A Review of the Accounting Cycle

Overview

This chapter covers the nuts and bolts of basic accounting, or rather basic bookkeeping. Accounting tends to cover much wider territory, and it features much more analysis, when compared with bookkeeping. Accountants do need to know how to do bookkeeping, however. If for no other reason, then they at least need to learn bookkeeping to be able to understand much of the remainder of the textbook which relies on a solid foundation in understanding how the accounting cycle works and how transactions flow through an accounting system.

Accounting entries can be broken down into three categories: recording entries (LO2), adjusting entries (LO3), and closing entries (LO3). The vast majority of entries fall into the first category. The final category of closing entries are only made once a month, quarter, or year depending on how often the company closes out its books in order to issue financial statements.

Finally, the chapter discusses the importance, an ever-increasing role, of computers in the field of accounting.

Learning Objectives

Refer to the Review of Learning Objectives at the end of the chapter. It is crucial that this section of the chapter is second nature to you before you attempt the homework, a quiz, or exam. This important piece of the chapter serves as your CliffsNotes or “cheat sheet” to the basic concepts and principles that must be mastered.

If after reading this section of the chapter you still don’t feel comfortable with all of the Learning Objectives covered, you will need to spend additional time and effort reviewing those concepts that you are struggling with.

The following “Tips, Hints, and Things to Remember” are organized according to the Learning Objectives (LOs) in the chapter and should be gone over after reading each of the LOs in the textbook.
Tips, Hints, and Things to Remember

LO1 – Identify and explain the basic steps in the accounting process (accounting cycle).

How? Synthesize the steps of the accounting process down into these easy-to-remember components. There are three types, or categories, of accounting entries as mentioned on page 2-1. In between those entries come trial balances, and at or near the end of the process come the financial statements.

LO2 – Analyze transactions and make and post journal entries.

How? Debits and credits, credits and debits: How is one to ever remember which is which? Do I really have to memorize something as complicated as Exhibit 2-2? The answer is no. Debits and credits are much simpler than that. You really only need to remember two things: the basic format of a balance sheet and that debits are on the left. Everything else flows out of those two easy-to-remember items.

In this textbook balance sheets usually have assets at the top, followed by liabilities and equity. Instead, picture in your mind (or better yet sketch out) a balance sheet with assets on the left and liabilities/equity on the right. This way the totals for both columns will be equal in the same row at the bottom since Assets = Liabilities + Equity.

Next, think of the income statement as part of equity. We learned in this chapter that nominal or temporary (income statement) accounts get closed out to equity. (Ultimately, revenue and gains will increase equity and expenses and losses will decrease equity. So revenue moves in the same direction as equity and expenses move in the opposite direction.)

With that nested income statement in a balance sheet in mind, the only thing left to remember is that debits are on the left. The effects of debits and credits flow out of this model with ease. Since assets are on the left of our balance sheet they increase with debits (and decrease with credits). Since liabilities and equity are on the right of our balance sheet they increase with credits (and decrease with debits). Again, think of the income statement as part of equity with revenue and gains being the same as equity for debit/credit purposes and expenses and losses being the opposite (since they decrease equity).

This is also a good way to remember that your debits and credits must always equal. If they didn’t, your balance sheet would no longer balance.

That’s it! You’ve now got debits and credits down without having to memorize more than a dozen items (which you’d surely get confused or backwards at times) like you’ll find in illustrations like Exhibit 2-2.
Feel free to crank out something like the following illustration when given a debit/credit homework assignment or attempting a debit/credit problem on an examination. Draw it before you ever start the assignment or problem. You'll find that after drawing and using it a few times you'll no longer need it as it will easily stick to your brain as a mental image with a little practice.

### Balance Sheet

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>+DR</td>
<td>+CR</td>
</tr>
<tr>
<td>−cr</td>
<td>−dr</td>
</tr>
</tbody>
</table>

**Equity**

- Income Statement
- Rev. +CR
- Exp. +DR

= How?

What’s the difference between journals and ledgers? The difference is that transactions start out in journals (or at least did historically) and end up in ledgers. To avoid getting them flip-flopped in your head, remember that the letter \( j \) comes before \( l \) in the alphabet just as transactions go through journals before ledgers. Ledgers look more like your checkbook. Ledgers show account balances and adjustments to specific, individual accounts. Journals provide more details about a transaction (including all the accounts affected) and tell you what really happened in total.
Why? Are journals and ledgers even used in today’s computerized environment? The answer is yes and no. Fewer transactions are entered into journals with today’s software programs. However, most software programs still keep the journals in the background, which are available more as a kind of report now than anything else. Adjusting and infrequent entries are also still frequently recorded through the general journal. Common entries, such as sales and purchases, are now generally run through a sales order system or a purchasing system which “journalize” the transactions into the correct accounts behind the scenes. Posting is one item that has been rendered nearly obsolete due to the computer. Posting still happens, of course, but it is typically automatic and not usually subject to the common user errors (forgetting to post, posting to the wrong account, or transposing numbers upon posting) that existed in manual accounting systems. Ledgers are just as important in a computerized environment as ever.

LO3 – Make adjusting entries, produce financial statements, and close nominal accounts.

How? Adjusting entries is an area that students frequently struggle with. Part of the problem is that there is more than one way to enter an original transaction or the corresponding adjusting entry. For instance, let’s say I purchase some supplies. Should I debit an asset called “Supplies” or an expense called “Supplies Expense”? The answer is it doesn’t matter. If you don’t plan to use the supplies before the next accounting period ends then an asset is probably better, and if you plan to use them all before the end of the period then an expense is probably better. But if you plan to use up only some of the supplies then it doesn’t matter at all. What does matter is that you adjust your account balances before issuing your financial statements.

