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# Introduction to Financial Accounting (Second Edition)



香港公開大學  
THE OPEN UNIVERSITY  
OF HONG KONG



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# Preface



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Henry Dauderis

David Annand

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December 8, 2014

# Chapter 1 Introduction to Financial Accounting



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## Learning Objectives

LO1 – Define accounting.

LO2 – Identify and describe the forms of business organizations.

LO3 – Identify and explain generally accepted accounting principles (GAAP).

LO4 – Identify and explain the uses of the four financial statements.

LO5 – Analyze transactions using the accounting equation.

## 1.1 Introduction



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Accounting is often called the language of business because it uses a unique vocabulary to communicate information to decision makers. In this chapter, we will discuss what financial accounting is and briefly introduce how financial information is communicated through financial statements. Then we will study how financial transactions are analyzed and reported on financial statements.

## 1.2 Accounting Defined



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LO1 – Define accounting.

**Accounting** is the process of identifying, measuring, recording, and communicating an organization's economic activities to users. Users need information for decision making. **Internal users** of accounting information work for the organization and are responsible for planning, organizing, and operating the entity. The area of accounting known as **managerial accounting** serves the decision-making needs of internal users. **External users** do not work for the organization and include investors, creditors, labour unions, and customers. **Financial accounting** is the area of accounting that

presents financial information of interest to external users. This book deals with financial accounting.

## 1.3 Business Organizations



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LO2 – Identify and describe the forms of business organizations.

An **organization** is a group of individuals who come together to pursue a common set of goals and objectives. There are typically two types of organizations: *business* and *non-business*. A **business organization** sells products or services for profit. A **non-business organization**, such as a charity or hospital, exists to meet various societal needs and does not have profit as a goal. All organizations record, report, and, most importantly, *use* accounting information for making decisions.

This book focuses on business organizations. There are three common forms of business organizations—a *proprietorship*, a *partnership*, and a *corporation*.

### 1.3.1 Proprietorship



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A **proprietorship** is a business owned by one person. It is not a separate legal entity, which means that the business and the owner are considered to be the same. For example, the profits of a proprietorship are reported on the owner's personal income tax return. Proprietorship accounting is covered in a later chapter.

### 1.3.2 Partnership



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A **partnership** is a business owned by two or more individuals. Like the proprietorship, it is not a separate legal entity. Partnership accounting is also covered in a later chapter.

### 1.3.3 Corporation



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A **corporation** is a business owned by one or more owners.<sup>1</sup> The owners are known as *shareholders*. A **shareholder** owns shares of the corporation. **Shares** are units of ownership in a corporation. For example, if a corporation has 1,000 shares, there may

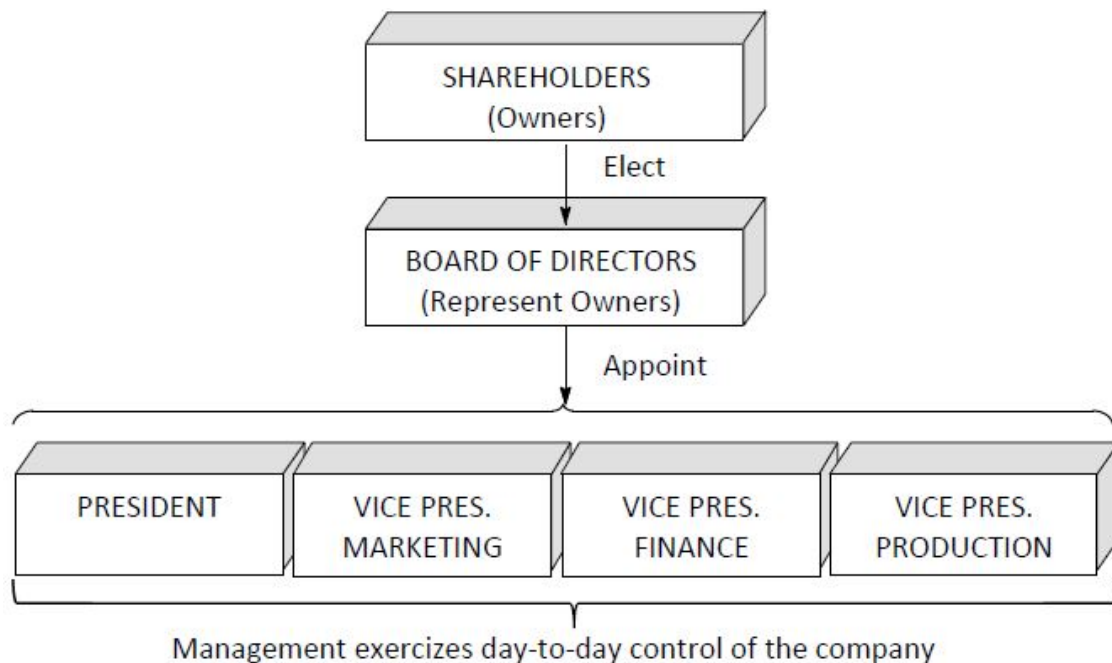
1. Equivalent designations for a corporation are "Corp.", "Incorporated", "Inc.", "Limited", and "Ltd."

be three shareholders who own 700 shares, 200 shares, and 100 shares respectively. The number of shares held by a shareholder represents how much of the corporation they own. The first shareholder who owns 700 shares owns 70% of the corporation ( $700/1,000 = 70\%$ ). A corporation can have different types of shares; this topic is discussed in a later chapter.

A corporation's shares can be privately held or available for public sale. A corporation that sells its shares publicly typically does so on a stock exchange. It is called a **publicly accountable enterprise**. It may have thousands or millions of shareholders. A corporation that holds its shares privately is known as a **private enterprise**. Its shares are often held by only one or a few shareholders.

Unlike the proprietorship and partnership, a corporation is a separate legal entity. This means, for example, that from an income tax perspective, a corporation files its own tax return. The owners or shareholders of a corporation are not responsible for the corporation's debts so have **limited liability** meaning that the most they can lose is the amount they invested in the corporation. They are not responsible for all the debts of an organization.

In larger corporations, there can be many shareholders. In these cases, shareholders do not manage a corporation but participate indirectly through the election of a **Board of Directors**. The Board of Directors does not participate in the day-to-day management of the corporation but delegates this responsibility to the officers of the corporation. An example of this delegation of responsibility is illustrated in [Figure 1.1](#).



**Fig. 1.1: Generalized Form of a Corporate Organization**

Shareholders usually meet annually to elect a Board of Directors. The Board of Directors meets regularly to review the corporation's operations and to set policies for future operations. Unlike shareholders, directors can be held personally liable for the debts of a corporation if a company fails.

## 1.4 Generally Accepted Accounting Principles (GAAP)



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LO3 – Identify and explain generally accepted accounting principles (GAAP).

The goal of accounting is to ensure information provided to decision makers is useful. To be useful, information must be relevant and faithfully represent a business's economic activities. This requires **ethics**, beliefs that help us differentiate right from wrong, in the application of underlying accounting concepts or principles. These underlying accounting concepts or principles are known as **generally accepted accounting principles (GAAP)**.

GAAP in Canada, as well as in many other countries, is based on **International Financial Reporting Standards (IFRS)**. IFRS are issued by the **International Accounting Standards Board (IASB)**. The IASB's mandate is to promote the adoption of a single set of global accounting standards through a process of open and transparent discussions among corporations, financial institutions, and accounting firms around the world.

GAAP are undergirded by qualitative characteristics and principles that inform how and when financial information is presented. Financial information that possesses the quality of:

- **relevance** has the ability to make a difference in the decision-making process.
- **faithful representation** is complete, neutral, and free from error.
- **comparability** tells users of the information that businesses utilize similar accounting practices.
- **verifiability** means that others are able to confirm that the information faithfully represents the economic activities of the business.
- **timeliness** is available to decision makers while it is still useful.
- **understandability** is clear and concise.

In addition, there are a number of accounting principles that guide development of GAAP. [Figure 1.2](#) lists these.

<i>Accounting principle</i>	<i>Explanation</i>
<b>Business entity</b>	Requires that each economic entity maintain separate records. Example: A business owner keeps separate accounting records for business transactions and for personal transactions.
<b>Consistency</b>	Requires that a business use the same accounting policies and procedures from period to period. Example: A business records a sale when goods are shipped to a customer, even if cash may not have been received yet. In the future, it cannot change the way in which it accounts for sales – by instead recognizing these when cash is received, for instance.
<b>Historical Cost</b>	Requires that each economic transaction be based on original cost. Example: A business purchased a piece of land for \$70,000 ten years ago. Even though the land can be now sold for more than this, it is not revalued in the financial statements. It remains recorded at \$70,000.
<b>Full disclosure</b>	Requires that accounting information communicate sufficient information to allow users to make knowledgeable decisions. Example: A business is applying to the bank for a \$1,000,000 loan. The business is being sued for \$20,000,000 and it is certain that it will lose. The business must tell the bank about the lawsuit even though the lawsuit has not yet been finalized.
<b>Going concern</b>	Assumes that a business will continue for the foreseeable future. Example: A business does not expense an asset like a delivery truck in the year in which it is purchased. It writes-off the purchase price of the truck over the estimated number of years it will provide useful service.
<b>Matching</b>	Requires that expenses be reported in the period in which they are incurred, not when cash is paid. Example: Supplies are purchased for \$700 on credit and used immediately. They are reported as expenses on the income statement even though the \$700 will not be paid in cash until the new year.
<b>Materiality</b>	Allows another accounting principle to be violated if the effect on the financial statements is so small that users will not be misled. Example: A business purchases a desk for \$100 that will last ten years. Technically, the desk has future value so it should be recorded as an asset. However, the business may record the \$100 as an expense in the current year instead of gradually reducing the cost of the stapler each year. Expensing it immediately will not affect the financial results enough to mislead financial statement readers.
<b>Monetary unit</b>	Requires that financial information be communicated in stable units of money. Example: Land was purchased in 1940 for \$5,000. It is maintained in the accounting records at \$5,000 even though the equivalent amount of purchasing power in 2015 is \$100,000.
<b>Recognition</b>	Requires that revenues be recorded when earned and not necessarily when cash is received. Example: A product is sold on March 5. The customer receives the product on March 5 but will pay for it on April 5. The business recognizes the revenue from the sale on March 5 when the sale occurred even though the cash is not received until a later date.

**Fig. 1.2: Accounting Principles**

## 1.5 Financial Statements



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LO4 – Identify and explain the uses of the four financial statements.



Recall that financial accounting focuses on communicating information to external users. That information is communicated using **financial statements**. There are four financial statements: the income statement, statement of changes in equity, balance sheet, and statement of cash flows. Each of these is briefly introduced in the following sections using an example based on a fictitious corporate organization called Big Dog Carworks Corp. (“Corp.” is the abbreviated form of “Corporation”).

### 1.5.1 The Income Statement



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An **income statement** communicates information about a business’s financial performance by summarizing **revenues** less **expenses** over a period of time. Revenues are created when a business provides products or services to a customer in exchange for assets. Assets are resources resulting from past events and from which future economic benefits are expected to result. Examples of assets include cash, equipment, and supplies. Assets will be discussed in more detail later in this chapter. Expenses are the assets that have been used up or the obligations incurred in the course of earning revenues. When revenues are greater than expenses, the difference is called **net income** or **profit**. When expenses are greater than revenue, a **net loss** results.

Consider the following income statement of Big Dog Carworks Corp. (BDCC). This business was started on January 1, 2015 by Bob “Big Dog” Baldwin in order to repair automobiles. All the shares of the corporation are owned by Bob.

At January 31, the income statement shows total revenues of \$10,000 and various expenses totalling \$7,800. Net income, the difference between \$10,000 of revenues and \$7,800 of expenses, equals \$2,200.

Big Dog Carworks Corp. Income Statement For the Month Ended January 31, 2015		} The heading shows the name of the entity, the type of financial statement, and in this case, the <i>period-in-time</i> date.
<i>Revenues</i>		
Repairs	\$10,000	
<i>Expenses</i>		
Rent	\$1,600	
Salaries	4,000	
Supplies	1,500	
Truck operating	700	
Total expenses	7,800	
Net income	\$2,200	← The net income is transferred to the statement of changes in equity.

## 1.5.2 The Statement of Changes in Equity



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The **statement of changes in equity** provides information about how the balances in Share capital and Retained earnings changed during the period. **Share capital** is a heading in the shareholders' equity section of the balance sheet and represents how much shareholders have invested. When shareholders buy shares, they are investing in the business. The number of shares they purchase will determine how much of the corporation they own. The type of ownership unit purchased by Big Dog's shareholders is known as *common shares*. These and other types of shares will be discussed in a later chapter. For now, all ownership units will be called share capital. When a corporation sells its shares to shareholders, the corporation is said to be *issuing shares* to shareholders.

In the statement of changes in equity shown below, share capital and retained earnings balances at January 1 are zero because the corporation started the business on that date. During January, share capital of \$10,000 was issued to shareholders so the January 31 balance is \$10,000.

**Retained earnings** is the sum of all net incomes earned by a corporation over its life, less any distributions of these net incomes to shareholders. Distributions of net income to shareholders are called **dividends**. Shareholders generally have the right to share in dividends according to the percentage of their ownership interest. To demonstrate the concept of retained earnings, recall that Big Dog has been in business for one month in which \$2,200 of net income was reported. If dividends of \$200 are distributed, these are subtracted from retained earnings. Big Dog's retained earnings are therefore \$2,000 at January 31, 2015 as shown in the statement of changes in equity below.

The heading shows the name of the entity, the type of financial statement, and in this case, the *period-in-time* date.

	Share capital	Retained earnings	Total equity
Opening balance	\$ -0-	\$ -0-	\$ -0-
Shares issued	10,000		10,000
Net income		2,200	2,200
Dividends		(200)	(200)
Ending balance	\$10,000	\$2,000	\$12,000

These totals are transferred to the balance sheet at January 31, 2015.

To demonstrate how retained earnings would appear in the next accounting period, let's assume that Big Dog reported a net income of \$5,000 for February, 2015 and

dividends of \$1,000 were paid to the shareholder. Based on this information, retained earnings at the end of February would be \$6,000, calculated as the \$2,000 January 31 balance plus the \$5,000 February net income less the \$1,000 February dividend. The balance in retained earnings continues to change over time because of additional net incomes/losses and dividends.

### 1.5.3 The Balance Sheet



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The **balance sheet** shows a business's assets, liabilities, and equity at a point in time. The balance sheet of Big Dog Carworks Corp. at January 31, 2015 is shown below.

The heading shows the name of the entity, the type of financial statement and the *point-in-time* date.

Big Dog Carworks Corp.  
Balance Sheet  
At January 31, 2015

<i>Assets</i>		<i>Liabilities</i>	
Cash	\$ 6,200	Bank loan	\$ 9,000
Accounts receivable	2,500	Accounts payable	700
Prepaid insurance	2,400	Unearned revenue	<u>400</u>
Equipment	3,000	Total liabilities	\$10,100
Truck	8,000		
		<i>Shareholders' Equity</i>	
		Share capital	\$10,000
		Retained earnings	<u>2,000</u>
Total assets	<u>\$22,100</u>	Total liabilities and equity	<u>\$22,100</u>

Total assets (\$22,100) always equal total liabilities (\$10,100) plus shareholders' equity (\$12,000).

### 1.5.4 What Is an Asset?



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**Assets** are economic resources that provide future benefits to the business. Examples include cash, accounts receivable, prepaid expenses, equipment, and trucks. **Cash** is coins and currency, usually held in a bank account, and is a financial resource with future benefit because of its purchasing power. **Accounts receivable** represent amounts to be collected in cash in the future for goods sold or services provided to customers on credit. **Prepaid expenses** are assets that are paid in cash in advance and have benefits that apply over future periods. For example, a one-year insurance policy purchased for cash on January 1, 2015 will provide a benefit until December 31, 2015 so is a prepaid asset when purchased. The equipment and truck were purchased on January 1, 2015 and will provide benefits for 2015 and beyond so are assets.

## 1.5.5 What Is a Liability?



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A **liability** is an obligation to pay an asset in the future. It is also known as **debt**. For example, Big Dog's bank loan represents an obligation to repay cash in the future to the bank. **Accounts payable** are obligations to pay a creditor for goods purchased or services rendered. A **creditor** owns the right to receive payment from an individual or business. **Unearned revenue** represents an advance payment of cash from a customer for Big Dog's services or products to be provided in the future. For example, Big Dog collected cash from a customer in advance for a repair to be done in the future.

## 1.5.6 What Is Shareholders' Equity?



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**Shareholders' equity** represents the net assets owned by the owners (the shareholders). **Net assets** are assets minus liabilities. For example, in Big Dog's January 31 balance sheet, net assets are \$12,000, calculated as total assets of \$22,100 minus total liabilities of \$10,100. This means that although there are \$22,100 of assets, only \$12,000 are owned by the shareholders and the balance, \$10,100, are financed by debt. Notice that net assets and total shareholders' equity are the same value; both are \$12,000. Shareholders' equity consists of share capital and retained earnings. Share capital represents how much the shareholders have invested in the business. Retained earnings are the sum of all net incomes earned by a corporation over its life, less any dividends distributed to shareholders. Shareholders have a right to these accumulated earnings because they own the corporation.

In summary, the balance sheet is represented by the equation:

$$\text{Assets} = \text{Liabilities} + \text{Shareholders' equity}$$

## 1.5.7 The Statement of Cash Flows (SCF)



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The fourth financial statement is the **statement of cash flows**. The SCF explains the sources (inflows) and uses (outflows) of cash over a period of time. The preparation and interpretation of the SCF will be covered in a later chapter.

## 1.5.8 Notes to the Financial Statements



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An essential part of financial statements are the notes that accompany them. These notes are generally located at the end of a set of financial statements. The notes provide greater detail about various amounts shown in the financial statements, or provide non-quantitative information that is useful to users. For example, a note may indicate the estimated useful lives of long-lived assets, or loan repayment terms. Examples of note disclosures will be provided in later chapters.

## 1.6 Transaction Analysis and Double-entry Accounting



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LO5 – Analyze transactions using the accounting equation.

The **accounting equation** is foundational to accounting. It shows that the total assets of a business must always equal the total claims against those assets by creditors and owners. The equation is expressed as:

$$\begin{array}{l} \text{ASSETS} \\ \text{(economic resources} \\ \text{owned by an entity)} \end{array} = \begin{array}{l} \text{LIABILITIES} \\ \text{(creditors' claims on} \\ \text{assets)} \end{array} + \begin{array}{l} \text{SHAREHOLDERS' EQUITY} \\ \text{(owners' claims on assets)} \end{array}$$

When financial transactions are recorded, combined effects on assets, liabilities, and shareholders' equity are always exactly offsetting. This is the reason that the balance sheet always balances.

Each economic exchange is referred to as a **financial transaction**—for example, when an organization exchanges cash for land and buildings. Incurring a liability in return for an asset is also a financial transaction. Instead of paying cash for land and buildings, an organization may borrow money from a financial institution. The company must repay this with cash payments in the future. The accounting equation provides a system for processing and summarizing these sorts of transactions.

Accountants view financial transactions as economic events that change components within the accounting equation. These changes are usually triggered by information contained in **source documents** (such as sales invoices and bills from creditors) that can be verified for accuracy.

The accounting equation can be expanded to include all the items listed on the Balance Sheet of Big Dog at January 31, 2015, as follows:

$$\begin{array}{l} \text{ASSETS} \\ \text{+ Cash + Accounts} \\ \text{Receivable + Prepaid} \\ \text{Insurance + Equipment} \\ \text{+ Truck} \end{array} = \begin{array}{l} \text{LIABILITIES} \\ \text{+ Bank + Accounts} \\ \text{Loan + Payable + Unearned} \\ \text{Revenue} \end{array} + \begin{array}{l} \text{S/H EQUITY} \\ \text{+ Share + Retained} \\ \text{Capital + Earnings} \end{array}$$



If one item within the accounting equation is changed, then another item must also be changed to balance it. In this way, the equality of the equation is maintained. For example, if there is an increase in an asset account, then there must be a decrease in another asset or a corresponding increase in a liability or shareholders' equity account. This equality is the essence of *double-entry accounting*. The equation itself always remains in balance after each transaction. The operation of double-entry accounting is illustrated in the following section, which shows 10 transactions of Big Dog Carworks Corp. for January 2015.

Transaction number	Date	Description of transaction	Effect on the accounting equation		
			ASSETS	= LIABILITIES	+ S/H EQUITY
1	Jan. 1	Big Dog Carworks Corp. issued 1,000 shares to Bob Baldwin for \$10,000 cash. The asset <i>Cash</i> is increased while the equity item <i>Share Capital</i> is also increased. The impact on the equation is: CASH SHARE CAPITAL Note that both sides of the equation are in balance.	+10,000		+10,000
2	Jan. 2	Big Dog Carworks Corp. borrowed \$4,000 from the bank and deposited the cash into the business's bank account. The asset <i>Cash</i> is increased and the liability <i>Bank Loan</i> is also increased. The impact on the equation is: CASH BANK LOAN	+4,000	+4,000	
3	Jan. 2	The corporation purchased \$3,000 of equipment for cash. There is an increase of the asset <i>Equipment</i> and a decrease to another asset, <i>Cash</i> . The impact on the equation is: EQUIPMENT CASH	+3,000 -3,000		
4	Jan. 3	The corporation purchased a tow truck for \$8,000, paying \$1,000 cash and incurring an additional bank loan for the remaining \$7,000. The asset <i>Cash</i> is decreased while the asset <i>Truck</i> is increased and the liability <i>Bank Loan</i> is also increased. The impact on the equation is: CASH TRUCK BANK LOAN	-1,000 +8,000	+7,000	

5	Jan. 5	<p>Big Dog Carworks Corp. paid \$2,400 for a one-year insurance policy, effective January 1.</p> <p>Here the asset <i>Prepaid Insurance</i> is increased and the asset <i>Cash</i> is decreased. The impact on the equation is:</p>		
		PREPAID INSURANCE	+2,400	
		CASH	-2,400	
		<p>Since the one-year period will not be fully used at January 31 when financial statements are prepared, the insurance cost is considered to be an asset at the payment date. The transaction does not affect liabilities or shareholders' equity.</p>		
6	Jan. 10	<p>The corporation paid \$2,000 cash to the bank to reduce the loan outstanding.</p> <p>The asset <i>Cash</i> is decreased and there is a decrease in the liability <i>Bank Loan</i>. The impact on the equation is:</p>		
		BANK LOAN		-2,000
		CASH	-2,000	
7	Jan. 15	<p>The corporation received \$400 as an advance payment from a customer for services to be performed over the next two months as follows: \$300 for February, \$100 for March.</p> <p>The asset <i>Cash</i> is increased by \$400 and a liability, <i>Unearned Revenue</i>, is also increased since the revenue will not be earned by the end of January. It will be earned when the work is performed in later months. At January 31, these amounts are repayable to customers if the work is not done (and thus recorded as a liability). The impact on the equation is:</p>		
		CASH	+400	
		UNEARNED REVENUE		+400
8	Jan. 31	<p>Automobile repairs of \$10,000 were made for a customer; \$7,500 of repairs was paid in cash and \$2,500 of repairs will be paid in the future by customers.</p> <p><i>Cash</i> and <i>Accounts Receivable</i> assets of the corporation increase. The repairs are a revenue; revenue causes an increase in net income and an increase in net income causes an increase in shareholders' equity. The impact on the equation is:</p>		
		CASH	+7,500	
		ACCOUNTS RECEIVABLE	+2,500	
		REPAIR REVENUE		+10,000
		<p>This activity increases assets and net income.</p>		
9	Jan. 31	<p>The corporation paid operating expenses for the month as follows: \$1,600 for rent; \$4,000 for salaries; and \$1,500 for supplies expense. The \$700 for truck operating expenses (e.g., oil, gas) was on credit.</p> <p>There is a decrease in the asset <i>Cash</i>. Expenses cause net income to decrease and a decrease in net income causes shareholders' equity to decrease. There is an increase in the liability <i>Accounts Payable</i>. The impact on the equation is:</p>		
		RENT EXPENSE		-1,600
		SALARIES EXPENSE		-4,000
		SUPPLIES EXPENSE		-1,500
		TRUCK OPERATING EXPENSE		-700
		CASH	-7,100	
		ACCOUNTS PAYABLE		+700
10	Jan. 31	<p>Dividends of \$200 were paid in cash to the only shareholder, Bob Baldwin.</p> <p>Dividends cause retained earnings to decrease. A decrease in retained earnings will decrease shareholders' equity. The impact on the equation is:</p>		
		DIVIDENDS		-200
		CASH	-200	

These various transactions can be recorded in the expanded accounting equation as shown below:

Trans.	ASSETS					=	LIABILITIES			+	S/H EQUITY	
	Cash	Acc. Rec.	Ppd. Insur.	Equip.	Truck	Bank Loan	Acc. Pay.	Un. Rev.	Share Capital	Retained Earnings		
1.	+10,000								+10,000			
2.	+4,000					+4,000						
3.	-3,000			+3,000								
4.	-1,000				+8,000	+7,000						
5.	-2,400		+2,400									
6.	-2,000					-2,000						
7.	+400							+400				
8.	+7,500	+2,500								+10,000		
9.	-7,100						+700			- 1,600		
										- 4,000		
										- 1,500		
										- 700		
10.	-200									- 200		
	6,200	+ 2,500	+ 2,400	+ 3,000	+ 8,000	= 9,000	+ 700	+ 400	+ 10,000	+ 2,000		

These transactions are used to prepare the Statement of Cash Flows.

These numbers are used to prepare the Income Statement.

Transactions in these columns are used to prepare the Statement of Changes in Equity.

Column totals are used to prepare the Balance Sheet.

ASSETS = \$22,100

LIABILITIES + EQUITY = \$22,100

**Fig. 1.3: Transactions Worksheet for January 31, 2015**

Transactions summary:

1. Issued share capital for \$10,000 cash.
2. Assumed a bank loan for \$4,000.
3. Purchased equipment for \$3,000 cash.
4. Purchased a truck for \$8,000; paid \$1,000 cash and incurred a bank loan for \$7,000.
5. Paid \$2,400 for a comprehensive one-year insurance policy effective January 1.
6. Paid \$2,000 cash to reduce the bank loan.
7. Received \$400 as an advance payment for repair services to be provided over the next two months as follows:
  - \$300 for February,
  - \$100 for March.
8. Performed repairs for \$7,500 cash and \$2,500 to be paid by customers at a later date.
9. Paid a total of \$7,100 for operating expenses incurred during the month; also incurred an expense on account for \$700.
10. Dividends of \$200 were paid in cash to the only shareholder, Bob Baldwin.

The transactions summarized in [Figure 1.3](#) were used to prepare the financial statements described earlier, and reproduced in [Figure 1.4](#) below.



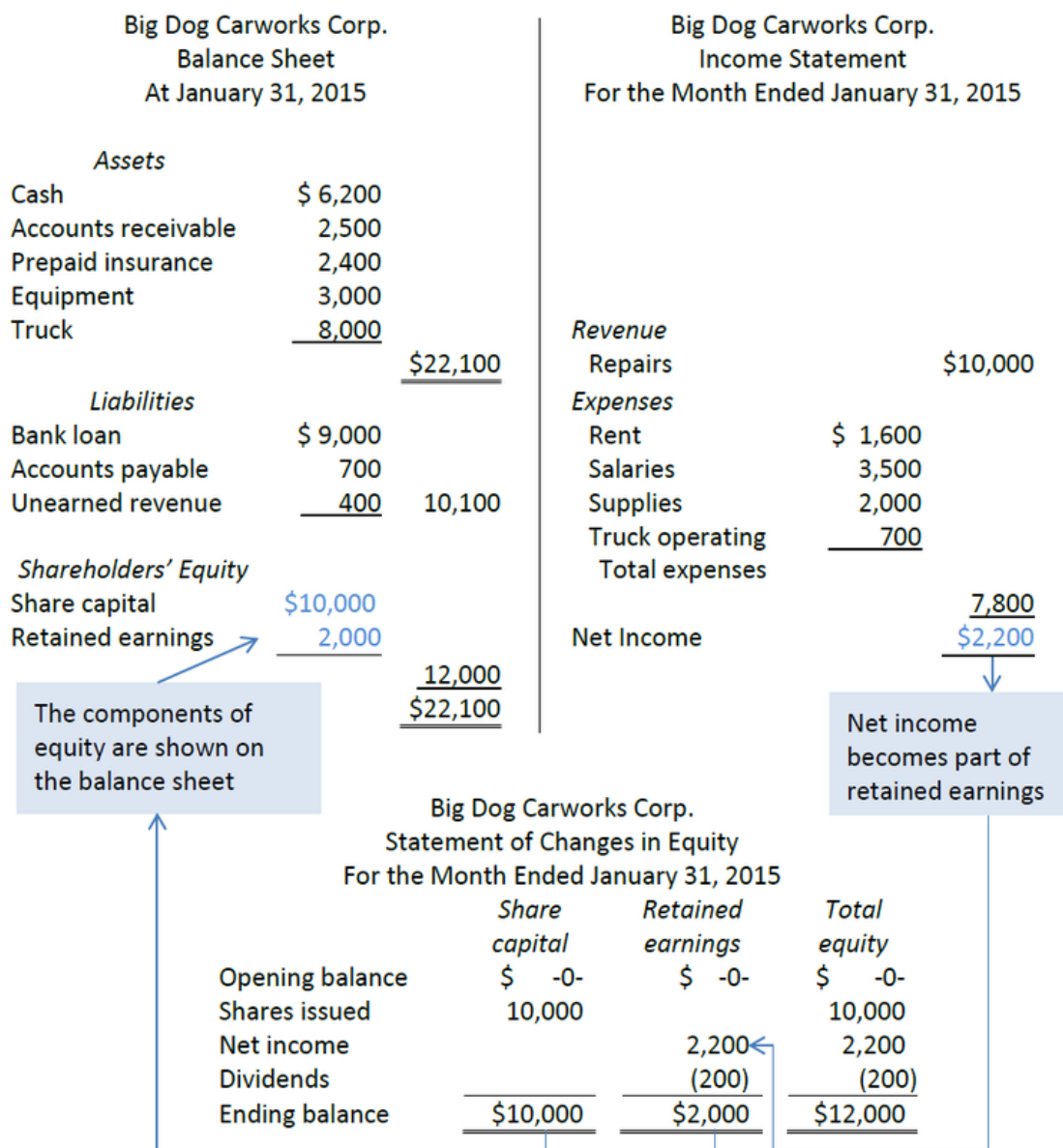


Fig. 1.4: Financial Statements of Big Dog Carworks Corp.

### 1.6.1 Accounting Time Periods



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Financial statements are prepared at regular intervals—usually monthly or quarterly—and at the end of each 12-month period. This 12-month period is called the **fiscal year**. The timing of the financial statements is determined by the needs of management and other users of the financial statements. For instance, financial statements may also be required by outside parties, such as bankers and shareholders if there are many. However, accounting information must possess the qualitative characteristic of timeliness—it must be available to decision makers in time to be useful—which is typically a minimum of once every 12 months.

Accounting reports, called the *annual financial statements*, are prepared at the end of each 12-month period, which is known as the **year-end** of the entity. Most companies' year-ends are on December 31, though this may not always be the case.

## 1.7 Summary of Chapter 1 Learning Objectives



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### **LO1 – Define accounting.**

Accounting is the process of identifying, measuring, recording, and communicating an organization's economic activities to users for decision making. Internal users work for the organization while external users do not. Managerial accounting serves the decision-making needs of internal users like managers. Financial accounting reports financial information useful for users external to the organization, like shareholders.

### **LO2 – Identify and describe the forms of business organizations.**

There are two types of organizations. A business organization sells products or services for profit. A non-business organization such as a charity or hospital, exists to meet various societal needs and does not have profit as a goal. Three types of business organizations are a proprietorship, partnership, and corporation. A corporation is different because it is considered a separate legal entity from shareholders, and these shareholders have limited liability for the debts of the corporation.

### **LO3 – Identify and explain generally accepted accounting principles(GAAP).**

GAAP are the guidelines that shape the way financial information is reported in financial statements prepared for external users. GAAP have qualitative characteristics of relevance, faithful representation, comparability, verifiability, timeliness, and understandability. Development of GAAP is guided by the principles of the business entity, consistency, historical cost, full disclosure, going concern, matching, materiality, a stable monetary unit, and revenue recognition.

### **LO4 – Identify, explain, and prepare the financial statements.**

The four financial statements are: income statement, statement of changes in equity, balance sheet, and statement of cash flows. The income statement reports financial performance by detailing revenues less expenses to arrive at net income for the period. The statement of changes in equity shows the changes during the period to share capital and retained earnings. The balance sheet identifies financial position at a point in time by listing assets, liabilities, and shareholders' equity. Finally, the statement of cash flows details the sources and uses of cash during the period.

### **LO5 – Analyze transactions by using the accounting equation.**

The accounting equation (Assets equals liabilities plus shareholders' equity, or  $A = L + E$ ), describes the asset investments (the left side of the equation) and the liabilities and shareholders' equity that financed the assets (the right side of the equation). The accounting equation provides a system for processing and summarizing financial transactions resulting from a business's activities. A financial transaction is an economic exchange between two parties that impacts the accounting equation. The equation must always balance.

## 1.8 Assignment Materials

### 1.8.1 Concept Self-check



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1. What is the difference between managerial and financial accounting?
2. What is the difference between a business organization and a nonbusiness organization?
3. What are the three types of business organizations?
4. What is a publicly accountable enterprise? A private enterprise?
5. What does the term limited liability mean?
6. Describe what GAAP refers to.
7. Identify and explain the six qualitative characteristics of GAAP.
8. What is the general purpose of financial statements? What are the four types of financial statements?
9. What is the purpose of an income statement? a balance sheet? How do they interrelate?
10. Define the terms “revenue” and “expense”.
11. What is net income? What information does it convey?
12. What is the purpose of a statement of changes in equity?
13. Shareholders’ equity consists of what two components?
14. Explain how retained earnings and dividends are related.
15. What are the three primary components of the balance sheet?
16. What are assets?
17. To what do the terms “liability” and “shareholders’ equity” refer?
18. What information is provided in the statement of cash flows?
19. What are notes to the financial statements?
20. Illustrate how the double-entry accounting system works.
21. Why are financial statements prepared at regular intervals? Who are the users of these statements?
22. What is the basic accounting equation? How does it work?
23. Explain what is meant by the term “financial transaction”. Give an example of a financial transaction.

### 1.8.2 Comprehension Problems

#### 1.8.2.1 CP 1-1



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The following list covers many of the types of financial transactions. Notice that each transaction has an equal and offsetting effect on the accounting equation.

*Types of Accounting Transactions*

---

	ASSETS	=	LIABILITIES	+	SHAREHOLDERS' EQUITY
1.	(+)				(+)
2.	(+)		(+)		
3.	(+)(-)				
4.	(-)				(-)
5.	(-)		(-)		
6.			(+)		(-)
7.			(-)		(+)
8.			(+)(-)		
9.					(+)(-)

*Required:* Using the appropriate accounting equation, study the following transactions and identify the effect of each on assets, liabilities and shareholders' equity, as applicable. Use a (+) to denote an increase and a (-) to denote a decrease, if any.

$$A = L + E$$

Example:

(+) ___ (+)	Issued share capital for cash
___ ___ ___	Purchased a truck for cash
___ ___ ___	Received a bank loan to pay for equipment
___ ___ ___	Made a deposit for electricity service to be provided in the future
___ ___ ___	Paid rent for the month just ended
___ ___ ___	Signed a new union contract that provides for increased wages in the future
___ ___ ___	Hired a messenger service to deliver letters during a mail strike
___ ___ ___	Received a parcel; paid the delivery service
___ ___ ___	Billed customers for services performed
___ ___ ___	Made a cash payment to satisfy an outstanding obligation
___ ___ ___	Received a payment of cash in satisfaction of an amount owed by a customer
___ ___ ___	Collected cash from a customer for services rendered
___ ___ ___	Paid cash for truck operating expenses (gas, oil, etc.)
___ ___ ___	Made a monthly payment on the bank loan; this payment included a payment on part of the loan and also an amount of interest expense. ( <i>Hint: This transaction affects more than two parts of the accounting equation.</i> )
___ ___ ___	Issued shares in the company to pay off a loan
___ ___ ___	Paid a dividend.

### 1.8.2.2 CP 1-2



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Refer to the list of accounting transactions in Comprehension Problem 1–1.

*Required:* Study the following transactions and identify, by number (1 to 9), the type of transaction. Some transactions may not require an accounting entry.

Example:

<u>  1  </u>	Issued share capital for cash
_____	Paid an account payable
_____	Borrowed money from a bank
_____	Collected an account receivable

- \_\_\_\_\_ Collected a commission on a sale made today
- \_\_\_\_\_ Paid for advertizing in a newspaper
- \_\_\_\_\_ Repaid money borrowed from a bank
- \_\_\_\_\_ Signed a contract to purchase a computer
- \_\_\_\_\_ Received a bill for supplies used during the month
- \_\_\_\_\_ Received a payment of cash in satisfaction of an amount owed by a customer
- \_\_\_\_\_ Sent a bill to a customer for repairs made today
- \_\_\_\_\_ Sold equipment for cash
- \_\_\_\_\_ Purchased a truck on credit, to be paid in six months
- \_\_\_\_\_ Requested payment from a customer of an account receivable that is overdue
- \_\_\_\_\_ Increased employee vacations from four to six weeks
- \_\_\_\_\_ Recorded the amount due to the landlord as rent
- \_\_\_\_\_ Received the monthly telephone answering service bill

### 1.8.2.3 CP 1-3



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*Required:* Calculate the missing amounts for companies A to E.

	A	B	C	D	E
Cash	\$3,000	\$1,000	\$ ?	\$6,000	\$2,500

Equipment	8,000	6,000	4,000	7,000	?
Accounts payable	4,000	?	1,500	3,000	4,500
Share capital	2,000	3,000	3,000	4,000	500
Retained earnings	?	1,000	500	?	1,000

### 1.8.2.4 CP 1-4



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*Required:* Calculate the net income earned during the year. Assume that the change to shareholders' equity results only from net income earned during the year.

	<i>Assets</i>	<i>Liabilities</i>
Balance Jan. 1, 2015	\$50,000	\$40,000
Balance Dec. 31, 2015	40,000	20,000

### 1.8.2.5 CP 1-5



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*Required:* Indicate whether each of the following is an asset (A), liability (L), or a shareholders' equity (E) item.

