies on financial statements	Exercise 2-9
Exercise 2-11	Prepaid items on financial statements	Exercise 2-11
Exercise 2-13	Unearned items on financial statements	Exercise 2-13
Exercise 2-15	Supplies, unearned revenue, and the financial statements model	Exercise 2-15
Exercise 2-20	Closing entries	Exercise 2-20
Exercise 2-26	Relationship of accounts to financial statements	Exercise 2-26
Exercise 2-30	Identifying source, use, and exchange transactions	Exercise 2-30

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Exercise 2-3

Plasma Inc. experienced the following events in Year 1, in its first year of operations:

1. Received $40,000 cash from the issue of common stock.
2. Performed services on account for $76,000.
3. Paid the utility expense of $5,000.
4. Collected $42,000 of the accounts receivable.
5. Recorded $30,000 of accrued salaries at the end of the year.
6. Paid a $4,000 cash dividend to the shareholders.

Required:

a. Record the events in general ledger accounts under an accounting equation. In the last column of the table, provide appropriate account titles for the Retained Earnings amounts.
b. Prepare the income statement, statement of changes in stockholders' equity, balance sheet, and statement of cash flows for the Year 1 accounting period.
c. Why is the amount of net income different from the amount of net cash flow from operating activities?

5. Re[illegible] year.

PLASMA INC. General Ledger Accounts								
Event	Assets		=	Liabilities	+	Stockholders' Equity		Acct. Titles for Ret. Earn
	Cash	Accounts Receivable	=	Salaries Payable	+	Common Stock	Retained Earnings	
1.	40,000	NA	=	NA	+	40,000	NA	
2.	NA	76,000	=	NA	+	NA	76,000	Revenue
3.	(5,000)	NA	=	NA	+	NA	(5,000)	Utility Expense
4.	42,000	(42,000)	=	NA	+	NA	NA	
5.	NA	NA	=	30,000	+	NA	(30,000)	Salaries Expense
6.	(4,000)	NA	=	NA	+	NA	(4,000)	Dividends
End. Bal.	73,000	34,000	=	30,000	+	40,000	37,000	

Event	Assets		=	Liabilities	+	Stockholders' Equity		Acct. Titles for Ret. Earn
	Cash	Accounts Receivable	=	Salaries Payable	+	Common Stock	Retained Earnings	
1.	40,000	NA	=	NA	+	40,000	NA	
2.	NA	76,000	=	NA	+	NA	76,000	Revenue
3.	(5,000)	NA	=	NA	+	NA	(5,000)	Utility Expense
4.	42,000	(42,000)	=	NA	+	NA	NA	
5.	NA	NA	=	30,000	+	NA	(30,000)	Salaries Expense
6.	(4,000)	NA	=	NA	+	NA	(4,000)	Dividends
End. Bal.	73,000	34,000	=	30,000	+	40,000	37,000	

PLASMA INC.
Income Statement
For the Year Ended December 31, Year 1

Revenue		**$ 76,000**
Expenses		
Utilities expense	**$ (5,000)**	
Salaries expense	**(30,000)**	
Total expenses		**(35,000)**
Net income		**$ 41,000**

Event	Assets		=	Liabilities	+	Stockholders' Equity		Acct. Titles for Ret. Earn
	Cash	Accounts Receivable	=	Salaries Payable	+	Common Stock	Retained Earnings	
1.	40,000	NA	=	NA	+	40,000	NA	
2.	NA	76,000	=	NA	+	NA	76,000	Revenue
3.	(5,000)	NA	=	NA	+	NA	(5,000)	Utility Expense
4.	42,000	(42,000)	=	NA	+	NA	NA	
5.	NA	NA	=	30,000	+	NA	(30,000)	Salaries Expense
6.	(4,000)	NA	=	NA	+	NA	(4,000)	Dividends
End. Bal.	73,000	34,000	=	30,000	+	40,000	37,000	

PLASMA INC.
Income Statement
For the Year Ended December 31, Year 1

Revenue		**$ 76,000**
Expenses		
Utilities expense	**$ 5,000**	
Salaries expense	**30,000**	
Total expenses		**(35,000)**
Net income		**$ 41,000**

PLASMA INC.
Statement of Changes in Stockholders' Equity
For the Year Ended December 31, Year 1

Beginning common stock	**$ 0**	
Plus: Common stock issued	**40,000**	
Ending common stock		**$40,000**
Beginning retained earnings	**$ 0**	
Plus: Net income	**41,000**	
Less: Dividends	**(4,000)**	
Ending retained earnings		**37,000**
Total stockholders' equity		**$77,000**

Event	Assets		=	Liabilities	+	Stockholders' Equity		Acct. Titles for Ret. Earn
	Cash	Accounts Receivable	=	Salaries Payable	+	Common Stock	Retained Earnings	
1.	40,000	NA	=	NA	+	40,000	NA	
2.	NA	76,000	=	NA	+	NA	76,000	Revenue
3.	(5,000)	NA	=	NA	+	NA	(5,000)	Utility Expense
4.	42,000	(42,000)	=	NA	+	NA	NA	
5.	NA	NA	=	30,000	+	NA	(30,000)	Salaries Expense
6.	(4,000)	NA	=	NA	+	NA	(4,000)	Dividends
End. Bal.	73,000	34,000	=	30,000	+	40,000	37,000	

PLASMA INC. Balance Sheet As of December 31, Year 1		
Assets		
Cash	**$ 73,000**	
Accounts receivable	**34,000**	
Total assets		**$ 107,000**
Liabilities		
Salaries payable		**$ 30,000**
Stockholders' equity		
Common stock	**$ 40,000**	
Retained earnings	**37,000**	
Total Stockhodlers' equity		**$ 77,000**
Total liabilities and stockholders' equity		**$ 107,000**

Event	Assets		=	Liabilities	+	Stockholders' Equity		Acct. Titles for Ret. Earn
	Cash	Accounts Receivable	=	Salaries Payable	+	Common Stock	Retained Earnings	
1.	40,000	NA	=	NA	+	40,000	NA	
2.	NA	76,000	=	NA	+	NA	76,000	Revenue
3.	(5,000)	NA	=	NA	+	NA	(5,000)	Utility Expense
4.	42,000	(42,000)	=	NA	+	NA	NA	
5.	NA	NA	=	30,000	+	NA	(30,000)	Salaries Expense
6.	(4,000)	NA	=	NA	+	NA	(4,000)	Dividends
End. Bal.	73,000	34,000	=	30,000	+	40,000	37,000	