So here is the key concept to get down when it comes to adjusting entries: Account balances need to be adjusted so they are correctly stated. That is it. If your physical count of supplies indicates that you have $500 in supplies, it doesn’t matter if your current supplies balance per your books is $0 or $50,000, you need to move the balance to $500. Perhaps “adjusting entry” isn’t even the best term to describe the process. What we are really doing is correcting entries.

Another struggle students encounter is what accounts should be adjusted. Take the above example. Let’s say our Supplies balance per books is $0 but I have $500 in supplies on hand at the end of the fiscal period. I know, therefore, that I must debit Supplies by $500 but what do I credit? Students sometimes make the error of hitting the missing debit or credit to Cash. There are two things to remember about adjusting entries:

1. Adjusting entries will always affect at least one balance sheet and at least one income statement account.
2. Cash is never adjusted in an adjusting entry (except in the rare instance in which cash per count doesn’t equal the Cash account on the books—an indication of other problems to be sure!).
So getting back to our missing credit... Since Supplies is a balance sheet account, we should be looking to credit an income statement account (not ever Cash). What income statement account goes along with our balance sheet account of Supplies? Supplies Expense, of course. You'll find similar related accounts for other adjusting entries as well. (Prepaid Rent with Rent Expense, Prepaid Insurance with Insurance Expense, Interest Payable with Interest Expense, Wages Payable with Wages Expense, Unearned Revenue with Sales Revenue, etc.)

LO4 – Distinguish between accrual and cash-basis accounting.

How? Students sometimes have difficulty understanding the accrual-basis concept. And then once they do master it, they seem to forget how to do cash-basis which isn't as difficult. So how does one keep the two separate in their mind? Think of the accrual-basis of accounting as being accounting based on when events transpire without ever considering cash. Contrast this with the cash-basis of accounting which is basically checkbook accounting—everything is based on cash.

LO5 – Discuss the importance and expanding role of computers to the accounting process.

See the Why? under LO2 on page 2-4.

The following sections, featuring various multiple choice questions, matching exercises, and problems, along with solutions and approaches to arriving at the solutions, is intended to develop your problem-solving and critical-thinking abilities. While learning through trial and error can be effective for improving your quiz and exam scores, and it can be a more interesting way to study than merely re-reading a chapter, that is only a secondary objective in presenting this information in this format.

The main goal of the following sections is to get you thinking, “How can I best approach this problem to arrive at the correct solution—even if I don’t know enough at this point to easily arrive at the proper results?” There is not one simple approach that can be applied to all questions to arrive at the right answer. Think of the following approaches as possibilities, as tools that you can place in your problem-solving toolkit—a toolkit that should be consistently added to. Some of the tools have yet to even be created or thought of. Through practice, creative thinking, and an ever-expanding knowledge base, you will be the creator of the additional tools.
Multiple Choice

MC2-1 (LO1) Which of the following is NOT among the first four steps in the accounting cycle?
   a. record transactions in journals
   b. record closing entries
   c. business documents analyzed
   d. post entries to general ledger accounts

MC2-2 (LO2) A routine collection on a customer's account was recorded and posted as a debit to Cash and a credit to Sales Revenue. The journal entry to correct this error would be a debit to
   a. Cash and a credit to Accounts Receivable.
   b. Sales Revenue and a credit to Unearned Revenue.
   c. Sales Revenue and a credit to Accounts Receivable.
   d. Accounts Receivable and a credit to Sales Revenue.

MC2-3 (LO2) In an accrual accounting system,
   a. all accounts have normal credit balances.
   b. revenues are recorded only when cash is received.
   c. liabilities, owner's capital, and expenses all have normal credit balances.
   d. a credit entry is recorded on the right-hand side of an account.

MC2-4 (LO2) Debits and credits are first determined in the accounting process of a transaction when the
   a. entry is recorded in a journal.
   b. entry is posted to a subsidiary ledger.
   c. trial balance is prepared.
   d. financial statements are prepared.

MC2-5 (LO3) If an expense has been incurred but not yet recorded, then the end-of-period adjusting entry would involve a(n)
   a. liability account and an asset account.
   b. liability account and an expense account.
   c. equity and a liability account.
   d. receivable account and a revenue account.

MC2-6 (LO3) Failure to record wage expense earned by employees at the end of an accounting period that will be paid on the following Friday results in
   a. understated income.
   b. understated liabilities.
   c. overstated expenses.
   d. overstated assets.
MC2-7 (LO3) Failure to record the expired amount of Prepaid Insurance Expense would NOT
a. understate expenses.
b. overstate net income.
c. overstate owners' equity.
d. understate liabilities.

MC2-8 (LO3) The balance in an Unearned Revenue account represents an amount that is

<table>
<thead>
<tr>
<th>Earned</th>
<th>Collected</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

MC2-9 (LO4) Which of the following statements regarding accrual versus cash-basis accounting is TRUE?

a. The FASB believes that cash-basis accounting is appropriate for some smaller companies, especially those in the service industry.
b. Cash-basis accounting is sometimes used by small, unincorporated businesses.
c. Application of cash-basis accounting results in an income statement reporting revenues and expenses.
d. Cash-basis accounting requires a complete set of double-entry records.

MC2-10 (LO5) The use of computers in processing accounting data

a. places responsibility on the information systems designer.
b. eliminates the double-entry system as a basis for analyzing transactions.
c. eliminates the need for financial reporting standards such as those promulgated by the FASB.
d. always increases document trails used to verify accounting records.
Matching

Matching 2-1 (LO2) Listed below are the terms and associated definitions from the chapter for LO2. Match the correct definition letter with each term number.