1. Accounts payable
2. Accounts receivable
3. Bank loan
4. Cash
5. Equipment
6. Insurance expense
7. Loan payable
8. Prepaid insurance
9. Rent expense
10. Repair revenue

11. Share capital
12. Truck operating expense
13. Unused office supplies
14. Dividends

### 1.8.2.6 CP 1-6



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The following accounts are taken from the records of Jasper Inc. at January 31, 2015, its first month of operations.

Cash	\$33,000
Accounts receivable	82,000
Unused supplies	2,000
Land	25,000
Building	70,000
Equipment	30,000
Bank loan	15,000
Accounts payable	27,000
Share capital	?
Net income	40,000
Dividends	1,000

*Required:*

1. Calculate the amount of total assets.
2. Calculate the amount of total liabilities.
3. Calculate the amount of share capital.



### 1.8.2.7 CP 1-7



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*Required:* From the financial information below, complete an income statement, statement of changes in shareholders' equity, and balance sheet.

Accounts receivable	\$4,000
Accounts payable	5,000
Cash	1,000
Share capital	?
Equipment	8,000
Insurance expense	1,500
Miscellaneous expense	2,500
Office supplies expense	1,000
Service revenue	20,000
Wages expense	9,000
Dividends	2,000

#### *Income Statement*

<i>Service revenue</i>		\$
<i>Expenses</i>		
Insurance	\$	
Miscellaneous		
Office supplies		
Wages		
Net income	_____	\$ _____

### Statement of Changes in Equity

	<i>Share capital</i>	<i>Retained earnings</i>	<i>Total equity</i>
Opening balance	\$ -0-	\$ -0-	\$ -0-
Shares Issued			
Net income	_____	_____	_____
Ending balance	=====	=====	=====

*Balance Sheet*

		<i>Liabilities and Shareholder's Equity</i>	
<i>Assets</i>			
Cash	\$	Accounts payable	\$
Accounts receivable		Share capital	
Equipment		Retained earnings	
	_____		_____
	\$		\$
	=====		=====

#### 1.8.2.8 CP 1-8



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A junior bookkeeper of Adams Ltd. prepared the following financial statements at the end of its first month of operations.

### Adams Ltd. Income Statement For the Month Ended January 31, 2015

<i>Revenue</i>		\$3,335
<i>Expenses</i>		
Accounts payable	\$ 300	
Land	1,000	
Dividends	500	1,635
Miscellaneous expenses	335	
Net income	=====	\$1,200

## Balance Sheet

<i>Assets</i>		<i>Liabilities and Shareholder's Equity</i>	
Cash	\$1,000	Rent expense	\$ 300
Repairs expense	500	Share capital	3,000
Salaries expense	1,000	Retained earnings	1,200
Building	2,000		
	\$4,500		\$4,500

*Required:* Prepare a revised income statement and balance sheet.

### 1.8.2.9 CP 1-9



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Financial statements are prepared according to a number of accounting principles, some of which are listed below:

- |                    |                    |
|--------------------|--------------------|
| 1. Business entity | 6. Consistency     |
| 2. Going concern   | 7. Full disclosure |
| 3. Monetary unit   | 8. Matching        |
| 4. Historical cost | 9. Materiality     |
| 5. Recognition     |                    |

*Required:* Identify the principle that would apply in each of the following situations. Explain your choice.

- |       |    |  |
|-------|----|--|
| _____ | a. | An accountant for Caldwell Corporation records a \$25 stapler with a five-year life as an expense. Caldwell has total assets of \$1,000,000. |
| _____ | b. | Fred Rozak, an independent consultant, must keep a set of books for his consulting firm  |

and a separate set of books for his personal records.

\_\_\_\_\_ c. A machine is recorded at its purchase price of \$9,000 and is not revalued at the end of the accounting period to reflect its market value of \$10,000.

\_\_\_\_\_ d. An asset purchased in 1985 for \$10,000 is not revalued even though it would take \$30,000 in equivalent money to purchase the land today.

\_\_\_\_\_ e. Accountants of Hull Corporation do not record the value of its equipment at the much lower amount for which it could be sold in the near future.

\_\_\_\_\_ f. Investors of Spellman Corporation note that the accounting policy for valuing inventory has not changed from the prior fiscal year.

\_\_\_\_\_ g. Looten Corporation senior managers decide to disclose a recent \$2 million lawsuit in a note to the financial statements even though the case will not likely be settled for two years.

## 1.8.3 Problems

### 1.8.3.1 P 1-1



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The following balances appeared on the transactions worksheet of Hill Chairs Inc. on April 1, 2015.

ASSETS				=	LIABILITY +		EQUITY	
Cash	+ Accounts Receivable	+ Prepaid Expense	+ Unused Supplies	=	Accounts Payable	+ Share Capital	+ Retained Earnings	
1,400	+ 3,600	+ 1,000	+ 350	=	2,000	+ 4,350		

The following transactions occurred during April:

- a. Collected \$2,000 cash in satisfaction of an amount owed by a customer
- b. Billed \$3,000 to customers for chairs rented to date
- c. Paid the following expenses: advertizing, \$300; salaries, \$2,000; telephone, \$100
- d. Paid half of the accounts payable
- e. Received a \$500 bill for April truck operating expenses
- f. Collected \$2,500 in satisfaction of an amount owed by a customer
- g. Billed \$1,500 to customers for chairs rented to date
- h. Transferred \$500 of prepaid expenses to rent expense
- i. Counted \$200 of supplies still on hand (recorded the amount used as an expense)
- j. Issued additional share capital and received \$1,000 cash
- k. Paid \$200 dividend in cash.

*Required:* Record the opening balances and the above transactions on a transactions worksheet and calculate the total of each column at the end of April. (Use the headings above on your worksheet.)

### 1.8.3.2 P 1-2



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The following transactions occurred in Larson Services Inc. during August 2015, its first month of operations.

- |      |    |   |
|------|----|---|
| Aug. | 1  | Issued share capital for \$3,000 cash   |
|      | 1  | Borrowed \$10,000 cash from the bank  |
|      | 1  | Paid \$8,000 cash for a used truck  |
|      | 4  | Paid \$600 for a one-year truck insurance policy effective August 1 (recorded as prepaid expense since it will benefit more than one month) |
|      | 5  | Collected \$2,000 fees from a client for work to be performed at a later date   |
|      | 7  | Billed \$5,000 fees to clients for services performed to date   |
|      | 9  | Paid \$250 for supplies used to date  |
|      | 12 | Purchased \$500 supplies on credit (record supplies as an asset)  |
|      | 15 | Collected \$1,000 of the amount billed August 7   |
|      | 16 | Paid \$200 for advertizing in The News during the first two weeks of August   |
|      | 20 | Paid half of the amount owing for the supplies purchased August 12  |
|      | 25 | Paid the following expenses: rent for August, \$350; salaries, \$2,150; telephone, \$50; truck operating, \$250                             |

- 28 Called clients for payment of the balances owing from August 7
- 29 Billed \$6,000 fees to clients for services performed to date, including \$1,500 related to cash received August 5
- 31 Transferred \$50 of August's prepaid expenses to insurance expense
- 31 Counted \$100 of supplies still on hand (recorded the amount used as an expense).

*Required:*

1. Record the above transactions on a transactions worksheet and calculate the total of each column at the end of August. Use the following headings on your worksheet.

ASSETS					=	LIABILITIES		+	EQUITY	
Cash	+ Acct. Rec.	+ Ppd. Exp.	+ Un. Supp.	+ Truck	=	Bank Loan	+ Acct. Pay.	+	Share Capital	+ Ret. Earn.

2. Prepare an income statement and statement of changes in equity for the month ended August 31, 2015, and a balance sheet at August 31, 2015. Identify the revenue earned as Fees. Record the expenses in alphabetical order.

### 1.8.3.3 P 1-3



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Following are the asset, liability, and shareholders' equity balances of Dumont Inc. at January 31, 2015, after its first month of operations.

ASSETS		=	LIABILITIES		+	SHAREHOLDERS' EQUITY	
Cash	\$1,300		Bank loan	\$8,000		Share capital	\$2,000
Accounts rec.	2,400		Accounts pay.	1,000		Service revenue	7,500
Prepaid exp.	550					Advertising expense	500
Unused supp.	750					Commissions expense	720
Truck	9,000					Insurance expense	50
						Interest expense	80
						Rent expense	400
						Supplies expense	100
						Telephone expense	150
						Wages expense	2,300
						Dividend paid	200

*Required:*

1. Prepare an income statement and statement of changes in equity for the month ending January 31, 2015. Record the expenses in alphabetical order. Assume no share capital was issued during the month.
2. Prepare a balance sheet at January 31.

### 1.8.3.4 P 1-4



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The following is an alphabetical list of data from the records of Kenyon Services Corporation at March 31, 2015.

Accounts payable	\$9,000	Equipment rental expense	\$500
Accounts receivable	3,900	Fees earned	4,500
Advertising expense	300	Insurance expense	400
Cash	3,100	Interest expense	100
Share capital	2,000	Truck operating expense	700
Equipment	5,000	Wages expense	1,500

*Required:*

1. Prepare an income statement and statement of changes in equity for the month ended March 31, 2015. Record the expenses in alphabetical order. Assume no share capital was issued during the month.
2. Prepare a balance sheet at March 31.

### 1.8.3.5 P 1-5



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The following “financial statement” was prepared from the records of Laberge Sheathing Inc. for the eight-month period ended August 31, 2015.



Laberge Sheathing Inc.  
Financial Statement  
For the Eight Month Period Ended August 31, 2015

Cash	\$ 400	Accounts payable	\$ 7,800
Accounts receivable	3,800	Share capital	3,200
Unused supplies	100	Service revenue	6,000
Equipment	8,700		
Advertising expense	300		
Interest expense	500		
Maintenance expense	475		
Supplies expense	125		
Wages expense	2,000		
Dividends	600		
	<u>\$17,000</u>		<u>\$17,000</u>

*Required:*

1. When is the corporation's likely fiscal year-end?
2. Prepare an income statement and statement of changes in equity for the eight-month period ended August 31, 2015.
3. Prepare a balance sheet at August 31.

### 1.8.3.6 P 1-6



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The following transactions took place in McIntyre Builders Corporation during June 2015, its first month of operations.

- |      |   |  |
|------|---|--|
| Jun. | 1 | Issued share capital for \$8,000 cash                              |
|      | 1 | Purchased \$5,000 equipment on credit                              |
|      | 2 | Collected \$600 cash for renovations completed today               |
|      | 3 | Paid \$20 for supplies used June 2                                 |
|      | 4 | Purchased \$1,000 supplies on credit (record supplies as an asset) |
|      | 5 | Billed customers \$2,500 for renovations completed to date         |

- 8 Collected \$500 of the amount billed June 5
- 10 Paid half of the amount owing for equipment purchased June 1
- 15 Sold excess equipment for a promise from the buyer to pay \$1,000 in the future. The same amount is the same as the original cost of this equipment. Record as a loan payable.
- 18 Paid for the supplies purchased June 4
- 20 Received a bill for \$100 for electrically used to date (record as utilities expense)
- 22 Paid \$600 to the landlord for June and July rent (record as prepaid expense)
- 23 Signed a union contract
- 25 Collected \$1,000 of the amount billed June 5
- 27 Paid the following expenses: advertizing, \$150; telephone, \$50; truck operating expense (repairs, gas), \$1,000; wages, \$2,500
- 30 Billed \$2,000 for repairs completed to date
- 30 Transferred the amount for June rent to rent expense
- 30 Counted \$150 of supplies still on hand (recorded the amount used as an expense)
- 30 Paid \$30 dividend in cash.

*Required:*

1. Record the above transactions on a transactions worksheet and calculate the total of each column at the end of June. Use the following headings on your worksheet.

ASSETS					=	LIABILITY	+	S/H EQUITY	
Cash	+ Acct. Rec.	+ Ppd. Exp.	+ Un. Supp.	+ Equip.	=	Acct. Pay.	+	Share Capital	+ Ret. Earn.

2. Prepare an income statement and statement of changes in equity for the one-month period ended June 30, 2015 and a balance sheet at June 30. Identify the revenue earned as “Renovations”. Record the expenses on the income statement in alphabetical order.

### 1.8.3.7 P 1-7



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Clarke Limited had the following balances in its accounting equation at the end of September 30, 2015:

ASSETS		=	LIABILITIES		+	S/H EQUITY	
Cash	\$14,215		Accounts payable	\$ 3,853		Share capital	\$ ?
Accounts receivable	11,785		Loan payable	25,000			
Unused supplies	1,220						
Land	?						
Building	?						
Furniture	8,000						
Equipment	60,000						
Truck	3,210						
	\$ ?			\$28,853			\$ ?

Land and building were acquired at a cost of \$30,000. It was estimated that one-third of the total cost should be applied to the cost of land. The following transactions were completed during the month of October:

- |      |    |   |
|------|----|---|
| Oct. | 2  | Paid \$110 to satisfy an account payable  |
|      | 3  | Collected in full an account receivable of \$670  |
|      | 4  | Purchased office supplies for \$400 for credit (record supplies as an asset)                            |
|      | 8  | Issued additional share capital for \$16,000 cash   |
|      | 10 | Collected \$1,000 cash owed by a customer   |
|      | 11 | Purchased equipment for \$22,000; made a cash payment of \$2,000, the balance to be paid within 30 days |
|      | 15 | Paid \$400 cash to satisfy an account payable   |

- 20 Paid \$10,000 in cash in partial settlement of the liability of October 11; took out a long-term loan for the balance
- 31 Collected in full an account receivable of \$300.

*Required:*

1. Calculate the missing figures in the September 30 accounting equation.
2. Record the September 30 balances on a transactions worksheet and record the October transactions. Total the columns and ensure that the accounting equation balances.
3. Calculate net income for the month of October.

## 1.8.4 Alternate Problems

### 1.8.4.1 AP 1-1



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The following amounts appeared on the transactions worksheet of Snider Truck Rentals Corporation on May 1, 2015.

ASSETS					=	LIABILITY	+	S/H EQUITY	
Cash	Prepaid Expense	Unused Supplies	Equip.	Truck	=	Accounts Payable	+	Share Capital	Retained Earnings
1,600		400	3,000	7,000	=	4,000	+	8,000	

The following transactions occurred during May:

- a. Collected \$5,000 cash for tool rental during the month
- b. Paid \$500 rent expense
- c. Paid \$1,500 cash to satisfy an account payable
- d. Paid \$600 for a one-year insurance policy effective May 1 (record the asset as prepaid expense)
- e. Purchased used truck for \$5,000 on credit
- f. Paid the following expenses: advertizing, \$300; salaries, \$2,500; telephone, \$150; truck operating, \$550

- g. Transferred the amount of May's insurance (\$50) to insurance expense
- h. Estimated \$200 of supplies to have been used during May
- i. Issued additional share capital and received \$1,000 cash
- j. Paid \$300 dividend in cash.

*Required:* Record the above transactions on a transactions worksheet and calculate the total of each column at the end of May.

### 1.8.4.2 AP 1-2



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Jewell Contractors Corporation was incorporated on May 1, 2015 and had the following transactions during its first month of operations.

- |     |    |  |
|-----|----|--|
| May | 1  | Issued share capital for \$5,000 cash  |
|     | 1  | Paid \$1,500 rent in advance for three months: May, June, and July (recorded as prepaid expense) |
|     | 2  | Purchased \$1,000 of supplies on credit (record the asset as unused supplies)                    |
|     | 2  | Received \$1,000 cash from a customer for work to be performed at a later date                   |
|     | 3  | Billed a customer \$1,500 for repairs performed  |
|     | 4  | Paid \$50 for an advertisement in The News   |
|     | 5  | Received \$250 cash for work completed today   |
|     | 10 | Collected the amount billed on May 3   |
|     | 15 | Paid \$500 cash to a creditor  |

- 18 Borrowed \$2,000 cash from the bank
- 20 Signed a major contract for work to be done in June
- 22 Purchased for cash \$3,000 of equipment
- 25 Billed customers \$3,500 for work completed to date
- 27 Paid the following expenses: electricity, \$75; telephone, \$25; and wages, \$2,000
- 31 Transferred the amount of May's rent (\$500) from prepaid expense to rent expense
- 31 Counted \$200 of supplies still on hand: the rest had been used during May
- 31 Completed \$600 of work that had been paid on May 2 and billed the customer.

*Required:*

1. Record the above transactions on a transactions worksheet and calculate the total of each end of May. Use the following headings on your worksheet.

ASSETS					=	LIABILITIES			+
Cash	+ Acct. Rec.	+ Ppd Exp.	+ Un. Supp.	+ Equip.	=	Bank Loan	+ Acct. Pay.	+ Un. Rev.	+ SH

2. Prepare an income statement for the month of May. Identify the revenue earned as "Repair" and the expenses in alphabetical order.

### 1.8.4.3 AP 1-3



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The following asset, liability, and shareholders' equity accounts are taken from the transactions worksheet of Arthur Products Corporation at December 31, 2015, its first month of operations.

ASSETS		=	LIABILITIES		+	S/H EQUITY	
Cash	\$ 1,000		Accounts Pay.	\$17,000		Share Capital	\$25,000
Accounts Rec.	9,000		Salaries Pay.	2,000		Fees Earned	13,600
Prepaid Exp.	2,250					Advertizing Expense	500
Land	10,000					Insurance Expense	250
Building	25,000					Property Tax Expense	200
Equipment	5,800					Salaries Expense	3,000
						Telephone Expense	100
						Dividend	500

*Required:*

1. Prepare an income statement and statement of changes in equity for the month ending December 31, 2015. Record the expenses in alphabetical order.
2. Prepare a balance sheet at December 31, 2015.

#### 1.8.4.4 AP 1-4



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The following is an alphabetical list of data from the records of Slemko Bookkeeping Corporation at September 30, 2015.

Accounts payable	\$2,000	Repair revenue	\$6,550
Accounts receivable	6,000	Rent expense	400
Advertizing expense	50	Salaries expense	2,350
Cash	700	Supplies expense	100
Share capital	5,000	Telephone expense	75
Equipment	2,000	Truck operating expense	325
Maintenance expense	250	Wages expense	1,100
		Dividend	400

*Required:*

1. Prepare an income statement and statement of changes in equity for the month ended September 30, 2015. Record the expenses on the income statement in alphabetical order. Assume no share capital was issued during the month.
2. Prepare a balance sheet at September 30.

### 1.8.4.5 AP 1-5



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The following “financial statement” was prepared from the records of Armfeld Industries Ltd:

**Armfeld Industries Ltd.**  
**Financial Statement**  
**For the Three-Month Period Ended November 30, 2015**

Cash	\$ 750	Bank loan	\$ 5,000
Accounts receivable	2,200	Accounts payable	3,000
Prepaid insurance	550	Share capital	1,000
Unused supplies	300	Repair revenue	5,000
Equipment	6,000		
Advertising expense	200		
Commissions expense	1,500		
Insurance expense	50		
Rent expense	450		
Wages expense	2,000		
	\$14,000		\$14,000

*Required:*

1. Prepare an income statement and statement of changes in equity for the three-month period ended November 30, 2015. Record the expenses on the income statement in alphabetical order. Assume no share capital was issued during the month.
2. Prepare a balance sheet at November 30.

### 1.8.4.6 AP 1-6



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Polarscape Snow Services Ltd. was incorporated on December 1, 2015 and had the following transactions during its first month of operations.

Dec. 1 Issued share capital for \$6,000 cash



- 
- 1 Purchased a used truck for \$9,000: paid \$4,000 cash, balance due January 15
- 2 Purchased a \$2,000 snowplough on credit to be attached to the truck (record as an increase in the cost of the truck)
- 5 Purchased salt, sand, and gravel on credit for \$500 (recorded as an asset, unused supplies)
- 6 Paid truck operating expenses of \$200
- 7 Paid \$360 for a one-year truck insurance policy effective December 1 (record as an asset, prepaid expense)
- 14 Paid \$1,500 in wages for two weeks
- 16 Paid \$40 traffic ticket (record as truck operating expense)
- 20 Received a bill for \$350 of truck repairs
- 24 Purchased tire chains on credit for \$100 (recorded as truck operating expense)
- 24 Collected \$3,500 of the amount billed December 3
- 27 Paid for the purchase made on December 5
- 28 Collected \$400 for snow removal performed today for a new customer
- 28 Paid \$1,500 in wages for two weeks
- 30 Called customers owing \$1,500 billed December 3
- 31 Transferred the amount of December's truck insurance (\$30) to insurance expense

- 31 Counted \$100 of salt, sand, and gravel still on hand  
(record the amount used as supplies expense)
- 31 Recorded unpaid wages for three days applicable to  
December in the amount of \$450
- 31 Billed customers \$5,000 for December snow  
removal
- 31 Paid \$200 dividend in cash.

*Required:*

Record the above transactions on a transactions worksheet and

- calculate the total of each column at the end of December. Use the following headings on your worksheet.

ASSETS					=	LIABILITIES		S/H EQUITY	
Cash	+ Acct. Rec.	+ Ppd. Exp.	+ Unused Supp.	+ Truck	=	Acct. Pay.	+ Wages Pay.	+ Share Capital	+ Ret. Earn.

- Prepare an income statement and a statement of changes in equity for the month-ended December 31, 2015, and a balance sheet at December 31. Identify the revenue as "Service Revenue". Record the expenses in alphabetical order.

# Chapter 2 The Accounting Process



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Chapter 2 looks more closely at asset, liability, and shareholder's equity accounts and how they are affected by double-entry accounting. The transactions introduced in Chapter 1 for Big Dog Carworks Corp. are used to explain "debit" and "credit" analysis. The preparation of a trial balance will be introduced. Additionally, this chapter will demonstrate how transactions are recorded in a general journal and posted to a general ledger. Finally, the concept of the accounting cycle is presented.

## Learning Objectives

LO1 – Identify the effect of debit and credit transactions on asset, liability, and shareholders' equity accounts.

LO2 – Analyze transactions using double-entry accounting.

LO3 – Prepare a trial balance, explain its use, and prepare financial statements from it.

LO4 – Record transactions in a general journal and post them to a general ledger.

LO5 – Define the accounting cycle.

## 2.1 Accounts



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LO1 – Identify the effect of debit and credit transactions on asset, liability, and shareholders' equity accounts.

Chapter 1 reviewed the analysis of financial transactions and the resulting impact on the accounting equation. We now expand that discussion by introducing the way transaction is recorded in an account. An account accumulates detailed information regarding the increases and decreases in a specific asset, liability, or shareholders' equity item. Accounts are maintained in a general ledger. We now review and expand our understanding of asset, liability, and shareholders' equity accounts.

## 2.1.1 Asset Accounts



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Recall that assets are resources that have future economic benefits for the business. The primary purpose of assets is that they be used in day-to-day operating activities in order to generate revenue either directly or indirectly. A separate account is established for each asset. Examples of asset accounts are reviewed below.

- **Cash** has future purchasing power. Coins, currency, cheques, and bank account balances are examples of cash.
- **Accounts receivable** occur when products or services are sold on account( or “on credit”). When a sale occurs on account or on credit, the customer has not paid cash but promises to pay in the future.
- **Notes receivable** are formal promises to pay accounts receivable on a specific future date along with a predetermined amount of interest.
- **Unused supplies** are things like paper, staples, and other business stock to be used in the future. If the supplies are used before the end of the accounting period or immaterial in amounts, they are considered an expense of the period rather than an asset.
- **Merchandise inventory** are items to be sold in the future.
- **Prepaid insurance** represents an amount paid in advance for insurance. The prepaid insurance will be used in the future.
- **Prepaid rent** represents an amount paid in advance for rent. The prepaid rent will be used in the future.
- **Buildings** indirectly help a business generate revenue over future accounting periods since they provide space for day-to-day operating activities.
- **Land** cost must be in a separate account from any building that might be on the land. Land usually has an indefinite useful life.

## 2.1.2 Liability Accounts



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As explained in Chapter 1, a liability is an obligation to pay for an asset in the future. One purpose of liabilities is to finance the purchase of assets like land, buildings, and equipment. Liabilities are also used to finance day-to-day operating activities. Examples of liability accounts are reviewed below.

- **Accounts payable** are debts owed to suppliers for goods purchased or services received as a result of day-to-day operating activities. An example of a service received on credit might be a plumber billing the business for a repair.
- **Wages payable** are wages owed to employees for work performed but not paid at the balance sheet date.
- **Bank loans** are debts owed to a bank or other financial institution.

- **Unearned revenues** are payments received in advance of the product or service being provided. If a customer pays \$1,000 for an automobile repair to be done in the next accounting period, this is recorded as a liability.

### 2.1.3 Shareholders' Equity Accounts



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Chapter 1 explained that shareholders' equity represents the net assets owned by the owners of a corporation. There are five different types of shareholders' equity accounts: share capital, retained earnings, dividends, revenues, and expenses. Share capital represents the investments made by owners into the business and causes shareholders' equity to increase. Retained earnings is the sum of all net incomes earned over the life of the corporation to date, less any dividends distributed to shareholders over the same time period.

Therefore, the Retained Earnings account includes revenues, which cause shareholders' equity to increase, along with expenses and dividends, which cause shareholders' equity to decrease. [Figure 2.1](#) summarizes shareholders' equity accounts.

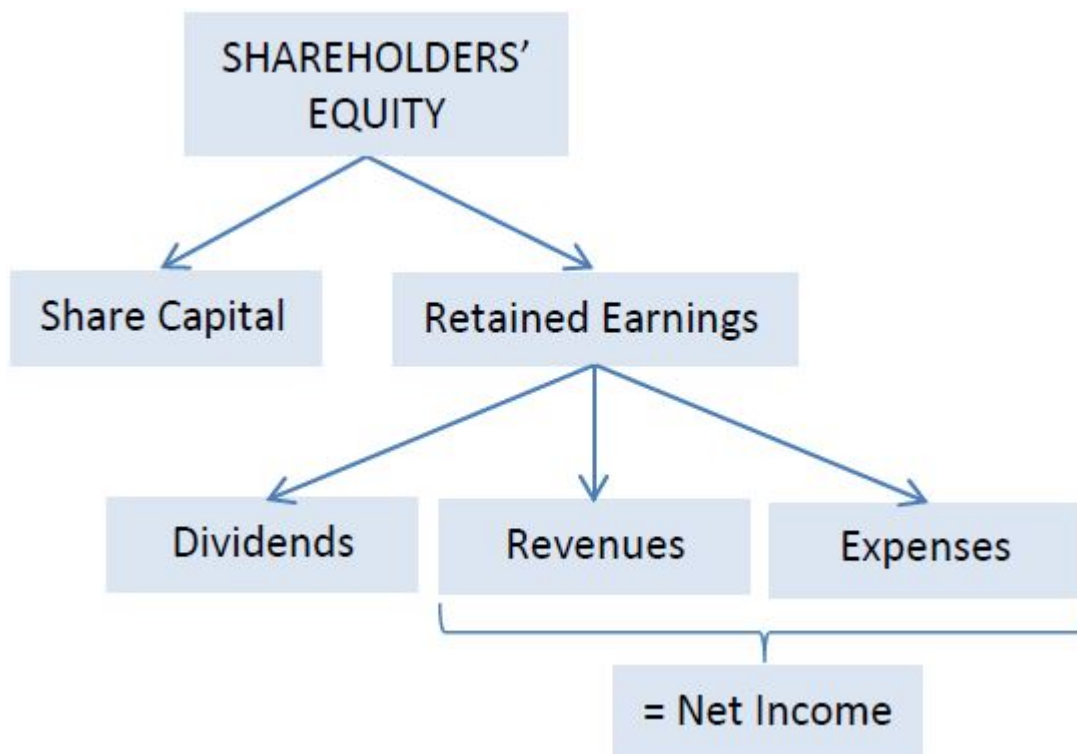


Fig. 2.1: Composition of Shareholders' Equity

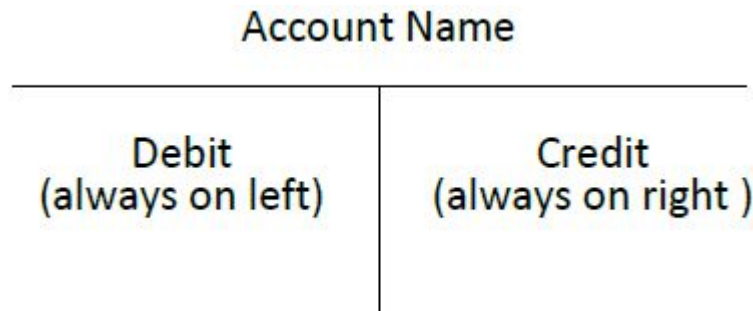
### 2.1.4 T-accounts



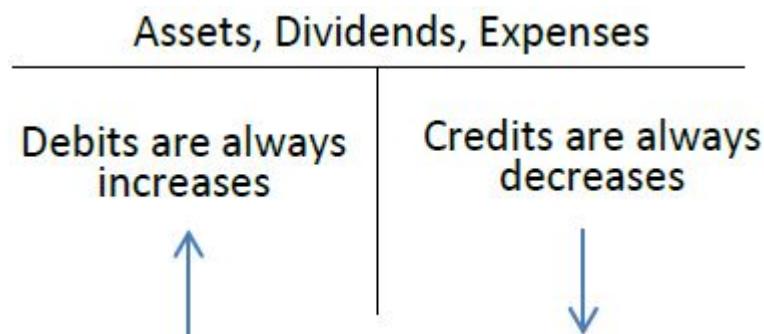
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A simplified account, called a **T-account**, is often used as a learning tool to show increases and decreases in an account. It is called a T-account because it resembles

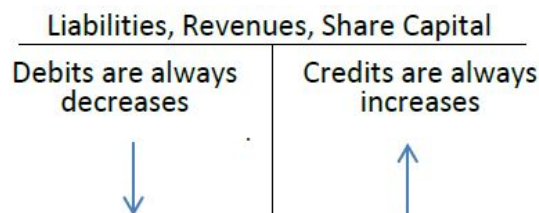
the letter *T*. As shown in the T-account below, the left side records **debit** entries and the right side records **credit** entries.



The *type* of account determines whether an increase or a decrease in a particular transaction is represented by a debit or credit. For financial transactions that affect *assets, dividends, and expenses*, increases are recorded by debits and decreases by credits. This guideline is shown in the following T-account.



For financial transactions that affect liabilities, share capital, and revenues, increases are recorded by credits and decreases by debits, as follows:



	<b>Assets</b>	=	<b>Liabilities</b>	+	<b>S/H Equity</b>
Increases are recorded as:	<b>Debits</b>		<b>Credits</b>		<b>Credits*</b>
Decreases are recorded as:	<b>Credits</b>		<b>Debits</b>		<b>Debits**</b>

\* Revenue and share capital transactions cause shareholders' equity to increase, so they are recorded as credits.

\*\*Expense and dividend transactions cause shareholders' equity to decrease, so they are recorded as debits.

The following summary shows how debits and credits are used to record increases and decreases in various types of accounts.

ASSETS  
DIVIDENDS  
EXPENSES

---

Increases are DEBITED  
Decreases are CREDITED

LIABILITIES  
SHARE CAPITAL

---

Increases are CREDITED  
Decreases are DEBITED

This summary will be used in a later section to illustrate the recording of debits and credits regarding the transactions of Big Dog Carworks Corp. introduced in Chapter 1.

The **account balance** is determined by adding and subtracting the increases and decreases in an account as shown below:

Cash		Accounts Payable	
<i>Debit</i>	<i>Credit</i>	<i>Debit</i>	<i>Credit</i>
10,000	4,000	700	5,000
3,000	2,000	Balance	4,300
400	2,400		
Balance 5,000			

The \$5,000 debit balance in the Cash account was calculated by adding all the debits and subtracting the credits (10,000 + 3,000 + 400 – 4,000 – 2,000 – 2,400). The \$5,000 is recorded on the debit side of the T-account because the debits are greater than the credits. In Accounts Payable, the balance is a \$4,300 credit calculated by subtracting the debits from the credits (5,000 – 700).

Notice that Cash shows a debit balance while Accounts Payable shows a credit balance. The Cash account is an asset so its *normal balance* is a debit. A **normal balance** is the side on which increases occur. Accounts Payable is a liability and because liabilities increase with credits, the normal balance in Accounts Payable is a credit as shown in the T-account above.

## 2.1.5 Chart of Accounts



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A business will create a list of accounts called a **chart of accounts** where each account is assigned both a name and a number. A common practice is to have the accounts arranged in a manner that is compatible with the order of their use in financial statements. For instance, Asset accounts may begin with the digit '1', liability accounts with the digit '2', and shareholders' equity accounts (excluding revenues and expenses) with the digit '3'. Each business will have a unique chart of accounts that corresponds to its specific needs. Assume Big Dog Carworks Corp. uses the following numbering system for its accounts:

100–199      Asset accounts

200–299      Liability accounts



300-399	Share capital, retained earnings, and dividend accounts
400-499	Revenue accounts
600-699	Expense accounts

## 2.2 Transaction Analysis Using Accounts



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LO2 – Analyze transactions using double-entry accounting.

In Chapter 1, transactions for Big Dog Carworks Corp. were analyzed to determine the change in each item of the accounting equation. In this next section, these same transactions will be used to demonstrate double-entry accounting. **Double-entry accounting** means each transaction is recorded in at least two accounts where the total debits always equal the total credits. As a result of double-entry accounting, the sum of all the debit balance accounts in the ledger must equal the sum of all the credit balance accounts. The rule that debits = credits is rooted in the accounting equation:

ASSETS = LIABILITIES + SHAREHOLDERS' EQUITY

Debits = Credits + Credits

### 2.2.1 Illustrative Problem—Double-Entry Accounting and the Use of Accounts



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In this section, the following debit and credit summary will be used to record the transactions of Big Dog Carworks Corp. into T-accounts.

ASSETS  
DIVIDENDS  
EXPENSES

Increases are DEBITED.  
Decreases are CREDITED.

LIABILITIES  
SHARE CAPITAL  
REVENUE

Increases are CREDITED.  
Decreases are DEBITED.

*Transaction 1*



Jan. 1 – Big Dog Carworks Corp. issued 1,000 shares to Bob Baldwin, a shareholder, for a total of \$10,000 cash.

*Debit:* An asset account, Cash, is increased resulting in a debit.

Cash	
10,000	

*Credit:* Share Capital, a shareholders' equity account, is increased resulting in a credit.

Share Capital	
	10,000

*Transaction 2*

Jan. 2 – Borrowed \$4,000 from the bank.

*Debit:* An asset account, Cash, is increased resulting in a debit.

Cash	
4,000	

*Credit:* A liability account, Bank Loan, is increased resulting in a credit.

Bank Loan	
	4,000

*Transaction 3*

Jan. 3 – Equipment was purchased for \$3,000 cash. In this case, one asset is acquired in exchange for another asset.

*Debit:* An asset account, Equipment, is increased resulting in a debit.

Equipment	
3,000	

*Credit:* A liability account, Bank Loan, is increased resulting in a credit.

Bank Loan	
	3,000

*Transaction 4*

Jan. 3 – A truck was purchased for \$8,000; Big Dog paid \$1,000 cash and incurred a \$7,000 bank loan for the balance. This transaction involves one debit and two credits.

Debit: An asset account, Truck, is increased by a debit.

Truck	
8,000	

Credit: An asset account, Cash, is decreased by a credit.

Cash	
	1,000

Credit: A liability account, Bank Loan, is increased by a credit.

Bank Loan	
	7,000

*Transaction 5*

Jan. 5 – Big Dog Carworks Corp. paid \$2,400 cash for a one-year insurance policy, effective January 1. Because the insurance provides future benefit, it is recorded as an asset until it is used.

Debit: An asset account, Prepaid Insurance, is increased by a debit.

Prepaid Insurance	
2,400	

Credit: An asset account, Cash, is decreased by a credit.

Cash	
	2,400

*Transaction 6*

Jan. 10 – The corporation paid \$2,000 cash to reduce the bank loan.

Debit: A liability account, Bank Loan, is decreased by a debit.

Bank Loan	
2,000	

Credit: An asset account, Cash, is decreased by a credit.

Cash	
	2,000

*Transaction 7*

Jan. 15 – The corporation received an advance payment of \$400 for repair services to be performed as follows: \$300 in February and \$100 in March. Since the revenue relating to this cash receipt is not earned as of this date, a liability account, Unearned Repair Revenue, is created.

	Cash
Debit: An asset, Cash, is increased at the time the cash is received by a debit.	400
	Unearned Repair Revenue
Credit: a liability account, Unearned Repair Revenue, is credited.	400

*Transaction 8*

Jan. 31 – A total of \$10,000 of automotive repair services is performed for a customer who paid \$7,500 cash. The remaining \$2,500 will be paid in 30 days. Two debits are required in this case.

	Cash
Debit: An asset, Cash, is increased by a debit.	7,500
	Accounts Receivable
Debit: Another asset, Accounts Receivable, is increased by a debit.	2,500
	Repair Revenue
Credit: A shareholders' equity account, Repair Revenue, is increased by a credit.	10,000

*Transaction 9*

Jan. 31 – Operating expenses of \$7,100 were paid in cash: Rent expense, \$1,600; salaries expense, \$4,000; and supplies expense of \$1,500. \$700 for truck operating expenses (e.g., oil, gas) was incurred on credit. This transaction increases four separate expense accounts and two separate balance sheet accounts.

Debit: An expense account, Rent Expense is increased by a debit.	<table border="1"> <thead> <tr> <th colspan="2">Rent Expense</th> </tr> </thead> <tbody> <tr> <td style="text-align: center;">1,600</td> <td></td> </tr> </tbody> </table>	Rent Expense		1,600	
Rent Expense					
1,600					
Debit: An expense account, Salaries Expense is increased by a debit.	<table border="1"> <thead> <tr> <th colspan="2">Salaries Expense</th> </tr> </thead> <tbody> <tr> <td style="text-align: center;">4,000</td> <td></td> </tr> </tbody> </table>	Salaries Expense		4,000	
Salaries Expense					
4,000					
Debit: An expense account, Supplies Expense is increased by a debit.	<table border="1"> <thead> <tr> <th colspan="2">Supplies Expense</th> </tr> </thead> <tbody> <tr> <td style="text-align: center;">1,500</td> <td></td> </tr> </tbody> </table>	Supplies Expense		1,500	
Supplies Expense					
1,500					
Debit: An expense account, Truck Operating Expense is increased by a debit.	<table border="1"> <thead> <tr> <th colspan="2">Truck Operating Expense</th> </tr> </thead> <tbody> <tr> <td style="text-align: center;">700</td> <td></td> </tr> </tbody> </table>	Truck Operating Expense		700	
Truck Operating Expense					
700					
Credit: An asset, Cash, is decreased by a credit.	<table border="1"> <thead> <tr> <th colspan="2">Cash</th> </tr> </thead> <tbody> <tr> <td></td> <td style="text-align: center;">7,100</td> </tr> </tbody> </table>	Cash			7,100
Cash					
	7,100				
Credit: A liability, Accounts Payable, is increased by a credit.	<table border="1"> <thead> <tr> <th colspan="2">Accounts Payable</th> </tr> </thead> <tbody> <tr> <td></td> <td style="text-align: center;">700</td> </tr> </tbody> </table>	Accounts Payable			700
Accounts Payable					
	700				

*Transaction 10*

Jan. 31 – Dividends of \$200 were paid in cash to the shareholder, Bob Baldwin. Dividends are a distribution of net income, and reduce shareholders' equity.