PLASMA INC.
Statement of Cash Flows
For the Year Ended December 31, Year 1

Cash flows from operating activities		
Cash receipts from customers	**$ 42,000**	
Cash paid for expenses	**(5,000)**	
Net cash flow from operating activities		**37,000**
Cash flow from investing activities		**-0-**
Cash flow from financing activities		
Issue of stock	**40,000**	
Paid dividends	**(4,000)**	
Net cash flow from financing activities		**36,000**
Net change in cash		**73,000**
Plus: Beginning Cash Balance		**-0-**
Ending Cash balance		**$73,000**

PLASMA INC. Statement of Cash Flows For the Year Ended December 31, Year 1	
Cash flow from operating activities	
Cash receipts from customers	**$ 42,000**
Cash paid for expenses	**(5,000)**
Net cash flow from operating activities	**$ 37,000**

PLASMA INC. Income Statement For the Year Ended December 31, Year 1		
Revenue		**$ 76,000**
Expenses		
Utilities expense	**$ 5,000**	
Salaries expense	**30,000**	
Total expenses		**(35,000)**
Net income		**$ 41,000**

Exercise 2-4

The following events apply to Purple leaf Inc., a public accounting firm, for the Year 1 accounting period.

1. Performed $48,000 of services for clients on account.
2. Performed $32,500 of services for cash.
3. Incurred $22,500 of other operating expenses on account.
4. Paid $13,000 cash to an employee for salary.
5. Collected $35,000 cash from accounts receivable.
6. Paid $19,000 cash on accounts payable.
7. Paid a $5,000 cash dividend to the stockholders.
8. Accrued salaries were $1,500 at the end of Year 1.

Required:

a. Show the effects of the events on the financial statements using a horizontal statements model. In the Cash Flow column, use OA to designate operating activity, IA for investment activity, FA for financing activity, and NC for net change in cash. Use NA to indicate the element is not affected by the event.
b. What is the amount of total assets at the end of Year 1?
c. What is the balance of accounts receivable at the end of Year 1?
d. What is the balance of accounts payable at the end of Year 1?
e. What is the difference between accounts receivable and accounts payable?
f. What is net income for Year 1?
g. What is the amount of net cash flow from operating activities for Year 1?

5. Collected $35,000 cash from accounts receivable.

Purple Leaf Inc.
Horizontal Statements Model

Event No.	Assets			=	Liabilities			+	Stk. Equity						Cash Flow
	Cash	+	Accts. Rec.	=	Accts. Pay.	+	Sal. Pay.	+	Ret. Earn.	Rev.	–	Exp.	=	Net Inc.	
1.	NA	+	48,000	=	NA	+	NA	+	48,000	48,000	–	NA	=	48,000	NA
2.	32,500	+	NA	=	NA	+	NA	+	32,500	32,500	–	NA	=	32,500	32,500 OA
3.	NA	+	NA	=	22,500	+	NA	+	(22,500)	NA	–	22,500	=	(22,500)	NA
4.	(13,000)	+	NA	=	NA	+	NA	+	(13,000)	NA	–	13,000	=	(13,000)	(13,000) OA
5.	35,000	+	(35,000)	=	NA	+	NA	+	NA	NA	–	NA	=	NA	35,000 OA

6. Paid $19,000 cash on accounts payable.

Purple Leaf Inc.
Horizontal Statements Model

Event No.	Assets			=	Liabilities			+	Stk. Equity							
	Cash	+	Accts. Rec.	=	Accts. Pay.	+	Sal. Pay.	+	Ret. Earn.	Rev.	–	Exp.	=	Net Inc.	Cash Flow	
1.	NA	+	48,000	=	NA	+	NA	+	48,000	48,000	–	NA	=	48,000	NA	
2.	32,500	+	NA	=	NA	+	NA	+	32,500	32,500	–	NA	=	32,500	32,500	OA
3.	NA	+	NA	=	22,500	+	NA	+	(22,500)	NA	–	22,500	=	(22,500)	NA	
4.	(13,000)	+	NA	=	NA	+	NA	+	(13,000)	NA	–	13,000	=	(13,000)	(13,000)	OA
5.	35,000	+	(35,000)	=	NA	+	NA	+	NA	NA	–	NA	=	NA	35,000	OA
6.	(19,000)	+	NA	=	(19,000)	+	NA	+	NA	NA	–	NA	=	NA	(19,000)	OA

8. Accrued salaries were $1,500 at the end of Year 1.

Purple Leaf Inc.
Horizontal Statements Model

Event No.	Assets			=	Liabilities			+	Stk. Equity							
	Cash	+	Accts. Rec.	=	Accts. Pay.	+	Sal. Pay.	+	Ret. Earn.	Rev.	–	Exp.	=	Net Inc.		
1.	NA	+	48,000	=	NA	+	NA	+	48,000	48,000	–	NA	=	48,000	NA	
2.	32,500	+	NA	=	NA	+	NA	+	32,500	32,500	–	NA	=	32,500	32,500	OA
3.	NA	+	NA	=	22,500	+	NA	+	(22,500)	NA	–	22,500	=	(22,500)	NA	
4.	(13,000)	+	NA	=	NA	+	NA	+	(13,000)	NA	–	13,000	=	(13,000)	(13,000)	OA
5.	35,000	+	(35,000)	=	NA	+	NA	+	NA	NA	–	NA	=	NA	35,000	OA
6.	(19,000)	+	NA	=	(19,000)	+	NA	+	NA	NA	–	NA	=	NA	(19,000)	OA
7.	(5,000)	+	NA	=	NA	+	NA	+	(5,000)	NA	–	NA	=	NA	(5,000)	FA
8.	NA	+	NA	=	NA	+	1,500	+	(1,500)	NA	–	1,500	=	(1,500)	NA	
End. Bal.	30,500	+	13,000	=	3,500	+	1,500	+	38,500	80,500	–	37,000	=	43,500	30,500	NC