<table>
<thead>
<tr>
<th>Term Number</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>exchanges of goods or services between/among two or more entities or some other event having an economic impact on a business enterprise</td>
</tr>
<tr>
<td>2.</td>
<td>an accounting record used to list a particular type of frequently recurring transaction</td>
</tr>
<tr>
<td>3.</td>
<td>a record used to classify and summarize the effects of transactions</td>
</tr>
<tr>
<td>4.</td>
<td>an entry on the right side of an account</td>
</tr>
<tr>
<td>5.</td>
<td>an entry on the left side of an account</td>
</tr>
<tr>
<td>6.</td>
<td>procedures used for analyzing, recording, classifying, and summarizing the information to be presented in accounting reports</td>
</tr>
<tr>
<td>7.</td>
<td>an accounting record used to record all business activities for which a special journal is not maintained</td>
</tr>
<tr>
<td>8.</td>
<td>the process of summarizing transactions by transferring amounts from the journals to the ledger accounts</td>
</tr>
<tr>
<td>9.</td>
<td>the grouping of supporting accounts that in total equal the balance of a control account in the general ledger</td>
</tr>
<tr>
<td>10.</td>
<td>the general ledger account that summarizes the detailed information in a subsidiary ledger</td>
</tr>
<tr>
<td>11.</td>
<td>a collection of all the accounts used by a business that could appear on the financial statements</td>
</tr>
<tr>
<td>12.</td>
<td>a system of recording transactions in a way that maintains the equality of the accounting equation</td>
</tr>
<tr>
<td>13.</td>
<td>records in which transactions are first entered, providing a chronological record of business activity</td>
</tr>
<tr>
<td>14.</td>
<td>the recording of a transaction in which debits equal credits; it usually includes a date and an explanation of the transaction</td>
</tr>
</tbody>
</table>
Matching 2-2 (LO3, LO4) Listed below are the terms and associated definitions from the chapter for LO3 through LO4. Match the correct definition letter with each term number.

___ 1. trial balance  
___ 2. adjusting entries  
___ 3. contra account  
___ 4. nominal (temporary) account  
___ 5. real (permanent) account  
___ 6. accrual accounting  
___ 7. cash-basis accounting  
___ 8. post-closing trial balance

a. used to record subtractions from a related account  
b. a list of all real accounts and their balances after the income statement has been prepared  
c. closed to a zero balance at the end of an accounting period  
d. revenues are recognized when earned and expenses are recognized when incurred  
e. revenues and expenses are recorded as they are received and paid  
f. a list of all accounts and their balances  
g. not closed to a zero balance at the end of each accounting period  
h. required at the end of each accounting period to update the accounts as necessary and to fully recognize, on an accrual basis, revenues and expenses for the period

Exercises

Exercise 2-1 (LO2) Indicate whether a debit will increase (I) or decrease (D) each of the following accounts

___ 1. Accumulated Depreciation  
___ 2. Buildings  
___ 3. Cash  
___ 4. Dividends  
___ 5. Dividends Payable  
___ 6. Allowance for Bad Debts  
___ 7. Accounts Receivable  
___ 8. Cost of Goods Sold  
___ 9. Depreciation Expense  
___ 10. Sales Revenue  
___ 11. Retained Earnings  
___ 12. Common Stock  
___ 13. Income Tax Expense  
___ 15. Advertising Expense  
___ 16. Prepaid Advertising  
___ 17. Unearned Revenue  
___ 18. Bad Debt Expense
Exercise 2-2 (LO3) For each of the following accounts, indicate by letter with an N (for nominal) or an R (for real) whether the account is a nominal (temporary) account or a real (permanent) account.

___ 1. Accumulated Depreciation
___ 2. Buildings
___ 3. Cash
___ 4. Dividends
___ 5. Dividends Payable
___ 6. Allowance for Bad Debts
___ 7. Accounts Receivable
___ 8. Cost of Goods Sold
___ 9. Depreciation Expense
___ 10. Sales Revenue
___ 11. Retained Earnings
___ 12. Common Stock
___ 13. Income Tax Expense
___ 15. Advertising Expense
___ 16. Prepaid Advertising
___ 17. Unearned Revenue
___ 18. Bad Debt Expense

Problems

Problem 2-1 (LO2) Record the following transactions and events of the Renato Galasso Company in general journal form. If the item does not require a journal entry, write “no entry.”

a. Sold services worth $8,000 for $1,000 cash and $7,000 on account.
b. Purchased land and building for $80,000 cash and a $320,000 mortgage. The land was recently appraised at $70,000 and the building at $330,000.
c. Received payment on account, $5,000.
d. Estimated that utilities expense for the coming six months will total $10,000.
e. Paid a cash dividend totaling $13,000.
Problem 2-2 (LO2) For each of the journal entries below, write a description of the underlying event.

a. Cash XXX
   Capital Stock XXX

b. Interest Expense XXX
   Notes Payable XXX
   Cash XXX

c. Cash XXX
   Unearned Revenue XXX

d. Supplies XXX
   Cash XXX

e. Cash XXX
   Accounts Receivable XXX

Problem 2-3 (LO3) The information listed below was obtained from the accounting records, by taking physical counts, and through inquiry of employees of Ringrose Company as of December 31, 2011.

a. Interest on a note receivable of $400 had been earned, but none of it had been received or recorded by December 31, 2011.

b. On December 28, 2011, Ringrose received $5,000 in cash in advance for services to be performed in 2012. The $5,000 was credited to Sales Revenue.

c. Building and land were purchased in 2000 for $780,000. The building's fair market value was $650,000 at the time of purchase. The building is being depreciated over a 25-year life using the straight-line method, and assuming no salvage value.

d. On November 1, 2011, $100,000 was loaned to a shareholder on a 6-month note with interest at an annual rate of 12 percent. Interest is due at maturity. No interest was accrued at the end of November.

e. Accrued salaries and wages are $3,100 at December 31, 2011. They will be paid on January 4, 2012.

f. The Office Supplies account has a balance of $3,500. An inventory of supplies revealed a total of only $500 actually on hand.