Debit: The Dividends account is increased by a debit.	<table border="1"> <thead> <tr> <th colspan="2">Dividends</th> </tr> </thead> <tbody> <tr> <td style="text-align: center;">200</td> <td></td> </tr> </tbody> </table>	Dividends		200	
Dividends					
200					
Credit: An asset, Cash, is decreased by a credit.	<table border="1"> <thead> <tr> <th colspan="2">Cash</th> </tr> </thead> <tbody> <tr> <td></td> <td style="text-align: center;">200</td> </tr> </tbody> </table>	Cash			200
Cash					
	200				

After the January transactions of Big Dog Carworks Corp. have been recorded in the T-accounts, each account is totalled and the difference between the debits and credits is



calculated, as shown in the following diagram. The numbers in parentheses refer to the transaction numbers used in the preceding section. To prove that the accounting equation is in balance, the account balances for each of assets, liabilities, and shareholders' equity are added. Notice that total assets of \$22,100 equal the sum of total liabilities of \$10,100 plus shareholders' equity of \$12,000.

ASSETS		=	LIABILITIES		+	SHAREHOLDERS' EQUITY					
Cash			Bank Loan			Share Capital		Dividends		Repair Revenue	
(1) 10,000	(3) 3,000		(6) 2,000	(2) 4,000		(1) 10,000	(10) 200			(8) 10,000	
(2) 4,000	(4) 1,000			(4) 7,000							
(7) 400	(5) 2,400			Bal. 9,000							
(8) 7,500	(6) 2,000										
	(9) 7,100										
	(10) 200										
Bal. 6,200			Accounts Payable						Rent Expense		
				(9) 700					(9) 1,600		
Accounts Receivable			Unearned Repair Revenue						Salaries Expense		
(8) 2,500				(7) 400					(9) 4,000		
Prepaid Insurance									Supplies Expense		
(5) 2,400									(9) 1,500		
Equipment										Truck Operating Expense	
(3) 3,000									(9) 700		
Truck											
(4) 8,000											
<u>22,100<sup>1</sup></u>		=	<u>10,100<sup>2</sup></u>		+	<u>12,000<sup>3</sup></u>					
<sup>1</sup> 6,200 + 2,500 + 2,400 + 3,000 + 8,000 = <u>22,100</u> <sup>2</sup> 9,000 + 700 + 400 = <u>10,100</u> <sup>3</sup> 10,000 - 200 + 10,000 - 1,600 - 4,000 - 1,500 - 700 = <u>12,000</u>											

## 2.3 The Trial Balance



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LO3 – Prepare a trial balance, explain its use, and prepare financial statements from it.

To help prove that the accounting equation is in balance, a trial balance is normally prepared instead of the T-account listing shown in the previous section. A **trial balance** is an internal document that lists all the account balances at a point in time. The total debits must equal total credits on the trial balance. The form and content of a trial balance is illustrated below, using the account numbers, account names, and account balances of Big Dog Carworks Corp. at January 31, 2015. Assume that the account numbers are those assigned by the business.

**Big Dog Carworks Corp.  
Trial Balance**

Acct. No.	Account	Account balances	
		Debit	Credit
101	Cash	\$6,200	
110	Accounts receivable	2,500	
161	Prepaid insurance	2,400	
183	Equipment	3,000	
184	Truck	8,000	
201	Bank loan		\$9,000
210	Accounts payable		700
247	Unearned repair revenue		400
320	Share capital		10,000
350	Dividends	200	
450	Repair revenue		10,000
654	Rent expense	1,600	
656	Salaries expense	4,000	
668	Supplies expense	1,500	
670	Truck operating expense	700	
		<u>\$30,100</u>	<u>\$30,100</u>

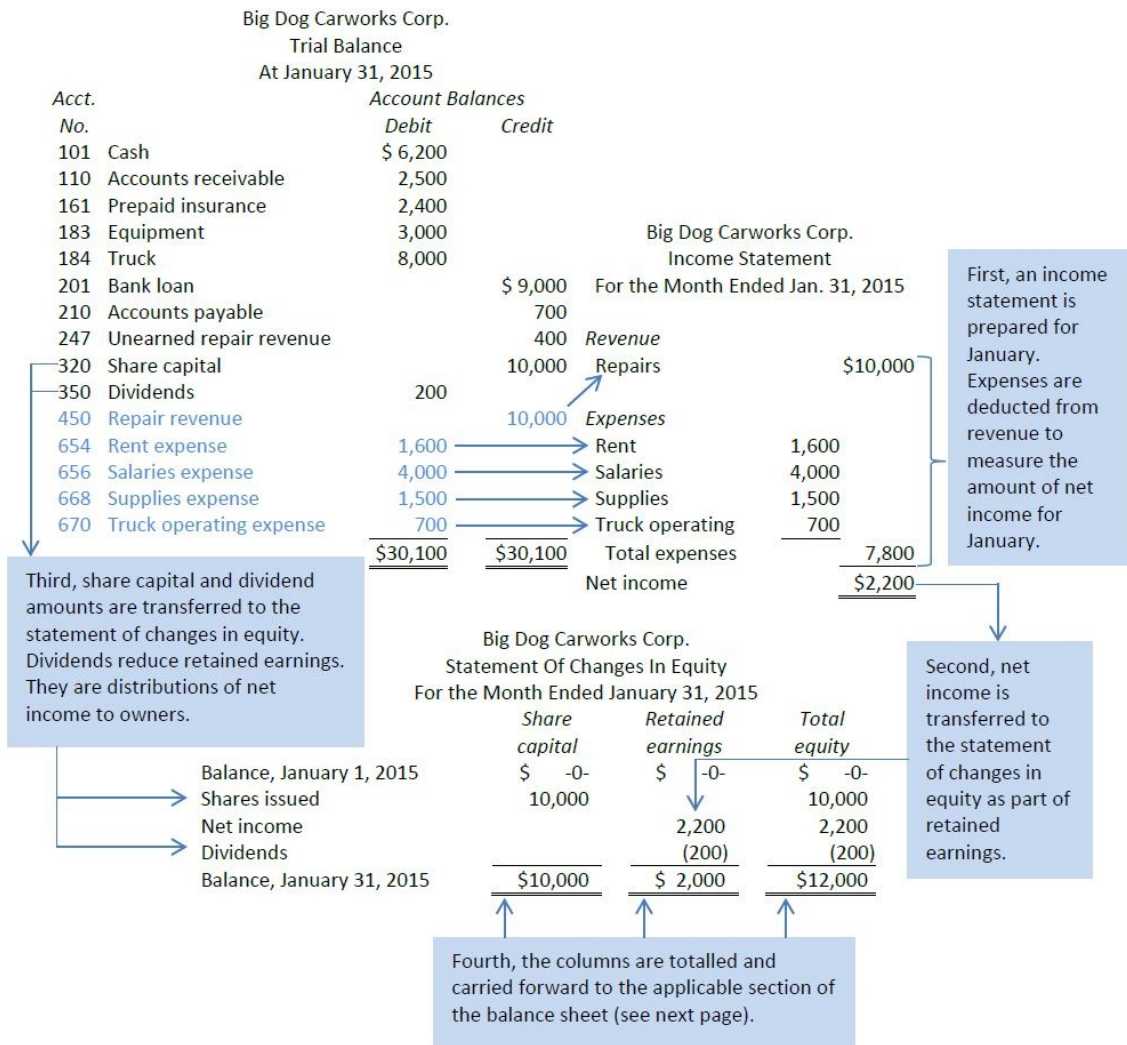
Double-entry accounting requires that debits equal credits. The trial balance establishes that this equality exists for Big Dog but it does not ensure that each item has been recorded in the proper account. Neither does the trial balance ensure that all items that should have been entered have been entered. In addition, a transaction may be recorded twice. Any or all of these errors could occur and the trial balance would still balance. Nevertheless, a trial balance provides a useful mathematical check before preparing financial statements.

### 2.3.1 Preparation of Financial Statements

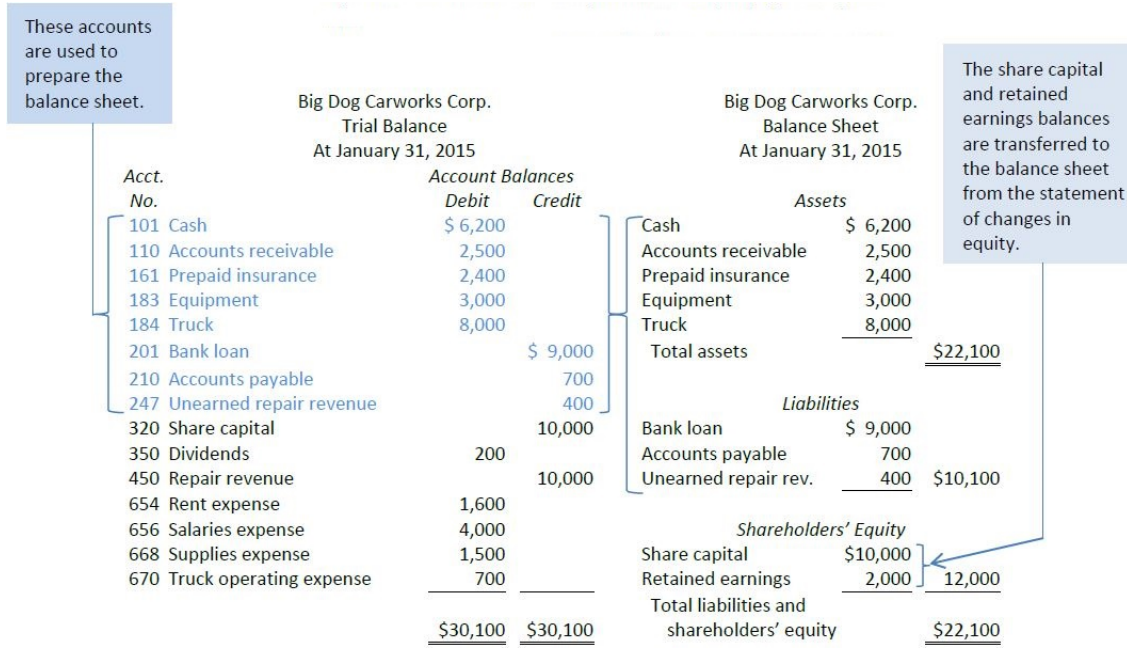


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Financial statements for the one-month period ended January 31, 2015 can now be prepared from the trial balance figures.



The asset and liability accounts from the trial balance and the ending balances for share capital and retained earnings on the statement of changes in equity are used to prepare the balance sheet.



Note the links between financial statements:

*The income statement is linked to the statement of changes in equity.* Revenues and expenses are reported on the income statement to show the details of net income. Because net income causes shareholders' equity to change, it is then reported on the statement of changes in equity.

*The statement of changes in equity is linked to the balance sheet.* The statement of changes in equity shows the details of how shareholders' equity changed during the accounting period. The balances for share capital and retained earnings that appear on the statement of changes in equity are transferred to the shareholders' equity section of the balance sheet.

*The balance sheet summarizes shareholders' equity.* It shows only account balances for share capital and retained earnings. To obtain the details regarding these shareholders' equity accounts, we must look at the income statement and the statement of changes in equity.

## 2.4 Using Formal Accounting Records



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LO4 – Record transactions in a general journal and post them to a general ledger.

The preceding analysis of financial transactions used T-accounts to record debits and credits. T-accounts will continue to be used for illustrative purposes throughout this book. In actual practice, financial transactions are recorded in a **general journal**.

A general journal is a document that is used to chronologically record a business's debit and credit transactions (see [Figure 2.2](#)). It is often referred to as the *book of original entry*. **Journalizing** is the process of recording a financial transaction in the journal. The resulting debit and credit entry recorded in the journal is called a **journal entry**.

A **general ledger** is a record that contains all of a business's accounts. **Posting** is the process of transferring amounts from the journal to the matching ledger accounts. Because amounts recorded in the journal eventually end up in a ledger account, the ledger is sometimes referred to as a *book of final entry*.

### 2.4.1 Recording Transactions in the General Journal



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Each transaction is first recorded in the journal. The January transactions of Big Dog Carworks Corp. are recorded in its journal as shown in [Figure 2.2](#). The journalizing procedure follows these steps (refer to [Figure 2.2](#) for corresponding numbers):



1. The year is recorded at the top and the month is entered on the first line of page 1. This information is repeated only on each new journal page used to record transactions.
2. The date of the first transaction is entered in the second column, on the first line. The day of each transaction is always recorded in this second column.
3. The name of the account to be debited is entered in the description column on the first line. By convention, accounts to be debited are usually recorded before accounts to be credited. The column titled Folio indicates the number given to the account in the General Ledger. For example, the account number for Cash is 101. The amount of the debit is recorded in the debit column.
4. The name of the account to be credited is on the second line of the description column and is indented about one centimetre into the column. Accounts to be credited are always indented in this way in the journal. The amount of the credit is recorded in the credit column.
5. An explanation of the transaction is entered in the description column on the next line. It is not indented.
6. A line is usually skipped after each journal entry to separate individual journal entries and the date of the next entry recorded. It is unnecessary to repeat the month if it is unchanged from that recorded at the top of the page.

## GENERAL JOURNAL

Page 1

	Date		Description	Folio	Debit	Credit
1	2015					
	Jan.	1	Cash	101	10,000	
2			Share Capital	320		10000
			To record share capital issued.			
3		2	Cash	101	4,000	
4			Bank Loan	201		4,000
			To record receipt of bank loan.			
5						
6		2	Equipment	183	3,000	
			Cash	101		3,000
			To record purchase of equipment for cash.			
		3	Truck	184	8,000	
			Bank Loan	201		7,000
			Cash	101		1,000
			To record purchase of a tow truck; paid cash and incurred additional bank loan.			
		5	Prepaid Insurance	161	2,400	
			Cash	101		2,400
			To record payment for one-year insurance policy.			
		10	Bank Loan	201	2,000	
			Cash	101		2,000
			To record payment on bank loan.			
		15	Cash	101	400	
			Unearned Repair Revenue	247		400
			To record receipt of cash for services that will not be performed in January.			
		31	Cash	101	7,500	
			Accounts Receivable	110	2,500	
			Repair Revenue	450		10,000
			To record repair revenue earned in January.			
		31	Rent Expense	654	1,600	
			Salaries Expense	656	4,000	
			Supplies Expense	668	1,500	
			Truck Operating Expense	670	700	
			Cash	101		7,100
			Accounts Payable	210		700
			To record payment of expenses for January.			
		31	Dividends	350	200	
			Cash	101		200
			To record payment of dividends.			

**Fig. 2.2: January General Journal Transactions for BDCC**

Most of Big Dog's entries have one debit and credit. An entry can also have more than one debit or credit, in which case it is referred to as a **compound entry**. The entry dated January 3 is an example of a compound entry.

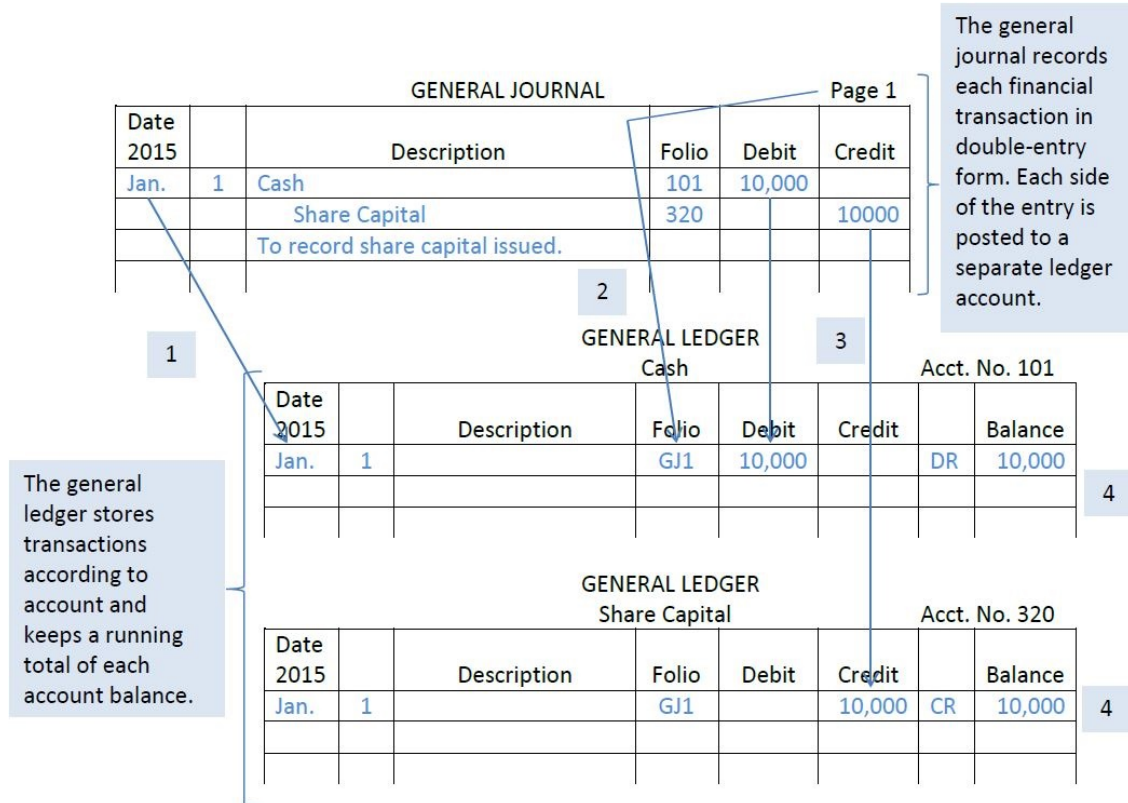
## 2.4.2 Posting Transactions to the General Ledger



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The **ledger account** is a formal variation of the T-account. The ledger accounts shown in [Figure 2.3](#) are similar to what is used in electronic/digital accounting programs. Ledger accounts are kept in the general ledger. Debits and credits recorded in the journal are transferred or “posted” to appropriate ledger accounts so that the details and balance for each account can be found easily. [Figure 2.3](#) uses the first transaction of Big Dog Carworks Corp. to illustrate how to post amounts and record other information. The posting procedure follows these steps (refer to [Figure 2.3](#) for corresponding numbers):

1. The date is recorded in the appropriate general ledger account.
2. The general journal page number is recorded in the Folio column of each ledger account as a cross reference. In this case, the posting has been made from general journal page 1 so the reference is recorded as “GJ1”.
3. The debit and credit amounts from the general journal are posted to the debit or credit columns in the appropriate general ledger account. Here the entry debiting Cash is posted to the Cash ledger account. The entry crediting share capital is then posted to the Share Capital general ledger account.
4. After posting the entry, a balance is calculated in the Balance column of each general ledger account. A notation is recorded in the column to the left of the Balance column indicating whether the balance is a debit (DR) or credit (CR). A brief description can be entered in the Description column of the account but this is usually not necessary since the journal includes a detailed description for each journal entry.



**Fig. 2.3: Illustration of a Transaction Posted to Two Accounts in the General Ledger**

This manual process of recording, posting, summarizing, and preparing financial statements is cumbersome and time-consuming. In virtually all businesses, the use of accounting software automates much of the process. In this and subsequent chapters, either the T-account or the general ledger account format will be used to explain and illustrate concepts.

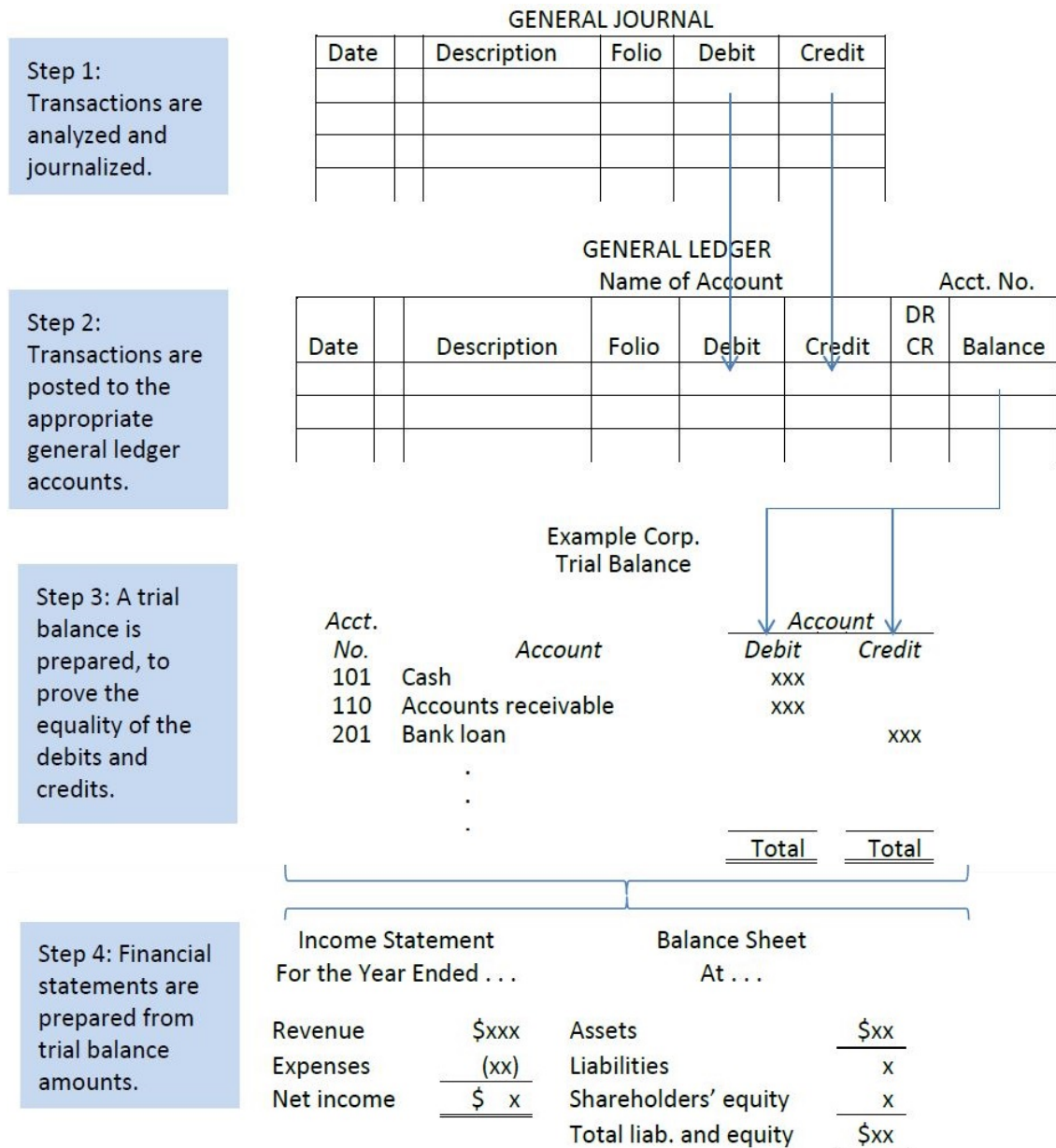
## 2.5 The Accounting Cycle



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LO5 – Define the accounting cycle.

In the preceding sections, the January transactions of Big Dog Carworks Corp. were used to demonstrate the steps performed to convert economic data into financial information. This conversion was carried out in accordance with the basic double-entry accounting model. These steps are summarized in [Figure 2.4](#).



**Fig. 2.4: Illustrated Steps in the Accounting Cycle**

The sequence just described, beginning with the journalising of the transactions and ending with the communication of financial information in financial statements, is commonly referred to as the **accounting cycle**. There are additional steps involved in the accounting cycle. These will be introduced in Chapter 3.

## 2.6 Summary of Chapter 2 Learning Objectives



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### **LO1 – Identify the effect of debit and credit transactions on asset, liability, and shareholders' equity accounts.**

Assets are resources that have future economic benefits. Examples are cash, accounts receivable, prepaid expenses, and machinery. Increases in assets are recorded as debits and decreases as credits. Liabilities represent an obligation to pay an asset in

the future. Examples include accounts payable and unearned revenues. Increases in liabilities are recorded as credits and decreases as debits. Shareholders' equity represents the amount of net assets of the corporation that belong to owners. It includes share capital, dividends, revenues, and expenses. Increases in shareholders' equity caused by the issuing shares and earning revenues are recorded as credits. Decreases in shareholders' equity, like paying dividends and incurring expenses, are recorded as debits.

### **LO2 – Analyze transactions using double-entry accounting.**

In double-entry accounting, each transaction is recorded in at least two accounts where the total debits always equal the total credits. The double-entry accounting rule is rooted in the accounting equation:  $\text{Assets} = \text{Liabilities} + \text{Shareholders' equity}$ .

### **LO3 – Prepare a trial balance, explain its use, and prepare financial statements from it.**

To help prove the accounting equation is in balance, a trial balance is prepared. The trial balance lists all the account balances at a point in time. The total debits must equal total credits on the trial balance. The trial balance is used to prepare the financial statements.

### **LO4 – Record transactions in a general journal and post them to a general ledger.**

Recording financial transactions was introduced in this chapter using T-accounts. A business actually records transactions in a general journal, a document which chronologically lists each debit and credit journal entry. To summarize the debit and credit entries by account, the entries in the general journal are posted (or transferred) to the general ledger. The account balances in the general ledger are used to prepare the trial balance.

### **LO5 – Define the accounting cycle.**

Analyzing transactions, journalizing them in the general journal, posting from the general journal into the general ledger, preparing the trial balance, and generating financial statements are steps followed each accounting period. These steps form the core of the accounting cycle. Additional steps in the accounting cycle will be introduced in Chapter 3.

## **2.7 Assignment Materials**

### **2.7.1 Concept Self-check**



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1. What is an 'account'? How are debits and credits used to record transactions?
2. Why are T-accounts used in accounting?
3. How do debits and credits impact the T-account?
4. What is a chart of accounts?
5. Are increases in shareholders' equity recorded as a debit or credit?
6. Are decreases in shareholders' equity recorded as a debit or credit?

7. Summarize the rules for using debits and credits to record assets, expenses, dividends, liabilities, share capital, and revenues.
8. What is a trial balance? Why is it prepared?
9. How is a trial balance used to prepare financial statements?
10. A general journal is often called a book of original entry. Why?
11. What is a general ledger? Why is it prepared?
12. Explain the posting process.
13. What are the steps in the accounting cycle?

## 2.7.2 Comprehension Problems

### 2.7.2.1 CP 2-1



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The following T-accounts show the relationship of increases (inc.) and decreases (dec.) to debits and credits:

Transaction	Any Asset		Any Liability		Share Capital		Any Revenue		Any Expense	
	Debit (inc.)	Credit (dec.)	Debit (dec.)	Credit (inc.)	Debit (dec.)	Credit (inc.)	Debit (dec.)	Credit (inc.)	Debit (dec.)	Credit (inc.)
(1)	X					X				
(2)										
(3)										
(4)										
(5)										
(6)										
(7)										
(8)										
(9)										
(10)										
(11)										
(12)										
(13)										

*Required:* For each of the following transactions, indicate in the chart above with an 'X' which accounts are debited and credited (transaction 1 is done for you):

1. Issued share capital for cash
2. Paid cash for a truck
3. Paid for prepaid insurance
4. Borrowed cash from the bank to purchase machinery
5. Received a bill from a local garage for truck repairs done last week
6. Collected cash for services performed today
7. Billed customers for services performed last week
8. Repaid part of the bank loan
9. Made a deposit for utility services to be used in the future
10. Paid cash for truck operating expenses related to 5. above
11. Received a bill for repair supplies used during the month
12. Made a cash payment to a creditor
13. Received a cash payment to satisfy an amount owed by a customer.



### 2.7.2.2 CP 2-2



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The following list shows totals for all accounts for four different companies: A, B, C, and D. In each case, one amount is omitted.

	A	B	C	D
Cash	\$10	\$	\$	\$
Truck	0	72	?	20
Accounts payable	200	130	71	200
Bank loan	50	10	5	10
Share capital	75	?	25	61
Net income	175	50	100	?
	?	20	6	10

*Required:* In each case, compute the missing figure.

### 2.7.2.3 CP 2-3



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*Required:* Record the debit and credit for each of the following transactions (transaction 1 is done for you):

1. Purchased a \$10,000 truck on credit
2. Borrowed \$5,000 cash from the bank
3. Paid \$2,000 of the bank loan in cash
4. Paid \$600 in advance for a one-year insurance policy
5. Received \$500 in advance from a renter for next month's rental of office space.



Assets		=	Liabilities		+	Equity	
<i>Debit</i> (inc.)	<i>Credit</i> (dec.)		<i>Debit</i> (dec.)	<i>Credit</i> (inc.)		<i>Debit</i> (dec.)	<i>Credit</i> (inc.)
10,000				10,000			

#### 2.7.2.4 CP 2-4



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*Required:* Record the debit and credit in the appropriate account for each of the following transactions (transaction 1 is done for you):

1. Issued share capital for cash
2. Purchased equipment on credit
3. Paid for a one-year insurance policy
4. Billed a customer for repairs completed today
5. Paid this month's rent
6. Collected the amount billed in transaction 4 above
7. Collected cash for repairs completed today
8. Paid for the equipment purchased in transaction 2 above
9. Signed a union contract
10. Collected cash for repairs to be made for customers next month
11. Transferred this month's portion of prepaid insurance to insurance expense.

<i>Debit</i>	<i>Credit</i>
Cash	Share Capital

### 2.7.2.5 CP 2-5



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*Required:* Post the following transactions to the appropriate accounts:

1. Issued share capital for \$5,000 cash (posted as an example)
2. Paid \$900 in advance for three months' rent, \$300 for each month
3. Billed \$1,500 to customers for repairs completed today
4. Purchased on credit \$2,000 of supplies to be used next month
5. Borrowed \$7,500 from a bank
6. Collected \$500 for the amount billed in transaction 3
7. Received a \$200 bill for electricity used to date (the bill will be paid next month)
8. Repaid \$2,500 of the bank loan
9. Used \$800 of the supplies purchased in transaction 4
10. Paid \$2,000 for the supplies purchased in transaction 4
11. Re. transaction 2: transferred this month's rent to expenses.

Cash	Bank Loan	Share Capital	Repair Revenue
(1) 5,000		(1) 5,000	
Accounts Receivable	Accounts Payable		Electricity Expense
Prepaid Rent			Rent Expense
Unused Supplies			Supplies Expense

### 2.7.2.6 CP 2-6



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*Required:* Prepare journal entries for each of the following transactions:

1. Issued share capital for \$3,000 cash
2. Purchased \$2,000 of equipment on credit
3. Paid \$400 cash for this month's rent
4. Purchased on credit \$4,000 of supplies to be used next month
5. Billed \$2,500 to customers for repairs made to date
6. Paid cash for one-half of the amount owing in transaction 4
7. Collected \$500 of the amount billed in transaction 5
8. Sold one-half of the equipment purchased in transaction 2 above for \$1,000 in cash.

### 2.7.2.7 CP 2-7



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*Required:* Prepare the journal entries and likely descriptions of the eleven transactions that were posted to the following general ledger accounts for the month ended January 31, 2015. Do not include amounts. For instance, the first entry would be:

1. Cash

Share Capital

To record share capital issued.

Cash		Bank Loan		Share Capital		Service Revenue	
1	2		11		1		3
3	5						4
8	10						
11							
Accounts Receivable		Accounts Payable		Rent Expense			
4		10	2	9			
			6				
			7				
Prepaid Rent		Supplies Expense					
5	9	7					
Equipment		Truck Operating Expense					
2	8	6					

### 2.7.2.8 CP 2-8



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The following trial balance was prepared from the books of Cross Corporation at its year-end, December 31, 2015. After the company's bookkeeper left, the office staff was unable to balance the accounts or place them in their proper order. Individual account balances are correct, but debits may be incorrectly recorded as credits and vice-versa.

Acct. No.	Account	Accounts Balances	
		Debits	Credits
101	Cash	\$120,400	
410	Commissions earned	5,000	
320	Share capital		\$170,000
210	Accounts payable	30,000	
631	Insurance expense	100	
180	Land		8,000
181	Building		120,000
654	Rent expense		1,000
110	Accounts receivable		26,000
173	Unused supplies	6,000	
668	Supplies expense		300
201	Bank loan		80,000
656	Salaries expense		3,000
669	Telephone expense	200	
	Totals	<u>\$161,700</u>	<u>\$408,300</u>

*Required:* Prepare a trial balance showing the balances in the correct column. List the accounts in numerical order. Total the columns and ensure total debits equal total credits. Assume all accounts have normal balances.

### 2.7.2.9 CP 2-9



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The following is Schulte Corporation's transactions worksheet for the month of March, 2015. Each line represents the dollar amount of a transaction for the month.

Mar.	ASSETS				=	LIABILITY		+	EQUITY					
	Cash	+	Acct. Rec.	+		Ppd. Rent	+		Equip.	=	Acct. Pay.	+	Share Capital	+
													Revenue	Expenses
1	+5										+5			
2	-3					+6			+3					
3	-2			+2										
15	+4		+2										+6	
													(Service)	
17	+1					-1								
18									+3					-3 (Supplies)
24			+1										+1	
													(Service)	
31				-1										-1 (Rent)
31									+2					-2 (Truck Op.)
31	-1								-1					

*Required:*

1. Prepare journal entries for the ten transactions including the likely description of the transaction. Include account numbers (Folio) using the same general ledger account numbers shown in chapter 2 plus:

Prepaid rent	162
--------------	-----

Service revenue	470
-----------------	-----

2. Post the journal entries to T-accounts and total the accounts.
3. From the T-accounts, prepare a trial balance. List expenses in alphabetical order.
4. Prepare an income statement and statement of changes in equity for the month ended March 31, 2015 and a balance sheet at March 31, 2015.

**2.7.2.10 CP 2-10**

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The following trial balance was prepared from the books of McQueen Corp. at its year-end, December 31, 2015. The new bookkeeper was unable to balance the accounts or to list them in their proper order. Individual account balances are correct, but debits may be classified as credits and vice-versa.

<i>Acct.</i>		<i>Account Balances</i>	
		<i>Debit</i>	<i>Credit</i>
No.	<i>Account</i>		
210	Accounts payable	\$ 13,250	
110	Accounts receivable		\$10,000
181	Building	50,000	
320	Share capital	75,000	
101	Cash	15,500	
182	Furniture	6,000	
180	Land		12,000
161	Prepaid insurance		9,600
201	Bank loan		28,000
350	Dividends	2,350	
162	Prepaid rent		8,000
173	Unused supplies	2,800	
	<b>Totals</b>	<u>\$164,900</u>	<u>\$67,600</u>

*Required:* Prepare a corrected trial balance showing the accounts in numerical order and balances in the correct column. Total the columns and ensure total debits equal total credits. Assume all accounts have normal balances.

### 2.7.2.11 CP 2-11



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The following general ledger accounts are taken from the books of Collins Corporation at June 30, 2015, the end of the first month of operation.

Cash		Bank Loan		Share Capital		Repair Revenue	
Jn. 1	25,000	Jn. 1	500	Jn. 30	4,000	Jn. 1	25,000
20	5,000	15	1,000			Jn. 20	5,000
		23	4,000			30	3,000
		30	1,000				
		30	2,000				
		30	16,000				
Prepaid Insurance		Accounts Payable		Rent Expense			
Jn. 1	2,000	Jn. 30	200	Jn. 27	100	Jn. 1	500
Accounts Receivable		Salaries Expense					
Jn. 30	3,000	Jn. 15	1,000				
		30	1,000				
Unused Supplies		Supplies Expense					
Jn. 23	4,000	Jn. 30	200				
Land		Telephone Expense					
Jn. 30	5,000	Jn. 27	100				
Building		Insurance Expense					
Jn. 30	15,000	Jn. 30	200				

**Required:**

1. Prepare journal entries to record the June transactions, including likely descriptions of the transactions.
2. Total the T-accounts and prepare a trial balance at June 30.
3. Prepare an income statement and statement of changes in equity for the month ended June 30, 2015 and a balance sheet at June 30, 2015.

**2.7.2.12 CP 2-12**

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The following trial balance has been prepared from the ledger of Sabre Travels Inc.



Sabre Travels Inc.  
Trial Balance  
January 31, 2015

	<i>Account Balances</i>	
	<i>Debits</i>	<i>Credits</i>
Cash	\$ 60	
Accounts receivable	140	
Unused supplies	10	
Equipment	300	
Building	700	
Land	300	
Bank loan		\$100
Accounts payable		20
Share capital		250
Fees earned		1,875
Advertizing expense	200	
Repairs expense	100	
Supplies expense	20	
Telephone expense	10	
Utilities expense	5	
Wages expense	400	

*Required:*

1. Calculate the total debits and credits.
2. Prepare an income statement and statement of changes in equity for the year ended January 31, 2015, and a balance sheet at January 31. Assume share capital was issued in the prior fiscal year and that opening retained earnings is zero.

### 2.7.2.13 CP 2-13



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The following journal entries were prepared for Elgert Corporation for its first month of operation, January 2015.

			<i>Debit</i>	<i>Credit</i>
Jan.	1	Cash	10,000	

	Share Capital	10,000
--	---------------	--------

To record the shares issued.

5	Rent Expense	200
---	--------------	-----

	Cash	200
--	------	-----

To record the payment of rent for the month.

9	Unused Supplies	4,000
---	-----------------	-------

	Cash	4,000
--	------	-------

To record the purchase of supplies.

11	Cash	1,300
----	------	-------

	Service Revenue	1,300
--	-----------------	-------

To record service revenue earned.

28	Truck Operating Expense	450
----	-------------------------	-----

	Accounts Payable	450
--	------------------	-----

To record truck repairs.

30	Salaries Expense	1,800
----	------------------	-------

	Cash	1,800
--	------	-------

To record payment of salaries for the month.

31	Accounts Receivable	1,600
----	---------------------	-------

	Service Revenue	1,600
--	-----------------	-------

To record service revenue earned during the month.

31	Supplies Expense	200	
	Unused Supplies		200
To record supplies used during the month.			
	Dividends	50	
	Cash		50

*Required:*

1. Prepare necessary general ledger T-accounts and post the transactions.
2. Prepare a trial balance at January 31, 2015.
3. Prepare an income statement and statement of changes in equity for the month ended January 31, 2015 and a balance sheet at January 31, 2015.