Purple Leaf Inc.
Horizontal Statements Model

Event No.	Assets			=	Liabilities			+	Stk. Equity							
	Cash	+	Accts. Rec.	=	Accts. Pay.	+	Sal. Pay.	+	Ret. Earn.	Rev.	–	Exp.	=	Net Inc.		
1.	NA	+	48,000	=	NA	+	NA	+	48,000	48,000	–	NA	=	48,000	NA	
2.	32,500	+	NA	=	NA	+	NA	+	32,500	32,500	–	NA	=	32,500	32,500	OA
3.	NA	+	NA	=	22,500	+	NA	+	(22,500)	NA	–	22,500	=	(22,500)	NA	
4.	(13,000)	+	NA	=	NA	+	NA	+	(13,000)	NA	–	13,000	=	(13,000)	(13,000)	OA
5.	35,000	+	(35,000)	=	NA	+	NA	+	NA	NA	–	NA	=	NA	35,000	OA
6.	(19,000)	+	NA	=	(19,000)	+	NA	+	NA	NA	–	NA	=	NA	(19,000)	OA
7.	(5,000)	+	NA	=	NA	+	NA	+	(5,000)	NA	–	NA	=	NA	(5,000)	FA
8.	NA	+	NA	=	NA	+	1,500	+	(1,500)	NA	–	1,500	=	(1,500)	NA	
End. Bal.	30,500	+	13,000	=	3,500	+	1,500	+	38,500	80,500	–	37,000	=	43,500	30,500	NC

Accounts Payable	$ 3,500

Net Income	$ 43,500
Cash from operating activities	$ 35,500

Exercise 2-6

Supernova Inc. experienced the following events in Year 1, its first year of operation.

1. Received $25,000 cash from the issue of common stock.
2. Performed services on account for $33,500.
3. Paid a $2,500 cash dividend to the stockholders.
4. Collected $22,500 of the accounts receivable.
5. Paid $24,500 cash for other operating expenses.
6. Performed services for $5,000 cash.
7. Recognized $1,000 of accrued utilities expense at the end of the year.

Required:

a. Identify the events that result in revenue or expense recognition.
b. Based on your response to Requirement a, determine the amount of net income reported on the Year 1 income statement.
c. Identify the events that affect the statement of cash flows.
d. Based on your response to Requirement c, determine the amount of cash flow from operating activities reported on the Year 1 statement of cash flows.
e. What is the before- and after-closing balance in the Service Revenue account? What other accounts would be closed at the end of the accounting cycle?
f. What is the balance of the Retained Earnings account that appears on the Year 1 balance sheet?

7. Recognized [illegible] of the year.

Event	Revenue	Expense	Statement of Cash flows	
1.	NA	NA	$25,000	FA
2.	$33,500	NA	NA	
3.	NA	NA	($2,500)	FA
4.	NA	NA	$22,500	OA
5.	NA	$24,500	($24,500)	OA
6.	$5,000	NA	$5,000	OA
7.	NA	$1,000	NA	

Event	Revenue	Expense	Statement of Cash flows	
1.	NA	NA	$25,000	FA
2.	$33,500	NA	NA	
3.	NA	NA	($2,500)	FA
4.	NA	NA	$22,500	OA
5.	NA	$24,500	($24,500)	OA
6.	$5,000	NA	$5,000	OA
7.	NA	$1,000	NA	

SUPERNOVA INC.
Income Statement
For the Year Ended December 31, Year 1

Revenue	**$ 38,500**
Less: Expenses	**$ 24,500**
Net Income	**$ 13,000**

Event	Revenue	Expense	Statement of Cash flows	
1.	NA	NA	$25,000	FA
2.	$33,500	NA	NA	
3.	NA	NA	($2,500)	FA
4.	NA	NA	$22,500	OA
5.	NA	$24,500	($24,500)	OA
6.	$5,000	NA	$5,000	OA
7.	NA	$1,000	NA	

SUPERNOVA INC. Income Statement For the Year Ended December 31, Year 1	
Revenue	**$ 38,900**

Ending Retained Earnings = $13,000 – $2,500 = $10,500

Event	Revenue	Expense	Statement of Cash flows	
1.	NA	NA	$25,000	FA
2.	$33,500	NA	NA	
3.	NA	NA	($2,500)	FA
4.	NA	NA	$22,500	OA
5.	NA	$24,500	($24,500)	OA
6.	$5,000	NA	$5,000	OA
7.	NA	$1,000	NA	

SUPERNOVA INC.
Statement of Cash Flows
For the Year Ended December 31, 2013

Cash Flows from Operating Activities		
Cash from Revenue	**$ 27,500**	
Cash Paid for Expenses	**(24,500)**	
Net Cash Flow from Operating Activities		**$ 3,000**

Exercise 2-9

E-Tech Inc. experienced the following events in Year 1, its first year of operation.

1.Performed services for $40,000 cash.
2.Purchased $8,000 of supplies on account.
3.A physical count on December 31, Year 1, found that there was $2,000 of supplies on hand.

Required:
Based on this information alone:

a.Record the events under an accounting equation.
b.What is the balance in the Supplies account as of January 1, Year 2?
c.What is the balance in the Supplies Expense account as of January 1, Year 2?
d.Prepare an income statement, balance sheet, and statement of cash flows for the Year 1 accounting period.

3. Determined, Sterling supplies on account.

2. Purchased, $8,000 of supplies on account.

E-Tech Inc. Effect of Events on the Accounting Equation							
Event	Assets		=	Liabilities	+	Stockholders' equity	
	Cash	Supplies	=	Accounts Payable	+	Common Stock	Retained Earnings
1.	40,000	NA	=	NA	+	NA	40,000
2.	NA	8,000	=	8,000	+	NA	NA
3.	NA	(6,000)	=	NA	+	NA	(6,000)
End. Bal.	40,000	2,000	=	8,000	+	NA	34,000

Beginning supplies balance	**$ 0**
+ Supplies purchased	8,000
− Ending supplies balance	(2,000)
= Supplies used	$ 6,000

E-Tech Inc. Effect of Events on the Accounting Equation							
Event	Assets		=	Liabilities	+	Stockholders' equity	
	Cash	Supplies	=	Accounts Payable	+	Common Stock	Retained Earnings
1.	40,000	NA	=	NA	+	NA	40,000
2.	NA	8,000	=	8,000	+	NA	NA
3.	NA	(6,000)	=	NA	+	NA	(6,000)
End. Bal.	40,000	2,000	=	8,000	+	NA	34,000

E-Tech Inc. Statement of Cash Flows For the Year Ended December 31, Year 1	
Cash flows from operating activities:	
Cash receipt from revenue	**$ 40,000**
Cash flows from investing activities:	**NA**
Cash flows from financing activities:	**NA**
Net Change In Cash	**40,000**
Plus: Beginning cash balance	**NA**
Ending cash balance	**$ 40,000**

Exercise 2-11

Aroma Inc. experienced the following events in 2016, its first year of operation:

1. Performed counseling services for $20,000 cash.
2. On April 1, 2016, paid $6,000 cash to rent office space for the coming year.
3. Adjusted the accounts to reflect the amount of rent used during the year.