Prepare journal entries to adjust the books of Ringrose Company at December 31, 2011.
Problem 2-4 (LO3) The following incomplete list of account balances pertain to the Chesnut Company at December 31, 2011 (before adjusting entries).

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts Receivable</td>
<td>$ 55,000</td>
</tr>
<tr>
<td>Allowance for Bad Debts</td>
<td>$ 500</td>
</tr>
<tr>
<td>Inventory</td>
<td>99,000</td>
</tr>
<tr>
<td>Prepaid Insurance</td>
<td>3,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>300,000</td>
</tr>
<tr>
<td>Accumulated Depreciation</td>
<td>120,000</td>
</tr>
<tr>
<td>Interest Payable</td>
<td>0</td>
</tr>
<tr>
<td>Notes Payable</td>
<td>50,000</td>
</tr>
<tr>
<td>Unearned Revenue</td>
<td>75,000</td>
</tr>
</tbody>
</table>

Additional information:

a. The controller and the credit manager agreed that, based on an aging of year-end accounts receivable, the Allowance for Bad Debts account should be increased to $5,000.

b. The credit manager determined that a customer account with a balance of $1,000 was uncollectible (without regard to the information in a above).

c. The note payable is dated August 31, 2006, and bears interest at 12 percent per annum. The note and interest are payable at maturity on July 31, 2012.

d. The Prepaid Insurance balance arose from the payment of an annual premium on June 30, 2011 of $3,000.

e. The inventory at December 31, 2011, was $98,000 as determined by physical count.

f. The equipment, purchased five years ago, is being depreciated over a ten-year estimated useful life.

g. The unearned revenue represents an amount received for a long-term equipment rental to another company. The cash ($75,000) was received on June 26, 2011, and represents prepayment of a one-year rental beginning July 1, 2011.

Prepare adjusting entries to Chesnut Company’s accounts at December 31, 2011. Each entry should be made in general journal format. Identify each entry by using the letter of the paragraph containing the additional information for the entry. Note that entry b is not really an adjusting entry (and hence won’t affect one balance sheet and one income statement account like adjusting entries typically do).
Problem 2-5 (LO3) Presented below is the December 31 trial balance of Coles Company.

Coles Company
Trial Balance
December 31, 2011

<table>
<thead>
<tr>
<th></th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$14,800</td>
<td></td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>33,600</td>
<td></td>
</tr>
<tr>
<td>Allowances for Bad Debts</td>
<td></td>
<td>$2,160</td>
</tr>
<tr>
<td>Inventory</td>
<td>62,400</td>
<td></td>
</tr>
<tr>
<td>Furniture and Equipment</td>
<td>67,200</td>
<td></td>
</tr>
<tr>
<td>Accumulated Depreciation</td>
<td></td>
<td>26,880</td>
</tr>
<tr>
<td>Prepaid Insurance</td>
<td>4,080</td>
<td></td>
</tr>
<tr>
<td>Notes Payable</td>
<td></td>
<td>22,400</td>
</tr>
<tr>
<td>Common Stock</td>
<td></td>
<td>72,000</td>
</tr>
<tr>
<td>Sales</td>
<td></td>
<td>480,000</td>
</tr>
<tr>
<td>Cost of Goods Sold</td>
<td>320,000</td>
<td></td>
</tr>
<tr>
<td>Sales Salaries Expense</td>
<td>40,000</td>
<td></td>
</tr>
<tr>
<td>Advertising Expense</td>
<td>5,360</td>
<td></td>
</tr>
<tr>
<td>Administrative Salaries Expense</td>
<td>52,000</td>
<td></td>
</tr>
<tr>
<td>Office Expense</td>
<td>4,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$603,440</strong></td>
<td><strong>$603,440</strong></td>
</tr>
</tbody>
</table>

Prepare the closing entries for Coles Company. What was Coles Company’s net income for the period just ended?

Problem 2-6 (LO4) Manami Company earned $50,000 during 2011 and incurred expenses (except taxes) of $30,000. They only collected $30,000 of their earnings, however, as their Accounts Receivable balance increased by $20,000 during 2011. Manami Company incurred all of their expenses on credit, paying off $20,000 of them, meaning their Accounts Payable account increased by $10,000 during 2011.

Manami Company obtained a loan of $10,000 on the last day of the year. Assuming a 30 percent tax rate and $5,000 in taxes actually paid, what is Manami Company’s net income on an accrual basis for 2011? On a cash basis, did their cash increase or decrease and by how much for 2011?
Solutions, Approaches, and Explanations

MC2-1
Answer: b
Approach and explanation: Notice the not. Underline it, highlight it, circle it, or do whatever it takes so that you don’t just immediately choose the first choice that is one of the first four steps.

Always examine the exhibits in the chapter. Don’t skip them just because they aren’t part of the main text body or because some are quite large. They aren’t put there merely to take up space and allow you to read a long chapter faster by only having to deal with the main body of text. Some are of critical importance and some should actually be committed to memory. Exhibit 2-1 is one that should be read but need not be memorized. Get a feel for the accounting process and where things fit, but there is little value in knowing, for instance, that Step 5 is “Adjustments.”

Notice, from Exhibit 2-1, that the first few steps involve getting a company’s day-to-day transactions into the system. That is only logical. A company can’t close the books or issue financial statements without first processing the normal transactions. The latter stages of the accounting process are going to be the items that come after the day-to-day transactions, at month, quarter, or year end (what accountants in the industry refer to as “the close”), which is their busiest time of the month. These items include adjusting the books, closing the books, and the creation of financial statements.

So for a question like this, if it asks for first steps you are looking for day-to-day transaction activity, and if it asks for last steps (as in this case), you are going to look for end-of-period activity. Choices a, c, and d are the day-to-day activities so choice b, an end-of-period activity, is going to be the only logical choice.