## 2.7.3 Problems

### 2.7.3.1 P 2-1



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The following account balances are taken from the records of Fox Creek Service Limited at October 31, 2015 after its first year of operation:

Accounts Payable	\$9,000	Insurance Expense	\$500
Accounts Receivable	6,000	Repair Revenue	19,000
Advertising Expense	2,200	Supplies Expense	800
Bank loan	5,000	Telephone Expense	250
Cash	1,000	Truck	9,000
Share Capital	2,000	Truck Operating Expense	1,250

Commissions Expense	4,500	Wages Expense	4,000
Equipment	7,000	Wages Payable	1,500

*Required:*

1. Prepare a trial balance at October 31, 2015. General ledger account numbers are not necessary.
2. Prepare an income statement and statement of changes in equity for the year ended October 31, 2015.
3. Prepare a balance sheet at October 31, 2015.

**2.7.3.2 P 2-2**

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The following ledger accounts were prepared for Davidson Tool Rentals Corporation during the first month of operation ending May 31, 2015. No journal entries were prepared to support of the amounts recorded in the ledger accounts.

Cash		Accounts Payable		Share Capital	Service Revenue
May 1 5,000	May 11 1,000	May 22 600	May 11 1,000	May 1 5,000	May 5 3,000
6 2,000	16 500		23 150		6 2,000
10 1,500	20 300		24 1,100		18 2,500
15 1,200	22 600				
21 800	28 400				
	29 3,500				
Accounts Receivable					Advertizing Expense
May 5 3,000	May 10 1,500				May 31 250
18 2,500	15 1,200				
Prepaid Advertizing					Commissions Expense
May 16 500	May 31 250				May 24 1,100
Unused Supplies					Rent Expense
May 20 300	May 30 100				May 28 400
Equipment					Salaries Expense
May 11 2,000	May 21 800				May 29 3,500
					Supplies Expense
					May 30 100
					Telephone Expense
					May 23 150

*Required:*

1. Reconstruct the transactions that occurred during the month and prepare journal entries to record these transactions, including appropriate descriptions. Use the same accounts numbers (Folio) as those used in the chapter plus the following:

---

Prepaid advertising	160
Service revenue	470
Advertising expense	610
Commissions expense	615
Telephone expense	669

Calculate the balance in each account.

2. Prepare a trial balance in numerical order at May 31, 2015.

### 2.7.3.3 P 2-3



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The following trial balance was prepared for Findlay Consultants Corp. at January 31, 2015, its first month of operation.

Findlay Consultants Corp.  
Trial Balance  
At January 31, 2015

Acct. No.	Account	Account Balances	
		Debits	Credits
210	Accounts payable	\$ 9,000	
110	Accounts receivable		
610	Advertizing expense	150	
101	Cash		\$ 3,625
320	Share capital	2,000	
183	Equipment		7,000
182	Furniture		4,000
236	Utilities payable		1,000
631	Insurance expense	200	
641	Maintenance expense		250
160	Prepaid advertizing	300	
420	Fees earned	9,500	
654	Rent expense		400
656	Salaries expense		2,600
226	Salaries payable		1,500
668	Supplies expense	350	
669	Telephone expense	125	
184	Truck	9,000	
370	Truck operating expense		750
677	Wages expense		1,500

*Required:*

1. Prepare a corrected trial balance at January 31. List the accounts in numerical order. Record the amounts in their proper debit or credit positions. Re-add total debits and credits and ensure they are equal. Assume all accounts have normal balances.
2. Prepare an income statement and statement of changes in equity for the month ended January 31, 2015.
3. Prepare a balance sheet at January 31, 2015.

### 2.7.3.4 P 2-4



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The following balances appeared in the general ledger accounts of Fenton Table Rentals Corporation at April 1, 2015.

Cash	\$1,400	Accounts payable	\$2,000
Accounts receivable	3,600	Share capital	4,350
Prepaid rent	1,000		
Unused supplies	350		

The following transactions occurred during April:

- a. Collected \$2,000 cash owed by a customer
- b. Billed \$3,000 to customers for tables rented to date
- c. Paid the following expenses: advertizing, \$300; salaries, \$2,000; telephone, \$100
- d. Paid half of the accounts payable owing at April 1
- e. Received a \$500 bill for April truck repair expenses
- f. Collected \$2,500 owed by a customer
- g. Billed \$1,500 to customers for tables rented to date
- h. Transferred \$500 of prepaid rent to rent expense
- i. Counted \$200 of supplies on hand at April 30; recorded the amount used as an expense
- j. Paid a \$100 dividend.



*Required:*

1. Open general ledger T-accounts for the following and enter the April 1 balances (account numbers are indicated in brackets): Cash (101), Accounts Receivable (110), Prepaid Rent (162), Unused Supplies (173), Accounts Payable (210), Share Capital (320), Dividends (350), Service Revenue (470), Advertising Expense (610), Rent Expense (654), Salaries Expense (656), Supplies Expense (668), Telephone Expense (669), and Truck Operating Expense (670).
2. Prepare journal entries to record the April transactions, including general ledger account numbers.
3. Post transactions a through j to the T-accounts.
4. Prepare a trial balance at April 30, 2015.
5. Prepare an interim income statement and statement of changes in equity for the month ended April 30, 2015 and interim balance sheet at April 30, 2015.

**2.7.3.5 P 2-5**

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The following transactions occurred in Thorn Accounting Services Inc. during August 2015, its first month of operation.

Aug.	1	Issued share capital for \$3,000 cash
	1	Borrowed \$10,000 cash from the bank
	1	Paid \$8,000 cash for a used truck
	4	Paid \$600 for a one-year truck insurance policy effective August 1
	5	Collected \$2,000 fees in cash from a client for work performed today (recorded as Fees Earned)
	7	Billed \$5,000 fees to clients for services performed to date (recorded as fees earned)
	9	Paid \$250 for supplies used to date
	12	Purchased \$500 of supplies on credit (recorded as unused supplies)
	15	Collected \$1,000 of the amount billed on August 7

- 16 Paid \$200 for advertizing in The News during the first two weeks of August
- 20 Paid half of the amount owing for the supplies purchased on August 12
- 25 Paid cash for the following expenses: rent for August, \$350; salaries, \$2,150; telephone, \$50; truck repairs, \$250
- 28 Called clients for payment of the balance owing from August 7
- 29 Billed \$6,000 of fees to clients for services performed to date (recorded as fees earned)
- 31 Transferred the amount of August's truck insurance (\$50) to insurance expense
- 31 Counted \$100 of supplies still on hand (recorded the amount used as supplies expense).

*Required:*

1. Open general ledger T-accounts for the following (account numbers are indicated in brackets): Cash (101), Accounts Receivable (110), Prepaid Insurance (161), Unused Supplies (173), Truck (184), Bank Loan (201), Accounts Payable (210), Share Capital (320), Fees Earned (420), Advertizing Expense (610), Insurance Expense (631), Rent Expense (654), Salaries Expense (656), Supplies Expense (668), Telephone Expense (669), and Truck Operating Expense (670).
2. Prepare journal entries to record the August transactions including general ledger account numbers.
3. Post these entries to the T-accounts. Total each account.
4. Prepare a trial balance at August 31, 2015.
5. Prepare an income statement and statement of changes in equity for the month ended August 31, 2015 and a balance sheet at August 31, 2015.

### 2.7.3.6 P 2-6



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The following transactions took place in Chan Renovations Corporation during June 2015, its first month of operation.

- Jun. 1 Issued share capital for \$8,000 cash
- 1 Purchased \$5,000 of equipment on credit
- 2 Collected \$600 cash for repairs completed today
- 3 Paid \$20 for supplies used today
- 4 Purchased \$1,000 of supplies on credit (recorded as unused supplies)
- 5 Billed customers \$2,500 for repairs performed to date
- 8 Collected \$500 of the amount billed on June 5
- 10 Paid half of the amount owing for equipment purchased on June 1
- 15 Sold excess equipment for \$1,000 (its original cost). The buyer will pay this amount in several months. (Recorded as accounts receivable).
- 18 Paid for the supplies purchased on June 4
- 20 Received a \$100 bill for electricity used to date (recorded as utilities expense)
- 22 Paid \$600 to the landlord for June and July rent (recorded as prepaid rent)
- 23 Signed a union contract that will increase wages 5% this year.
- 25 Collected \$1,000 of the amount billed on June 5
- 27 Paid the following expenses in cash: advertizing, \$150; telephone, \$50; truck operating expense, \$1,000; wages, \$2,500

- 30 Billed customers \$2,000 for repairs completed to date
- 30 Transferred the amount for June's rent to rent expense (\$300)
- 30 Counted \$150 of supplies still on hand (recorded the amount used as supplies expense).

*Required:*

1. Open general ledger T-accounts for the following (account numbers are indicated in brackets): Cash (101), Accounts Receivable (110), Prepaid Rent (162), Unused Supplies (172), Equipment (183), Accounts Payable (210), Share Capital (320), Repair Revenue (450), Advertising Expense (610), Rent Expense (654), Supplies Expense (668), Telephone Expense (669), Truck Operating Expense (670), Utilities Expense (676), and Wages Expense (677).
2. Prepare journal entries to record the June transactions including general ledger account numbers.
3. Post the June entries to the T-accounts.
4. Prepare a trial balance at June 30, 2015
5. Prepare an income statement and statement of changes in equity for the month ended June 30, 2015 and a balance sheet at June 30, 2015.

## 2.7.4 Alternate Problems

### 2.7.4.1 AP 2-1



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The following account balances are taken from the general ledger of Chipcura Repairs Corporation at November 30, 2015.

Accounts payable	\$5,000	Rent expense	\$700
Accounts receivable	6,000	Repair revenue	8,350
Advertising expense	500	Salaries expense	3,000
Bank loan	4,500	Salaries payable	1,000

Cash	2,000	Unused supplies	500
Share capital	8,000	Supplies expense	250
Commissions expense	1,500	Truck	8,000
Equipment	3,500	Truck operating expense	900

*Required:*

1. Prepare a trial balance at November 30, 2015. Ensure total debits equal total credits. General ledger account numbers (folio) are not necessary.
2. Prepare an interim income statement and statement of changes in equity for the month ended November 30, 2015.
3. Prepare an interim balance sheet at November 30, 2015.

### 2.7.4.2 AP 2-2



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The following accounts were prepared for McRann Auto Repairs Corporation during the first month of operation ending July 31, 2015. No journal entries were prepared in support of the amounts recorded in the ledger accounts.

Cash	No. 101	Acc. Pay.	No. 210	Share Capital	No. 320	Repair Revenue	No. 450
a. 3,000	b. 1,000	i. 300	b. 6,000	a. 3,000		c. 2,500	
e. 1,500	f. 400	k. 1,100	d. 500			e. 1,500	
g. 1,200	h. 600		o. 200			m. 3,500	
j. 2,000	i. 300		p. 100				
	k. 1,100						
	l. 3,200						
						Advertisizing Expense	No. 610
						p. 100	
Acct. Rec.	No. 110					Insurance Expense	No. 631
c. 2,500	g. 1,200					n. 50	
m. 3,500	j. 2,000						
Ppd. Ins.	No. 161					Rent Expense	No. 654
h. 600	n. 50					f. 400	
Un. Supp.	No. 173					Salaries Expense	No. 656
d. 500	q. 150					l.	
Truck	No. 184					Supplies Expense	No. 668
b. 7,000						q.	

Required:

1. Reconstruct the transactions that occurred during the month and prepare journal entries to record them, including descriptions and account numbers.
2. Calculate the balance in each general ledger T-account.
3. Prepare a trial balance at July 31, 2015. Ensure total debits equal total credits.

### 2.7.4.3 AP 2-3



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The following trial balance was prepared for Overeen Consulting Corporation at March 31, 2015, its first month of operation.

### Overeen Consulting Corporation Trial Balance March 31, 2015

Acct. No.	Account	Account Balances	
		Debits	Credits
210	Accounts payable	\$ 5,000	
110	Accounts receivable		\$ 3,000
101	Cash	1,500	
320	Share capital	3,000	
183	Equipment	2,000	
236	Utilities payable		3,550
420	Fees earned	6,900	
610	Advertizing expense		100
631	Insurance expense	50	
654	Rent expense		600
184	Truck		8,000
676	Utilities expense		200
677	Wages expense		3,000

Required:

1. Prepare a trial balance showing the balances in the correct column. List the accounts in numerical order. Total the columns and ensure total debits equal total credits. Assume all accounts have normal balances.
2. Prepare an income statement and statement of changes in equity for the month ended March 31, 2015.
3. Prepare a balance sheet at March 31, 2015.

### 2.7.4.4 AP 2-4



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The following balances appeared in the general ledger of Owens Truck Rentals Incorporated at May 1, 2015.

Cash	\$1,600	Accounts payable	\$4,000
Unused supplies	400	Share capital	8,000
Equipment	3,000		
Trucks	7,000		

The following transactions occurred during May:

- a. Collected \$5,000 cash for truck rentals during the month
- b. Paid \$500 rent expense
- c. Paid \$1,500 to a creditor
- d. Paid \$600 for a one-year insurance policy effective May 1
- e. Purchased a rental truck for \$5,000 on credit
- f. Paid the following expenses: advertizing, \$300; salaries, \$2,500; telephone, \$150; truck repairs, \$550
- g. Transferred the amount of May's insurance (\$50) to Insurance Expense.
- h. Estimated \$200 of supplies to have been used during May (record as supplies expense)
- i. Issued additional share capital for \$2,000 cash
- j. Paid dividends of \$50.



*Required:*

1. Open general ledger T-accounts for the following and enter the May 1 balances (account numbers are indicated in brackets): Cash (101), Prepaid Insurance (161), Unused Supplies (173), Equipment (183), Trucks (184), Accounts Payable (210), Share Capital (320), Rent Earned (440), Advertising Expense (610), Insurance Expense (631), Rent Expense (654), Salaries Expense (656), Supplies Expense (668), Telephone Expense (669), and Truck Operating Expense (670).
2. Prepare journal entries to record the May transactions including general ledger account numbers.
3. Post the journal entries to the T-accounts. Total each account.
4. Prepare a trial balance at May 31, 2015.
5. Prepare an interim income statement and statement of changes in equity for the month ended May 31, 2015 and an interim balance sheet at May 31, 2015.

**2.7.4.5 AP 2-5**

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Oneschuk Contractors Corporation had the following transactions during its first month of operation ended May 31, 2015:

May	1	Issued share capital for \$5,000 cash
	1	Paid \$1,500 for three months' rent in advance: May, June, and July (recorded as prepaid rent)
	2	Purchased \$1,000 of supplies on credit (recorded as unused supplies)
	3	Billed a customer \$1,500 for repairs performed
	4	Paid \$50 for an advertisement in <i>The Daily Bugle</i>
	5	Received \$250 cash for contracting work completed today
	10	Collected the amount billed on May 3
	15	Paid \$500 to a creditor
	18	Borrowed \$2,000 cash from the bank

- 20 Signed a contract for \$10,000 work to be done in June
- 22 Purchased \$3,000 of equipment; paid cash
- 25 Billed customers \$3,500 for work completed to date
- 27 Paid the following expenses: electricity, \$75; telephone, \$25; wages, \$2,000
- 31 Transferred the amount of May's rent from prepaid rent to rent expense (\$500)
- 31 Counted \$200 of supplies still on hand; the rest had been used during May.

*Required:*

1. Open general ledger T-accounts for the following (account numbers are indicated in brackets): Cash (101), Accounts Receivable (110), Prepaid Rent (162), Unused Supplies (173), Equipment (183), Bank Loan (201), Accounts Payable (210), Share Capital (320), Repair Revenue (450), Advertising Expense (610), Rent Expense (654), Supplies Expense (668), Telephone Expense (669), Utilities Expense (676), and Wages Expense (677).
2. Prepare journal entries to record the May transactions, including account numbers.
3. Post the journal entries to the T-accounts. Total each account.
4. Prepare a trial balance at May 31, 2015. Ensure total debits equals total credits.
5. Prepare an interim income statement and statement of changes in equity for the month ended May 31, 2015 and an interim balance sheet at May 31, 2015.

### 2.7.4.6 AP 2-6



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Sandul Snow Removal Corporation had the following transactions during its first month of operation, December 2015:

- Dec. 1 Issued share capital for \$6,000 cash
- 1 Purchased a used truck for \$9,000: paid \$4,000 cash, balance borrowed from the bank

- 
- 2 Purchased a \$2,000 snow plough on credit  
(recorded as an increase in the cost of the truck)
- 3 Billed customers \$5,000 for December snow  
removal (Sandul's customers are billed at the  
beginning of each month)
- 5 Purchased salt, sand, and gravel for \$500 on credit  
(recorded as unused supplies)
- 6 Paid truck repair expenses of \$200
- 7 Paid \$360 for a one-year insurance policy effective  
December 1 (recorded as prepaid insurance)
- 14 Paid \$1,500 for two weeks wages
- 16 Paid \$40 cash for advertizing
- 20 Received a bill for \$350 for truck repairs
- 24 Purchased tire chains on credit for \$100 (recorded  
as truck operating expense)
- 24 Collected \$3,500 from customers billed on  
December 3
- 27 Paid for the purchase made on December 5
- 28 Collected \$400 for snow removal performed today  
for a new customer
- 28 Paid \$1,500 for two weeks wages
- 30 Called customers owing \$1,500 billed on December  
3 and not yet paid
- 31 Transferred the amount of December's truck  
insurance to insurance expense (\$30)

- 31 Counted \$100 of salt, sand, and gravel still on hand (recorded the amount used as supplies expense)
- 31 Recorded three days wages of \$450 applicable to December 29, 30, and 31, to be paid in January, 2016.

*Required:*

1. Open general ledger T-accounts accounts for the following (account numbers are indicated in brackets): Cash (101), Accounts Receivable (110), Prepaid Insurance (161), Unused Supplies (173), Truck (184), Bank Loan (201),Accounts Payable (210), Wages Payable (237), Share Capital (320), Service Revenue (470), Advertizing Expense (610), Insurance Expense (631), Supplies Expense (668), Truck Operating Expense (670), and Wages Expense (677).
2. Prepare journal entries to record the December transactions including general ledger account numbers.
3. Post the journal entries to the T-accounts. Total each account.
4. Prepare a trial balance at December 31, 2015. Ensure total debits equal total credits.
5. Prepare an income statement and statement of changes in equity for the month ended December 31, 2015 and a balance sheet at December 31, 2015.

**2.7.4.7 AP 2-7**



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Accounts included in the trial balance of the John Saul Corporation as of November 30, 2015 were as follows:

<i>Acct.</i>	<i>Account</i>	<i>Balance</i>
<i>No.</i>	<i>Account</i>	<i>Balance</i>
101	Cash	\$25,200
110	Accounts receivable	12,000
162	Prepaid rent	1,500
180	Land	12,000

181	Building	24,000
182	Furniture	9,000
183	Equipment	75,000
184	Truck	3,500
210	Accounts payable	4,000
320	Share capital	158,200
340	Retained earnings	-0-

The following transactions were completed during the month of December:

Dec.	2	Paid \$200 of the accounts payable
	3	Collected in full an account receivable of \$700
	4	Purchased equipment for \$500 cash
	5	Billed customers for \$2,000 of services provided in December
	8	Issued additional shares for \$20,000 cash
	10	Collected \$1,500 owing from a customer
	11	Purchased equipment for \$25,000; paid \$5,000 cash, the balance to be paid within 30 days (recorded as accounts payable)
	15	Paid salaries of \$1,000
	16	Paid \$600 of the accounts payable

- 20 Paid \$15,000 cash in partial settlement of the liability of December 11; issued a note payable for the balance
- 24 Paid utilities of \$50
- 30 Received a bill for December telephone services
- 31 Collected in full an account receivable of \$400
- 31 Paid salaries of \$1,000
- 31 Transferred \$500 prepaid rent to rent expense for December
- 31 Received \$1,000 cash for services to be performed in January 2016.

*Required:*

1. Open general ledger T-accounts for the accounts listed in the trial balance above. Add accounts and account numbers as follows:

Bank loan	201
Other unearned revenue	249
Service revenue	470
Rent expense	654
Salaries expense	656
Telephone expense	669
Utilities expense	676

2. Enter the November 30 balances and ensure total debits equal total credits. Journalize the December transactions.
3. Post the December entries and determine the balances for each general ledger account at December 31.
4. Prepare a trial balance as at December 31, 2015. Ensure total debits equals total credits.
5. Prepare an income statement and statement of changes in equity for the month ended December 31, 2015 and a balance sheet as at December 31, 2015.

## 2.7.5 Decision Problem

### 2.7.5.1 DP 2-1



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Stan Samuelson, a second-year university business student, had a hard time finding an enjoyable summer job that paid well. He decided to start his own business. He and two high school friends established a home repair company. Stan runs the business side of the operation while his two friends, Owen Saltz and Mort Schnitzler, do the majority of the home repairs. Stan fills in as needed.

A corporation was formed. It issued \$1,000 of share capital to each student on June 1, 2015 for total cash consideration of \$3,000. The three called the company Sam, Salt, and Schnitz Corp. (SSS). SSS agreed to rent a van from Jim Stephens for \$200 per month; under this agreement, SSS was liable for all fuel and repair bills. After this transaction, the corporation was ready to begin business.

The business proved to be successful from the start. Stan spent most of his time promoting the business, making sales calls, and writing up estimates. He devoted little effort toward establishing an accounting system. He thought that SSS could get by with only a chequebook. So that all transactions would pass through the chequebook, Stan arranged with local businesses to pay all the corporation's expenses by cheque.

On August 31, the students had completed their summer's work and prepared to return to school. All payments from customers were received and all suppliers' bills were paid. The students asked Owen's sister, Amanda, to determine the financial position of SSS at August 31.

From the records, Amanda discovered that receipts from customers for the summer totalled \$35,542. The repair materials bought for use by SSS amounted to \$24,500, with \$2,500 of unused material (paint, lumber, nails, and electrical fixtures) remaining; of these 80 per cent could be returned for full credit, while 20 per cent had to be



expensed. Other expenses incurred were \$75 for advertizing, and \$375 for fuel and oil for the van. The three students paid themselves \$1,500 each on August 31 for the summer. The bank balance for SSS on August 31 was \$8,492. The unused supplies had not yet been returned. Amanda was still owed \$300 for her work.

*Required:*

1. Open general ledger T-accounts as needed and post the transactions. Ignore account numbers.
2. Prepare an income statement and statement of changes in equity for the three months ended August 31, 2015 and a balance sheet at August 31, 2015.
3. If each student worked 190 hours per month from June 1 through August 31, how successful have they been?

# Chapter 3 Financial Accounting and the Use of Adjusting Entries



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Chapters 1 and 2 described the recording and reporting of economic transactions in detail. However, the account balances used to prepare the financial statements in these previous chapters did not necessarily reflect correct amounts. Chapter 3 introduces the concept of *adjusting entries* and how these satisfy the *matching principle*. This enables revenues and expenses to be reported in the correct accounting period. The preparation of an adjusted trial balance is discussed, as well as its use in completing financial statements. At the end of the accounting period, after financial statements have been prepared, it is necessary to close temporary accounts to retained earnings. This process is introduced in this chapter, as is the preparation of a postclosing trial balance. The accounting cycle – the steps performed each accounting period to produce financial statements – is also reviewed.

## Learning Objectives

LO1 – Explain how adjusting entries match revenues and expenses to the appropriate time period.

LO2 – Explain the use of and prepare the adjusting entries required for prepaid expenses, depreciation, unearned revenues, accrued revenues, and accrued expenses.

LO3 – Prepare an adjusted trial balance and explain its use.

LO4 – Use an adjusted trial balance to prepare financial statements.

LO5 – Identify and explain the steps in the accounting cycle.

LO6 – Explain the purpose of closing entries and use closing entries to prepare a post-closing trial balance.

## 3.1 The Operating Cycle



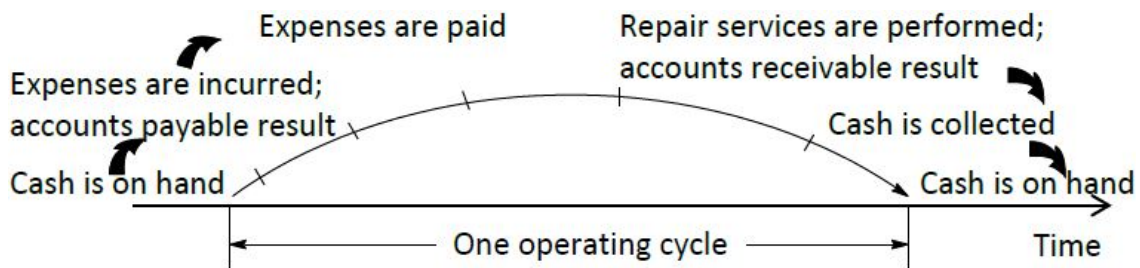
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LO1 – Explain how adjusting entries match revenues and expenses to the appropriate time period.

Financial transactions occur continuously during an accounting period as part of a sequence of operating activities. For Big Dog Carworks Corp., this sequence of operating activities takes the following form:

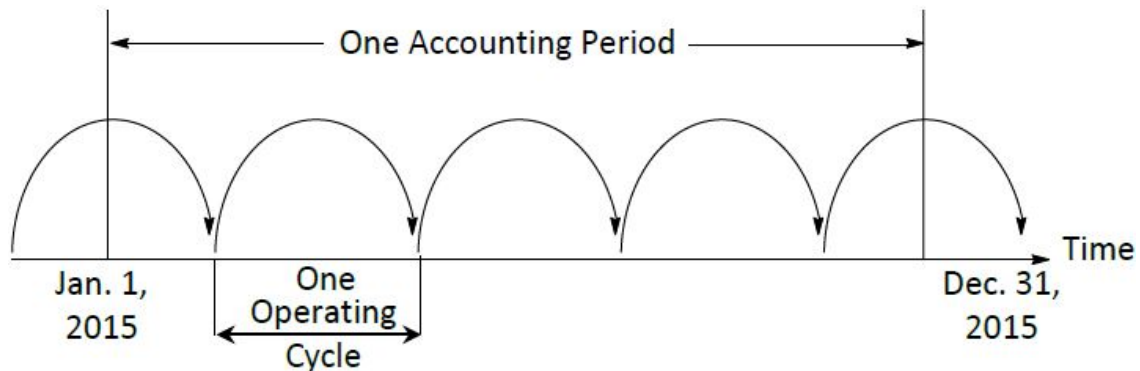
1. Operations begin with some cash on hand.
2. Cash is used to purchase supplies and to pay expenses.
3. Revenue is earned as repair services are completed for customers.
4. Cash is collected from customers.

This cash-to-cash sequence of transactions is commonly referred to as the **operating cycle** and is illustrated in [Figure 3.1](#).



**Fig. 3.1: One Operating Cycle**

Depending on the type of business, an operating cycle can vary in duration from short, such as one week (for example, a small grocery store) to much longer, such as one year (for example, a large construction company). Therefore, an annual accounting period could involve multiple operating cycles as shown in [Figure 3.2](#).



**Fig. 3.2: Operating Cycles Within an Annual Accounting Period**

Notice that not all of the operating cycles in [Figure 3.2](#) are completed within the accounting period. Since financial statements are prepared at specific time intervals to meet the GAAP requirement of timeliness, it is necessary to consider how to record and report transactions related to the accounting period's incomplete operating cycles. There are two criteria. These are discussed in the following section.

### 3.1.1 Revenue Recognition Principle in More Detail



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GAAP provide guidance about when financial transactions should be recognized in financial statements. At this point in our studies, a financial transaction is recognized when it meets two criteria:

1. It is probable that any future economic benefit (usually cash) associated with the transaction will be received or paid at some time in the future; and
2. The value of the transaction can be reliably measured.

### 3.1.2 Revenue Recognition Illustrated



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**Revenue recognition** is the process of recording revenue in the accounting period in which it was earned; this is not necessarily when cash is received. Most corporations assume that revenue has been earned at a consistent point in the accounting cycle. For instance, it is often convenient to recognize revenue at the point when a sales invoice has been sent to a customer and the related goods have been shipped or services performed. This point can occur before receipt of cash from a customer, creating an asset called *Accounts Receivable*. This concept was illustrated in Transaction 8 in Chapter 2. The general form of the journal entry is as follows, based on the format for entries in the general journal discussed in the prior chapter:

2015			
Date	Accounts Receivable	XX	
	Revenue		XX
	<i>To record revenue earned on credit; cash will be paid at a later date.</i>		

When cash payment is later received, the asset *Accounts Receivable* is exchanged for the asset *Cash* and the following entry is made:

2015			
Date	Cash	XX	
	Accounts Receivable		XX
	<i>To record cash received from credit customer.</i>		

Revenue is recognized in the first entry (the credit to revenue), prior to the receipt of cash. The second entry has no effect on revenue.

When cash is received at the same time that revenue is recognized, the following entry is made:

2015			
Date	Cash	XX	
	Revenue		XX
	<i>To record cash received from customer at time of sale.</i>		

Transaction 8 in Chapter 2 illustrated these two possibilities.

When a cash deposit or advance payment is obtained *before* revenue is earned, a liability called Unearned Revenue is recorded as follows:

2015			
Date	Cash	XX	
	Unearned Revenue		XX
	<i>To record cash received from customer for work to be done in the future.</i>		

Transaction 7 in Chapter 2 illustrated this. There is no effect on the income statement at this point. Revenue is recognized only when the services have been performed. At that time, the following entry is made:

2015			
Date	Unearned Repair Revenue	XX	
	Repair Revenue		XX
	<i>To record the earned portion of Unearned Revenue.</i>		

This entry reduces the unearned revenue account by the amount of revenue earned. At this point, revenue is recognized in the income statement account called Repair Revenue.

The matching of revenue to a particular time period, regardless of when cash is received, is an example of *accrual accounting*. **Accrual accounting** is the process of recognizing revenues when earned and expenses when incurred regardless of when cash is exchanged. Accrual accounting is an important generally accepted accounting principle. It allows revenue and expenses to be matched to the applicable time period, regardless of when cash receipts or outlays occur. Recognition of expenses is discussed in the next section.

### 3.1.3 Expense Recognition Illustrated



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In a business, costs are incurred continuously. To review, a cost is recorded as an asset if it will be incurred in producing revenue in future accounting periods. A cost is recorded as an expense if it will be used or consumed during the current period to earn revenue. This distinction between types of cost outlays is illustrated in [Figure 3.3](#).



2015			
Date	Prepaid Insurance	XX	
	Cash		XX
	<i>To record payment of insurance in advance.</i>		

Transaction 5 in Chapter 2 illustrated this. As the prepaid insurance benefit is used up, the appropriate expense is reported on the income statement by following entry:

2015			
Date	Insurance Expense	XX	
	Prepaid Insurance		XX
	<i>To record the expiry of Prepaid Insurance.</i>		

The preceding examples illustrate how to *match* expenses to the appropriate accounting period. The **matching principle** requires that expenses be reported in the same period as the revenues they helped generate. That is, expenses are reported on the income statement: a) when related revenue is recognized, or b) during the appropriate time period, regardless of when cash is paid.

To ensure the recognition and matching of revenues and expenses to the correct accounting period, account balances must be reviewed and adjusted prior to the preparation of financial statements. This is the topic of the next section.

## 3.2 Adjusting Entries



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LO2 – Explain the use of and prepare the adjusting entries required for prepaid expenses, depreciation, unearned revenues, accrued revenues, and accrued expenses.

At the end of an accounting period, before financial statements can be prepared, the accounts must be reviewed for potential adjustments. This review is done by using the **unadjusted trial balance**. The trial balance of Big Dog Carworks Corp. at January 31 was prepared in Chapter 2 and is reproduced in [Figure 3.4](#) below. It is an unadjusted trial balance because the accounts have not yet been updated for accruals and other adjustments. We will use this trial balance to illustrate how adjustments are identified and recorded.



Big Dog Carworks Corp.  
Unadjusted Trial Balance  
At January 31, 2015

Acct. No.	Account	Balance	
		Debit	Credit
101	Cash	\$6,200	
110	Accounts receivable	2,500	
161	Prepaid insurance	2,400	
183	Equipment	3,000	
184	Truck	8,000	
201	Bank loan		\$9,000
210	Accounts payable		700
247	Unearned revenue		400
320	Share capital		10,000
350	Dividends	200	
450	Repair revenue		10,000
654	Rent expense	1,600	
656	Salaries expense	4,000	
668	Supplies expense	1,500	
670	Truck operating expense	700	
		<u>\$30,100</u>	<u>\$30,100</u>

Fig. 3.4: Unadjusted Trial Balance of Big Dog Carworks Corp. at January 31, 2015

Adjustments are recorded with **adjusting entries**. Their purpose is to ensure both the balance sheet and the income statement more accurately represent financial information. Adjusting entries help satisfy the matching principle.

There are five types of adjusting entries, each of which will be discussed in the following sections.

1. Adjust prepaid assets;
2. Adjust unearned liabilities;
3. Adjust plant and equipment assets;
4. Adjust accrued revenues; and
5. Adjust accrued expenses

An **accrued revenue** is a revenue that has been earned but has not yet been collected or recorded. An **accrued expense** is an expense that has been incurred but has not yet been paid or recorded.

### 3.2.1 Adjusting Prepaid Asset Accounts



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An asset or liability account requiring adjustment at the end of an accounting period is referred to as a **mixed account** because it includes both a balance sheet portion and an income statement portion. The income statement portion must be removed from the balance sheet account by an adjusting entry.

Refer to [Figure 3.4](#) which shows an unadjusted balance in prepaid insurance of \$2,400. Recall from Chapter 2 that Big Dog paid for a 12- month insurance policy that went into effect on January 1 (transaction 5).

The unadjusted trial balance shows the following balance in the Prepaid Insurance account:

Prepaid Insurance
2,400

The balance resulted when the journal entry below was recorded:

Prepaid Insurance	2,400	
Cash		2,400

At January 31, one month or \$200 of the policy has expired (been used up) calculated as  $\$2,400/12 \text{ months} = \$200$ .

The adjusting entry on January 31 to transfer \$200 out of prepaid insurance and into insurance expense is:

		(a)	
2015			
Jan. 31	Insurance Expense	200	
	Prepaid Insurance		200
<i>To adjust for the use of one month of Prepaid Insurance.</i>			

As shown below, the balance remaining in the Prepaid Insurance account is \$2,200 after the adjusting entry is posted. The \$2,200 balance represents the unexpired asset that will benefit future periods, namely, the 11 months from February to December, 2015. The \$200 transferred out of prepaid insurance is posted as a debit to the Insurance Expense account to show how much insurance has been used during January.

Insurance Expense	Prepaid Insurance
200	2,400
	200
	Bal. 2,200

←

An expense account, Insurance Expense, is increased by the benefit used up in January.

The asset account, Prepaid Insurance, is decreased by the \$200 of insurance coverage that expired during January.

If the adjustment was not recorded, assets on the balance sheet would be overstated by \$200 and expenses would be understated by the same amount on the income statement.

### 3.2.2 Adjusting Unearned Liability Accounts



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Recall from Chapter 2 (Transaction 7) that on January 15, Big Dog received a \$400 cash payment in advance of services being performed: \$300 for January and \$100 for February.

The unadjusted trial balance shows the following in the Unearned Repair Revenue account:

The receipt of the \$400 advance payment was recorded as follows:

<b>Unearned Repair Revenue</b>		<b>Cash</b>	
400		400	
		<b>Unearned Repair Rev.</b>	<b>400</b>

This advance payment was originally recorded as unearned revenue, since the cash was received *before* repair services were performed. Assume now that at January 31, \$300 of the \$400 unearned amount has been earned. Therefore, \$300 must be transferred from unearned repair revenue into repair revenue. The adjusting entry at January 31 is:

(b)

2015

Jan. 31	Unearned Repair Revenue	300	
	Repair Revenue		300
	<i>To adjust for repair revenue earned.</i>		

After posting the adjustment, the \$100 remaining balance in unearned repair revenue (\$400 - \$300) represents the amount at the end of January that will be earned in February.

Unearned Repair Revenue		Repair Revenue	
	400		10,000
300		→	300
	100 Bal.		10,300 Bal.
<p>A liability account, unearned repair revenue, is decreased by the \$300 adjustment.</p>		<p>A revenue account, repair revenue, is increased by the \$300 adjustment.</p>	

If the adjustment was not recorded, unearned repair revenue would be overstated (too high) by \$300 causing liabilities on the balance sheet to be overstated. Additionally, revenue would be understated (too low) by \$300 on the income statement.

### 3.2.3 Adjusting Plant and Equipment Accounts



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Plant and equipment assets, also known as *long-lived assets*, are expected to generate revenues over the current and future accounting periods because they are used to produce goods, supply services, or used for administrative purposes. The truck and equipment purchased by Big Dog Carworks Corp. in January are examples of assets that provide economic benefits for more than one accounting period. Because of this, their costs also must be spread over the same time period, or **useful life**. Useful life is an estimate of how long the asset will be used to produce benefits for the business. This is done to satisfy the matching principle. For example, the \$100,000 cost of a machine expected to be used over five years is not expensed entirely in the year of purchase because the benefits it provides will last for several years. Immediately expensing the purchase would cause expenses to be overstated in Year 1 and understated in Years 2, 3, 4, and 5. More appropriately, the \$100,000 cost should be spread over the asset's five-year useful life.

The process of allocating the cost of a long-lived asset over the period of time it is expected to be used is called **depreciation**. Various depreciation methods and considerations are discussed in a later chapter.

For our purposes here, the benefit of plant and equipment that is used up each month will be calculated as its cost divided by its estimated useful life, calculated in months.

Let's work through two examples to demonstrate depreciation adjustments. Recall that in January, BDCC purchased two assets – equipment and a truck. Assume that they are considered long-lived asset because they have an estimated useful life greater than one year. The equipment was purchased for \$3,000 (Transaction 3, Chapter 2). If its actual useful life is 10 years (120 months), monthly depreciation expense is \$25, calculated as:

$$\frac{\text{Cost}}{\text{Estimated Useful Life}} = \frac{\$3,000}{120 \text{ months}} = \$25/\text{month}$$

The following adjusting entry is made in the records of BDCC on January 31:

(c)

2015

Jan. 31	Depreciation Expense – Equipment	25	
	Accumulated Depreciation – Equipment		25
	<i>To record one month of depreciation expense on the equipment (\$3,000/120 months).</i>		

Notice that the credit side of the entry is not made to the Equipment account. Rather, a **contra account** called “Accumulated Depreciation – Equipment” is used. A contra account is a general ledger account that is related to another account (in this case, Equipment). It has a credit balance, which is subtracted from the debit balance of its related account on the financial statements. **Accumulated depreciation** is a contra account that records the amount of a particular asset's cost that has been expensed since it was put into use. The original cost of the long-lived asset needs to be maintained in the accounting records in case it is sold. Maintaining a separate accumulated depreciation contra account allows this original cost to be retained in the records.