Required

Based on this information alone:

a. Record the events under an accounting equation.
b. Prepare an income statement, balance sheet, and statement of cash flows for the 2016 accounting period.
c. Ignoring all other future events, what is the amount of rent expense that would be recognized in 2017?

2. On April 1, 2016, paid $6,000 cash to rent $20,000 of space for the coming year.

3. Adjusted the accounts to reflect the rent of 9 months of the coming year.

AROMA INC. Accounting Equation - 2016						
Events	**Assets**		**=**	**Liabilities**	**+**	**Stockholders' Equity**
	Cash	**Prepaid Rent**			**Common Stock**	**Retained Earnings**
1)	20,000					20,000
2)	(6,000)	6,000				
3)		(4,500)				(4,500)

Rent per month	=	Annual rent cost	÷	12 months
$500 per month	=	$6,000	÷	12 months

Rent per month	×	Number of months used	=	Rent expense
$500	×	9 months	=	$4,500

2. On April 1, 2016, paid $6,000 cash to a rent office for the coming year.

3. Adjusted the accounts for $20,000 rent for the coming year.

AROMA INC. Accounting Equation - 2016								
Events	Assets			=	Liabilities	+	Stockholders' Equity	
	Cash	+	Prepaid Rent				Common Stock	+ Retained Earnings
1)	20,000							20,000
2)	(6,000)		6,000					
3)			(4,500)					(4,500)

AROMA INC. Income Statement For the Year Ended December 31, 2016	
Service revenue	$ 20,000
Rent expense	(4,500)
Net income	$ 15,500

AROMA INC. Statement of Cash Flows For the Year Ended December 31, 2016		
Cash flows from operating activities		
Cash receipt from revenue	$ 20,000	
Cash payment for rent	(6,000)	
Net cash flow from operating activities		$ 14,000
Cash flows from investing activities		-0-
Cash flows from financing activities		-0-
Net change in cash		14,000
Plus: Beginning cash balance		-0-
Ending cash balance		$ 14,000

AROMA INC. Accounting Equation - 2016								
Events	**Assets**			**=**	**Liabilities**	**+**	**Stockholders' Equity**	
	Cash	**+**	**Prepaid Rent**				**Common Stock**	**+** **Retained Earnings**
1)	20,000							20,000
2)	(6,000)		6,000					
3)			(4,500)					(4,500)
Bal.	**14,000**		**1,500**					**15,500**

AROMA INC. Balance Sheet December 31, 2016		
Assets		
Cash	$ 14,000	
Prepaid rent	1,500	
Total assets		$ 15,500
Liabilities		
Stockholders' equity		
Common stock	$ -0-	
Retained earnings	15,500	
Total stockholders' equity		15,500
Total liabilities and stockholders' equity		$ 15,500

Exercise 2-13

Neptune Consultants experienced the following events in 2016, its first year of operation:

1. On October 1, 2016, Neptune collected $48,000 for consulting services it agreed to provide during the coming year.

2. Adjusted the accounts to reflect the amount of consulting service revenue recognized in 2016.

Required

Based on this information alone:

a. Record the events under an accounting equation.

b. Prepare an income statement, balance sheet, and statement of cash flows for the 2016 accounting period.

c. Ignoring all other future events, what is the amount of service revenue that would be recognized in 2017?

2. Adjusted the accounts to reflect the amount of consulting service revenue recognized in 2016. during the coming year.

Neptune Consultants Effect of Events on the Accounting Equation					
Event	**Assets**	**=**	**Liabilities**	**+**	**Stockholders' equity**
	Cash	=	Unearned Revenue	+	Retained Earnings
1.	48,000	=	48,000	+	NA
2.	NA	=	(12,000)	+	12,000
End. Bal.	48,000	=	36,000	+	12,000

$48,000 ÷ 12 months = $4,000 revenue earned per month

$4,000 × 3 months = $12,000 revenue to be recognized in 2016

Neptune Consultants Effect of Events on the Accounting Equation					
Event	**Assets**	**=**	**Liabilities**	**+**	**Stockholders' equity**
	Cash	=	Unearned Revenue	+	Retained Earnings
1.	48,000	=	48,000	+	NA
2.	NA	=	(12,000)	+	12,000
End. Bal.	48,000	=	36,000	+	12,000

Neptune Consultants Statement of Cash Flows For the Year Ended December 31, 2016		
Cash flows from operating activities:		
Cash Receipt from Revenue	$ 48,000	
Net cash flow from operating activities		**48,000**
Cash flow from investing activities:		**-0-**
Cash flow from financing activities:		**-0-**
Net change in cash		**48,000**
Plus: Beginning cash balance		**-0-**
Ending cash balance		**$ 48,000**

Exercise 2-15

Daniel, Attorney at Law, experienced the following transactions in 2016, the first year of operations:

1. Accepted $18,000 on February 1, 2016, as a retainer for services to be performed evenly over the next 12 months.
2. Performed legal services for cash of $42,000.
3. Purchased $750 of office supplies on account.
4. Paid $600 of the amount due on accounts payable.
5. Paid a cash dividend to the stockholders of $4,000.
6. Paid cash for operating expense of $16,000.
7. Determined that at the end of the accounting period $75 of office supplies remained on hand.
8. On December 31, 2016, recognized the revenue that had been earned for services performed in accordance with Transaction 1.

Required

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

5. Paid a cash dividend to the stockholders of $4,000.

Daniel Attorney at Law
Effect of Transactions on the Financial Statements for 2016

Event No.	Assets			=	Liabilities			+	Stk. Equity							
	Cash	+	Supplies	=	Accts. Pay.	+	Unearn. Rev.	+	Ret. Earn.	Rev.	–	Exp.	=	Net Inc.	Cash Flow
1.	18,000	+	NA	=	NA	+	18,000	+	NA	NA	–	NA	=	NA	18,000 OA
2.	42,000	+	NA	=	NA	+	NA	+	42,000	42,000	–	NA	=	42,000	42,000 OA
3.	NA	+	750	=	750	+	NA	+	NA	NA	–	NA	=	NA	NA
4.	(600)	+	NA	=	(600)	+	NA	+	NA	NA	–	NA	=	NA	(600) OA
5.	(4,000)	+	NA	=	NA	+	NA	+	(4,000)	NA	–	NA	=	NA	(4,000) FA

8. On December 31, 2016, recognized the revenue that had been earned for services performed in accordance with Transaction 1.