MC2-2
Answer: c
Approach and explanation: If you are a visual learner, it may help to sketch out T-accounts for the accounts involved. There are examples of T-accounts in the textbook in LO3 for this chapter. Basically, one for Cash would look like the following:

```
| Cash |
```

A T-account represents what is happening to an account’s balance in the general ledger. Numbers on the left are debits that increase asset account balances, and numbers on the right are credits that decrease asset account balances.
It may also be useful to give a problem some real numbers. So, in this case, let’s say $1,000 was collected from the customer. First, let’s sketch out how the transaction should have been recorded. A routine collection on a customer’s account is going to increase Cash and decrease Accounts Receivable (since the customer no longer owes the money). In debit/credit or T-Account format, they will look like the following:

\[
\begin{array}{c|c}
\text{Cash} & \text{Accounts Receivable} \\
1,000 & 1,000 \\
\end{array}
\]

Instead of making the above entry, the entry was erroneously recorded and posted like the following:

\[
\begin{array}{c|c}
\text{Cash} & \text{Sales Revenue} \\
1,000 & 1,000 \\
\end{array}
\]

Looking at it visually, we can easily see that Cash is OK. We don’t need to do anything to fix it. Hence, any choice with Cash in it can be crossed out. Unearned Revenue wasn’t included in our recorded transaction; nor would it have been included had we recorded things correctly the first time. Hence, any choice with Unearned Revenue in it can also be crossed out. Goodbye choices \(a\) and \(b\)!

We can also see that both Sales Revenue and Accounts Receivable are now too high by $1,000. We need to get rid of the credit to Sales Revenue and include a credit to Accounts Receivable to right things like the following:

\[
\begin{array}{c|c}
\text{Accounts Receivable} & \text{Sales Revenue} \\
1,000 & 1,000 \\
\end{array}
\]

Now the account balances are where they should have been to begin with had the erroneous entry not been made. Cash has a debit of $1,000, Accounts Receivable has a credit of $1,000, and Sales Revenue has nothing from the transaction. Choice \(c\) describes this entry and is, hence, the correct answer.
MC2-3
Answer: d
Approach and explanation: First, think of the definition of accrual (which is covered in LO4—not LO2). Under the accrual method, revenues are earned when a good is delivered or when a service is performed—not necessarily when cash is received. Expenses are recognized when an item is consumed or as incurred—not necessarily when cash is paid. Therefore, choice b cannot be correct. The other choices have more to do with an accounting system than accrual measurement.

Remember that debits go on the left and credits on the right. Debits and credits are no more mysterious than that. One isn’t “good” or “bad.” Therefore, choice d is a true statement. Choices a and c are both false because assets (left-hand side of the balance sheet) and expenses (contra-kind of account to equity which is on the right-hand side of the balance sheet) both have normal debit balances.

MC2-4
Answer: a
Approach and explanation: Remember from the How? under LO2 on page 2-3 that transactions start in journals and then move on to ledgers. From the ledgers, a trial balance can be derived. Financial statements are the last step in the process, the data used to prepare them coming from the trial balance. There are no debits and credits in the financial statements, but there are in the other three choices. So the question gets back to which comes first and that would be the journal. The debits and credits first determined (to initially record the entry in a journal) merely flows through to the other items. The numbers don’t switch from being a debit to being a credit (or vice versa) when they are posted to ledgers or when eventually listed as part of an account balance in a trial balance.

MC2-5
Answer: b
Approach and explanation: What do adjusting entries involve? At least one balance sheet and at least one income statement account. With that in mind, you can safely cross out choices a and c. Since the expense has not yet been recorded, you know that the answer has to include an expense account, so that eliminates choice d. Through a process of elimination, you now know that the correct choice must be b.

Incurred (or accrued) expenses are frequently the most common type of adjusting entry. Examples include wages earned by employees but not yet paid, interest incurred on debt that is not due until the following month or at maturity of the debt, taxes for the period that will be paid in the following period, and utilities and other kinds of bills that have been received for costs that have been incurred (or costs that have been incurred for which the bill has yet to be received) which are still owed at period end and will be paid in a subsequent period.
MC2-6
Answer: b
Approach and explanation: Before looking at the choices, write down what the journal entry is to record the accrual of wages as follows:

\[
\begin{align*}
\text{Salaries and Wages Expense} & \quad xxx \\
\text{Salaries and Wages Payable} & \quad xxx
\end{align*}
\]

Then think of what this (or rather the lack of the above entry) means to the accounting system. It means that expenses are understated, and hence, income is overstated and so is equity once income is closed out to Retained Earnings. It also means that liabilities are understated.

MC2-7
Answer: d
Approach and explanation: There are two things you should do before ever looking at the choices. The first is to circle, underline, or highlight not in the question. The second is to write out what the entry would be to record expired prepaid insurance. You should come up with the following:

\[
\begin{align*}
\text{Insurance Expense} & \quad xxx \\
\text{Prepaid Insurance Expense} & \quad xxx
\end{align*}
\]

Then, looking at the above entry, think, or better yet write out, what would happen if this didn’t take place. Answers include the following:

- Expenses are understated.
- Net income is overstated.
- Retained earnings will eventually (after the closing entry) be overstated.
- Equity will eventually (after the closing entry) be overstated.
- Assets are overstated.

Now you can look at the choices and see that three of them match the list. Liabilities aren’t affected, so it being off is the correct choice (since we are looking for the not).