When this adjusting entry is posted, the accounts appear as follows:



Equipment	Accumulated Depreciation – Equipment	Depreciation Expense – Equipment
3,000	25	25

The Equipment account remains unchanged by the adjusting entry.

A contra account, accumulated depreciation, is increased by \$25.

Depreciation expense is increased by \$25, the amount of the equipment's cost that has been allocated to expense.

For financial statement reporting, the asset and contra asset accounts are combined. This **carrying amount** or *net book value* of the equipment on the balance sheet is shown as \$2,975 (\$3,000 – \$25) at January 31, like this:

Equipment	3,000
Acc. Dep. – Equip.	(25)
Carrying amount	2,975

Recall that BDCC also purchased a truck for \$8,000 during January (Transaction 4, Chapter 2). Assume the truck has an estimated useful life of 80 months. At January 31, one month of the truck cost has expired. Depreciation is calculated as:

$$\frac{\text{Cost}}{\text{Estimated Useful Life}} = \frac{\$8,000}{80 \text{ months}} = \$100/\text{month}$$

The adjusting entry recorded on January 31 is:

(d)

2015

Jan. 31	Depreciation Expense, Truck	100
	Accumulated Depreciation, Truck	100

*To record one month of depreciation expense on the truck (\$8,000/80 months).*

When the adjusting entry is posted, the accounts appear as follows:

Truck	Accumulated Depreciation - Truck	Depreciation Expense - Truck
8,000	100	100

The Truck account remains unchanged by the adjusting entry.

A contra account, accumulated depreciation, is increased by \$100.

Depreciation expense is increased by \$100, the amount of the truck's cost that has been allocated to expense.

The value of the truck on the balance sheet at January 31 is shown as \$7,900 (\$8,000 – \$100), like this:

Truck	8,000
Acc. Dep. – Truck.	<u>(100)</u>
Carrying amount	7,900

Although land is a long-lived asset, it is not depreciated because its benefits do not decrease over time. Therefore, land is often referred to as a *non-depreciable asset*.

### 3.2.4 Adjusting for Accrued Revenues and Expenses



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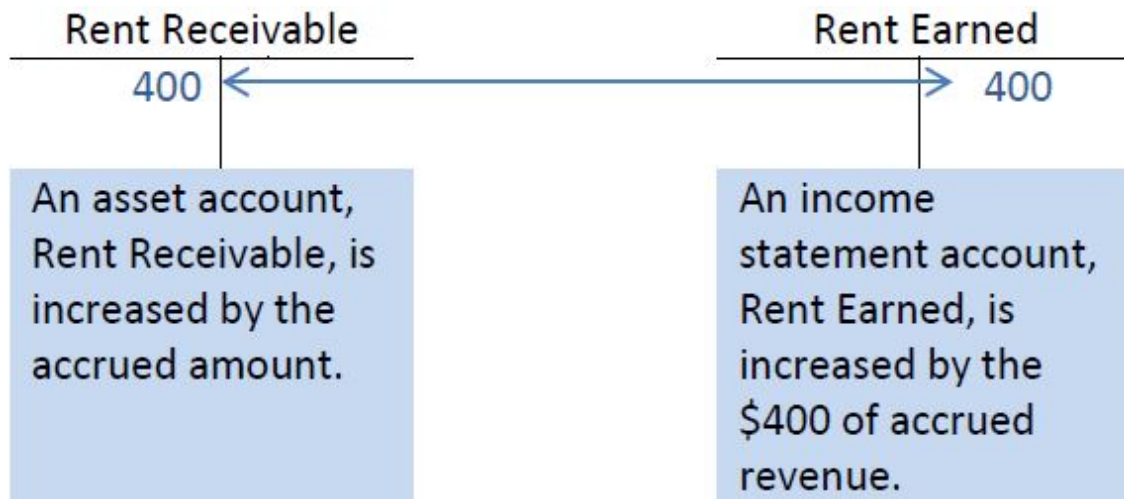
Some revenues and expenses increase as time passes and are therefore said to *accrue*. **Accrued revenues** and **accrued expenses** are items that need to be reported in the income statement for a certain time period. However, they are not recognized by the accounting system until they are received or paid in cash, because there are no source documents like sales invoices or purchase invoices to trigger their recording. Often these types of revenue and expenses need to be recognized earlier in the accounting records. This is done by adjusting entries. Common types of accrued revenues are rent and interest from investments. Common expenses are interest on debt, salaries, and income taxes.

Accrued revenues are revenues that have been earned but not yet collected or recorded. Assume that BDCC has rented out part of the building in which it operates to another business (this is often called a *sublet*) as of January 1, 2015. The rent is \$400 per month. If the rent has not been paid to BDCC by January 31, and an accrued revenue amount needs to be recorded, as follows:

(e)			
2015			
Jan. 31	Rent Receivable	400	
	Rent Earned		400
	<i>To record January rent from sublet.</i>		

When the adjusting entry is posted, the accounts appear as follows:





In this way, rent revenue would be appropriately reported in the January income statement. If the adjustment was not recorded, assets on the balance sheet would be understated by \$200 and revenues would be understated by the same amount on the income statement.

If the rent payment is received on February 3, the entry to record this would be:

2015

Feb. 3	Cash	400	
	Rent Receivable		400
	<i>To record receipt of January rent from sublet.</i>		

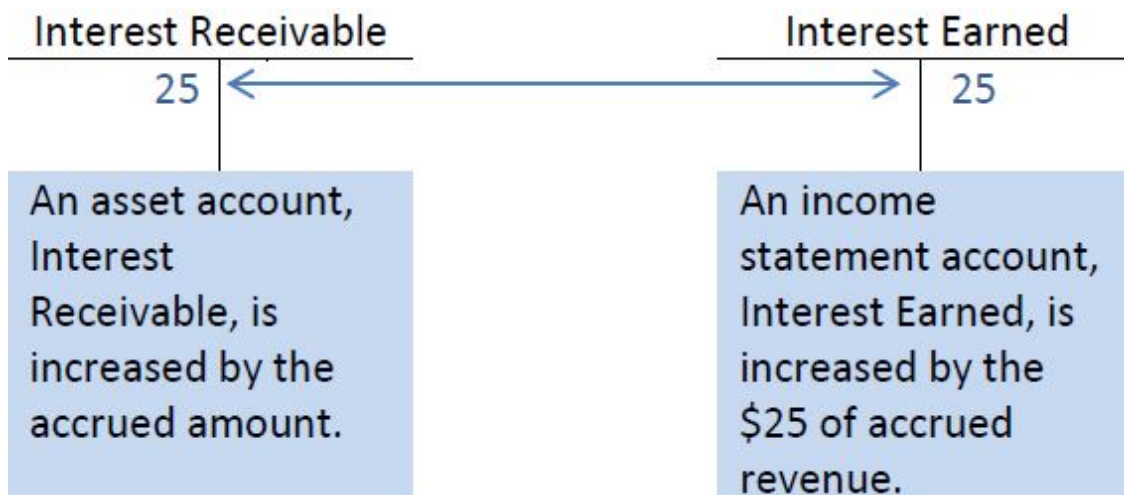
Another example of accrued revenue is interest receivable. Assume that cash on deposit with the bank pays interest every three months and that the interest revenue earned on the account is \$25 at January 31. An accrued revenue amount needs to be recorded at January 31, as follows:

(f)

2015

Jan. 31	Interest Receivable	25	
	Interest Earned		25
	<i>To record January accrued revenue on chequing account.</i>		

When the adjusting entry is posted, the accounts appear as follows:



Accrued expenses are expenses that have been incurred but not yet paid or recorded. Like accrued revenue, these items are not usually recorded in the accounting records because they are not recorded on source documents like a sales invoice or a bill from a supplier. An example of an accrued expense in the case of BDCC is interest expense. Interest expense arises when a business borrows money from a financial institution like a bank. Interest accrues (increases) daily but is paid only at certain time, perhaps monthly or every six months.

For Big Dog Carworks Corp., the January 31, 2015 unadjusted trial balance shows a \$9,000 bank loan balance. Recall from Chapter 2 that this consists of a \$4,000 loan on January 2 (Transaction 2), an additional \$7,000 loan on January 3 (Transaction 3), and a repayment of \$2,000 on January 10 (Transaction 6). No interest has been paid on this loan as of January 31 because there is no interest expense recorded in the income statement. However, interest has been accruing on the loans since they were received. The interest needs to be recorded by means of adjusting entry.

Assume that interest expense amounts to \$18. BDCC's adjusting entry to accrue this expense on January 31 is:

		(g)		
2015				
Jan. 31	Interest Expense		18	
	Interest Payable			18
	<i>To record January accrued interest on the bank loan.</i>			

This adjusting entry enables BDCC to include the interest expense on the January income statement even though interest has not yet been paid. The entry also creates a payable that will be reported as a liability on the balance sheet at January 31.

When the adjusting entry is posted, the accounts appear as:

<b>Interest Expense</b>		<b>Interest Payable</b>
18	←————→	18
An expense account is established to record the debit.		Interest payable (a liability) is established to record the credit.

### 3.2.5 Accruing Salaries Expense



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Transaction 9 in Chapter 2 included a \$4,000 cash payment for salaries expense. ("Wages" are similar expenses, paid to hourly workers.) Let's assume that the payments were for work performed by staff only until January 28. There are four days of salary that have not been paid to January 31. Assume this amounts to \$150. This

additional accrued expense for work done on January 28, 29, 30, and 31 needs to be recorded to appropriately match the salaries expense to the month of January. This is the adjusting entry:

(h)

2015				
Jan. 31	Salaries Expense	150		
	Salaries Payable		150	
	<i>To accrue salaries for January 28-31.</i>			

This entry enables the company to include in expense all salaries earned by employees, even though these amounts will not be paid in cash until the next pay period in February. The entry creates an accrued liability for an expense incurred during one accounting period (January) but paid in another accounting period (February).

When the adjusting entry is posted, the accounts appear as follows:

Salaries Expense		Salaries Payable
4,000		
150	←—————→	150
Bal. 4,150		

An additional \$150 expense is recorded for the period ended January 31.

A liability, Salaries Payable, is created at January 31.

### 3.2.6 Accruing Income Taxes Expense



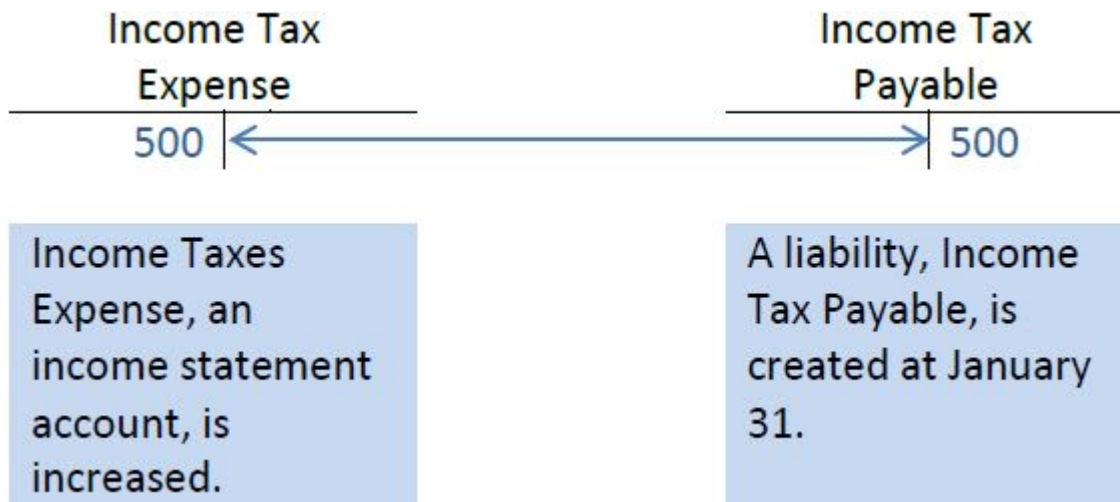
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Corporate income taxes expense also needs to be accrued for BDCC. In most jurisdictions, a corporation is taxed as an entity separate from its shareholders. For simplicity, assume BDCC's income tax expense for January 2015 is \$500 and that this amount will be paid after the company's year-end, December 31. The adjusting entry for January is:

(i)

2015				
Jan. 31	Income Tax Expense	500		
	Income Tax Payable		500	
	<i>To adjust for January accrued income taxes.</i>			

When the adjusting entry is posted, the accounts appear as follows:



This adjusting entry enables the company to match the income tax expense accrued in January to the income earned during the same month.

### 3.3 The Adjusted Trial Balance



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LO3 – Prepare an adjusted trial balance and explain its use.

In the last section, adjusting entries were recorded and posted. As a result, some account balances reported on the January 31, 2015 unadjusted trial balance in [Figure 3.4](#) have changed. Recall that an unadjusted trial balance reports account balances *before* adjusting entries have been recorded and posted. An **adjusted trial balance** reports account balances *after* adjusting entries have been recorded and posted. [Figure 3.5](#) shows the unadjusted trial balance, adjustments a through i discussed above, and the adjusted trial balance for BDCC at January 31, 2015. Changes are shown in blue.

Big Dog Carworks Corp.  
Adjusted Trial Balance  
January 31, 2015

Acct. No.	Account	Unadjusted trial balance		Adjustments		Adjusted trial balance	
		Debit	Credit	Debit	Credit	Debit	Credit
101	Cash	\$ 6,200				\$6,200	
110	Accounts receivable	2,500				2,500	
116	Interest receivable			(f) 25			25
125	Rent receivable			(e) 400			400
161	Prepaid insurance	2,400			(a) 200	2,200	
183	Equipment	3,000				3,000	
184	Truck	8,000				8,000	
193	Acc. dep. – equipment				(c) 25		\$ 25
194	Acc. dep. – truck				(d) 100		100
201	Bank loan		\$9,000				9,000
210	Accounts payable		700				700
222	Interest payable				(g) 18		18
226	Salaries payable				(h) 150		150
247	Unearned repair revenue		400	(b) 300			100
260	Income taxes payable				(i) 500		500
320	Share capital		10,000				10,000
350	Dividends	200				200	
430	Interest earned				(f) 25		25
440	Rent earned				(e) 400		400
450	Repair revenue		10,000		(b) 300		10,300
623	Dep. exp. – equipment			(c) 25			25
624	Dep. exp. – truck			(d) 100			100
631	Insurance expense			(a) 200			200
632	Interest expense			(g) 18			18
654	Rent expense	1,600				1,600	
656	Salaries expense	4,000		(h) 150		4,150	
668	Supplies expense	1,500				1,500	
670	Truck operating expense	700				700	
830	Income taxes expense			(i) 500			500
		<u>\$30,100</u>	<u>30,100</u>	<u>\$1,718</u>	<u>\$1,718</u>	<u>\$31,318</u>	<u>\$31,318</u>

**Fig. 3.5: BDCC's January 31, 2015 Adjusted Trial Balance**

## 3.4 Using the Adjusted Trial Balance to Prepare Financial Statements



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LO4 – Use an adjusted trial balance to prepare financial statements.

Financial statements can now be prepared using the adjusted trial balance, in the same manner as shown in Chapter 2. The income statement is prepared first, followed by the statement of changes in equity:



Big Dog Carworks Corp.  
Trial Balance  
At January 31, 2015

Acct. No.	Account	Account Balances				
		Debit	Credit			
101	Cash	\$ 6,200				
110	Accounts receivable	2,500				
116	Interest receivable	25				
125	Rent receivable	400				
161	Prepaid insurance	2,200				
183	Equipment	3,000				
184	Truck	8,000				
193	Acc. dep. – equipment		\$ 25			
194	Acc. dep. – truck		100			
201	Bank loan		9,000			
210	Accounts payable		700			
222	Interest payable		18			
226	Salaries payable		150			
247	Unearned repair revenue		100			
260	Income taxes payable		500			
320	Share capital		10,000			
350	Dividends	200				
430	Interest earned		25	Revenue		
440	Rent earned		400	Interest	\$ 25	
450	Repair revenue		10,300	Rent	400	
				Repairs	<u>10,300</u>	\$10,725
				<b>Expenses</b>		
623	Dep. expense – equipment	25		Dep. – equip.	25	
624	Dep. expense – truck	100		Dep. – truck	100	
631	Insurance expense	200		Insurance	200	
632	Interest expense	18		Interest	18	
654	Rent expense	1,600		Rent	1,600	
656	Salaries expense	4,150		Salaries	4,150	
668	Supplies expense	1,500		Supplies	1,500	
670	Truck operating expense	700		Truck operating	700	
830	Income taxes expense	500		Income taxes	500	8,793
		<u>\$30,318</u>	<u>\$30,318</u>	Net income		<u>\$1,932</u>

Big Dog Carworks Corp.  
Income Statement  
For the Month Ended January 31, 2015

	Share capital	Retained earnings	Total equity
Balance at January 1, 2015	\$ -0-	\$ -0-	\$ -0-
Shares issued	10,000		10,000
Net income		1,932	1,932
Dividends		(200)	(200)
Balance at January 31, 2015	<u>\$10,000</u>	<u>\$ 1,732</u>	<u>\$11,732</u>

The balance sheet can be prepared once the statement of changes in equity is complete.

Big Dog Carworks Corp. Trial Balance At January 31, 2015				Big Dog Carworks Corp. Balance Sheet At January 31, 2015			
Acct. No.	Account	Account Balances					
		Debit	Credit	Assets			
101	Cash	\$ 6,200		Cash		\$6,200	
110	Accounts receivable	2,500		Accounts receivable		2,500	
116	Interest receivable	25		Interest receivable		25	
125	Rent receivable	400		Rent receivable		400	
161	Prepaid insurance	2,200		Prepaid insurance		2,200	
183	Equipment	3,000		Equipment	3,000	} 2,975	
184	Truck	8,000		Acc. Dep. – Equip.	(25)		
193	Acc. dep. – equipment		\$ 25	Truck	8,000	} 7,900	
194	Acc. dep. – truck		100	Acc. Dep. – Truck	(100)		
201	Bank loan		9,000	<b>Total assets</b>		<b>\$22,200</b>	
210	Accounts payable		700				
222	Interest payable		18				
226	Salaries payable		150				
247	Unearned repair revenue		100				
260	Income taxes payable		500				
320	Share capital		10,000				
350	Dividends	200					
430	Interest earned		25				
440	Rent earned		400				
450	Repair revenue		10,300				
623	Dep. expense – equipment		25				
624	Dep. expense – truck		100				
631	Insurance expense		200				
632	Interest expense		18				
654	Rent expense		1,600				
656	Salaries expense		4,150				
668	Supplies expense		1,500				
670	Truck operating expense		700				
830	Income taxes expense		500				
		<u>\$30,318</u>	<u>\$30,318</u>				

Big Dog Carworks Corp. Balance Sheet At January 31, 2015			
Assets			
Cash		\$6,200	
Accounts receivable		2,500	
Interest receivable		25	
Rent receivable		400	
Prepaid insurance		2,200	
Equipment	3,000		} 2,975
Acc. Dep. – Equip.	(25)		
Truck	8,000		} 7,900
Acc. Dep. – Truck	(100)		
<b>Total assets</b>			<b>\$22,200</b>
Liabilities			
Bank loan	9,000		
Accounts payable	700		
Interest payable	18		
Salaries payable	150		
Unearned repair rev.	100		
Income taxes pay.	500		10,468
Shareholders' Equity			
Share capital	10,000		} 11,732
Retained earnings	1,732		
<b>Total liabilities and shareholders' equity</b>			<b>\$22,200</b>

Equipment and truck are shown net of depreciation.

These amounts are transferred from the Statement of Changes in Equity.

### 3.5 The Accounting Cycle



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LO5 – Identify and explain the steps in the accounting cycle.

Recall from Chapter 2 that the accounting cycle is the process used to convert economic data into financial statement information using the double-entry accounting model. The complete accounting cycle consists of eight steps:



*Step 1: Transactions are analyzed and recorded in the general journal.*

*Step 2: The journal entries in the general journal are posted to accounts in the general ledger.*

*Step 3: An unadjusted trial balance is prepared to ensure total debits equal total credits.*

*Step 4: The unadjusted account balances are analyzed and adjusting entries are journalized in the general journal and posted to the general ledger.*

*Step 5: An adjusted trial balance is prepared to prove the equality of debits and credits.*

*Step 6: The adjusted trial balance is used to prepare financial statements.*

*Step 7: Closing entries are journalized and posted.*

*Step 8: A post-closing trial balance is prepared.*

Steps 4 was introduced in this chapter. Steps 7 and 8 are discussed in the next section.

### 3.6 The Closing Process



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LO6 – Explain the purpose of closing entries and use closing entries to prepare a postclosing trial balance

At the end of a fiscal year after steps 1-6 of the accounting cycle have been completed and financial statements have been prepared, the revenue, expense, and dividend account balances must be zeroed so that they can begin to accumulate amounts belonging to the new fiscal year. To accomplish this, *closing entries* are journalized and posted. **Closing entries** transfer each revenue and expense account balance, as well as any balance in the Dividend account, into retained earnings. Revenues, expenses, and dividends are therefore referred to as **temporary accounts** because their balances are zeroed at the end of each accounting period. Balance sheet accounts such as Cash and Retained Earnings, are **permanent accounts** because they have a continuing balance from one fiscal year to the next. The closing process transfers temporary account balances into the Retained Earnings account. An interim closing

account called the **Income Summary** is used. In this text, its assigned general ledger account number is 360. The four entries in the closing process are detailed below.

**Entry 1: Close the revenue accounts to the Income Summary account**

A single closing entry is used to transfer all revenue account (credit) balances to the Income Summary account. All revenue accounts with a credit balance are debited to bring them to zero. Their balances are transferred to the Income Summary account as an offsetting credit.

**Entry 2: Close the expense accounts to the Income Summary account**

A single closing entry is used to transfer all expense account (debit) balances to the Income Summary account. All expense accounts with a debit balance are credited to bring them to zero. Their balances are transferred to the Income Summary account as an offsetting debit.

The Dividend account is not closed to the Income Summary account because this is not an income statement account. The Dividend account is closed in Entry 4 directly to the Retained Earnings account.

After entries 1 and 2 above are posted to the Income Summary account, a new balance is calculated for the Income Summary account. If net income is reported on the income statement, the balance in the Income Summary should be a credit; if a net loss has been reported, the balance will be a debit. *If the income summary balance does not match the net income or loss reported on the income statement, the revenues and expenses have not been closed correctly.*

**Entry 3: Close the Income Summary account to the Retained Earnings account**

The balance in the Income Summary account is transferred to the Retained Earnings account because the net income belongs to the shareholders. An equal and offsetting entry (a debit in the case of net income) is made to the Income Summary account to bring its balance to zero. The same amount is credited to the Retained Earnings account. Again, the amount must always equal the net income reported on the income statement.

**Entry 4: Close the Dividends account to Retained Earnings**

The Dividend account is closed to the Retained Earnings account. This results in transferring the balance in dividends, a temporary account, to retained earnings, a permanent account.

The closing entries for Big Dog Carworks Corp. are shown in [Figure 3.6](#).

*These are for illustrative purposes only. Closing entries are only done at the fiscal year-end.*

		GENERAL JOURNAL		Page 2	
Date 2015		Description Closing Entries	Folio	Debit	Credit
		(1)			
Jan.	31	Interest Earned	430	25	
		Rent Earned	440	400	
		Repair Revenue	450	10,300	
		Income Summary	360		10,725
		<i>To close revenue account balances.</i>			
		(2)			
Jan.	31	Income Summary	360	8,793	
		Depreciation Expense – Equipment	623		25
		Depreciation Expense – Truck	624		100
		Insurance Expense	631		200
		Interest Expense	632		18
		Rent Expense	654		1,600
		Salaries Expense	656		4,150
		Supplies Expense	668		1,500
		Truck Operating Expense	670		700
		Income Tax Expense	830		500
		<i>To close expense account balances.</i>			
		(3)			
Jan.	31	Income Summary	360	1,932	
		Retained Earnings	340		1,932
		<i>To close Income Summary.</i>			
		(4)			
Jan.	31	Retained Earnings	360	200	
		Dividends	350		200
		<i>To close dividends to retained earnings.</i>			

This amount must agree to the net income shown on the income statement.

Fig. 3.6: Closing Entries for BDCC at January 31, 2015 for illustrative purposes only.

### 3.6.1 Posting the Closing Entries to the General Ledger



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When entries 1 and 2 are posted to the general ledger, the balances in all revenue and expense accounts are transferred to the Income Summary account. The transfer of these balances is shown in Figure 3.7. Notice that a zero balance results for each revenue and expense account after the closing entries are posted, and there is a \$1,932 credit balance in the income summary. The income summary balance agrees to the net income reported on the income statement.

Closing Expense Accounts			Closing Revenue Accounts		
Dep'n Expense – Equip.	623		Interest Earned	430	
Bal.	25	25		25	
Bal.	-0-			-0-	Bal.
Dep'n Expense – Truck.	624		Rent Earned	440	
Bal.	100	100		400	
Bal.	-0-			-0-	Bal.
Insurance Expense	631		Repair Revenue	450	
Bal.	200	200		10,300	
Bal.	-0-			10,300	-0-
Interest Expense	632				Bal.
Bal.	18	18			
Bal.	-0-				
Rent Expense	654				
Bal.	1,600	1,600			
Bal.	-0-				
Salaries Expense	656				
Bal.	4,150	4,150			
Bal.	-0-				
Supplies Expense	668				
Bal.	1,500	1,500			
Bal.	-0-				
Truck Operating Expense	670				
Bal.	700	700			
Bal.	-0-				
Income Taxes Expense	830				
Bal.	500	500			
Bal.	-0-				

Income Summary		
8,793	10,725	
	1,932	Bal.

All revenue and expense account balances are now zero.

Fig. 3.7: Closing Revenue and Expense Accounts

When the income summary is closed to retained earnings in the third closing entry, the \$1,932 credit balance in the income summary account is transferred into retained earnings as shown in Figure 3.8. As a result, the income summary is left with a zero balance.

Income Summary		360		Retained Earnings		340
	8,793	10,725			1,932	←
	1,932	1,932	Bal.			
Bal.	-0-					

Fig. 3.8: Closing the Income Summary Account

Finally, when dividends is closed to retained earnings in the fourth closing entry, the \$200 debit balance in the Dividends account is transferred into retained earnings as shown in Figure 3.9. After the closing entry is posted, the Dividends account is left with a zero balance and retained earnings is left with a credit balance of \$1,857.



Dividends		350	Retained Earnings		340
	200	200	→	200	1,932
Bal.	-0-				1,732 Bal.

↑  
This amount must agree to the retained earnings balance calculated on the statement of changes in equity.

Fig. 3.9: Closing the Dividends Account

### 3.6.2 The Post-Closing Trial Balance



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A **post-closing trial balance** is prepared immediately following the posting of closing entries. The purpose is to ensure that the debits and credits in the general ledger are equal and that all temporary accounts have been closed. The post-closing trial balance for Big Dog Carworks Corp. appears below.

**Big Dog Carworks Corp.**  
**Post-Closing Trial Balance**  
**January 31, 2015**

Acct. No.	Account	Account Balances	
		Debit	Credit
101	Cash	\$6,200	
110	Accounts receivable	2,500	
116	Interest receivable	25	
125	Rent receivable	400	
161	Prepaid insurance	2,200	
183	Equipment	3,000	
184	Truck	8,000	
193	Accumulated dep. – equip.		\$ 25
194	Accumulated dep. – truck		100
201	Bank loan		9,000
210	Accounts payable		700
222	Interest payable		18
226	Salaries payable		150
247	Unearned repair revenue		100
260	Income taxes payable		500
320	Share capital		10,000
340	Retained earnings		1,732
	<b>Total debits and credits</b>	<u>\$22,325</u>	<u>\$22,325</u>

Only permanent accounts remain.

Only balance sheet accounts – the permanent accounts – have balances and are carried forward to the next accounting year. All income statement and dividend accounts – temporary accounts – begin the new fiscal year with a zero balance, so they can be used to accumulate amounts belonging to the new fiscal year.

## 3.7 Summary of Chapter 3 Learning Objectives



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### **LO1 – Explain how adjusting entries match revenues and expenses to the appropriate time period.**

Financial statements must be prepared in a timely manner, at minimum, once per fiscal year. For statements to reflect activities accurately, revenues and expenses must be recognized and reported in the appropriate accounting period. In order to achieve this type of matching, adjusting entries need to be prepared.

### **LO2 – Explain the use of and prepare the adjusting entries required for prepaid expenses, depreciation, unearned revenues, accrued revenues, and accrued expenses.**

Adjusting entries are prepared at the end of an accounting period. They allocate revenues and expenses to the appropriate accounting period regardless of when cash was received or paid. The five types of adjustments are:

		(1)		
Date	Expense		XX	
	Prepaid Expense			XX
	<i>To adjust prepaid expense for the amount of benefit used.</i>			
		(2)		
Date	Account Recievable		XX	
	Revenue			XX
	<i>To record revenue earned on credit.</i>			
		(3)		
Date	Depreciation Expense		XX	
	Accumulated Depreciation			XX
	<i>To allocate the costs of plant and equipment over their useful lives.</i>			
		(4)		
Date	Unearned Revenue		XX	
	Revenue			XX
	<i>To adjust unearned amounts now earned.</i>			
		(5)		
Date	Expense		XX	
	Payable			XX
	<i>To adjust for accrued expenses.</i>			

**LO3 - Prepare an adjusted trial balance and explain its use.**

The adjusted trial balance is prepared using the account balances in the general ledger after adjusting entries have been posted. Debits must equal credits. The adjusted trial balance is used to prepare the financial statements.

**LO4 - Use an adjusted trial balance to prepare financial statements.**

Financial statements are prepared based on adjusted account balances.

**LO5 - Identify and explain the steps in the accounting cycle.**

The steps in the accounting cycle are:

*Steps occurring continually during the fiscal year:*



1. Transactions are analyzed and recorded in the general journal.
2. The journal entries in the general journal are posted to accounts in the general ledger.

*Steps occurring whenever interim or year-end financial statements are prepared at the end of an accounting period*

3. An unadjusted trial balance is prepared to ensure total debits equal total credits.
4. The unadjusted account balances are analyzed, and adjusting entries are journalized in the general journal and posted to the general ledger.
5. An adjusted trial balance is prepared to prove the equality of debits and credits.
6. The adjusted trial balance is used to prepare financial statements.

*Steps occurring only at the fiscal year-end*

7. Closing entries are journalized and posted.
8. A post-closing trial balance is prepared.

**LO6 – Explain the purpose of closing entries and use closing entries to prepare a post-closing trial balance.**

After the financial statements have been prepared, the temporary account balances (revenues, expenses, and dividends) are transferred to retained earnings, a permanent account, via closing entries. The result is that the temporary accounts will have a zero balance and will be ready to accumulate transactions for the next accounting period.

The general forms of the four closing entries are:

		(1)		
Dec. 31	Revenue		XX	
	Income Summary			XX
	To close revenue account balances to the Income Summary account.			
		(2)		
Dec. 31	Income Summary		YY	
	Expense			YY
	To close expense account balances to the Income Summary account.			
		(3)		
Dec. 31	Income Summary		ZZ	
	Retained Earnings			ZZ
	To close the Income Summary account balance to Retained Earnings (ZZ = XX – YY; ZZ must equal net income). <sup>1</sup>			
		(4)		
Dec. 31	Retained Earnings		AA	
	Dividends			AA
	To close the Dividend account to Retained Earnings.			

---

<sup>1</sup> When there is a net loss, the Income Summary account will have a debit balance after revenues and expenses have been closed. To close the Income Summary account when there is a net loss the Income Summary must be credited. The following closing entry is required:

Dec. 31	Retained Earnings	XXX	
	Income Summary		XXX
	<i>To close the Income Summary account balance to Retained Earnings</i>		

The post-closing trial balance is prepared after the closing entries have been posted to the general ledger. The post-closing trial balance will contain only permanent accounts because all the temporary accounts have been closed.

## 3.8 Assignment Materials

### 3.8.1 Concept Self-check



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1. Explain the sequence of financial transactions that occur continuously during an accounting time period. What is this sequence of activities called?
2. Do you have to wait until the operating cycle is complete before you can measure income using the accrual basis of accounting?
3. What is the relationship between the matching concept and accrual accounting? Are revenues matched to expenses, or are expenses matched to revenues? Does it matter one way or the other?
4. What are adjusting entries and why are they required?
5. What are the five types of adjusting entries?
6. Why are asset accounts like Prepaid Insurance adjusted? How are they adjusted?
7. How are long-lived asset accounts adjusted? Is the procedure similar to the adjustment of other asset and liability accounts at the end of an accounting period?
8. What is a contra account and why is it used?
9. How are liability accounts like Unearned Repair Revenue adjusted?
10. Explain the terms *accrued revenues* and *accrued expenses*. Give examples of each.
11. Why is an adjusted trial balance prepared?
12. How is the adjusted trial balance used to prepare financial statements?
13. List the eight steps in the accounting cycle.
14. Which steps in the accounting cycle occur continuously throughout the accounting period?
15. Which steps in the accounting cycle occur at the end of the fiscal year? Explain how they differ from the other steps.
16. In general, income statement accounts accumulate amounts for a time period not exceeding one year. Why is this done?
17. Identify which types of general ledger accounts are temporary and which are permanent.
18. What is the Income Summary account and what is its purpose?
19. What are the four types of closing entries, and why are they journalized?
20. Why is the Dividends account not closed to the Income Summary account when closing entries are prepared?
21. What is a post-closing trial balance and why is it prepared?

## 3.8.2 Comprehension Problems

### 3.8.2.1 CP 3-1



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The preparation of adjusting entries requires a debit entry to one account and a credit entry to another account.

A	B
a. Insurance Expense	1. Commissions Earned
b. Rent Earned	2. Supplies Expense
c. Prepaid Rent	3. Salaries Expense
d. Interest Payable	4. Unearned Fees
e. Interest Receivable	5. Accumulated Depreciation
f. Fees Earned	6. Rent Expense
g. Unused Supplies	7. Prepaid Insurance
h. Unearned Commissions Revenue	8. Interest Earned
i. Salaries Payable	9. Interest Expense
j. Depreciation Expense	10. Unearned Rent

*Required:* Match each account in column A with the appropriate account in column B.

### 3.8.2.2 CP 3-2



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The following unadjusted accounts are extracted from the general ledger of A Corp. at December 31, 2016:

Truck	184	Depreciation Expense – Truck	624	Acc. Dep'n – Truck	194
10,000		1,300			1,300

Additional Information: The truck was purchased January 1, 2016. It has an estimated useful life of 4 years.

*Required:* Prepare the needed adjusting entry at December 31, 2016.

### 3.8.2.3 CP 3-3



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The following unadjusted accounts are taken from the records of B Corp. at December 31, 2016:

Bank Loan	201	Interest Expense	632	Interest Payable	222
	12,000	1,100			100

Additional Information: Interest expense for the year should be \$1,200.

*Required:* Prepare the adjusting entry at December 31, 2016.

### 3.8.2.4 CP 3-4



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An extract from the trial balance of Armstrong Corp. at June 30, 2016 is reproduced below:

<i>Account</i>	<i>Amount in unadjusted trial balance</i>	<i>Amount in adjusted trial balance</i>
Unused office supplies	\$ 190	\$ 55
Accumulated depreciation – truck	0	400
Prepaid insurance	850	610
Interest payable	0	100
Unearned rent	1,000	500

*Required:* Prepare in general journal format the entries that were posted, including a plausible description. General ledger account numbers are not necessary.

### 3.8.2.5 CP 3-5



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The following are account balances of Graham Corporation:

<i>Account</i>	<i>Amount in unadjusted trial balance</i>	<i>Amount in adjusted trial balance</i>
Rent Receivable	\$ -0-	\$ 110
Prepaid Insurance	1,800	600
Interest Payable	-0-	90

*Required:*

1. Enter the unadjusted balance for each account in the following T-accounts: Interest Receivable, Prepaid Insurance, Interest Payable, Salaries Payable, Unearned Rent, Interest Earned, Rent Earned, Insurance Expense, Interest Expenses, and Salaries Expense.
2. Reconstruct the adjusting entry that must have been recorded for each account. General ledger account numbers are not necessary.
3. Post these adjusting entries and agree ending balances in each T-account to the adjusted balances above.
4. List revenue and expense amounts for the period.

### 3.8.2.6 CP 3-6



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The following data are taken from an unadjusted trial balance at December 31, 2016:

Prepaid rent	\$ 600
Office supplies	700

Income taxes payable	-0-
Unearned commissions revenue	1,500
Salaries expense	5,000

Additional Information:

- a. The prepaid rent consisted of a payment for three months' rent at \$200 per month for December 2016, January 2017, and February 2017.
- b. Office supplies on hand at December 31, 2016 amounted to \$300.
- c. The estimated income taxes for 2016 are \$5,000.
- d. All but \$500 in the Unearned Commissions account has been earned in 2016.
- e. Salaries for the last three days of December amounting to \$300 have not yet been recorded.

*Required:*

1. Prepare all necessary adjusting entries in general journal format at December 31, 2016. General ledger account numbers are not necessary.
2. Calculate the cumulative financial impact on assets, liabilities, shareholders' equity, revenue and expense if these adjusting entries are not made.

### 3.8.2.7 CP 3-7



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The following are general ledger accounts extracted from the records of Bernard Inc. at December 31, 2016, its year-end ('UB' = unadjusted balance):



Prepaid Advertizing	160	Accounts Payable	210	Share Capital	320
UB 1,000	500		UB 15,000		UB 8,000
			200		
			100	Subscription Revenue	480
Unused Supplies	173		400		5,000
UB 750	400		800		
		Salaries Payable	226	Advertizing Expense	610
			700	500	
Equipment	183				
UB 21,750					
		Unearned Subscription Revenue	250	Commissions Expense	615
Acc. Dep'n – Equip.		5,000	UB 10,000	UB 800	
	1,500				
	250			Dep'n Expense – Equip.	623
				250	
				Maintenance Expense	641
				200	
				Salaries Expense	656
				UB 9,500	
				700	
				Supplies Expense	688
				UB 2,500	
				400	
				Telephone Expense	669
				100	
				Utilities Expense	676
				400	

*Required:* Prepare in general journal format the adjusting entries that were posted. Include general ledger account and plausible descriptions.