Daniel Attorney at Law
Effect of Transactions on the Financial Statements for 2016

Event No.	Assets			=	Liabilities			+	Stk. Equity							
	Cash	+	Supplies	=	Accts. Pay.	+	Unearn. Rev.	+	Ret. Earn.	Rev.	–	Exp.	=	Net Inc.	Cash Flow	
1.	18,000	+	NA	=	NA	+	18,000	+	NA	NA	–	NA	=	NA	18,000	OA
2.	42,000	+	NA	=	NA	+	NA	+	42,000	42,000	–	NA	=	42,000	42,000	OA
3.	NA	+	750	=	750	+	NA	+	NA	NA	–	NA	=	NA	NA	
4.	(600)	+	NA	=	(600)	+	NA	+	NA	NA	–	NA	=	NA	(600)	OA
5.	(4,000)	+	NA	=	NA	+	NA	+	(4,000)	NA	–	NA	=	NA	(4,000)	FA
6.	(16,000)	+	NA	=	NA	+	NA	+	(16,000)	NA	–	16,000	=	(16,000)	(16,000)	OA
7.	NA	+	(675)	=	NA	+	NA	+	(675)	NA	–	675	=	(675)	NA	
8.	NA	+	NA	=	NA	+	(16,500)	+	16,500	16,500	–	NA	=	16,500	NA	
End. Bal.	39,400	+	75	=	150	+	1,500	+	37,825	58,500	–	16,675	=	41,825	39,400	NC

Exercise 2-20

Royce Company's accounting records show an after-closing balance of $9,700 in its Retained Earnings account on December 31, 2016. During the 2016 accounting cycle, Royce earned $7,550 of revenue, incurred $4,600 of expense, and paid $750 of dividends. Revenues and expenses were recognized evenly throughout the accounting period.

Required

a. Determine the balance in the Retained Earnings account as of January 1, 2017.

b. Determine the balance in the temporary accounts as of January 1, 2016.

c. Determine the after-closing balance in the Retained Earnings account as of December 31, 2015.

d. Determine the balance in the Retained Earnings account as of June 30, 2016.

Ending retained earnings	$ 9,700
Revenue	7,550
Expense	4,600
Dividends	750

Net income = $ 2,950

Retained earnings, January 1, 2017	$9,700
– Net income	(2,950)
+ Dividends	750
Retained earnings, June 30, 2016	$ 7,500

Exercise 2-26

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

Supplies Expense	Supplies
Salaries Payable	Beginning Retained Earnings
Ending Common Stock	Cash Flow from Financing Activities
Beginning Cash Balance	Accounts Receivable
Net Change in Cash	Ending Cash Balance
Land	Accounts Payable
Total Liabilities	Beginning Common Stock
"For the Year Ended" Date Notation	Dividends
Salaries Expense	Total Assets
Net Income	"As of" Date Notation
Service Revenue	Prepaid Rent
Cash Flow from Operating Activities	Insurance Expense
Interest Receivable	Price/Earnings Ratio
Interest Revenue	Taxes Payable
Rent Expense	Consulting Revenue
Notes Payable	Utilities Expense
Unearned Revenue	Operating Cycle
Cash Flow from Investing Activities	Operating Expenses
Ending Retained Earnings	Prepaid Insurance