One final point to make, in case you missed it while reading the chapter in the textbook, is that Prepaid Rent Expense or Prepaid Insurance Expense is a tricky name for an asset. A caution in the textbook explained that prepaids are always assets and should not be confused with expenses found on the income statement even if they have the word expense in the account name. (In practice you will see the accounts called various names including, for instance, Prepaid Insurance Expense or just Prepaid Insurance which reduces the confusion.)
MC2-8
Answer: c
Approach and explanation: Recall that unearned revenues are amounts that have come in from customers that have yet to be earned. (To the customer, these are prepaids. Prepaids and unearned items are therefore two sides of the same coin. What is an unearned revenue to one company is a prepaid asset to another company.) Do not confuse the Unearned Revenue account with revenues on the income statement. Unearned revenues are never on the income statement. They are always liabilities. They are liabilities because a service must be rendered or a good must be provided for them (or they could be refunded). In any event, they are not revenues, have not been earned (yet), and are an obligation of the company who has them.

For these types of questions (which are frequent in accounting courses and on the CPA exam) in which you have columns of possibilities, go down each column independently of the other(s) and circle the correct answer(s). So for this one, go down the Earned column and circle the correct choices c and d (No). Then go down the Collected column and circle the correct choices a and c (Yes). The only choice for which you have circled both answers is the correct one, choice c.

MC2-9
Answer: b
Approach and explanation: This one is a little bit tricky since choices a and b look similar, and therefore, both might be thrown out as false on that basis. However, choices c and d are both clearly false.

Income statements are prepared on the accrual basis, not the cash basis. Revenues do not equal cash inflows (usually), and expenses do not equal cash expenditures (usually).

The cash basis does not require a complete set of double-entry records. The cash basis can be thought of, as mentioned previously, as checkbook accounting. Double entries are not required in checkbook accounting. All one needs to know on the cash basis is what cash came in and what cash went out.

So now we turn back to choices a and b to find out which one is the true one. Choice b is correct since businesses not required to follow FASB (because they have no creditors requiring financial statements prepared in accordance with GAAP and because the IRS allows some small businesses to report their accounting information on a cash basis) can use the cash basis. Choice a is incorrect because FASB requires GAAP and GAAP is on the accrual basis (for the balance sheet and income statement at least).
MC2-10
Answer: a
Approach and explanation: The key point made in LO5 is that professional judgment is just as important as ever with the advent of computers processing accounting data. Other points made included that document trails can be lost if the system isn’t adequately designed and the importance of a good design in the creation of the information system.

Financial reporting standards are not affected by computers at all. Hence, choice c can be eliminated. Answers that include the word “always” are always suspect (pun intended). Circle the word “always” or “never” when you encounter it in a multiple choice question just like you would the word “not.” Choices with “always” or “never” are seldom the correct answer and choice d is no exception. If choice b were the correct one, do you really think the chapter would also talk about the double-entry system?

Matching 2-1
1. g
2. i
3. a
4. o
5. h
6. d
7. q
8. e
9. p
10. b
11. j
12. c
13. f
14. m
15. k
16. n
17. l

Complete these terminology matching exercises without looking back to the textbook or on to the glossary. After all, you probably won’t have those as a reference at test time. Learning through trial and error causes the item to be learned better and to stick in your memory longer than if you just look to the textbook, glossary, or a dictionary and “cook book” the answers. Sure you may get the answer correct on your first attempt, but missing something is sometimes best for retention. Don’t be afraid of failure while studying and practicing.
Matching 2-2
1. f
2. h
3. a
4. c
5. g
6. d
7. e
8. b

Exercise 2-1
If debits and credits are still giving you problems, sketch out the diagram on page 2-3 for the first nine of these accounts. Then cover it up for the last nine and see how you do. If you miss any, try doing this exercise again tomorrow until you have debits and credits down well.

1. D (Remember that Accumulated Depreciation is a contra-asset account, so it moves in the opposite direction typical assets move.)
2. I
3. I
4. I (Be careful! Although Dividends move like expenses, they do not show up on an income statement.)
5. D
6. D (Allowance for Bad Debts is similar to Accumulated Depreciation in that it is a contra-asset account.)
7. I
8. I (As counter-intuitive as it may seem at first glance, expenses do move in the same direction as assets. Remember that debits are not good or bad things. They are merely the left side of entries.)
9. I (Since this account increases when Accumulated Depreciation does, it makes sense that it moves in the opposite direction as Accumulated Depreciation.)
10. D
11. D
12. D
13. I
14. D
15. I
16. I
17. D
18. I
Exercise 2-2
Approach and explanation: There is a hard way and an easy way to determine whether an account is real or nominal in nature. The hard way is to scrutinize the account and try to figure each out on a case-by-case basis or (heaven forbid!) to memorize what type each possible account is.

The easy way is this. Just ask yourself the question, “Does this account appear on a balance sheet?” If the answer is yes (because it is an asset, contra-asset, liability, or equity account), then you’ve got yourself a real account. If the answer is no, then you’ve got yourself a nominal account. This exercise is really that easy.

1. R (This is an example of a contra-asset account that is *not* closed out.)
2. R
3. R
4. N (Although Dividends do not appear on an income statement, they are closed out and are, hence, a nominal rather than real account.)
5. R (Don’t let the Dividends part of the account name fool you; accounts with Payable in the name will always be liabilities showing up on a balance sheet and, hence, real in nature.)
6. R (This is another example of a contra-asset account, offsetting Accounts Receivable in this case, that is *not* closed out.)
7. R
8. N (One of the few nominal accounts that does not contain “Revenue” or “Expense” in its title. Recall that Cost of Goods Sold is always an expense and Inventory is always an asset.)
9. N
10. N
11. R (This is the only account involved in closing entries that isn’t a nominal account. It is also the only account involved in closing entries that isn’t closed.)
12. R
13. N
14. R (See the note for #5 above.)
15. N
16. R (Prepaids will always be an asset even if they also have “Expense” in the account name (e.g., Prepaid Advertising Expense). Hence, they won’t be closed out like their expense counterparts (#15).)
17. R (Unearned items will always be a liability even if they also have “Revenue” in the account name. Hence, they won’t be closed out like their revenue counterparts (#10).)
18. N
Problem 2-1

a. Cash 1,000
   Accounts Receivable 7,000
   Sales 8,000

b. Land 70,000
   Building 330,000
   Cash 80,000
   Mortgage Payable 320,000

c. Cash 5,000
   Accounts Receivable 5,000

d. No entry

e. Dividends (or Retained Earnings) 13,000
   Cash 13,000

It is crucial that you know how to record the journal entries for both regular transactions and adjusting entries by the end of Chapter 2. Hopefully, it is a review topic for you. If not, or if you are struggling with journal entries, spend the extra time now to master the topic. Subsequent chapters will expect you to know and understand journal entries.