### 3.8.2.8 CP 3-8



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The following general ledger accounts are taken from the books of the Hynes Corporation at the end of its fiscal year, December 31, 2016:

Cash		101	Accounts Payable		210	Share Capital		320
750	50		70	145			400	
950	150							
90	50		Unearned Repair Revenue		247	Ret. Earn.		340
	24			500			350	
	20		400			Repair Rev.		450
	70						950	
							228	
Accounts Receivable		110	Interest Payable		222	Rent Earned		440
228	90			12			40	
Rent Receivable		125				Dep'n Exp. - Furniture		621
40						2		
Prepaid Insurance		161	Income Taxes Pay.		260			
24	2			400		Insurance Exp.		631
Unused Office Supplies		170				2		
50	25		Interest Expense		632	Office Supplies Exp.		650
			12			25		
Unused Repair Supplies		171						
145	80		Income Taxes Expense		830	Rent Expense		654
			400			50		
Furniture		182						
150						Repair Supplies Expense		655
						80		
Acc. Dep'n - Furniture		191						
	2					Telephone Expense		669
						20		

*Required:*

1. Label the debit and credit amounts that represent each adjusting entry made at December 31 (for example: a, b, c).
2. Prepare the adjusting entries made at December 31 in general journal form. Include general ledger account numbers and plausible descriptions.

### 3.8.2.9 CP 3-9



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The trial balance of Lauer Corporation at December 31, 2016 follows, before and after the posting of adjusting entries.

Acct. No.	Account	Unadjusted trial balance		Adjustments		Adjusted trial balance	
		Debit	Credit	Debit	Credit	Debit	Credit
101	Cash	\$ 4,000				\$ 4,000	
110	Accounts receivable	5,000				5,000	
161	Prepaid insurance	3,600				3,300	
162	Prepaid rent	1,000				500	
184	Truck	6,000				6,000	
194	Acc. dep. – truck						\$1,500
210	Accounts payable		\$7,000				7,000
222	Interest payable						400
226	Salaries payable						1,000
248	Unearned rent revenue		1,200				600
320	Share capital		2,700				2,700
440	Rent earned		25,000				25,600
610	Advertizing expense	700				700	
615	Commissions expense	2,000				2,000	
624	Dep. expense – truck					1,500	
631	Insurance expense					300	
632	Interest expense	100				500	
654	Rent expense	5,500				6,000	
656	Salaries expense	8,000				9,000	
	Totals	<u>\$35,900</u>	<u>\$35,900</u>			<u>\$38,800</u>	<u>\$38,800</u>

Required:

1. Indicate in the “Adjustments” column the debit or credit difference between the unadjusted trial balance and the adjusted trial balance.
2. Prepare in general journal format the adjusting entries that must have been recorded. Include general ledger account numbers and plausible descriptions.

### 3.8.2.10 CP 3-10



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The following general ledger accounts and additional information are taken from the records of Wolfe Corporation at the end of its fiscal year, December 31, 2016.

Additional information:

- a. The prepaid insurance is for a one-year policy, effective July 1, 2016.

- b. A physical count indicated that \$500 of supplies is still on hand.
- c. \$50 of December rent expense has not been recorded.

Cash	101	Unused Supplies	173	Advertizing Exp.	610
Bal. 2,700		Bal. 700		Bal. 200	
Accounts Receivable	110	Share Capital	320	Salaries Expense	656
Bal. 2,000		Bal. 3,800		Bal. 4,500	
Prepaid Insurance	161	Repair Revenue	450	Rent Expense	654
Bal. 1,200		Bal. 7,750		Bal. 250	

Required:

- Record all necessary adjusting entries in general journal format including general ledger account numbers. Assume the following account numbers: Insurance Expense: 631; Supplies Expense: 668.
- Post the adjusting entries to T-accounts and calculate balances.
- Prepare all closing entries in general journal format. Include general ledger account numbers.
- Post the closing entries to the applicable general ledger accounts.

### 3.8.3 Alternate Problems

#### 3.8.3.1 AP 3-1



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The following unrelated accounts are from the trial balance of Gabel Inc. at December 31, 2016 its fiscal year-end.

	<u>Balance</u>	
	<i>Unadjusted</i>	<i>Adjusted</i>
a. Prepaid insurance	\$ 500	\$ 300
b. Unused supplies	850	400
c. Accumulated depreciation – truck	-0-	1,200
d. Salaries payable	2,500	2,600
e. Unearned fees revenue	5,000	1,000
f. Income taxes payable	-0-	3,500

g. Other revenue	50,000	45,000
h. Commissions expense	4,000	5,500
i. Interest expense	800	850

*Required:* For each of the above accounts, prepare the most likely adjusting entry that was recorded. General ledger account numbers and descriptions are not necessary.

### 3.8.3.2 AP 3-2



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The unadjusted trial balance of Inaknot Insurance Corp. includes the following account balances at December 31, 2016, its fiscal year-end. Assume all accounts have normal debit or credit balances.

Prepaid insurance	\$ 1,800
Truck	18,000
Unearned commissions revenue	9,000
Rent earned	-0-
Advertizing expense	5,000
Salaries expense	25,000
Supplies expense	900

The following information is available:

- a. A physical count indicates that \$200 of supplies have not been used at December 31.
- b. The prepaid insurance consists of a one-year policy, effective October 1.

- c. The truck was purchased on July 1; it is expected to have a useful life of 6 years. No depreciation has been recorded during the year.
- d. The unearned commission revenue at December 31 is \$7,500.
- e. Two days of salary amounting to \$200 remain unpaid and unrecorded at December 31; the amounts will be included with the next Friday's payment, which will be in January.
- f. Rental revenue of \$300 has not yet been received for a sublet of part of a warehouse for 2 weeks during December.
- g. A \$300 bill for December advertizing has not yet been recorded.

*Required:* Prepare all necessary adjusting entries at December 31, 2016. General ledger account numbers and descriptions are not necessary.

### 3.8.3.3 AP 3-3



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The unadjusted trial balance of Langford Limited includes the following account balances at December 31, 2016, its fiscal year-end. Assume all accounts have normal debit or credit balances.

Short-term investments	\$15,000
Prepaid rent	1,200
Unused supplies	-0-
Bank loan	7,500
Unearned subscriptions revenue	9,000
Insurance expense	2,400

---

Salaries expense	75,000
Supplies expense	600
Utilities expense	-0-

The following information relates to the fiscal year-end:

- a. Accrued interest revenue on the short-term investment amounts to \$40 at December 31.
- b. The prepaid rent applies equally to the months of November and December 2016 and January 2017.
- c. Accrued interest expense on the bank loan amounts to \$50 at December 31.
- d. One-third of the subscriptions revenue remains unearned at December 31.
- e. Insurance expense includes the cost of a one-year insurance policy, effective January 1, 2016, and the cost of a one-year renewal, effective January 1, 2017. The cost for each year is \$1,200.
- f. Two days of salary have not yet been accrued at December 31; the usual salary for a five-day week is \$2,500.
- g. A physical count indicates that \$100 of supplies is still on hand at December 31.
- h. A \$200 bill for electricity has not yet been recorded for December.

*Required:* Prepare all necessary adjusting entries. General ledger account numbers and descriptions are not necessary.



**3.8.3.4 AP 3-4**

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The following accounts are taken from the records of Trebell Ltd. at the end of its first twelve months of operations, December 31, 2016. In addition to the balances in each set of accounts, additional data are provided for adjustment purposes. Treat each set of accounts independently.

a.

Cash	Prepaid Rent	Rent Expense
5,200		5,200

Additional information: The monthly rent is \$400

b.

Interest Expense	Interest Payable
850	

Additional information: Accrued interest expense on the bank loan amounts to \$150.

c.

Unused Supplies	Supplies Expense
	800

Additional information: Supplies still on hand amount to \$300.

d.

Cash	Salaries Expense	Salaries Payable
4,000	5,000	1,000

Additional information: Salaries owing at December 31 amount to \$1,000 in total.

e.

Prepaid Advertizing	Advertizing Expense
800	3,000

Additional information: Prepaid advertizing at December 31 amounts to \$1,200.

f.

Equipment	Depreciation Expense	Acc. Dep'n – Equipment
6,000	500	500

Additional information: The equipment was purchased on July 1; it has an estimated useful life of 5 years.

g.

Unearned Rent Revenue	Rent Earned
	10,000

Additional information: Rent Earned during the year should be \$7,500.

h.

Cash	Prepaid Insurance	Insurance Expense
600	100	500

Additional information: \$600 was paid for a 1-year policy effective January 1, 2016.

i.

Utilities Expense	Utilities Payable
875	

Additional information: The December utility bill has not yet been received; the amount owing has been estimated at \$225.

*Required:* Prepare the necessary adjusting entries at December 31, 2016. General ledger account numbers and descriptions are not necessary.

### 3.8.3.5 AP 3-5



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The following unadjusted trial balance has been prepared for Sellit Realty Corporation at the end of its first year of operations, December 31, 2016:

Acct. No.	Account	Balance	
		Debit	Credit
101	Cash	3,500	
110	Accounts receivable	7,000	
162	Prepaid rent	1,200	
173	Unused supplies	100	
183	Equipment	3,000	
193	Acc. dep. – equipment		-0-
210	Accounts payable		6,000
222	Interest payable		-0-
237	Wages payable		-0-
242	Unearned commissions revenue		3,000
260	Income taxes payable		-0-
320	Share capital		600
350	Dividends	100	
410	Commissions earned		22,000
610	Advertizing expense	850	
615	Commissions expense	3,600	
623	Dep. expense – equipment	-0-	
632	Interest expense	550	
654	Rent expense	4,400	
668	Supplies expense	700	
677	Wages expense	6,600	
830	Income taxes expense	-0-	
		<u>31,600</u>	<u>31,600</u>

The following additional information is available:

- a. Prepaid rent represents equal amounts of rent for the months of December 2016, and January and February 2017.
- b. A physical count indicates that \$200 of supplies is on hand at December 31.
- c. The equipment was purchased on July 1; it has an estimated useful life of 3 years.
- d. Wages of \$300 for December 30 and 31 are unpaid; they will be included in the first Friday's payment in January.

- e. Revenue includes \$2,500 received for commissions that will be earned in 2017.
- f. Unrecorded interest expense amounts to \$150.
- g. Income taxes expense amounts to \$200. This will be paid in the next fiscal year.

*Required:*

1. Prepare all necessary adjusting entries at December 31, 2016. Include general ledger account numbers and calculations as needed. Descriptions are not necessary.
2. Prepare an adjusted trial balance.
3. Prepare an income statement, statement of changes in equity, and balance sheet.
4. Prepare closing entries including general ledger account numbers and descriptions.
5. Prepare a post-closing trial balance.

### 3.8.3.6 AP 3–6



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Scuttlebutt Publishers Corporation was incorporated on June 1, 2016. The company had the following transactions during June:

#### **Part A**

- a. Issued share capital for \$10,000 cash
- b. Purchased equipment for \$6,000 on credit
- c. Purchased \$750 of supplies on credit. These are expected to last three months (record as unused supplies)
- d. Paid two months of newspaper advertizing for \$500 (record as prepaid advertizing expense)
- e. Collected \$12,000 of three-month subscription revenue for its ONLINE REVIEW magazine, effective June 1 (record as unearned subscription revenue)

- f. Paid the following expenses in cash: telephone, \$350; rent for June, \$500
  
- g. Collected \$5,000 revenue in cash from advertizers for the June edition of ONLINE REVIEW magazine
  
- h. Paid half of the equipment purchased June 1
  
- i. Paid \$2,000 for supplies purchased
  
- j. Paid the following expenses in cash: telephone, \$250; salaries, \$3,000
  
- k. Received a \$200 bill for electricity used during the month (recorded as Utilities Expense).

*Required:*

- 1. Open general ledger T-accounts for the following: Cash, Prepaid Advertizing, Unused Supplies, Equipment, Accounts Payable, Unearned Subscriptions Revenue, Share Capital, Other Revenue, Rent Expense, Salaries Expense, Supplies Expense, Telephone Expense, and Utilities Expense. General ledger account numbers are not needed.
  
- 2. 1. Prepare journal entries to record the June transactions. Descriptions are not needed.
  
- 3. Post the entries to general ledger T-accounts and calculate balances at June 30, 2016.

**Part B**

At June 30, the following additional information is available.

- l. The June portion of advertizing paid in transaction (c) has expired.
  
- m. One month of the subscriptions revenue collected June 5 has been earned.

- n. A physical count indicates that \$100 of supplies is still on hand.
- o. \$200 of commission expense is owed on the June portion of the subscriptions revenue.
- p. Two days of salary for June 29 and 30 are unpaid, amounting to \$600.
- q. The equipment purchased in transaction (b) has an estimated useful life of 5 years.
- r. Income taxes payable at June 30 amount to \$50.

*Required:*

- 4. Open additional general ledger T-accounts for the following: Accumulated Depreciation – Equipment, Salaries Payable, Income Taxes Payable, Subscription Revenue, Advertising Expense, Commissions Expense, Depreciation Expense – Equipment, and Income Taxes Expense.
- 5. Prepare all necessary adjusting entries at June 30, 2016. General ledger account numbers and descriptions are not necessary, but show depreciation calculations.
- 6. Post the entries to the general ledger T-accounts and calculate balances.
- 7. Prepare an adjusted trial balance at June 30.
- 8. Assume that the company's year-end is June 30. Prepare an income statement, statement of changes in equity, and balance sheet.
- 9. Prepare closing entries and a post-closing trial balance.

### 3.8.3.7 AP 3-7



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Rigney Productions Corporation was incorporated and began operations on January 1, 2016 with \$50,000 cash and \$50,000 of share capital issued.

#### Part A

The following transactions occurred during January 2016.

- a. Paid salaries of \$15,000 during the month
- b. Purchased \$750 of supplies on credit (record as unused supplies)
- c. Paid 7,200 cash for equipment
- d. Invested \$10,000 temporarily-idle cash in a term deposit (record as short-term investment)
- e. Paid \$1,200 for a one-year insurance policy, effective January 1 (record as an asset)
- f. Collected \$6,000 of one-year subscriptions, beginning January 1 (record as unearned subscription revenue)
- g. Paid \$1,500 for January, February, and March rent (record as an asset)
- h. Collected \$600 for sublet of the company's warehouse for January and February (record as unearned rent revenue)
- i. Paid \$6,000 for a used truck.

*Required:*

1. Open general ledger T-accounts for the following: Cash, Shortterm Investments, Prepaid Insurance, Prepaid Rent, Unused Supplies, Equipment, Truck, Accounts Payable, Share Capital, Unearned Rent Revenue, Unearned



Subscriptions Revenue, and Salaries Expense. General ledger account numbers are not necessary.

- Prepare journal entries to record the January transactions.
2. General ledger account numbers and descriptions are not necessary.
  3. Post the entries to the general ledger T-accounts.

### Part B

At the end of the month, the following adjusting entries are needed.

- j. Two days of salary amounting to \$1,000 remain unpaid; the amount will be included in the first Friday salary payment in February.
- k. A physical count indicates that \$250 of supplies is still on hand.
- l. The equipment has an estimated useful life of three years .
- m. An amount of \$100 interest revenue is accrued on the term deposit.
- n. One month of the insurance policy has expired.
- o. The January portion of the subscriptions revenue has been earned.
- p. The January portion of the rent payment has expired.
- q. Half of the sublet revenue has been earned but not yet received in cash.
- r. The truck has an estimated useful life of four years .

*Required:*

- Open additional general ledger T-accounts for the following: Interest Receivable, Accumulated Depreciation—Equipment, Accumulated Depreciation—Truck, Salaries Payable, Interest Earned, Rent Earned, Subscription Revenue, Depreciation Expense—Equipment, Depreciation Expense—Truck, Insurance Expense, Rent Expense, and Supplies Expense. General ledger account numbers are not necessary.
- 4.
  5. Prepare all adjusting entries at January 31, 2016. General ledger account numbers and descriptions are not needed. Show the depreciation calculation.
  6. Post the entries to the general ledger T-accounts.
  7. Prepare an adjusted trial balance at January 31.

### 3.8.4 Problems

#### 3.8.4.1 P 3-1



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The following unrelated accounts are extracted from the trial balance of Meekins Limited at December 31, its fiscal year-end:

<i>Account</i>	<i>Balance</i>	
	<i>Unadjusted</i>	<i>Adjusted</i>
a. Prepaid rent	\$ 300	\$ 600
b. Wages payable	500	700
c. Income taxes payable	-0-	1,000
d. Unearned commissions revenue	2,000	3,000
e. Other unearned revenue	25,000	20,000
f. Advertizing expense	5,000	3,500
g. Depreciation expense - equipment	-0-	500
h. Supplies expense	850	625
i. Truck operating expense	4,000	4,500

*Required:* For each of the above accounts, prepare the most likely adjusting entry, including plausible descriptions. General ledger account numbers are not necessary.

### 3.8.4.2 P 3-2



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The unadjusted trial balance of Lukas Films Corporation includes the following account balances at December 31, 2016, its fiscal year-end. Assume all accounts have normal debit or credit balances as applicable.

Prepaid rent	\$ 1,500
Equipment	2,400
Unearned advertizing revenue	1,000
Insurance expense	900
Supplies expense	600
Telephone expense	825
Wages expense	15,000

The following information applies at December 31:

- a. A physical count of supplies indicates that \$300 of supplies have not yet been used at December 31.
- b. A \$75 telephone bill for December has been received but not recorded.
- c. One day of wages amounting to \$125 remains unpaid and unrecorded at December 31; the amount will be included with the first Friday payment in January.
- d. The equipment was purchased December 1; it is expected to last 2 years. No depreciation has yet been recorded.

- e. The prepaid rent is for December 2016, and January and February 2017; rent is \$500 per month.
- f. Half of the advertizing revenue has been earned at December 31.
- g. The \$900 amount in Insurance Expense is for a one-year policy, effective July 1, 2016.

*Required:* Prepare all necessary adjusting entries at December 31, 2016. Include general ledger account numbers (see chart of accounts in chapter 2). Descriptions are not needed.

### 3.8.4.3 P 3-3



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The unadjusted trial balance of Mighty Fine Services Inc. includes the following account balances at December 31, 2016, its fiscal year-end. No adjustments have been recorded. Assume all accounts have normal debit or credit balances.

Prepaid insurance	\$ 600
Unused supplies	500
Bank loan	5,000
Subscription revenue	9,000
Salaries payable	500
Rent expense	3,900
Truck operating expense	4,000

The following information applies to the fiscal year-end:

- a. The \$600 prepaid insurance is for a one-year policy, effective September 1, 2016.

- b. A physical count indicates that \$300 of supplies is still on hand at December 31.
- c. Interest on the bank loan is paid on the fifteenth day of each month; the unrecorded interest for the last 15 days of December amounts to \$25.
- d. The Subscription Revenue account consists of a cash receipts for 6-month subscriptions to the corporation's Computer Trends report; the subscription period began December 1.
- e. Three days of salary amounting to \$300 remain unpaid at December 31, in addition to the previous week's salaries of \$500, which have not yet been paid.
- f. The monthly rent expense amounts to \$300.
- g. A bill for December truck operating expense has not yet been received; an amount of \$400 is owed.

*Required:* Prepare all necessary adjusting entries at December 31, 2016. General ledger account numbers and descriptions are not necessary.

### 3.8.4.4 P 3-4



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The following accounts are taken from the records of Bill Pitt Corp. at the end of its first 12 months of operations ended December 31, 2016, prior to any adjustments. In addition to the balances in each set of accounts, additional data are provided for adjustment purposes if applicable. Treat each set of accounts independently of the others.

a.

Truck	Depreciation Expense – Truck	Acc. Dep'n – Truck
6,000	600	600

Additional information: The truck was purchased July 1; it has an estimated useful life of 4 years.

b.

Cash	Unearned Rent	Rent Earned
600	-0-	600

Additional information: A part of Harrison's office was sublet during the entire 12 months for \$50 per month.

c.

<b>Unused Supplies</b>	<b>Supplies Expense</b>
	1,250

Additional information: A physical inventory indicated \$300 of supplies still on hand at December 31.

d.

<b>Prepaid Rent</b>	<b>Rent Expense</b>
1,200	4,400

Additional information: The monthly rent is \$400.

e.

<b>Wages Expense</b>	<b>Wages Payable</b>
6,000	500

Additional information: Unrecorded wages at December 31 amount to \$250.

f.

<b>Bank Loan</b>	<b>Interest Expense</b>	<b>Interest Payable</b>
8,000	600	100

Additional information: Total interest expense for the year should be \$800.

g.

<b>Cash</b>	<b>Utilities Expense</b>	<b>Utilities Payable</b>
1,000	1,200	200

Additional information: The December bill has not yet been received or any accrual made; the amount owing at December 31 is estimated to be another \$150.

h.

<b>Cash</b>	<b>Prepaid Insurance</b>	<b>Insurance Expense</b>
1,200	600	600

Additional information: A \$1,200 one-year insurance policy had been purchased effective February 1, 2016; there is no other insurance policy in effect.

i.

<b>Unearned Rent Revenue</b>	<b>Rent Earned</b>
900	300

Additional information: The Unearned Rent Revenue balance applies to the months of November and December 2016 and to January 2017 at \$300 per month.

j.

<b>Cash</b>	<b>Other Unearned Revenue</b>	<b>Commissions Earned</b>
25,200	-0-	25,200

---

Additional information: An amount of \$2,000 commission revenue has not been earned at December 31.

*Required:* Prepare all necessary adjusting entries and descriptions at December 31, 2016. General ledger account numbers are not necessary.

### 3.8.4.5 P 3-5



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Following is the unadjusted trial balance of Pape Pens Corporation at the end of its first year of operations, December 31, 2016:



<i>Acct.</i>		<i>Balance</i>	
		<i>Debit</i>	<i>Credit</i>
<i>No.</i>	<i>Account</i>		
101	Cash	3,300	
110	Accounts receivable	4,000	
161	Prepaid insurance	1,200	
173	Unused supplies	500	
184	Truck	8,000	
194	Acc. dep. – truck		-0-
210	Accounts payable		5,000
226	Salaries payable		-0-
248	Unearned rent revenue		2,400
260	Income taxes payable		-0-
320	Share capital		7,000
350	Dividends	1,000	
410	Commissions earned		16,100
440	Rent earned		-0-
610	Advertizing expense	200	
615	Commissions expense	1,000	
624	Dep. expense – truck	-0-	
631	Insurance expense	-0-	
632	Interest expense	400	
654	Rent expense	3,600	
656	Salaries expense	7,000	
668	Supplies expense	-0-	
669	Telephone expense	300	
830	Income taxes expense	-0-	
		<u>30,500</u>	<u>30,500</u>

The following additional information is available:

- a. Prepaid insurance at December 31 amounts to \$600.
- b. A physical count indicates that \$300 of supplies is still on hand at December 31.
- c. The truck was purchased on July 1; it has an estimated useful life of 4 years.

- d. One day of salaries for December 31 is unpaid; the unpaid amount of \$200 will be included in the first Friday payment in January.
- e. The balance in the Unearned Rent Revenue account represents six months rental of warehouse space, effective October 1.
- f. A \$100 bill for December telephone charges has not yet been recorded.
- g. Income taxes expense for the year is \$300. This amount will be paid in the next fiscal year.

*Required:*

1. Prepare all necessary adjusting entries at December 31, 2016, including general ledger account numbers. Descriptions are not needed.
2. Prepare an adjusted trial balance at December 31, 2016.
3. Prepare an income statement, statement of changes in equity, and balance sheet.
4. Prepare closing entries including general ledger account numbers and descriptions.
5. Prepare a post-closing trial balance.

### 3.8.4.6 P 3-6



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Roth Contractors Corporation was incorporated on December 1, 2016 and had the following transactions during December:

#### Part A

- a. Issued share capital for \$5,000 cash
- b. Paid \$1,200 cash for three months' rent: December 2016; January and February 2017
- c. Purchased a used truck for \$10,000 on credit (recorded as an account payable)

- d. Purchased \$1,000 of supplies on credit. These are expected to be used during the month (recorded as expense)
- e. Paid \$1,800 for a one-year truck insurance policy, effective December 1
- f. Billed a customer \$4,500 for work completed to date
- g. Collected \$800 for work completed to date
- h. Paid the following expenses in cash: advertizing, \$350; interest, \$100; telephone, \$75; truck operating, \$425; wages, \$2,500
- i. Collected \$2,000 of the amount billed in f above
- j. Billed customers \$6,500 for work completed to date
- k. Signed a \$9,000 contract for work to be performed in January 2017
- l. Paid the following expenses: advertizing, \$200; interest, \$150; truck operating, \$375; wages, \$2,500
- m. Collected a \$2,000 advance on work to be done in January (the policy of the corporation is to record such advances as revenue at the time they are received)
- n. Received a bill for \$100 for electricity used during the month (recorded as utilities expense).

*Required:*

- 1. Open general ledger T-accounts for the following: Cash, Accounts Receivable, Prepaid Insurance, Prepaid Rent, Truck, Accounts Payable, Share Capital, Repair Revenue, Advertizing Expense, Interest Expense, Supplies Expense, Telephone Expense, Truck Operating Expense, Utilities Expense, and Wages Expense. General ledger account numbers are not necessary.

2. Prepare journal entries to record the December transactions. General ledger account numbers and descriptions are not needed.
3. Post the entries to general ledger T-accounts.

### Part B

The following information relates to December 31, 2016:

- o. One month of the prepaid insurance has expired.
- p. The December portion of the rent paid has expired.
- q. A physical count indicates that \$350 of supplies is still on hand.
- r. The amount collected in transaction *m* is unearned at December 31.
- s. Three days of wages for December 29, 30, and 31 are unpaid; the unpaid amount of \$1,500 will be included in the first wages payment in January.
- t. The truck has an estimated useful life of 4 years.
- u. Income taxes expense is \$500. This amount will be paid in the next fiscal year.

### Required:

4. Open additional general ledger T-accounts for the following: Unused Supplies, Accumulated Depreciation, Wages Payable, Unearned Revenue, Income Taxes Payable, Depreciation Expense, Insurance Expense, Rent Expense, and Income Taxes Expense. General ledger account numbers are not necessary.
5. Prepare all necessary adjusting entries. General ledger account numbers and descriptions are not necessary.

6. Post the entries to general ledger T-accounts and calculate balances.
7. Prepare an adjusted trial balance at December 31.
8. Assume the fiscal year-end is December 31, 2016. Prepare an income statement, statement of changes in equity, and balance sheet.
9. Prepare closing entries and a post-closing trial balance at December 31, 2016.

### 3.8.4.7 P 3-7



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Snow Services Corporation performs snow removal services and sells advertizing space on its vehicle. The company started operations on January 1, 2016 with \$30,000 cash and \$30,000 of share capital. It sublets some empty office space.

#### Part A

The following transactions occurred during January 2016:

- a. Purchased a truck for \$15,000 cash on January 1
- b. Collected snow removal revenue for January, February, and March amounting to \$4,000 per month, \$12,000 in total (recorded as Service Revenue)
- c. Paid \$600 for a one-year insurance policy, effective January 1
- d. Invested \$5,000 of temporarily-idle cash in a term deposit (recorded as Short-term Investments)
- e. Purchased \$500 of supplies on credit (recorded as Supplies Expense)
- f. Received three months of advertizing revenue amounting to \$900 (recorded as Other Revenue)

- g. Received two months of interest amounting to \$150 (recorded as Interest Earned)
- h. Paid \$5,000 cash for equipment
- i. Received \$1,200 cash for January, February, and March rent of unused office space (recorded as Rent Earned)
- j. Paid \$3,000 of wages during the month.

*Required:*

1. Open general ledger T-accounts for the following: Cash, Short-term Investments, Prepaid Insurance, Equipment, Truck, Accounts Payable, Share Capital, Other Revenue, Interest Earned, Rent Earned, Service Revenue, Supplies Expense, and Wages Expense. General ledger account numbers are not necessary.
2. Prepare journal entries to record the January transactions. Descriptions are not needed.
3. Post the entries to the general ledger accounts.

**Part B**

At the end January, the following adjusting entries are needed:

- k. The truck purchased in transaction a has a useful life of five years.
- l. One-third of the snow removal revenue from transaction b has been earned.
- m. The January portion of the insurance policy has expired.
- n. Half of the interest revenue still has not been earned.
- o. A physical count indicates \$200 of supplies is still on hand.

- p. The January component of the advertizing revenue has been earned.
- q. \$50 interest for January is accrued on the term deposit; this amount will be included with the interest payment to be received at the end of February.
- r. The equipment purchased in transaction h on January 1 is expected to have a useful life of four years.
- s. January rent revenue has been earned.
- t. Three days of wages amounting to \$150 remain unpaid; the amount will be included in the first Friday payment in February.

*Required:*

4. Open additional general ledger T-accounts for the following: Interest Receivable, Unused Supplies, Accumulated Depreciation—Equipment, Accumulated Depreciation—Truck, Wages Payable, Unearned Advertizing Revenue, Unearned Fees Revenue, Unearned Interest Revenue, Unearned Rent Revenue, Insurance Expense, Depreciation Expense—Equipment, and Depreciation Expense—Truck. General ledger account numbers are not necessary.
5. Prepare all adjusting entries at January 31. Descriptions are not necessary.
6. Post the entries to the general ledger accounts and post balances.
7. Prepare an adjusted trial balance at January 31.



## 3.8.5 Review Problem

### 3.8.5.1 RP 3-1



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The unadjusted trial balance of Packer Corporation showed the following balances at the end of its first 12-month fiscal year ended August 31, 2016:

Acct. No.	Account	Balance	
		Debit	Credit
101	Cash	7,000	
106	Short-term investment	5,000	
110	Accounts receivable	3,600	
116	Interest receivable	-0-	
161	Prepaid insurance	-0-	
173	Unused supplies	2,500	
180	Land	15,000	
181	Building	60,000	
182	Furniture	3,000	
183	Equipment	20,000	
191	Accumulated depreciation—building		-0-
192	Accumulated depreciation—equipment		-0-
193	Accumulated depreciation—furniture		-0-
201	Bank loan		47,600
210	Accounts payable		4,400
226	Salaries payable		-0-
222	Interest payable		-0-
242	Unearned commissions revenue		1,200
250	Unearned subscription revenue		800
260	Income taxes payable		-0-
320	Share capital		53,100
340	Retained earnings		-0-
350	Dividends	1,000	
360	Income summary		-0-
410	Commissions earned		37,900
430	Interest earned		-0-
480	Subscription revenue		32,700
610	Advertising expense	2,300	
621	Depreciation expense—building	-0-	
622	Depreciation expense—equipment	-0-	
623	Depreciation expense—furniture	-0-	
631	Insurance expense	1,800	
632	Interest expense	2,365	
656	Salaries expense	33,475	
668	Supplies expense	15,800	
676	Utilities expense	2,860	
830	Income taxes expense	2,000	
		<u>177,700</u>	<u>177,700</u>

At the end of August, the following additional information is available:

- 
- a. The company's insurance coverage is provided by a single comprehensive 12-month policy that began on March 1, 2016.
  - b. Supplies on hand total \$2,850.
  - c. The building has an estimated useful life of 50 years .
  - d. The furniture has an estimated useful life of ten years .
  - e. The equipment has an estimated useful life of 20 years .
  - f. Interest of \$208 on the bank loan for the month of August will be paid on September 1, when the regular \$350 payment is made.
  - g. Unearned commission revenue is \$450.
  - h. Unearned subscription revenue is \$2,800.
  - i. Salaries that have been earned by employees in August but are not due to be paid to them until the next payday (in September) amount to \$325.
  - j. Accrued interest from the short-term investments amounts to \$50.
  - k. An additional \$1,000 of income taxes is payable.

*Required:*

1. Set up necessary general ledger T-accounts and record their unadjusted balances. Include general ledger account numbers.
2. Prepare the adjusting entries. Include general ledger account numbers and applicable calculations. Descriptions are not needed.
3. Post the adjusting entries to the general ledger T-accounts and calculate balances.
4. Prepare an adjusted trial balance at August 31, 2016.
5. Prepare an income statement, statement of changes in equity, and balance sheet.
6. Prepare and post the closing entries, including descriptions.
7. Prepare a post-closing trial balance.

## 3.8.6 Decision Problem

### 3.8.6.1 DP 3-1



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Net income over a fiscal year is determined in accordance with the matching concept.

*Required:* For each of the following independent situations, indicate how you think the transaction should be recorded in the corporation. Provide reasons for your answers.

1. An advertising expenditure of \$100,000 is made on the first day of the current fiscal year. The company's advertising agency estimates that three-fourths of the expected increase in sales will take place this fiscal year and one-fourth will occur next year.
2. The company sustained a fire loss this period of \$180,000 in excess of insurance proceeds.
3. Research outlays amounted to \$480,000 this year. These resulted in a new production technique that is in the process of being patented. It will be introduced into the company's manufacturing processes in the next fiscal year.
4. A machine was purchased for \$10,000. It is expected to have a 10-year life. Each period was expected to benefit equally from the machine's output. In the first year, the machine operated according to expectations. However, the machine was idle in the second fiscal year because of a recession.
5. At the end of the fiscal year, salaries and wages for services performed were unpaid in the amount of \$25,000.
6. The company is facing a lawsuit. The company's lawyers cannot predict the outcome of the case with certainty, but indicate the damages could be as high as \$400,000.
7. At the end of the period, accounts receivable from sales to customers amounted to \$190,000. Based on past experience, it is estimated that \$6,000 of this amount will have to be written off as uncollectible.
8. Pensions will be paid to workers still employed by the company at the time of their retirement. Estimated pension expense for employees applicable to this fiscal year is \$95,000.
9. A bill for property taxes will not be received until the beginning of fiscal year. It is expected that the property taxes will amount to \$30,000, of which three-fourths applies to the current year.
10. A fire insurance premium of \$3,000 was paid on the first day of the current fiscal year. The premium covers the current year plus the next two fiscal years.

# Chapter 4 The Classified Balance Sheet and Related Disclosures



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Chapters 1 through 3 discussed and illustrated the steps in the accounting cycle. They also discussed the concepts, assumptions, and procedures that provide a framework for financial accounting as a whole. Chapter 4 expands upon the content and presentation of financial statements. It reinforces what has been learned in previous chapters and introduces the classification or grouping of accounts on the balance sheet. Chapter 4 expands on notes to the financial statements, the auditor's report, and the management's responsibility report which are all integral to meeting disclosure requirements.

## Learning Objectives

LO1 – Explain the importance of and challenges related to basic financial statement disclosure.

LO2 – Explain and prepare a classified balance sheet.

LO3 – Explain the purpose and content of notes to financial statements.

LO4 – Explain the purpose and content of the auditor's report.

LO5 – Explain the purpose and content of the report that describes management's responsibility for financial statements.

## 4.1 Financial Statement Disclosure Decisions



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LO1 – Explain the importance of and challenges related to basic financial statement disclosure.

Financial statements communicate information, with a focus on the needs of financial statement users such as a company's investors and creditors. Accounting information should make it easier for management to allocate resources and for shareholders to evaluate management. A key objective of financial statements is to fairly present the entity's economic resources, obligations, equity, and financial performance.

Fulfilling these objectives is challenging. Accountants must make a number of subjective decisions about how to apply generally accepted accounting principles. For

example, they must decide how to measure wealth and how to apply recognition criteria. They must also make practical cost-benefit decisions about how much information is useful to disclose. Some of these decisions are discussed in the following section.

### 4.1.1 Making Accounting Measurements



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Economists often define wealth as an increase or decrease in the entity's ability to purchase goods and services. Accountants use a more specific measurement—they consider only increases and decreases resulting from actual transactions. If a transaction has not taken place, they do not record a change in wealth.

The accountant's measurement of wealth is shaped and limited by the assumptions underlying generally accepted accounting principles that were introduced and discussed in Chapter 1. These included the use of historical cost, matching expenses to revenues or the period in which they are incurred, and assumptions about a stable monetary unit, a separate business entity, revenue recognition, , and going concern. These assumptions mean that accountants record transactions in one currency (for example, dollars), currency retains its purchasing power, and changes in market values of assets are generally not recorded.

Economists, on the other hand, make different assumptions. They often recognize changes in market value of assets. For example, if an entity purchased land for \$100,000 that subsequently increased in value to \$125,000, economists would recognize a \$25,000 increase in wealth. International Financial Reporting Standards generally do not recognize this increase until the entity actually disposes of the asset; accountants would continue to value the land at its \$100,000 purchase cost. This practice is based on the application of the historical cost principle, which is a part of GAAP.

Economic wealth is also affected by changes in the **purchasing power** of the dollar. For example, if the entity has cash of \$50,000 at the beginning of a time period and purchasing power drops by 10% because of inflation, the entity has lost wealth because the \$50,000 can purchase only \$45,000 of goods and services. Conversely, the entity gains wealth if purchasing power increases by 10%. In this case, the same \$50,000 can purchase \$55,000 worth of goods and services. However, accountants do not record any changes because the monetary unit principle assumes that the currency unit is a stable measure.

### 4.1.2 Qualities of Accounting Information



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Financial statements are focused primarily on the needs of external users, primarily creditors and shareholders. They use materiality considerations to decide how particular items of information should be recorded and disclosed. To provide

information to these users, accountants also make **cost-benefit judgments**. For example, if the costs associated with financial information preparation are too high or if an amount is not sufficiently large or important, a business might implement a materiality policy for various types of asset purchases to guide how such costs are to be recorded. For example, a business might have a materiality policy for the purchase of office equipment whereby anything costing \$100 or less is expensed immediately instead of recorded as an asset. In this type of situation, purchases of \$100 or less are recorded as an expense instead of an asset to avoid the time and effort needed to record depreciation expense each year for small amounts. This small violation of GAAP will not impact decisions made by external users of the business's financial statements.

Accountants must also make decisions based on whether information is useful. Is it comparable to prior periods? Is it verifiable? Is it presented with clarity and conciseness to make it understandable? Readers' perception of the usefulness of accounting information is determined by how well those who prepare financial statements address these qualitative considerations.

## 4.2 Classified Balance Sheet



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LO2 – Explain and prepare a classified balance sheet.

The accounting cycle and double-entry accounting have been the focus of the preceding chapters. This chapter focuses on the presentation of financial statements, including how financial information is *classified* (the way accounts are grouped) and what is disclosed.

A common order for the presentation of financial statements is:

1. Income statement
2. Statement of changes in equity
3. Balance sheet
4. Statement of cash flows
5. Notes to the financial statements

In addition, the financial statements are often accompanied by an auditor's report and a statement entitled "Management's Responsibility for Financial Statements." Each of these items will be discussed below. Financial statement information must be disclosed for the most recent year as well as the prior year for comparison purposes.