Notes Payable

Income Statement
For the Year Ended _____

Revenues

Service revenue
Interest Revenue

Expenses

Salary Expense
Supplies Expense

Net Income

Statement of Changes in Stockholders' Equity
For the Year Ended _____

Ending common stock

Net Income

Balance Sheet

Assets

Land
Interest Receivable

Liabilities

Salaries Payable
Notes Payable
Total Liabilities

Stockholders' equity
Common stock

Statement of Cash Flows
For the Year Ended _____

Cash Flow from Operating Activities

Net Change in cash
Beginning Cash Balance

Prepaid Insurance

Income Statement

Revenues

Consulting Revenue

Expenses

Utilities Expense
Operating Expenses

Statement of Changes in Stockholders' Equity

Beginning Common Stock

Beginning Retained Earnings

Dividends
Ending Retained Earnings

Balance Sheet

As of _____

Assets

Cash
Supplies
Accounts Receivable
Prepaid Rent
Prepaid Insurance

Total Assets

Liabilities

Accounts Payable
Accounts Payable
Unearned Revenue

Stockholders' equity
Retained Earnings

Statement of Cash Flows

Cash Flow from Investing Activities

Cash Flow from Financing Activities
Cash dividends

Ending Cash Balance

Exercise 2-30

Required

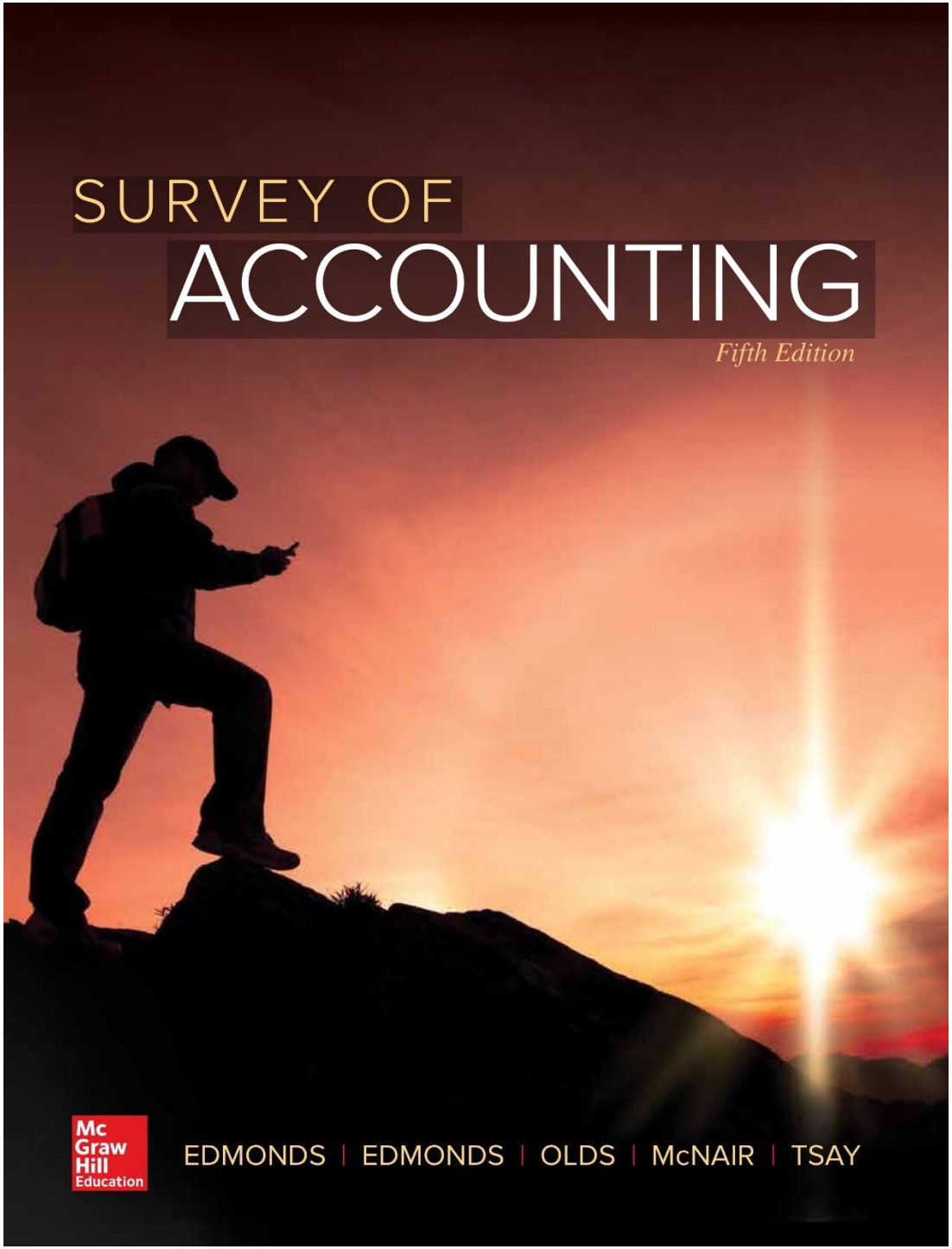
Indicate whether each of the following transactions is an asset source, asset use, asset exchange, or claims exchange transaction.

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

Purchased land with cash

Assets	=	Liabilities	+	Stk. Equity
+		+		+

Asset Exchange



Chapter 2

Accounting for Accruals and Deferrals

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Accrual Accounting

Accrual

A revenue or expense event that is recognized before cash is exchanged

Deferral

A revenue or expense event that is recognized after cash has been exchanged

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LO 1:

Show how receivables affect financial statements.

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Event 1

Cato Consultants was started on January 1, 2018, when it acquired $5,000 cash by issuing common stock.

Asset Source Transaction

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

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Event 2

During 2018, Cato Consultants provided $84,000 of consulting services to its clients but no cash has been collected.

Asset Source Transaction

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

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Event 3

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

Asset Exchange Transaction

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

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Other 2018 Events

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

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

Event 5: Cato paid $2,000 for advertising costs. The advertisements appeared in 2018.

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

Event 6: Cato signed contracts for $42,000 of consulting services to be performed in 2019.

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

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LO 2:

Show how payables affect financial statements.

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Event 7

At the end of 2018, Cato recorded accrued salary expense of $6,000 (the salary expense is for courses the instructor taught in 2018 that Cato will pay cash for in 2019).

Claims Exchange Transaction

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

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LO 3:

Prepare financial statements that include accruals.

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Vertical Statements Model

EXHIBIT 2.2 Vertical Statements Model

CATO CONSULTANTS
Financial Statements*
Income Statement
For the Year Ended December 31, 2018

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

Statement of Changes in Stockholders' Equity
For the Year Ended December 31, 2018

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

Balance Sheet
As of December 31, 2018

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

Statement of Cash Flows
For the Year Ended December 31, 2018

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

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Comparing Cash Flow from Operating Activities with Net Income

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

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The Closing Process

EXHIBIT 2.3

Cato Corporation, 2018 Closing Process

Panel 1 Closing Entries

C1 Transfers the balance from the Consulting Revenue account to the Retained Earnings account.
C2 Transfers the balance from the Salary Expense account to the Retained Earnings account.
C3 Transfers the balance from the Advertising Expense account to the Retained Earnings account.