For part d, recall from Chapter 1 that items are not recognized (recorded) in the accounting system until something has happened. A transaction has yet to take place when future costs are merely estimated. Those costs should be recorded in the company’s journal, posted to the accounts, and show up in the financial statements when they are actually incurred in later periods. Variations on this theme that you may see are the hiring of employees, the signing of contracts, and the ordering of goods. It is premature to record any of these items in the accounting records for financial statement purposes. For management and budgeting purposes, all three of the items and the one given in d should be somehow noted however.

Problem 2-2

a. Investment of cash by a shareholder in a corporation.
b. Cash payment on a note payable. Part of the payment is for principal and part is for interest.
c. Received cash in advance for products or services not yet delivered.
d. Purchased supplies for cash and have not used them yet.
e. Received customer payment on account.

Don’t look back to Exhibit 2-3 to solve the problem. Try and think through each transaction until you can come up with what happened.
Problem 2-3
Read the How? for LO3 on pages 2-4 and 2-5 if you haven’t already. With that information in mind, figure out how to adjust these accounts to get them to the correct balances, remembering that each of these adjusting journal entries is going to affect at least one balance sheet account and at least one income statement account. None of the entries should include a debit or credit to cash since these are adjusting entries.

a. Interest Receivable  400
   Interest Revenue        400

b. Sales Revenue          5,000
   Unearned Sales Revenue  5,000

c. Depreciation Expense—Building 26,000
   Accumulated Depreciation—Building 26,000

d. Interest Receivable  2,000
   Interest Revenue         2,000

e. Salaries and Wages Expense  3,100
   Salaries and Wages Payable 3,100

f. Office Supplies Expense  3,000
   Office Supplies           3,000

Note for part c: The calculation is 650,000/25 = 26,000. The land is not depreciated, so you do nothing with the 780,000. The land will be shown on the balance sheet at 130,000 (780,000 – 650,000).

Note for part d: The calculation is (100,000 × 0.12)/12 months × 2 months (November and December) = 2,000.

Note for part f: One way to visualize this answer is to create a T-account for Office Supplies. Fill in the known and then back into the unknown as follows:

<table>
<thead>
<tr>
<th>Office Supplies</th>
</tr>
</thead>
<tbody>
<tr>
<td>3,500</td>
</tr>
<tr>
<td>?</td>
</tr>
<tr>
<td>500</td>
</tr>
</tbody>
</table>
Problem 2-4

a. Bad Debt Expense
   Allowance for Bad Debts  4,500

b. Allowance for Bad Debts
   Accounts Receivable  1,000

c. Interest Expense ($50,000 × 0.12)/ 3
   Interest Payable  2,000

d. Insurance Expense ($3,000/2*)
   Prepaid Insurance  1,500

e. Cost of Goods Sold
   Inventory  1,000

f. Depreciation Expense
   Accumulated Depreciation  30,000

g. Unearned Revenue ($75,000/2**)
   Rental Revenue  37,500

* = half the policy period
** = half the rental period

Approach: Recall that for adjusting entries you are getting the accounts to their correct balances. Therefore, for part a you are effectively doing the following to the Allowance for Bad Debts balance:

<table>
<thead>
<tr>
<th>Allowance for Bad Debts</th>
</tr>
</thead>
<tbody>
<tr>
<td>500</td>
</tr>
<tr>
<td>4,500</td>
</tr>
<tr>
<td>5,000</td>
</tr>
</tbody>
</table>

For part c, you need to first take a look at the existing balance in the Interest Payable account. If the interest had been accrued at the end of each of the prior months, the amount in December would only be for $500 and you’d expect a balance in the Interest Payable account of $1,500. Since the balance is $0, however, you know that it hasn’t been accrued yet, and hence, you need to accrue a full four months’ worth.

On these open-ended problems, it is a good idea to write down what you do know and then fill in the missing pieces as you remember them. Don’t leave one blank just because you can’t remember both accounts that get entries or because you can’t figure out the amount. For part g, for instance, an answer of
g. Unearned Revenue 37,500

or

g. 37,500

or

g. Unearned Revenue
Rental Revenue

is better than an answer of

g.

In addition, by filling in what you do know, the answer(s) to the remaining empty piece(s) may become more apparent.

**Problem 2-5**

You can “cook book” this solution by looking at the example given in the textbook. There is some value in cook booking a solution—especially if it is for homework that is to be graded. However, for study purposes, you are better off not cook booking the solution. Instead, try and do it without looking back to the textbook. If you can’t remember how to do it, then look back to the textbook and review the applicable section that has a similar example. After doing so, close the textbook and crank out the solution to this practice problem on your own. You’ll learn more as you struggle through it than if you rely completely on a similar example.

Sales 480,000

Retained Earnings 480,000

To close revenue accounts.