Because external users of financial statements have no access to the entity's accounting records, it is important that financial statements be organized in a manner that is easy to understand. Thus, financial data are usually grouped into useful, similar categories within **classified financial statements**, as discussed below.



## 4.2.1 The Classified Balance Sheet



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A **classified balance sheet** organizes the asset and liability accounts into categories. The previous chapters used an unclassified balance sheet which included only three broad account groupings: assets, liabilities, and shareholders' equity. The classification of asset and liability accounts into meaningful categories is designed to facilitate the analysis of balance sheet information by external users. Assets and liabilities are classified as either *current* or *non-current*.

## 4.2.2 Current Assets



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**Current assets** are those resources that the entity expects to convert to cash or consume during the next fiscal year<sup>1</sup>. Examples of current assets include:

- cash, comprising paper currency and coins, deposits at banks, cheques, and money orders.
- short-term investments, cash that is invested in interest-bearing deposits or shares that are easily convertible back into cash.
- accounts receivable that are due to be collected within one year.
- notes receivable, account receivables with formalized, written promises to pay specified amounts with interest, and due to be collected within one year.
- merchandize inventory that is expected to be sold within one year.

The current asset category also includes accounts whose future benefits are expected to expire within one fiscal year, such as:

- prepaid expenses, usually consisting of advance payments for insurance, rent, and similar items.
- supplies on hand at the end of an accounting year that will be used during the next year.

In North America, current assets are normally reported before noncurrent assets on the balance sheet. They are listed by decreasing levels of **liquidity** – their ability to be converted into cash. Therefore, cash appears first under the current asset heading.

## 4.2.3 Non-current Assets



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**Non-current assets** are assets that will be useful for more than one year; they are often referred to as *long-lived assets*. Non-current assets include **property, plant, and**

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1. Or within the normal operating cycle of the entity, whichever is longer. In this text, the fiscal year will always be assumed to be longer.

**equipment (PPE)** – items used to conduct the operations of the business. Some examples of PPE are: land, buildings, equipment, and motor vehicles.

Other types of non-current assets include long-term investments and intangible assets. **Long-term investments** include notes receivable that will be paid by customers over a period greater than one fiscal year and investments in shares and debt of other companies that will be held for more than one year. **Intangible assets** are resources that do not have a physical form and whose value comes from the rights held by the owner. They are used over the long term to produce or sell products and services and include copyrights, patents, trademarks, and franchises. These types of assets will be discussed in detail in a later chapter.

## 4.2.4 Current Liabilities



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**Current liabilities** are obligations that must be paid within the next fiscal year. In North America, they are shown first in the liabilities section of the balance sheet and listed in order of their due dates. Bank loans are shown first. Examples of current liabilities include:

- bank loans (or borrowings) that are payable on demand or due within the next 12 months (or next operating cycle, whichever is longer)
- accounts payable
- accrued liabilities such as interest payable, wages payable, and income taxes payable
- unearned revenue, and
- the **current portion of non-current liabilities**; that is, the amount that will be paid in the next fiscal year. For example, assume a \$30,000 bank loan is issued on December 31, 2015 and this amount is to be repaid at the rate of \$1,000 at the end of each month over two years. The current portion of this loan on the December 31, 2015 balance sheet would be \$12,000 (calculated as 12 months X \$1,000/month). The remaining principal (\$18,000) would be reported on the December 31, 2015 balance sheet as a non-current liability.

## 4.2.5 Non-Current or Long-Term Liabilities



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**Non-current liabilities**, also referred to as *long-term liabilities*, are borrowings that do not require repayment for more than one year. Examples include a bank loan (as noted above, minus the current portion). A **mortgage** is a liability that is secured by real estate.

## 4.2.6 Shareholders' Equity



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As discussed in prior chapters, the shareholders' equity section of the classified balance sheet consists of two major accounts: share capital and retained earnings.

## 4.2.7 Presentation of the Balance Sheet



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The balance sheet can be presented in the **account form** where liabilities and equities are presented to the right of the assets. An alternative is the **report form** where liabilities and shareholders' equity are presented below the assets. The following illustrates the classified balance sheet of Big Dog Carworks Corp. after several years of operation, presented in account form:

		Big Dog Carworks Corp. Balance Sheet At December 31, 2018				
Assets		2018	2017	Liabilities	2018	2017
<i>Current assets</i>				<i>Current</i>		
Cash	\$ 10,800	\$ 12,000		Borrowings (Note 5)	\$ 39,000	\$ 82,250
Accounts receivable	26,000	24,000		Accounts payable	24,000	22,000
Merchandise inventories	120,000	100,000		Income taxes payable	15,000	10,000
Prepaid expenses	1,200	570		Total current liabilities	78,000	114,250
Total current assets	158,000	136,570				
<i>Property, plant, and equipment (Note 4)</i>		126,645	10,430	<i>Non-current</i>		
				Borrowings (Note 5)	163,145	-0-
				Total liabilities	241,145	114,250
				<i>Shareholders' Equity</i>		
				Share capital (Note 6)	11,000	11,000
				Retained earnings	32,500	21,750
				Total shareholders' equity	43,500	32,750
Total assets	\$284,645	\$147,000		Total liabilities and equity	\$284,645	\$147,000

These refer to notes included at the end of the financial statements. Among other purposes, they provide details about a particular category on the balance sheet or income statement.

The prior year's information is also presented for comparison.

The statement of changes in equity is as follows:

Big Dog Carworks Corp.  
Statement of Changes in Equity  
For the Year Ended December 31, 2018

	<i>Share capital</i>	<i>Retained earnings</i>	<i>Total equity</i>
Balance at January 1, 2017	\$11,000	\$10,000	\$21,000
2017 net income		15,000	15,000
Dividends		<u>(3,250)</u>	<u>(3,250)</u>
Balance at December 31, 2017	<u>11,000</u>	<u>21,750</u>	<u>32,750</u>
2018 net income		20,000	20,000
Dividends		<u>(9,250)</u>	<u>(9,250)</u>
Balance at December 31, 2018	<u><b>\$11,000</b></u>	<u><b>\$32,500</b></u>	<u><b>\$43,500</b></u>

↑

This column shows the continuity of retained earnings from one year-end to the next. Bolded amounts agree to the balance sheet. They are highlighted only for illustrative purposes.

## 4.2.8 The Classified Income Statement



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Recall that the income statement summarizes a company's revenues less expenses over a period of time. An income statement for BDCC was presented in the first few pages of Chapter 1:

**Big Dog Carworks Corp.**  
**Income Statement**  
**For the Month Ended January 31, 2015**

<i>Revenue</i>		
Repairs		\$10,000
 <i>Expenses</i>		
Rent	\$1,600	
Salaries	3,500	
Supplies	2,000	
Truck operating	700	
Total expenses	7,800	
Net income		\$2,200

The format used above was sufficient to disclose relevant financial information for Big Dog's simple start-up operations. When operations become more complex, an income statement can be classified like the balance sheet. The classified income statement will be discussed in detail in a later chapter.

Regardless of the type of financial statement, any items that are **material** must be disclosed separately so users will not otherwise be misled. A material amount is one which would affect the decision of a reader if it was omitted. Materiality is a matter for judgment. Office supplies of \$1,000 per month used by BDCC in January 2015 in its first month of operations might be a material amount and therefore disclosed as a separate item on the income statement for the month ended January 31, 2015. If annual revenues grew to \$1 million several years later, \$1,000 per month for supplies might be considered immaterial. These expenditures would then be grouped with other similar items and disclosed as a single amount on the income statement.

### 4.3 Notes to Financial Statements



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LO3 – Explain the purpose and content of notes to financial statements.

As an integral part of its financial statements, a company provides **notes to the financial statements**. In accordance with the disclosure principle, these provide relevant details that are not included in the body of the financial statements. For instance, details about Big Dog's property, plant, and equipment are shown in Note 4

in the following sample notes to the financial statements. The notes help external users better understand and analyze the financial statements.

Although a detailed discussion of disclosures that might be included as part of the notes is beyond the scope of an introductory financial accounting course, a simplified example of note disclosure is shown below for Big Dog Carworks Corp.

Big Dog Carworks Corp.

Notes to the Financial Statements

For the Year Ended December 31, 2018

### **Nature of operations**

1. The principal activity of Big Dog Carworks Corp. is the servicing and repair of vehicles.

### **General information and statement of compliance with IFRS**

Big Dog Carworks Corp. is a limited liability company incorporated and domiciled in Canada. Its registered office and principal place of business is 123 Fox Street, Edmonton, Alberta, T5J 2Y7, Canada. Big Dog Carworks Corp.'s shares are listed on the Toronto Stock Exchange.

2. The financial statements of Big Dog Carworks Corp. have been prepared in accordance with International Financial Reporting Standards (IFRS) as issued the International Accounting Standards Boards (IASB).

The financial statements for the year ended December 31, 2018 were approved and authorized for issue by the board of directors on March 17, 2019.

### **Summary of accounting policies**

3. The financial statements have been prepared using the significant accounting policies and measurement bases summarized below.

#### Revenue

- a. Revenue arises from the rendering of service. It is measured by reference to the fair value of consideration received or receivable.

#### Operating expenses

- b. Operating expenses are recognized in the income statement upon utilization of the service or at the date of their origin.

- c. Borrowing costs



Borrowing costs directly attributable to the acquisition, construction, or production of property, plant, and equipment are capitalized during the period of time that is necessary to complete and prepare the asset for its intended use or sale. Other borrowing costs are expensed in the period in which they are incurred and reported as interest expense.

#### Property, plant, and equipment

- d. Land held for use in production or administration is stated at cost. Other property, plant, and equipment are initially recognized at acquisition cost plus any costs directly attributable to bringing the assets to the locations and conditions necessary to be employed in operations. They are subsequently measured using the cost model: cost less subsequent depreciation.

Depreciation is recognized on a straight-line basis to write down the cost, net of estimated residual value. The following useful lives are applied:

Buildings: 25 years

Equipment: 10 years

Truck: 5 years

Residual value estimates and estimates of useful life are updated at least annually.

#### Income taxes

- e. Current income tax liabilities comprise those obligations to fiscal authorities relating to the current or prior reporting periods that are unpaid at the reporting date. Calculation of current taxes is based on tax rates and tax laws that have been enacted or substantively enacted by the end of the reporting period.

#### f. Share capital

Share capital represents the nominal value of shares that have been issued.

#### Estimation uncertainty

- g. When preparing the financial statements, management undertakes a number of judgments, estimates, and assumptions about the recognition and measurement of assets, liabilities, income, and expenses. Information about estimates and assumptions that have the most significant effect on recognition and measurement of



assets, liabilities, income, and expenses is provided below. Actual results may be substantially different.

### Property, plant, and equipment

Details of the company's property, plant, and equipment and their carrying amounts at December 31 are as follows:

	2018				2017	
	<i>Land</i>	<i>Building</i>	<i>Equip.</i>	<i>Truck</i>	<i>Total</i>	<i>Total</i>
<i>Gross Carrying Amount</i>						
Balance, January 1	\$ -0-	\$ -0-	\$ 3,000	\$8,000	\$ 11,000	\$11,000
Additions	30,000	90,000			120,000	
Balance, Dec. 31	30,000	90,000	3,000	8,000	131,000	11,000
<i>Depreciation</i>						
Balance, January 1		-0-	90	480	570	285
Deprecation for year		3,500	45	240	3,785	285
Balance, Dec. 31		3,500	135	720	4,355	570
<i>Carrying Amount</i>						
December 31	\$30,000	\$86,500	\$ 2,865	\$7,280	\$126,645	\$10,430

These amounts agree to the PPE balances shown in the assets section of BDCC's balance sheet.

### Borrowings

Borrowings include the following financial liabilities measured at cost:

	<i>Current</i>		<i>Non-current</i>	
	<i>2018</i>	<i>2017</i>	<i>2018</i>	<i>2017</i>
Demand bank loan	\$ 20,000	\$ 52,250	\$ -0-	\$ -0-
Subordinated shareholder loan	13,762	30,000	-0-	-0-
Mortgage	5,238	-0-	163,145	-0-
Total carrying amount	\$39,000	\$82,250	\$163,145	\$ -0-

These amounts agree to the Borrowings balances shown in the current and non-current liability sections of BDCC's balance sheet.

The bank loan is due on demand and bears interest at 6% per year. It is secured by accounts receivable and inventories of the company.

The shareholder loan is due on demand, non-interest bearing, and unsecured.

The mortgage is payable to First Bank of Alberta. It bears interest at 5% per year and is amortized over 25 years. Monthly payments including interest are \$960. It is secured by land and buildings owned by the company. The terms of the mortgage will be renegotiated in 2021.

### Share capital

6. The share capital of Big Dog Carworks Corp. consists of fully-paid common shares with a stated value of \$1 each. All shares are eligible to receive dividends, have their capital repaid, and represent one vote at the annual shareholders' meeting. There were no shares issued during 2017 or 2018.

## 4.4 The Auditor's Report



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LO4 – Explain the purpose and content of the auditor's report.

Financial statements are often accompanied by an auditor's report. An **audit** is an external examination of a company's financial statement information and its system of *internal controls*.

**Internal controls** are the processes instituted by management of a company to direct, monitor, and measure the accomplishment of its objectives. This includes the prevention and detection of fraud and error. An audit seeks not certainty, but reasonable assurance that the financial statement information is not materially misstated.

The auditor's report is a structured statement issued by an independent examiner, usually a professional accountant, who is contracted by the company to report the audit's findings to the company's board of directors. An audit report provides some assurance to present and potential investors and creditors that the company's financial statements are trustworthy. Therefore, it is a useful means to reduce the risk of their financial decisions. Put in simple terms, an **unqualified auditor's report** indicates that the financial statements are considered reliable. A **qualified auditor's report** is one that indicates the financial statements may not be reliable. A Canadian example of an unqualified auditor's report for BDCC is shown below, along with a brief description of each component.



## 4.5 Management's Responsibility for Financial Statements



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LO5 – Explain the purpose and content of the report that describes management's responsibility for financial statements.

The final piece of information often included with the annual financial statements is a report describing management's responsibility for the accurate preparation and

presentation of financial statements. This statement underscores the division of duties involved with the publication of financial statements. Management is responsible for preparing the financial statements, including estimates that underlie the accounting numbers. An example of an estimate is the useful life of property, plant and equipment used to calculate depreciation as shown in the preceding note 3(d).

On the other hand, the independent auditor is responsible for examining the financial statement information as prepared by management, including the reasonableness of estimates, and then expressing an opinion on their accuracy. In some cases, the auditor may assist management with aspects of financial statement preparation. For instance, the auditor may provide guidance on how a new accounting standard will affect financial statement presentation or other information disclosure. Ultimately, however, the preparation of financial statements is management's responsibility.

A Canadian example of a statement describing management's responsibility for the preparation and presentation of annual financial statements is shown below.

### MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL STATEMENTS

Management's responsibility for all aspects of financial statement presentation and disclosure is expressly stated.

The accompanying financial statements of the company are the responsibility of management. The financial statements were prepared by management in accordance with accounting principles generally accepted in Canada, applied on a consistent basis, and conform in all material respects with International Accounting Standards. The significant accounting policies, which management believes are appropriate for the company, are described in Note 3 to the financial statements.

Management's responsibility for estimates used and maintenance of internal controls is acknowledged.

Management is responsible for the integrity and objectivity of the financial statements. Estimates are necessary in the preparation of these statements and, based on careful judgments, have been properly reflected.



Management has established systems of internal control that are designed to provide reasonable assurance that assets are safeguarded from loss or unauthorized use, and to produce reliable accounting records for the preparation of financial information.

The board of directors is responsible for ensuring that management fulfils its responsibilities for financial reporting and internal control. The audit committee of the board, which is comprised solely of directors who are not employees of the company, is appointed by the board of directors annually. The audit committee of the board meets regularly with financial management of the company and with the shareholders' independent auditor to discuss internal controls, audit matters, including audit scope and auditor remuneration, and financial reporting issues. The independent shareholders' auditor has unrestricted access to the audit committee. The audit committee reviews the annual financial statements and reporting to the board, and makes recommendations with respect to their acceptance. The audit committee also makes recommendations to the board with respect to the appointment and remuneration of the company's auditor.

The board of directors' and audit committee's respective roles are explained.

Management acknowledges its obligation to oversee all aspects of the company's operations in a legal and ethical manner.

Management recognizes its responsibility for conducting the company's affairs in compliance with established financial standards and applicable laws, and maintains proper standards of conduct for its activities.

The officer responsible for the financial affairs of the company signs and dates the statement.

(signed)  
Bill Brown II, Chief Financial Officer  
March 3, 2019

## 4.6 Summary of Chapter 4 Learning Objectives



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### **LO1 – Explain the importance of and challenges related to basic financial statement disclosure.**

The objective of financial statements is to communicate information to meet the needs of external users. In addition to recording and reporting verifiable financial information, accountants make decisions regarding how to measure transactions. Applying GAAP can present challenges when judgment must be applied as in the case of cost benefit decisions and materiality.

### **LO2 – Explain and prepare a classified balance sheet.**

A classified balance sheet groups assets and liabilities as follows:

#### *Assets*

Current assets

Non-current assets:

Property, plant, and equipment

Long-term investments

#### *Liabilities*

Current liabilities

Non-current or long-term liabilities

## Intangible assets

Current assets are those that are used within one year or one operating cycle, whichever is longer, and include cash, accounts receivables, and unused supplies. Non-current assets have benefits beyond one fiscal year, or are not expected to be converted to cash within one fiscal year or one operating cycle, whichever is longer. There are three types of non-current assets: property, plant, and equipment (PPE), long-term investments, and intangible assets. Longterm investments include holdings of shares and debt of other companies. Intangible assets are rights held by the owner and do not have a physical substance; they include copyrights, patents, franchises, and trademarks. Current liabilities must be paid within one year or one operating cycle, whichever is longer. Non-current liabilities are due beyond one year or one operating cycle, whichever is longer.

### **LO3 - Explain the purpose and content of notes to financial statements.**

In accordance with the GAAP principle of full disclosure, relevant details not contained in the body of financial statements are included in the accompanying notes to financial statements. Notes generally include a summary of significant accounting policies, details regarding property, plant, and equipment assets, and specifics about liabilities such as the interest rates and repayment terms.

### **LO4 - Explain the purpose and content of the auditor's report.**

An audit as it relates to the auditor's report is an external examination of a company's financial statement information and its system of internal controls. Internal controls are the processes instituted by management of a company to direct, monitor, and measure the accomplishment of its objectives including the prevention and detection of fraud and error. The auditor's report provides some assurance that the financial statements are trustworthy. In simple terms, an unqualified auditor's report indicates that the financial statements are reliable.

### **LO5 - Explain the purpose and content of the report that describes management's responsibility for financial statements.**

This report describes management's responsibility for the preparation and presentation of financial statements, the accuracy of estimates used therein, the adequacy of internal controls, and legal and ethical oversight of all aspects of the corporation. It also explains the responsibilities of the board of directors and the audit committee.



## 4.7 Assignment Materials

### 4.7.1 Concept Self-check



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1. What shapes and limits an accountant's measurement of wealth?
2. Are financial statements primarily intended for internal or external users?
3. What are the common classifications within a classified balance sheet?
4. What are current assets?
5. What are non-current assets?
6. What are current liabilities?
7. What are non-current liabilities?
8. What is the purpose and content of the notes to the financial statements?
9. What is the purpose and content of the auditor's report?
10. What is the purpose and content of the report that describes management's responsibility for financial statements?

To answer the following, refer to the Big Dog Carworks Corp. financial statements for the year ended December 31, 2018 and other information included in this chapter.

11. Identify the economic resources of Big Dog Carworks Corp. shown in its financial statements.
12. What comprise the financial statements of BDCC?

13. Why does BDCC prepare financial statements?

14. From the balance sheet at December 31, 2018 extract the appropriate amounts to complete the following accounting equation:

$$\text{ASSETS} = \text{LIABILITIES} + \text{SHAREHOLDERS' EQUITY}$$

15. If  $\text{ASSETS} - \text{LIABILITIES} = \text{NET ASSETS}$ , how much is net assets at December 31, 2018? Is net assets synonymous with shareholders' equity?

16. What types of assets are reported by Big Dog Carworks Corp.? What types of liabilities?

17. Accounting for financial transactions makes it possible to measure the progress of the entity. How do generally accepted accounting principles positively affect this measurement process?

18. From reading the financial statements including the notes to the financial statements, can you tell whether BDCC has made any cost-benefit judgements about certain disclosures? How do these take materiality into account?

19. Does Big Dog Carworks Corp. use the cash basis of accounting or the accrual basis? How can you tell?

20. What kind of assumptions is made by Big Dog Carworks Corp. about asset capitalization? Over what periods of time are assets being amortized?

21. Should the salary of BDCC's president be recorded as an asset since his salary brings benefits to the company in future accounting periods?

22. What adjustments might management make to the financial information when preparing the annual financial statements? Consider the following categories:

a. Current asset accounts

b. Non-current asset accounts

- c. Current liability accounts
- d. Non-current liability accounts.

Indicate several examples in each category. Use the BDCC balance sheet and notes 3 and 5 for ideas.

23. What sequence of steps is likely followed in preparing BDCC's annual financial statements?
24. What are the advantages of using a classified balance sheet? Why are current accounts shown before non-current ones on BDCC's balance sheet?
25. How does Big Dog Carworks Corp. make it easier to compare information from one time period to another?
26. Who is the auditor of BDCC? What does the auditor's report tell you about BDCC's financial statements? Does it raise any concerns?
27. What does the auditor's report indicate about the application of generally accepted accounting principles in BDCC's financial statements?
28. What is BDCC management's responsibility with respect to the company's financial statements? Do the financial statements belong to management? the auditor? the board of directors? shareholders?

## 4.7.2 Problems

### 4.7.2.1 P 4-1



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The following list of accounts is taken from the records of the Viking Company Ltd. at December 31, 2016:

<i>Account</i>	<i>Balance</i>
Accounts payable	\$200

Accounts receivable	100
Bank loan, due within 90 days	500
Building	1,000
Cash	20
Equipment	500
Land	2,000
Mortgage payable (due 2019)	1,500
Notes receivable, due within 90 days	40
Prepaid insurance	30
Retained earnings	?
Salaries payable	60
Share capital	1,200
Unused supplies	10

*Required:* Prepare a classified balance sheet. Assume all accounts have normal balances.

#### 4.7.2.2 P 4-2



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The Oregon Corporation has been operating for a number of years. On October 31, 2016 the accountant of the company disappeared, taking the records with him. You have been hired to reconstruct the accounting records, and with this in mind you assemble a list of all company assets. By checking with banks, counting the materials on hand, and investigating the ownership of buildings and equipment, you developed the following information as of October 31.

<i>Account</i>	<i>Balance</i>
Accounts Receivable	\$ 5
Buildings	10
Cash	2
Equipment	5
Land	200
Investment	3
Investment*	4

\*These are shares in another corporation that will be held indefinitely.

Statements and unpaid invoices found in the office indicate that \$30 is owed to trade creditors. There is a \$10 mortgage outstanding, \$4 of which is due by October 31, 2017. Interviews with the board of directors and a check of the share capital records indicate that there are 100 shares outstanding. Shareholders paid \$100 in total to the corporation for these. No record is available regarding past retained earnings.

*Required:* Prepare a classified balance sheet at October 31, 2016.

### 4.7.2.3 P 4-3



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The following balance sheet was prepared for Abbey Limited:

Abbey Limited Balance Sheet As at November 30, 2016			
	<i>Assets</i>		<i>Liabilities</i>
<i>Current</i>		<i>Current</i>	
Bank loan	\$ 1,000	Accounts payable	\$ 5,600
Notes receivable	6,000	Notes payable	2,000
Building	12,000	Cash	<u>1,000</u>
Merch. inventory	<u>3,000</u>		\$ 8,600
	\$22,000		
<i>Non-current</i>		<i>Non-current</i>	
Short-term investments	2,500	Mortgage payable	6,000
Retained earnings	2,000	Equipment	2,000
Unused supplies	100	Salaries payable	<u>250</u>
Truck	<u>1,350</u>		<u>8,250</u>
	5,950	Total liabilities	<u>16,850</u>
		<i>Shareholders' Equity</i>	
		Share capital	11,100
Total assets	<u>\$27,950</u>	Total liabilities and assets	<u>\$27,950</u>

Other information you have gathered:

- a. Amounts due on borrowings by November 30, 2017 are as follows:
- |                  |       |
|------------------|-------|
| Bank loan        | \$400 |
| Mortgage payable | 2,000 |
| Notes payable    | 500   |
- b. Notes receivable that will be collected by November 30, 2017 amount to \$5,000.
- c. The building was sold on December 15, 2016 for \$20,000.

*Required:*

1. Identify the errors that exist in the balance sheet of Abbey Limited and why you consider this information incorrect.
2. Prepare a corrected, classified balance sheet.
3. Based on the balance sheet categories, what additional information should be disclosed in the notes to the financial statements?

#### 4.7.2.4 P 4-4



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The following accounts and account balances are taken from the records of Joyes Enterprises Ltd. at December 31, 2016.

<i>Account</i>	<i>2016</i>	<i>2015</i>
Accounts payable	\$ 7,000	\$ 4,000
Accounts receivable	5,000	3,000
Notes receivable	3,000	2,000
Bank loan	5,000	5,000
Building	24,000	20,000
Cash	2,000	1,000
Dividends	1,000	-0-
Equipment	16,000	12,000
Income taxes payable	3,000	2,500
Land	5,000	5,000
Merchandise inventory	19,000	24,500
Mortgage payable	5,000	7,000
Prepaid insurance	1,000	1,000
Share capital	48,000	48,000
Retained earnings, start of year	2,000	1,000
Net income	?	?



Other information:

- a. One-half of the notes receivable at December 31, 2016 will be received in cash during 2017. All of the notes receivable at December 31, 2015 were received in cash during 2016.
- b. \$1,000 of the bank loan and \$2,000 of the mortgage payable must be repaid by December 31, 2017.

*Required:*

1. Calculate net income for 2015 and 2016.
2. Prepare a classified balance sheet. Assume all accounts have normal balances. Disclose all amounts separately on the balance sheet.
3. Does Joyes Enterprises Ltd. have sufficient resources to meet its current obligations in 2017?
4. Refer to BDCC's note 4 shown in this chapter. Assume now that Joyes' property, plant, and equipment are combined into one amount on the balance sheet. Prepare a suitable note to the financial statements. Assume there are no additions to PPE in 2015, and that there is no depreciation calculated for either year.

#### 4.7.2.5 P 4-5



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*Required:* Identify whether each of the following sentences would be found in (a) the auditor's report; (b) the statement of management's responsibility for the financial statements; or (c) the notes to the financial statements. The answer to the first sentence is provided.

- b      1.    The significant accounting policies, which management believes are appropriate for the company, are described in Note X to the financial statements.

- \_\_\_\_\_ 2.    The financial statements of Acme Supplies Ltd. have been prepared in accordance with International Financial Reporting Standards (IFRS) as issued the International Accounting Standards Boards (IASB).

- 3. Management has established systems of internal control that are designed to provide reasonable assurance that assets are safeguarded from loss or unauthorized use [ . . . ]
- 4. The board of directors is responsible for ensuring that management fulfils its responsibilities for financial reporting and internal control.
- 5. When preparing the financial statements, management undertakes a number of judgments, estimates, and assumptions about the recognition and measurement of assets, liabilities, income, and expenses. Information about estimates and assumptions that have the most significant effect on recognition and measurement of assets, liabilities, income, and expenses is provided below. Actual results may be substantially different.
- 6. The mortgage is payable to Last Chance Bank. It bears interest at 5% per year and is amortized over 20 years.
- 7. [ . . . ] the accompanying financial statements of Acme Supplies Ltd., which comprise the balance sheet as at December 31, 2018, the income statement, statement of changes in equity, and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.
- 8. An [ . . . ] involves performing procedures to obtain [ . . . ] evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the [ . . . ] judgment, including assessment of the risks of material misstatement of the financial statements, whether due to fraud or error.
- 9. The accompanying financial statements of the company are the responsibility of management.

- 
- \_\_\_ 10. Revenue arises from the rendering of service. It is measured by reference to the fair value of consideration received or receivable.
- \_\_\_ 11. The bank loan is due on demand and bears interest at 4% per year. It is secured by real estate of the company.
- \_\_\_ 12. The audit committee reviews the annual financial statements and reporting to the board, and makes recommendations with respect to their acceptance.
- \_\_\_ 13. Management recognizes its responsibility for conducting the company's affairs in compliance with established financial standards and applicable laws, and maintains proper standards of conduct for its activities.
- \_\_\_ 14. My responsibility is to express an opinion on the financial statements based on my audit.
- \_\_\_ 15. Estimates are necessary in the preparation of these statements and, based on careful judgments, have been properly reflected.
- \_\_\_ 16. I believe that the [. . .] evidence I have obtained is sufficient and appropriate to provide a basis for my [. . .].
- \_\_\_ 17. Land held for use in production or administration is stated at cost. Other property, plant, and equipment are initially recognized at acquisition cost plus any costs directly attributable to bringing the assets to the locations and conditions necessary to be employed in operations. They are subsequently measured using the cost model: cost less subsequent depreciation.
- \_\_\_ 18. In making those risk assessments, [. . .]considers internal control relevant to the entity's preparation and fair presentation of the financial

statements in order to design [. . .]procedures that are appropriate in the circumstances

- \_\_\_\_\_ 19. The share capital of Acme Supplies Ltd. consists of fully-paid common shares with a stated value of \$1 each.
- \_\_\_\_\_ 20. The principal activity of Acme Supplies Ltd. is the retail sale of merchandize.

### 4.7.3 Alternate Problems

#### 4.7.3.1 AP 4-1



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The following list of accounts is taken from the records of the Norman Company Ltd. at December 31, 2016:

<i>Account</i>	<i>Balance</i>
Accounts payable	\$125
Accounts receivable	138
Bank loan ( $\frac{1}{2}$ due in 2017)	110
Building	400
Cash	250
Equipment	140
Land	115
Mortgage payable (due 2019)	280
Notes receivable, due within 90 days	18
Prepaid insurance	12

Retained earnings	?
Salaries payable	14
Share capital	400
Unused supplies	70

*Required:* Prepare a classified balance sheet. Assume all accounts have normal balances.

#### 4.7.3.2 AP 4-2



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The Washington Corporation has been operating for a number of years. On December 31, 2015, the accountant of the company disappeared, taking the records with him. You have been hired to reconstruct the accounting records, and with this in mind you assemble a list of all company assets. By checking with banks, counting the materials on hand, and investigating the ownership of buildings and equipment, you developed the following information as of December 31.

<i>Account</i>	<i>Balance</i>
Accounts receivable	\$10
Buildings	20
Cash	56
Equipment	25
Inventories	14
Land	15
Short-term investment	5

Statements and unpaid invoices found in the office indicate that \$40 is owed to trade creditors. There is a \$30 bank loan outstanding. Principal is repayable at \$1 per

month. Interviews with the board of directors and a check of the share capital records indicate that there are 1,000 shares outstanding. Shareholders paid \$30 in total to the corporation for these. No record is available regarding past retained earnings. The land and buildings were sold on January 31, 2016 for \$44.

*Required:* Prepare a classified balance sheet at December 31, 2015.

### 4.7.3.3 AP 4-3



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The assets, liabilities, and shareholders' equity accounts of Lawson Corporation at December 31, 2015 are as follows:

<i>Account</i>	<i>Balance</i>
Accounts payable	\$10,000
Accounts receivable	15,200
Accumulated depreciation – building	1,000
Accumulated depreciation – equipment	500
Building	14,000
Cash	5,600
Equipment	4,000
Land	5,000
Merchandise inventory	5,600
Mortgage payable, due in 5 years	8,000
Notes payable, due within 90 days	7,500
Notes receivable, due in 120 days	3,000
Prepaid insurance	400

Retained earnings	16,000
Share capital	10,000
Unused supplies	200

*Required:*

1. Prepare a classified balance sheet.
2.
  - a. What is the proportion of shareholder claims to the total assets of the corporation?
  - b. What is the proportion of creditor's claims to the total assets of the corporation?
3. What does this indicate to you?

#### 4.7.3.4 AP 4-4



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The following adjusted trial balances have been extracted from the records of Dark Edge Sports Inc. at December 31, 2016 and 2017. Assume all accounts have normal debit and credit balances.

<i>Account</i>	<i>2017</i>	<i>2016</i>
Accounts payable	\$ 8,350	\$ 6,000
Accounts receivable	18,700	6,800
Accumulated depreciation – equipment	2,000	1,000
Advertizing expense	6,200	5,000
Bank loan, due May 31, 2018	10,000	5,000



Cash	1,500	2,000
Depreciation expense – equipment	1,000	1,000
Dividends	42,300	29,000
Equipment	48,200	48,200
Income taxes expense	2,300	800
Income taxes payable	3,600	3,000
Insurance expense	1,200	1,100
Interest expense	1,300	500
Merchandise inventory	1,300	2,000
Prepaid insurance	1,300	1,300
Prepaid rent	600	600
Rent expense	550	550
Repairs expense	1,100	900
Retained earnings (Jan. 1)	?	25,550
Revenue – fees	83,000	80,000
Salaries expense	21,600	20,100
Share capital	3,000	3,000
Telephone expense	100	100
Utilities expense	3,600	3,600

*Required:*

1. Prepare income statements and statements of changes in equity for the years ended December 31, 2016 and 2017, and classified balance sheets at December 31, 2016 and 2017.
2. By what amounts do total current assets exceed total current liabilities at each year-end? Comment on the differences between 2016 and 2017.
3. Assume a \$5,000 bank loan is received at the end of 2017, payable in six months. What is the effect on your answer to (2) above?
4. As the bank manager, what questions might you raise regarding the loan?

#### 4.7.3.5 AP 4-5



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*Required:* Identify whether each of the following sentences would be found in (a) the auditor's report; (b) the statement of management's responsibility for the financial statements; or (c) the notes to the financial statements. The answer to the first sentence is provided.

- |              |    |  |
|--------------|----|--|
| <u>  c  </u> | 1. | Calculation of current taxes is based on tax rates and tax laws that have been enacted or substantively enacted by the end of the reporting period.  |
| ___          | 2. | The financial statements were prepared by management in accordance with accounting principles generally accepted in Canada, applied on a consistent basis, and conform in all material respects with International Accounting Standards.   |
| ___          | 3. | The financial statements for the year ended December 31, 2018 were approved and authorized for issue by the board of directors on April 17, 2019.  |
| ___          | 4. | Management is responsible for the preparation and fair presentation of these financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. |
| ___          | 5. | Borrowing costs directly attributable to the acquisition, construction, or production of   |

property, plant, and equipment are capitalized during the period of time that is necessary to complete and prepare the asset for its intended use or sale. Other borrowing costs are expensed in the period in which they are incurred and reported as interest expense.

- 6. The audit committee of the board, which is comprised solely of directors who are not employees of the company, is appointed by the board of directors annually.
- 7. Details of the company's property, plant, and equipment and their carrying amounts at December 31 are as follows:
- 8. I conducted [. . .] in accordance with Canadian generally accepted [. . .]. Those [. . .] require that I comply with ethical requirements, and plan and perform the [. . .] to obtain reasonable assurance about whether the financial statements are free from material misstatement.
- 9. Share capital represents the nominal value of shares that have been issued.
- 10. In my opinion, the financial statements present fairly, in all material respects, the financial position of Acme Supplies Ltd. as at December 31, 2018, and its financial performance and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.
- 11. The shareholder loan is due on demand, non-interest bearing, and unsecured.
- 12. An [. . .] also includes evaluation of the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statement.

- 
13. The financial statements have been prepared using the significant accounting policies and measurement bases summarized below.
14. Management is responsible for the integrity and objectivity of the financial statements, and to produce reliable accounting records for the preparation of financial information.
15. Acme Supplies Ltd. is a limited liability company incorporated and domiciled in Canada.
16. Depreciation is recognized on a straight-line basis to write down the cost, net of estimated residual value.
17. The independent shareholders' [...] has unrestricted access to the audit committee. The audit committee also makes recommendations to the board with respect to the appointment and remuneration of the company's auditor.
18. Current income tax liabilities comprise those obligations to fiscal authorities relating to the current or prior reporting periods that are unpaid at the reporting date.
19. The audit committee of the board meets regularly with financial management of the company and with the shareholders' independent auditor to discuss internal controls, audit matters, including audit scope and auditor remuneration, and financial reporting issues.
20. Operating expenses are recognized in the income statement upon utilization of the service or at the date of their origin.
21. All shares are eligible to receive dividends, have their capital repaid, and represent one vote at the annual shareholders' meeting.

# Chapter 5 Accounting for the Sale of Goods



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To this point, examples of business operations have involved the sale of services. This chapter introduces business operations based on the purchase and resale of goods. For example, Canadian Tire and Walmart each purchase and resell goods—such businesses are known as merchandizers. The accounting transactions for merchandizing companies differ from those of service-based businesses. Chapter 5 covers accounting for transactions of sales of goods on credit and related cash collections by merchandizing firms, and transactions involving purchases and payments for goods sold in the normal course of business activities.

## Learning Objectives

LO1 – Describe merchandizing and explain the financial statement components of sales, cost of goods sold, merchandize inventory, and gross profit; differentiate between the perpetual and periodic inventory systems.

LO2 – Analyze and record purchase transactions for a merchandizer.

LO3 – Analyze and record sales transactions for a merchandizer.

LO4 – Record adjustments to merchandize inventory.

LO5 – Explain and prepare a classified multiple-step income statement for a merchandizer.

LO6 – Explain the closing process for a merchandizer.

LO7 – (Appendix) Explain and identify the entries for purchase and sales transactions in a periodic inventory system.

## 5.1 The Basics of Merchandizing



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LO1 – Describe merchandizing and explain the financial statement components of sales, cost of goods sold, merchandize inventory, and gross profit; differentiate between the perpetual and periodic inventory systems.

A merchandizing company, or **merchandizer**, differs in several basic ways from a company that provides services. First, a merchandizer purchases and then sells goods whereas a service company sells services. For example, a car dealership is a merchandizer that sells cars while an airline is a service company that sells air travel. Because merchandizing involves the purchase and then the resale of goods, an expense called **cost of goods sold** results. Cost of goods sold is the purchase price of items that are then re-sold to customers. For example, the cost of goods sold for a car dealership would be the cost of the cars purchased from the manufacturer. A service company does not have an expense called cost of goods sold since it does not sell physical items. As a result, the income statement for a merchandizer includes different details. A merchandizing income statement highlights cost of goods sold by showing the difference between sales revenue and cost of goods sold, which is called **gross profit** or *grossmargin*. The basic income statement differences between a service business and a merchandizer are illustrated in [Figure 5.1](#).