Panel 2 General Ledger Accounts after Closing

Assets	=	Liabilities	+	Permanent Equity	+	Temporary Equity

Cash

Bal.	0
(1)	5,000
(3)	60,000
(4)	(10,000)
(5)	(2,000)
Bal.	53,000

Accounts Receivable

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

Salaries Payable

(6) Adj.	6,000
Bal.	6,000

Common Stock

Bal.	0
(1)	5,000
Bal.	5,000

Retained Earnings

Bal.	0
Cl.1	84,000
Cl.2	(16,000)
Cl.3	(2,000)
Bal.	66,000

Consulting Revenue

(2)	84,000
Bal.	84,000
Cl.1	(84,000)
Bal.	0

Salary Expense

(4)	(10,000)
(6) Adj.	(6,000)
Bal.	16,000
Cl.2	16,000
Bal.	0

Advertising Expense

(5)	(2,000)
Bal.	(2,000)
Cl.3	2,000
Bal.	0

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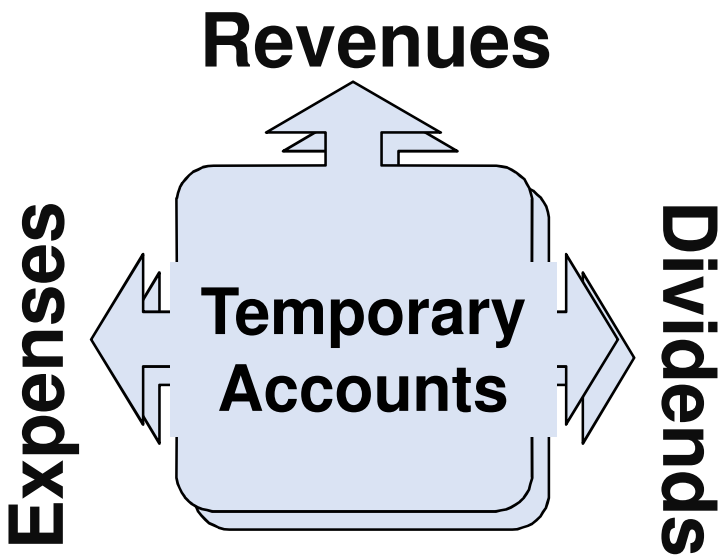
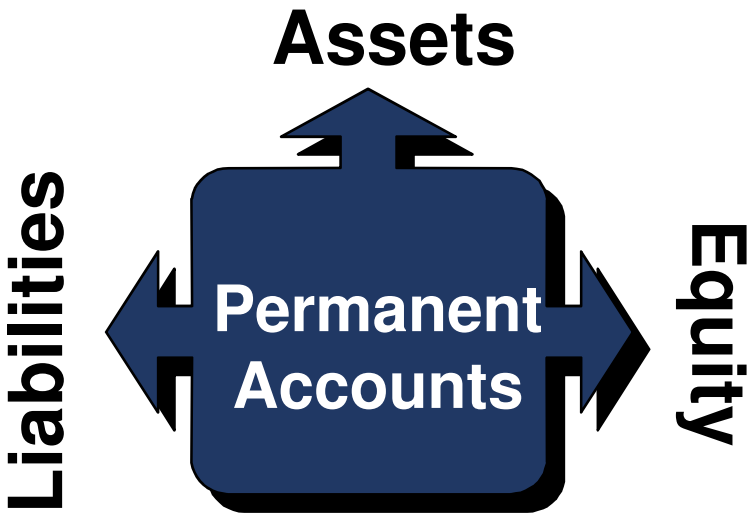
Temporary and Permanent Accounts



Temporary accounts track financial results for a limited period of time.



Permanent accounts track financial results from year to year.

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LO 4:

Identify the steps in the accounting cycle.

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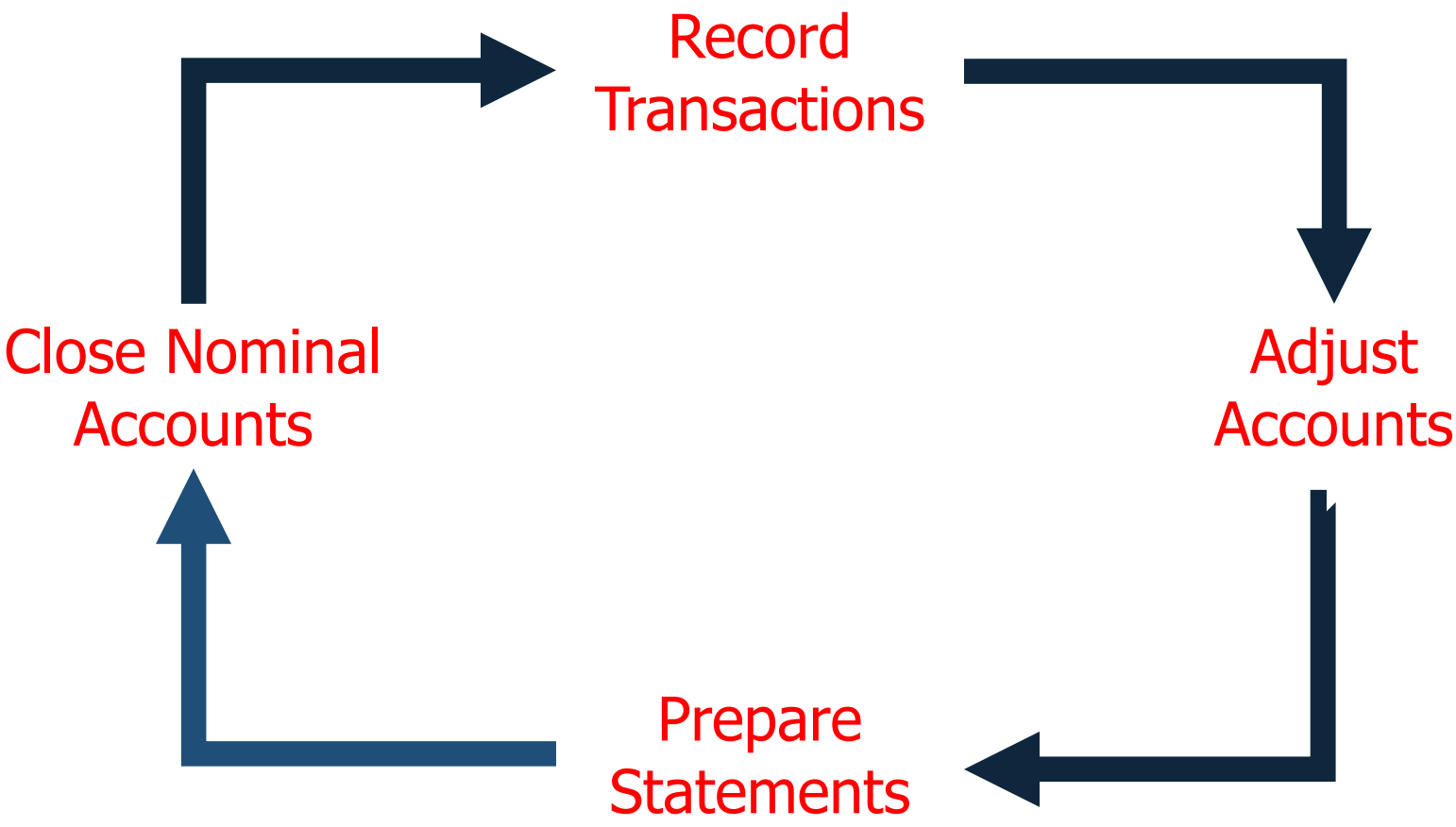
Steps in an Accounting Cycle



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Matching Concept

Cash basis accounting can distort the measurement of net income because it sometimes fails to properly match revenues with expenses.

The problem is that cash is not always received or paid in the period when the revenue is earned or when the expense is incurred.

The objective of accrual accounting is to improve matching of revenues with expenses.

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2019 Event 1

Cato pays $6,000 to the instructor to settle the salaries payable obligation.