Retained Earnings 421,360

Cost of Goods Sold 320,000
Sales Salaries Expense 40,000
Advertising Expense 5,360
Administrative Salaries Expense 52,000
Office Expense 4,000

To close expense accounts.
The net income can be figured in one of two ways. You can take the change in Retained Earnings (since there are no dividends) as net income (the balance of Retained Earnings went from $0 to $58,640 with the above entries) or you can simply subtract the expenses from the revenue. The net income for the period is thus $58,640 ($480,000 – 421,360).

Problem 2-6
Approach and solution: Set up two columns, one for accrual and one for cash, and record the affects for each of the items under each method as follows:

<table>
<thead>
<tr>
<th></th>
<th>Accrual</th>
<th>Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manami earned $50,000</td>
<td>$ 50,000</td>
<td>$ 0</td>
</tr>
<tr>
<td>Incurred expenses of $30,000</td>
<td>(30,000)</td>
<td>0</td>
</tr>
<tr>
<td>Collected $30,000</td>
<td>0</td>
<td>30,000</td>
</tr>
<tr>
<td>Paying off $20,000</td>
<td>0</td>
<td>(20,000)</td>
</tr>
<tr>
<td>Loan of $10,000</td>
<td>0</td>
<td>10,000</td>
</tr>
<tr>
<td>30% tax rate</td>
<td>(6,000)</td>
<td>0</td>
</tr>
<tr>
<td>$5,000 in taxes actually paid</td>
<td>0</td>
<td>(5,000)</td>
</tr>
<tr>
<td>Totals</td>
<td>$ 14,000</td>
<td>$ 15,000</td>
</tr>
</tbody>
</table>

Therefore, net income for 2011 was $14,000. Cash increased by $15,000.

Note that the loan does not affect revenue (it isn’t an item that is earned), and hence, it does increase cash but does not increase revenue and net income. The changes in Accounts Receivable and Accounts Payable do not affect net income either. They are there in the problem to show you, in part, why the cash and accrual methods differ. More on this will be presented in Chapter 5. The income tax expense of $6,000 is computed as $(50,000 – 30,000) \times 30\%$.

One final note regarding test-taking strategies and this problem: Remember to always answer all of the questions in a problem. Sometimes students focus on the first question (what is net income?) and forget to answer the question about cash (or vice versa). You may want to circle, underline, or highlight all of the questions in a problem and then write out the number of answers that you should come up with at the bottom of the blank space. Here is an example of what your answer sheet might look like before ever attempting to answer the questions (with the underlines and “4 answers” being items written in by the student):

1. What is $1 + 1$? What is $2 + 2$? What is $3 + 3$? What is $4 + 4$?

4 answers
2. What is the . . .

When you finish answering question 1, you then see that you should have four answers written in the blank space above your handwritten “4 answers” to check yourself.

Glossary

Note that Appendix C in the rear portion of the textbook contains a comprehensive Glossary for all of the terms used in the textbook. That is the place to turn to if you need to look up a word but don’t know which chapter(s) it appeared in. The glossary below is identical with one major exception: It contains only those terms used in Chapter 2. This abbreviated glossary can prove quite useful when reviewing a chapter, when studying for a quiz for a particular chapter, or when studying for an exam which covers only a few chapters including this one. Use it in those instances instead of wading through the 19 pages of comprehensive glossary in the textbook trying to pick out just those words that were used in this chapter.

**account**  A record used to classify and summarize the effects of transactions.

**accounting process**  The procedures used for analyzing, recording, classifying, and summarizing the information to be presented in accounting reports; also referred to as the accounting cycle.

**accounting system**  The procedures and methods used, including data processing equipment, to collect and report accounting data.

**accounts payable**  Amounts due for the purchase of materials by a manufacturing company or merchandise by a wholesaler or retailer.

**accounts receivable**  Trade receivables that are not evidenced by a formal agreement or “note”; accounts receivable are usually unsecured “open accounts” and represent an extension of short-term credit to customers.

**accrual accounting**  A basic assumption that revenues are recognized when earned and expenses are recognized when incurred without regard to when cash is received or paid.

**adjusting entries**  Entries required at the end of each accounting period to update the accounts as necessary and to fully recognize, on an accrual basis, revenues and expenses for the period.

**business (source) document**  Business record used as the basis for analyzing and recording transactions; examples include invoices, check stubs, receipts, and similar business papers.

**cash-basis accounting**  A system of accounting in which revenues and expenses are recorded as they are received and paid.
closing entries  Entries that reduce all temporary accounts to a zero balance at the end of each accounting period, transferring the preclosed balances to a permanent account.

contra account  An account used to record subtractions from a related account. Also called an offset account.

control account  A general ledger account that summarizes the detailed information in a subsidiary ledger.

credit  An entry on the right side of an account.

debit  An entry on the left side of an account.

double-entry accounting  A system of recording transactions in a way that maintains the equality of the accounting equation: Assets = Liabilities + Owners’ Equity.

general journal  An accounting record used to record all business activities for which a special journal is not maintained.

general ledger  A collection of all the accounts used by a business that could appear on the financial statements.

journals  Accounting records in which transactions are first entered, providing a chronological record of business activity.

journal entry  A recording of a transaction in which debits equal credits; it usually includes a date and an explanation of the transaction.

ledger  A collection of accounts maintained by a business.

nominal (temporary) accounts  Accounts that are closed to a zero balance at the end of an accounting period.

post-closing trial balance  A list of all real accounts and their balances after the closing process has been completed.

posting  The process of summarizing transactions by transferring amounts from the journals to the ledger accounts.

real (permanent) accounts  Accounts that are not closed to a zero balance at the end of each accounting period.

special journal  An accounting record used to list a particular type of frequently recurring transaction.

subsidiary ledgers  A grouping of supporting accounts that in total equal the balance of a control account in the general ledger.

transactions  Exchanges of goods or services between/among two or more entities or some other event having an economic impact on a business enterprise.

trial balance  A list of all accounts and their balances.