The Second Accounting Cycle

Asset Use Transaction

Balance Sheet							Income Statement					Statement of Cash Flows	
Assets	=	Liab.	+	C. Stk.	+	R. Earn.	Rev.	–	Exp.	=	Net Inc.		
(6,000)	=	(6,000)	+	NA	+	NA	NA	–	NA	=	NA	(6,000)	OA

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LO 5:

Show how accounting for supplies affects financial statements.

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2019 Event 2

Cato purchases $800 of supplies on account.

Asset Source Transaction

Balance Sheet							Income Statement					Statement of Cash Flows
Assets	=	Liab.	+	C. Stk.	+	R. Earn.	Rev.	−	Exp.	=	Net Inc.	
800	=	800	+	NA	+	NA	NA	−	NA	=	NA	NA

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2019 Adj. 1

After determining through a physical count that it has $150 of unused supplies on hand as of December 31, Cato recognizes supplies expense.

Beginning balance of supplies	0
Plus: Supplies purchases	800
Supplies available for use	800
Less: Ending balance of supplies	(150)
Supplies used	650

Balance Sheet							Income Statement					Statement of Cash Flows
Assets	=	Liab.	+	C. Stk.	+	R. Earn.	Rev.	−	Exp.	=	Net Inc.	
(650)	=	NA	+	NA	+	(650)	NA	−	650	=	(650)	NA

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LO 6:

Show how accounting for prepaid items affects financial statements.

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2019 Event 3

On March 1, Cato signs a one-year lease agreement and pays $12,000 cash in advance to rent office space. The one-year lease term begins March 1.

Balance Sheet							Income Statement					Statement of Cash Flows	
Assets	=	Liab.	+	C. Stk.	+	R. Earn.	Rev.	−	Exp.	=	Net Inc.		
NA	=	NA	+	NA	+	NA	NA	−	NA	=	NA	(12,000)	OA

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2019 Adj. 2

Cato recognizes rent expense for the office space used during the accounting period.

Balance Sheet							Income Statement					Statement of Cash Flows
Assets	=	Liab.	+	C. Stk.	+	R. Earn.	Rev.	−	Exp.	=	Net Inc.	
(10,000)	=	NA	+	NA	+	(10,000)	NA	−	10,000	=	(10,000)	NA

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LO 7:

Show how accounting for unearned revenues affects financial statements.

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2019 Event 4

Cato receives $18,000 cash in advance from Westberry Company for consulting services to be performed over a one-year period beginning June 1, 2019.

Asset Source Transaction

Balance Sheet							Income Statement					Statement of Cash Flows	
Assets	=	Liab.	+	C. Stk.	+	R. Earn.	Rev.	–	Exp.	=	Net Inc.		
18,000	=	18,000	+	NA	+	NA	NA	–	NA	=	NA	18,000	OA

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2019 Adj. 3

Cato recognizes the portion of the unearned revenue it earned during the accounting period.

Balance Sheet							Income Statement					Statement of Cash Flows
Assets	=	Liab.	+	C. Stk.	+	R. Earn.	Rev.	−	Exp.	=	Net Inc.	
NA	=	(10,500)	+	NA	+	10,500	10,500	−	NA	=	10,500	NA

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Other 2019 Events

Event 5: Provided $96,400 of consulting services on account.

Event 6: Collected $105,000 cash from customers in partial settlement of its accounts receivable.

Event 7: Paid $32,000 cash for salary expense.

Event 8: Incurred $21,000 of other operating expenses on account.

Event 9: Paid $18,200 cash in partial settlement of accounts payable.

Event 10: Paid $79,500 for land it planned to use in the future as a building site for its home office.

Event 11: Paid $21,000 in cash dividends to its stockholders.

Event 12: Acquired $2,000 cash from issuing additional shares of common stock.

Adj. 4: Recognized $4,000 of accrued salary expense.

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LO 8:

Prepare financial statements that include deferrals.

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Preparing Financial Statements — Income Statements

EXHIBIT 2.7 Vertical Statements Model

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

	2018	2019
Consulting revenue	$84,000	$106,900
Operating expenses	(18,000)	(67,650)
Net income	$66,000	$ 39,250

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

	2018	2019
Beginning common stock	$ 0	$ 5,000
Plus: Common stock issued	5,000	2,000
Ending common stock	5,000	7,000
Beginning retained earnings	0	66,000
Plus: Net income	66,000	39,250
Less: Dividends	0	(21,000)
Ending retained earnings	66,000	84,250
Total stockholders' equity	$71,000	$ 91,250

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Preparing Financial Statements — Balance Sheets

Balance Sheets As of December 31	2018	2019
Assets		
Cash	$53,000	$ 9,300
Accounts receivable	24,000	15,400
Supplies	0	150
Prepaid rent	0	2,000
Land	0	79,500
Total assets	$77,000	$106,350
Liabilities		
Accounts payable	$ 0	$ 3,600
Unearned revenue	0	7,500
Salaries payable	6,000	4,000
Total liabilities	6,000	15,100
Stockholders' equity		
Common stock	5,000	7,000
Retained earnings	66,000	84,250
Total stockholders' equity	71,000	91,250
Total liabilities and stockholders' equity	$77,000	$106,350

continued

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Preparing Financial Statements — Statements of Cash Flows

EXHIBIT 2.7 *Concluded*

Statements of Cash Flows For the Years Ended December 31	2018	2019
Cash Flows from Operating Activities		
Cash receipts from customers	$60,000	$123,000
Cash payments for operating expenses	(12,000)	(68,200)
Net cash flow from operating activities	48,000	54,800
Cash Flows from Investing Activities		
Cash payment to purchase land	0	(79,500)
Cash Flows from Financing Activities		
Cash receipts from issuing common stock	5,000	2,000
Cash payments for dividends	0	(21,000)
Net cash flow from financing activities	5,000	(19,000)
Net change in cash	53,000	(43,700)
Plus: Beginning cash balance	0	53,000
Ending cash balance	$53,000	$ 9,300

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LO 9:

Classify accounting events into one of four categories.

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Recap: Types of Transactions

The described transactions can be classified into one of four categories:

Asset source	Asset use	Asset exchange	Claims exchange
Increase assets, increase claims on assets.	Decrease assets, decrease claims on assets.	Increase one asset, decrease another asset.	Increase one claims account, decrease another.

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End of Chapter 2

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