<i>Service Company</i>	<i>Merchandizing Company</i>
Revenues	Sales
	Less: Cost of Goods Sold
	-----
	Equals: Gross Profit
Less: Expenses	Less: Other Expenses
-----	-----
Equals: Net Income	Equals: Net Income
-----	-----

**Fig. 5.1: Differences Between the Income Statements of Service and Merchandizing Companies**

Assume that Excel Cars Corporation decides to go into the business of buying used vehicles from a supplier and reselling these to customers. If Excel purchases a vehicle for \$2,000 and then sells it for \$3,000, the gross profit would be \$1,000, as follows:

Sales	\$ 3,000
Cost of goods sold	2,000
Gross profit	\$ 1,000

The word “gross” is used by accountants to indicate that other expenses incurred in running the business must still be deducted from this amount before net income is calculated. In other words, gross profit represents the amount of sales revenue that remains to pay expenses after the cost of the goods sold is deducted.

A **gross profit percentage** can be calculated to express the relationship of gross profit to sales. The sale of the vehicle that cost \$3,000 results in a 33.3% gross profit percentage ( $\$1,000/\$3,000$ ). That is, for every \$1 of sales, the company has \$.33 left to cover other expenses after deducting cost of goods sold. Readers of financial statements use this percentage as a means to evaluate the performance of one company against other companies in the same industry, or in the same company from year to year. Small fluctuations in the gross profit percentage can have significant effects on the financial performance of a company because the amount of sales and

cost of goods sold are often very large in comparison to other income statement items.

Another difference between a service company and a merchandizer relates to the balance sheet. Since a merchandizer purchases goods for resale, goods held for resale by a merchandizer are called **merchandise inventory** and are reported as an asset on the balance sheet. A service company would not normally have merchandise inventory.

### 5.1.1 Inventory Systems



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There are two ways that inventory is managed: the perpetual inventory system or periodic inventory system. This chapter focuses on the perpetual system. In a **perpetual inventory system**, the Merchandise Inventory and Cost Of Goods Sold accounts in the general ledger are updated immediately when a purchase or sale of goods occurs. When merchandise inventory is purchased, the cost is debited to the Merchandise Inventory account. As inventory is sold to customers, the cost of the inventory sold is removed from the Merchandise Inventory account and debited to the Cost Of Goods Sold account. Under a perpetual system, the detailed composition of merchandise inventory – item description, number of items, cost per item, and total cost – is known at any time. However, a physical count is still performed at the end of the accounting period to determine and adjust for differences between the actual inventory on hand and the Merchandise Inventory account balance in the general ledger.

Some businesses will use a **periodic inventory system** instead. The purchase of merchandise inventory is debited to a temporary account called Purchases in the general ledger. At the end of the accounting period, inventory is counted, the Merchandise Inventory account is updated, and cost of goods sold is calculated. In a periodic inventory system, the real-time balances in Merchandise Inventory and Cost Of Goods Sold accounts are not known. The entry to record this difference is discussed later in this chapter. The periodic system is discussed in greater detail in the appendix to this chapter.

## 5.2 The Purchase and Payment of Merchandise Using the Perpetual Inventory Method



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LO2 – Analyze and record purchase transactions for a merchandizer.





			Accounts Payable
May 3 Accounts Payable	210	300	300
Merchandise Inventory	150	300	2,000
			1,700
			2,000
			300

*To record reduction in account payable: vehicle wrong colour.*

Note that the cost of the vehicle has been reduced to \$1,700 (\$2,000 – 300) as has the amount owing to the supplier.

### 5.2.3 Purchase Discounts



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**Purchase discounts** affect the purchase price of merchandise if payment is made within a time period specified in the supplier's invoice. For example, if the terms on the \$2,000 invoice for one vehicle received by Excel indicates "1/15, n45", this means that the \$2,000 must be paid within 45 days ('n' = net). However, if cash payment is made by Excel within 15 days, the purchase price will be reduced by 1%.

Assuming the amount is paid within 15 days, the supplier's terms entitle Excel to deduct \$17 [(\$2,000 - \$300) = \$1,700 x 1% = \$17]. The payment to the supplier if payment was made on May 9 would be recorded as:

			Accounts Payable
May 9 Accounts Payable	210	1,700	1,700
Merchandise Inventory	150	17	2,000
Cash	101	1,683	300
			17
			1,683
			Cash
			1,683

*To record payment on account in full and purchases discount applied.*

The cost of the vehicle in Excel's inventory records is now \$1,683 (\$2,000 – 300 – 17). If payment is made after the discount period, \$2,700 of cash is paid and the entry would be:

Accounts Payable			1,700
Cash			1,700

*To record payment on account; no purchase discount applied.*

In this case, the Merchandise Inventory account is not affected. The cost of the vehicle in the general ledger remains at \$1,700.

**Trade discounts** are similar to purchase discounts. A supplier advertizes a **list price** which is the normal selling price of its goods to merchandizers. Trade discounts are given by suppliers to merchandizers that buy a large quantity of goods. For instance,

assume a supplier offers a 10% trade discount on purchases of 1,000 units or more where the list price is \$1/unit. If Beta Merchandizer Corp. buys 1,000 units on account, the entry in Beta's records would be:

Merchandise Inventory	900	
Accounts Payable		900
<i>To record purchase of cups; 5% trade discount applied</i>		
<i>(1,000 x \$1 x 95% = \$900)</i>		

Note that just the net amount (list price less trade discount) is recorded.

## 5.2.4 Transportation



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Costs to transport goods from the supplier to the seller must also be considered when recording the cost of merchandise inventory. The shipping terms on the invoice identify the point at which ownership of the inventory transfers from the supplier to the purchaser. When the terms are **FOB shipping point**, ownership transfers at the 'shipping point' so the purchaser is responsible for transportation costs.

**FOB destination** indicates that ownership transfers at the 'destination point' so the seller is responsible for transportation costs. FOB is the abbreviation for "free on board."

Assume that Excel's supplier sells with terms of FOB shipping point indicating that transportation costs are Excel's responsibility. If the cost of shipping is \$125 and this amount was paid in cash to the truck driver at time of delivery on May 9, the entry would be:

				Merch. Inventory	
				2,000	
					300
					17
				125	
May 9	Merchandise Inventory	150	125	1,808	
	Cash	101	125		Cash
					125
	<i>To record freight on vehicle purchased.</i>				

The cost of the vehicle in the Excel Merchandise Inventory account is now \$1,808. It is important to note that Excel's transportation costs to deliver goods to customers are recorded as *delivery expenses* that do not affect the Merchandise Inventory account.

The next section describes how the sale of merchandise is recorded as well as the related costs of items sold.

## 5.3 Merchandize Inventory: Sales and Collection Using the Perpetual Inventory System



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LO3 – Analyze and record sales transactions for a merchandizer.

In addition to purchases on account, a merchandizing company's operating cycle includes the sale of merchandize inventory *on account* or *on credit* as highlighted in Figure 5.3.

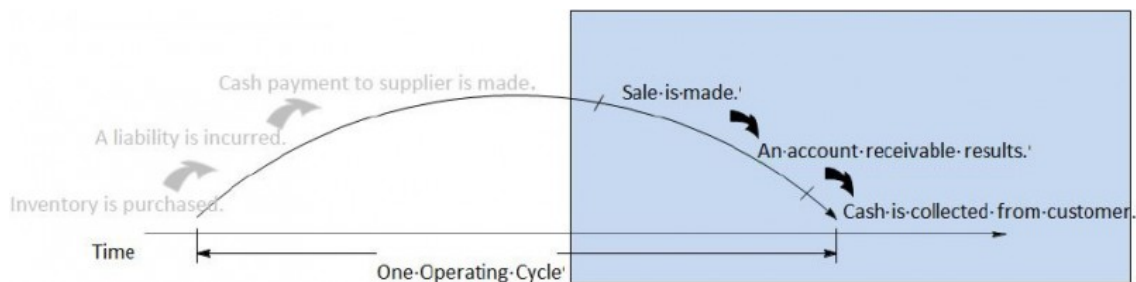


Fig. 5.3: Sales and Collection Portion of the Operating Cycle

There are some slight recording differences when revenue is earned in a merchandizing company. These are discussed below.

### 5.3.1 Recording the Sale of Merchandize Inventory



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The sale of merchandize inventory is recorded with two entries:

1. recording the sale by debiting Cash or Accounts Receivable and crediting Sales, and
2. recording the cost of the sale by debiting Cost of Goods Sold and crediting Merchandize Inventory.

Assume the vehicle purchased by Excel is sold on May 15 for \$3,000 on account. Recall that the cost of this vehicle in the Excel Merchandize Inventory account is \$1,808, as shown below.

The entries to record the sale of the merchandize inventory are:

May 15	Accounts Receivable	110	3,000		<u>Accounts Receivable</u>			
					3,000			
	Sales	500	3,000			<u>Sales</u>		
						3,000		
	Cost of Goods Sold	570	1,808		<u>Cost of Goods Sold</u>			
					1,808			
	Merchandise Inventory	150	1,808			<u>Merch. Inventory</u>		
					1,808		1,808	
								-0-

*To record sale of vehicle.*

Costs are transferred to the income statement from the balance sheet at the same time the sale is recorded.

The first part of the entry records the sales revenue. The second part is required to reduce the Merchandise Inventory account and transfer the cost of the merchandise sold to the Cost of Goods Sold account, and then to the income statement. The part of the entry ensures that both the Merchandise Inventory and Cost of Goods Sold accounts in the general ledger are up to date.

### 5.3.2 Sales Returns and Allowances



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When merchandise inventory that has been sold is returned to the merchandiser by the customer, a **sales return and allowance** is recorded. For example, assume some damage occurs to the car sold by Excel while it is being delivered to the customer on May 17. Excel would give the customer a *sales allowance* by agreeing to reduce the amount owing by, say, \$100. The entry is:

May 17	Sales Returns and Allowances	508	100		<u>Sales Ret. &amp; Allow.</u>			
					100			
	Accounts Receivable	110	100		<u>Accounts Receivable</u>			
					3,000			
								100
					2,900			

*To record customer allowance for damage to vehicle during delivery.*

Accounts receivable is credited because the original sale was made on account and has not yet been paid. The amount owing from the customer is reduced to \$2,900. If the \$2,900 had already been paid, a credit would be made to Cash and \$100 refunded to the customer. The Sales Returns and Allowances account is a *contra* revenue account, meaning it is *deducted* from Sales when preparing the income statement.

If goods are returned by a customer, a sales return occurs. The related sales and cost of goods sold recorded on the income statement are reversed and the goods are returned to inventory. For example, assume Max Corporation sells a plastic container for \$3 that it purchased for \$1. The dual entry at the time of sale would be:

Accounts Receivable	3	
Sales		3
Cost of Goods Sold	1	
Merchandise Inventory		1
<i>To record sale of plastic container.</i>		

If the container is returned, the journal entry would reverse the original entry, except that Sales Returns and Allowances would be debited instead of the Sales account:

Sales Returns and Allowances	3	
Accounts Receivable		3
Merchandise Inventory	1	
Cost of Goods Sold		1
<i>To record return of plastic container.</i>		

Use of a Sales Returns and Allowances contra account allows management to track the amount of returned and damaged items for their information purposes.

### 5.3.3 Sales Discounts



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Another contra revenue account, **Sales Discounts**, records reductions in sales amounts when a customer pays within a certain time period. For example, assume Excel Cars Corporation offers sales terms of "2/10, n30." This means that the amount owed must be paid by the customer within 30 days ('n' = net); however, if the customer chooses to pay within 10 days, a 2% discount may be deducted from the amount owing.

Consider the sale of the vehicle for \$2,900 (\$3,000 less the \$100 allowance for damage). Payment within 10 days entitles the customer to a \$58 discount ( $\$2,900 \times 2\% = \$58$ ). If payment is made on May 21 and therefore within the discount period, Excel receives \$2,842 cash ( $\$2,900 - 58$ ) and prepares the following entry:

May 21	Cash	101	2,842		Cash	
					2,842	
	Sales Discounts	509	58			Sales Discounts
					58	
	Accounts Receivable	110	2,900			Accounts Receivable
					2,900	2,900
					-0-	

*To record payment on account and sales discount applied.*



This entry reduces the accounts receivable amount to zero which is the desired result. If payment is not made within the discount period, the customer pays the full amount owing of \$2,900.

The Sales Allowances and Sales Discounts contra accounts are deducted from sales on the income statement to arrive at net sales. Cost of goods sold is deducted from net sales. If Excel purchased and sold only this one vehicle, the partial income statement for the period from January 1 to May 31 would show:

**Excel Cars Corporation**  
**Partial Income Statement**  
**For the Five Month Period Ended May 31, 2016**

Sales		\$3,000
Less: Sales returns and allowances	\$100	
Sales discounts	58	158
Net sales		2,842
Cost of goods sold		1,808
Gross profit		1,034

As was the case for Sales Returns and Allowances, the balance in the Sales Discounts account is deducted from Sales on the income statement to arrive at Net Sales. Merchandizers often report only the net sales amount on the income statement. Details from sales returns and allowances, and sales discounts, are often omitted because they are immaterial in amount relative to total sales. However, separate general ledger accounts for each of sales returns and allowances, and sales discounts, are useful in helping management identify potential problems that require investigation.

## 5.4 Adjustments to Merchandize Inventory Using the Perpetual Inventory System



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LO4 – Record adjustments to merchandize inventory.

In the simple example above, Excel did not have any merchandize inventory on hand at either the start of the year or at the end of May. It purchased and sold one vehicle during the month.

Now assume that Excel Cars Corporation purchased five vehicles from its supplier for \$2,000 each on June 2, 2016. The company sold three of these for \$3,000 each on June





Cash		Accounts Payable		Share Capital	Sales	
5,000	1,683 <sup>3</sup>	<sup>2</sup> 300	2,000 <sup>1</sup>	5,000		3,000 <sup>5</sup>
<sup>7</sup> 2,842	125 <sup>4</sup>	<sup>3</sup> 1,700	10,000 <sup>8</sup>			9,000 <sup>9</sup>
6,034			10,000			12,000
Accounts Rec.				Sales Ret. & Allow.		
<sup>5</sup> 3,000	100 <sup>6</sup>			<sup>6</sup> 100		
<sup>9</sup> 9,000	2,900 <sup>7</sup>					
9,000						
Merchandise Inv.				Sales Discounts		
<sup>1</sup> 2,000	300 <sup>2</sup>			<sup>7</sup> 58		
<sup>4</sup> 125	17 <sup>3</sup>					
1,808						
	1,808 <sup>5</sup>			Cost of Goods Sold		
-0-				<sup>5</sup> 1,808		
<sup>8</sup> 10,000	6,000 <sup>9</sup>			<sup>9</sup> 6,000		
4,000				7,808		

## Summary of transactions

<sup>1</sup> Purchased one vehicle on credit, May 2<sup>2</sup> Adjustment by supplier for wrong colour<sup>3</sup> Paid supplier May 9; purchase discount taken<sup>4</sup> Paid transportation costs<sup>5</sup> Sold one vehicle on May 15<sup>6</sup> Customer credited for delivery damage May 17<sup>7</sup> Payment received from customer on May 21; sales discount applied<sup>8</sup> Purchased five vehicles on credit, June 2<sup>9</sup> Sold three vehicles on June 16

An unadjusted trial balance would be prepared based on this information, as follows:

**Excel Cars Corporation**  
**Unadjusted Trial Balance**  
**December 31, 2016**

<i>Account</i>		<i>Account Balance</i>	
<i>No.</i>	<i>Account Title</i>	<i>Debit</i>	<i>Credit</i>
101	Cash	\$ 6,034	
110	Accounts Receivable	9,000	
150	Merchandise Inventory	4,000	
210	Accounts Payable		\$ 10,000
320	Share Capital		5,000
500	Sales		12,000
508	Sales Returns and Allowances	100	
509	Sales Discounts	58	
570	Cost of Goods Sold	7,808	
		<u>\$27,000</u>	<u>\$27,000</u>

## 5.4.1 Shrinkage



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There is one adjusting entry that may need to be made at year-end related to merchandize inventory. Usually, a physical count of inventory is conducted at the fiscal year-end. Costs are attached to these items and all are totalled. This total is then compared to the Merchandize Inventory account balance. These should agree, unless inventory has been lost for some reason. This discrepancy is called **shrinkage**. Theft and deterioration of goods held for re-sale are the most common examples of shrinkage.

Assume that one of the two vehicles remaining on Excel's vehicle lot is stolen prior to the year-end and that this has (somehow) gone unnoticed by staff. A physical count at December 31 would reveal one vehicle on hand. This vehicle would be traced to the related purchase invoice and valued at \$2,000. Comparing this amount to the balance in the Merchandize Inventory account would reveal a discrepancy of \$2,000 (\$4,000 – 2,000), and the theft would be revealed. This ability to compare accounting records with actual items on hand can be a valuable means for management to safeguard assets of the company, as it alerts managers to possible shrinkage problems.

At the year-end, this shrinkage must be reflected in the accounting records. The following adjusting entry would be made:

				<u>Cost of Goods Sold</u>
				1,808
				6,000
Dec. 31	Cost of Goods Sold	570	2,000	<u>2,000</u>
				9,808
				<u>Merch. Inventory</u>
				10,000
				6,000
				<u>4,000</u>
	Merchandize Inv.	550	2,000	<u>2,000</u>
				2,000

*To adjust merchandize inventory to physical count at year-end: vehicle stolen*

Generally, shrinkage is recorded as part of cost of goods sold. If the amounts are abnormally large, however, a separate general ledger account can be maintained called, say, Inventory Shrinkage. The amount is still combined with cost of goods sold and not disclosed separately on the income statement, as it is considered information to be used only internally (to spur investment in the protection of physical inventory, for instance).

As there are no more adjustments at year-end in this example, an adjusted trial balance is prepared, as follows:

Excel Cars Corporation  
Adjusted Trial Balance  
December 31, 2016

Acct. No.	Account	Account Balance	
		Debit	Credit
101	Cash	\$ 6,034	
110	Accounts Receivable	9,000	
150	Merchandise Inventory	2,000	
210	Accounts Payable		\$ 10,000
320	Share Capital		5,000
500	Sales		12,000
508	Sales Returns and Allowances	100	
509	Sales Discounts	58	
570	Cost of Goods Sold	9,808	
		<u>\$27,000</u>	<u>\$27,000</u>

The financial statements for the year ended December 31 would be prepared from this information, as follows:

Excel Cars Corporation  
Income Statement  
For the Year Ended December 31, 2016

Sales		\$12,000
Less: Sales returns and allowances	\$100	
Sales discounts	58	158
Net sales		<u>11,842</u>
Cost of goods sold		9,808
Gross profit and net income		<u>\$ 2,034</u>

In this case, sales consists of four vehicles sold for \$3,000 each, or \$12,000 in total. Cost of goods sold of \$9,808 consists of four vehicles that were originally purchased for \$2,000 each, or \$8,000 in total, plus transportation costs of \$125 and the loss of one vehicle, less a purchase allowance of \$300, a purchase discount of \$17 related to the May sale, ( $\$8,000 + 125 + 2,000 - 300 - 17 = \$9,808$ ). Gross profit therefore equals \$2,034. Since there are no other expenses, net income is the same amount.

The statement of changes in equity would show:



Excel Cars Corporation  
Statement of Changes in Equity  
For the Year Ended December 31, 2016

	<i>Share capital</i>	<i>Retained earnings</i>	<i>Total equity</i>
Balance at January 1, 2016	\$5,000	\$ -0-	\$5,000
Net income		2,034	2,034
Balance at December 31, 2016	\$5,000	\$2,034	\$7,034

The balance sheet at year-end would show:

Excel Cars Corporation  
Balance Sheet  
At December 31, 2016  
*Assets*

*Current assets*

Cash	\$ 6,034
Accounts receivable	9,000
Merchandise inventory	2,000
Total assets	\$17,034

*Liabilities*

Accounts payable	\$10,000
------------------	----------

*Shareholders' Equity*

Share capital	\$5,000	
Retained earnings	2,034	7,034
Total liabilities and shareholders' equity		\$17,034

The one vehicle remaining in inventory at December 31 is valued at \$2,000. This is the amount that remains in the Merchandise Inventory general ledger account, verified by physical count at year-end. It is appropriately shown as an asset on the balance sheet at December 31.

## 5.5 Merchandizing Income Statement



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LO5 – Explain and prepare a classified multiple-step income statement for a merchandizer.

Businesses are required to show expenses on the income statement based on either the *nature* or the *function* of the expense. The **nature of an expense** is determined by its basic characteristics (what it is). For example, when expenses are listed on the income statement as interest, depreciation, income taxes, or salaries, this identifies the nature of each expense. In contrast, the **function of an expense** describes the grouping of expenses based on their purpose (what they relate to). For example, an income statement that shows cost of goods sold, selling expenses, and general and administrative expenses has grouped expenses by their function. When expenses are grouped by function, additional information must be disclosed to show the nature of expenses within each group. **Full disclosure** is the generally accepted accounting principle that requires financial statements to report all relevant information about the operations and financial position of the entity. Information that is relevant but not included in the body of the statements is provided in the notes to the financial statements.

A merchandizing income statement can be prepared in different formats. For this course, only one format will be used—the classified multiple-step format. This format is generally used only for internal reporting because of the detail. Most external financial statement users would find this detail excessive and distracting.

An example of a classified multiple-step income statement is shown below using assumed data for XYZ Inc. for its month ended December 31, 2015.

XYZ Inc.  
Income Statement  
Month Ended December 31, 2015

Sales		\$100,000
Less: Sales discounts	\$1,000	
Sales returns and allowances	500	1,500
Net sales		98,500
Cost of goods sold		50,000
Gross profit		48,500
<i>Operating expenses</i>		
Selling		
Sales salaries	\$11,000	
Rent, store	12,000	
Advertizing	5,000	
Total selling	28,000	
General and administrative		
Office salaries	9,000	
Rent, office	3,000	
Supplies	2,500	
Insurance	1,000	
Total general and administrative	15,500	
Total operating expenses		43,500
Income from operations		5,000
Other revenues (expenses)		
Rent revenue	12,000	
Interest expense	(1,500)	10,500
Income before income taxes		15,500
Income taxes		2,000
Net income		\$13,500

Notice that the classified multiple-step income statement shows expenses by both function and nature. The broad categories that show expenses by function include operating expenses, selling expenses, general and administrative expenses, and income taxes. Within each category, the nature of expenses is disclosed including sales salaries, advertizing, depreciation, supplies, and insurance. Notice that Rent Expense and Depreciation Expense have been divided between two groupings because these apply to more than one category or function.

The normal operating activity for XYZ Inc. is merchandizing. Revenues and expenses that are not part of normal operating activities are listed under Other Revenues and Expenses. XYZ Inc. shows Rent Revenue under Other Revenues and Expenses because this type of revenue is not part of its merchandizing operations. Interest earned, dividends earned, and gains on the sale of property, plant, and equipment are more examples of other revenues not related to merchandizing operations. XYZ Inc. deducts interest expense under Other Revenues and Expenses. Interest expense does not result from operating activities; it is a financing activity because it is associated with the borrowing of money. Other examples of non-operating expenses include losses



on the sale of property, plant, and equipment. Finally, income taxes expense is deducted. Income tax is a government levy, unrelated to how a business operates.

## 5.6 Closing Entries for a Merchandizer Using the Perpetual Inventory System



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LO6 – Explain the closing process for a merchandizer.

The process of recording closing entries for service companies was illustrated in Chapter 3. The closing procedure for merchandizing companies is the same as for service companies—all income statement accounts are transferred to the Income Summary account, the Income Summary is closed to Retained Earnings, and Dividends are closed to Retained Earnings.

When preparing closing entries for a merchandizer, the income statement accounts unique for merchandizers need to be considered—Sales, Sales Discounts, Sales Returns and Allowances, and Cost of Goods Sold. Sales is a revenue account so has a normal credit balance. To close Sales, it must be debited with a corresponding credit to the income summary. Sales Discounts and Sales Returns and Allowances are both contra revenue accounts so each has a normal debit balance. Cost of Goods Sold has a normal debit balance because it is an expense. To close these debit balance accounts, a credit is required with a corresponding debit to the income summary.

All accounts listed in the income statement columns are transferred to the income summary account, and then the income summary is closed to retained earnings. The same three-step process is used, as shown in chapter 3, as applied to the financial information of Excel Cars Corporation for the year ended December 31, 2016:

### Entry 1

All income statement accounts with credit balances are debited to bring them to zero. Their balances are transferred to the income summary account.

(a)			
Dec. 31	Sales	150	12,000
	Income Summary	360	12,000
	<i>To close all income statement accounts with credit balances to the income summary.</i>		

### Entry 2

All income statement accounts with debit balances are credited to bring them to zero. Their balances are transferred to the income summary account.

(b)

Dec. 31	Income Summary	360	9,966
	Cost of Goods Sold	570	9,808
	Sales Returns and Allow.	508	100
	Sales Discounts	509	58

*To close all income statement accounts with credit balances to income summary.*

**Entry 3**

The Income Summary account is closed to the Retained Earnings account. The effect is to transfer temporary (income statement) account balances in the income summary totalling \$4,034 to the permanent (balance sheet) account, Retained Earnings.

(c)

Dec. 31	Income Summary	360	2,034
	Retained Earnings	340	2,034

*To close income summary account to retained earnings.*

After these closing entries are posted, the general ledger T-accounts would appear as follows:

Cash	Accounts Payable	Share Capital	Sales																																					
<table border="0" style="width: 100%;"> <tr><td style="width: 50%;">5,000</td><td style="width: 50%;">1,683<sup>3</sup></td></tr> <tr><td>7,284<sup>7</sup></td><td>125<sup>4</sup></td></tr> <tr><td>6,034</td><td></td></tr> </table>	5,000	1,683 <sup>3</sup>	7,284 <sup>7</sup>	125 <sup>4</sup>	6,034		<table border="0" style="width: 100%;"> <tr><td style="width: 50%;"><sup>2</sup>300</td><td style="width: 50%;">2,000<sup>1</sup></td></tr> <tr><td><sup>3</sup>1,700</td><td>10,000<sup>8</sup></td></tr> <tr><td></td><td>10,000</td></tr> </table>	<sup>2</sup> 300	2,000 <sup>1</sup>	<sup>3</sup> 1,700	10,000 <sup>8</sup>		10,000	<table border="0" style="width: 100%;"> <tr><td style="width: 50%;"></td><td style="width: 50%;">5,000</td></tr> </table>		5,000	<table border="0" style="width: 100%;"> <tr><td style="width: 50%;"></td><td style="width: 50%;">3,000<sup>5</sup></td></tr> <tr><td></td><td>9,000<sup>9</sup></td></tr> <tr><td></td><td>12,000</td></tr> </table>		3,000 <sup>5</sup>		9,000 <sup>9</sup>		12,000																	
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All income statement accounts and the income summary account are reduced to zero and net income for the year of \$2,034 is transferred to retained earnings.

## 5.7 Appendix: The Periodic Inventory System



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LO7 – Explain and identify the entries for purchase and sales transactions in a periodic inventory system.

The perpetual inventory system maintains a continuous, real-time balance in both Merchandise Inventory, a balance sheet account, and Cost of Goods Sold, an income statement account. As a result, the Merchandise inventory general ledger account balance should always equal the value of physical inventory on hand at any point in time. Additionally, the Cost of goods sold general ledger account balance should always equal the total cost of merchandise inventory sold for the accounting period. The accounts should perpetually agree; hence the name. An alternate system is considered below, called the *periodic* inventory system.

### 5.7.1 Description of the Periodic Inventory System



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The periodic inventory system does not maintain a constantly-updated merchandise inventory balance. Instead, ending inventory is determined by a physical count and valued at the end of an accounting period. The change in inventory is recorded only periodically. Additionally, a Cost of goods sold account is not maintained in a periodic system. Instead, cost of goods sold is calculated at the end of the accounting period.

When goods are purchased using the periodic inventory system, the cost of merchandise is recorded in a **Purchases** account in the general ledger, rather than in the Merchandise Inventory account as is done under the perpetual inventory system. The Purchases account is an income statement account that accumulates the cost of merchandise acquired for resale.

Recall that Excel purchased a vehicle on account from its supplier on May 2 for \$2,000. The journal entry and general ledger T-account effects using the periodic inventory system would be as follows:

May 2	Purchases	550	2,000		Purchases
					2,000
	Accounts Payable	210	2,000		Accounts Payable
	<i>To record purchase of vehicle.</i>				2,000

Other types of activities related to the purchase of merchandize, like allowances for damaged items, purchase discounts, and transportation and handling charges, are not recorded in the Merchandize Inventory account either. Rather, they are recorded in special income statement accounts. Accounting for each type of transaction is explained below.

## 5.7.2 Purchase returns and Allowances



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Recall that the price of the vehicle purchased on May 2 was reduced from \$2,000 to \$1,700 because it was the wrong colour. Under the periodic inventory system, the amount of the reduction is accumulated in a separate **Purchase returns and Allowances**, an income statement account. Excel would record the transaction as follows:

				Accounts Payable	
				300	2,000
May 3	Accounts Payable	210	300		
				Purch. Ret. & Allow.	
				300	300
				<i>To record reduction in account payable: vehicle damaged.</i>	

The Purchase returns and Allowances amount of \$300 is deducted from Purchases when calculating cost of goods sold on the income statement. It is a contra account.

## 5.7.3 Purchase discounts



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Another contra account, **Purchase discounts**, accumulates reductions in the purchase price of merchandize if payment is made within a time period specified in the supplier's invoice. Recall that if amount owing on the vehicle is paid within 15 days, the supplier's terms entitle Excel to deduct \$17 [(\$2,000 - 300) = \$1,700 x 1% = \$17].

Under the periodic inventory system, the \$1,683 cash payment to the supplier on May 9 is recorded as follows:

				Accounts Payable	
				1,700	1,700
May 9	Accounts Payable	210	1,700		
				Purchase discounts	
				17	17
				<b>Cash</b>	
				1,683	1,683
				101	
				<i>To record payment on account in full and purchases discount applied.</i>	

The discount of \$17 is deducted when calculating cost of goods sold on the income statement.

## 5.7.4 Transportation



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Under the perpetual inventory system, the cost of transporting the vehicle to Excel's premises was added to the Merchandize Inventory account on the balance sheet. Under the periodic inventory system, a **Transportation-in** account is used to accumulate freight charges on merchandize purchased for re-sale. Like the Purchases and Purchase discounts accounts, this is also an income statement account which is used to calculate cost of goods sold directly on the income statement.

Recall the cost of shipping the vehicle is \$125 and it is paid in cash to the truck driver. Payment would be recorded as follows:

				Transportation-In
May 9	Transportation-In	560	125	125
	Cash	101	125	125
	<i>To record transportation costs on vehicle.</i>			

The vehicle is then sold for \$3,000 on May 15. A \$100 allowance is granted for damage to the vehicle during delivery. A \$58 sales discount is granted because the customer paid the balance owing to Excel within the discount period. The sales transactions are recorded in the same manner under both the perpetual and periodic inventory systems.

The summary of these transactions is:

May 15	Accounts Receivable	110	3,000	
	Sales	500		3,000
May 17	Sales Ret. and Allowances	508	100	
	Accounts Receivable	110		100
May 21	Cash	101	2,842	
	Sales Discounts	509	58	
	Accounts Receivable	110		2,900

Note, however, that there is no entry made to adjust Merchandize Inventory and cost of goods sold when recording the May 15 sales. This is different from the perpetual inventory system. There have been no entries made to the Merchandize Inventory account to date using the periodic inventory system.

The same transactions also occur in June as described earlier. Five vehicles are purchased for \$2,000 each, or \$10,000 in total. The entry to record the purchase of the vehicles is:

				Purchases
				2,000
June 2	Purchases	550	10,000	10,000
				12,000
				Accounts Payable
				-0-
	Accounts Payable	210	10,000	10,000
				10,000

Three vehicles are sold during June for \$3,000 each, or \$9,000 in total. The entry to record the sale of the vehicles is:

				Accounts Receivable
				-0-
June 16	Accounts Receivable	110	9,000	9,000
				9,000
				Sales
				3,000
	Sales	500	9,000	9,000
				12,000

Again, note that there are no adjustments to the Merchandise Inventory or Cost of Goods Sold accounts in the general ledger at this point, unlike the perpetual inventory system. After the June transactions are recorded, the general ledger T-accounts would appear as follows:



Cash		Accounts Payable		Share Capital		Sales	
5,000	1,683 <sub>3</sub>	<sup>2</sup> 300	2,000 <sup>1</sup>		5,000		3,000 <sup>5</sup>
<sup>7</sup> 2,842	125 <sup>4</sup>	<sup>3</sup> 1,700	10,000 <sup>8</sup>				9,000 <sup>9</sup>
6,034			10,000				12,000
Accounts Rec.						Sales Ret. & Allow.	
<sup>5</sup> 3,000	100 <sup>6</sup>					<sup>6</sup> 100	
<sup>9</sup> 9,000	2,900 <sub>7</sub>						
9,000							
Merchandise Inventory						Sales Discounts	
-0-	←					<sup>7</sup> 58	
						Purchases	
						<sup>1</sup> 2,000	
						<sup>9</sup> 10,000	
						12,000	
						Purch. Ret. & Allows.	
							300 <sup>2</sup>
						Purchase Discounts	
							17 <sup>3</sup>
						Transportation-In	
						<sup>4</sup> 125	

Using the periodic inventory system, no transactions are recorded during the year in the Merchandise Inventory account.

#### Summary of transactions

- <sup>1</sup> Purchased one vehicle on credit, May 2
- <sup>2</sup> Adjustment by supplier for wrong colour
- <sup>3</sup> Paid supplier May 9; purchase discount taken
- <sup>4</sup> Paid transportation costs
- <sup>5</sup> Sold one vehicle on May 15
- <sup>6</sup> Customer credited for delivery damage May 17
- <sup>7</sup> Payment received from customer on May 21; sales discount applied
- <sup>8</sup> Purchased five vehicles on credit, June 2
- <sup>9</sup> Sold three vehicles on June 16

Assume again that no other transactions occur during the year. When financial statements are prepared at December 31, a physical count of inventory is taken. Purchase invoices are referenced to determine the value of the items counted. The resulting amount is inserted into the income statement to determine the cost of goods sold for the year.

In the case of Excel, a physical count should show that there is one vehicle left on the lot. Referring to the purchase documents, this vehicle would be valued at its purchase price - \$2,000. The value of ending inventory would thus be calculated as \$2,000. This



information is inserted directly into the income statement of Excel for the year ended December 31, 2016. Combined with the information in the general ledger T-accounts, the income statement would show:

**Excel Cars Corporation**  
**Income Statement**  
**For the Year Ended December 31, 2016**

Sales		\$12,000
Less: Sales returns and allowances	\$100	
Sales discounts	58	158
Net sales		11,842
<i>Cost of goods sold:</i>		
Opening inventory	-0-	
Purchases	12,000	
Transportation-in	125	
Less: Purchase returns and allow.	(300)	
Purchase discounts	(17)	
Cost of goods available for sale	11,808	
Less: Ending inventory	(2,000)	
Cost of goods sold		9,808
Gross profit and net income		\$ 2,034

Ending inventory is counted and valued. The total amount is inserted into the income statement to determine cost of goods sold.

Net income remains the same under either the perpetual or periodic inventory system (\$2,034). The periodic method is simpler to use than the perpetual inventory system, and is often used by small businesses because the costs of inventory recordkeeping are reduced. However, a perpetual inventory system enables management to compare inventory records to actual goods on hand at a period end to determine if any shrinkage has occurred, for instance. This security feature is not present with the periodic inventory system. The extra costs of recordkeeping using a perpetual inventory system are offset by the added control over a high-value asset like inventory, especially when there are thousands of items that a business may buy for re-sale each year and where shrinkage can be a significant issue.

### 5.7.5 Closing Entries – Periodic Inventory System



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The process of closing the general ledger temporary accounts to retained earnings at the end of an accounting year is the same under the perpetual or periodic system, with one exception. Under the periodic system, an entry must be made in the Merchandise Inventory account to adjust this balance to the amount of inventory counted and valued at year-end. Otherwise, the steps are the same:

#### Entry 1

All income statement accounts with credit balances are debited to bring them to zero. Their balances are transferred to the income summary account. *At the same time, the*

ending inventory balance(\$2,000 in this case) is debited to the Merchandize Inventory account.

(a)			
Dec. 31	Merchandize Inv. (ending)	150	2,000
	Sales	500	12,000
	Purchase Ret. and Allow.	558	300
	Purchase Discounts	559	17
	Income Summary	360	14,317

*To close all income statement accounts with credit balances to income summary and record ending inventory balance in Merchandize Inventory account.*

### Entry 2

All income statement accounts with debit balances are credited to bring them to zero. Their balances are transferred to the Income Summary account. *At the same time, the opening inventory balance(zero in this case) is credited to the Merchandize Inventory account:*

(b)			
Dec. 31	Income Summary	360	12,283
	Merch. Inv. (opening)	150	-0-
	Sales Return and Allows.	508	100
	Sales Discounts	509	58
	Purchases	550	12,000
	Transportation-In	560	125

*To close all income statement accounts with credit balances to income summary and remove opening inventory from the Merchandize Inventory account.*

The combined effect of entries 1 and 2 on the Merchandize Inventory account is to adjust it to the actual ending balance at December 31 of \$2,000. At the end of this process, the account will show:

		Merchandize Inventory	
Jan. 1	Opening balance	-0-	
	Add: Ending inventory (closing entry posted)	2,000	
	Less: Opening inventory (closing entry posted)		-0-
Dec. 31	Ending balance	2,000	

### Entry 3

The income summary account is closed to the Retained Earnings account. The effect is to transfer temporary account balances in the income summary totalling \$2,034 to the permanent general ledger account, Retained Earnings.

	(c)			
Dec. 31	Income Summary	360	2,034	
	Retained Earnings	340		2,034
	<i>To close the Income Summary account to the Retained Earnings account.</i>			

After these closing entries are posted, the general ledger T-accounts would appear as follows:

Cash	Accounts Payable	Share Capital	Sales
5,000	<sup>2</sup> 300	5,000	3,000 <sup>5</sup>
1,683 <sup>3</sup>	2,000 <sup>1</sup>		9,000 <sup>9</sup>
7,842	1,700 <sup>3</sup>		12,000
125 <sup>4</sup>	10,000 <sup>8</sup>		Retained Earnings
6,034	10,000		<sup>a</sup> 12,000
		Retained Earnings	-0-
		2,034 <sup>c</sup>	
Accounts Rec.		Income Summary	Sales Ret. & Allow.
<sup>5</sup> 3,000		12,283 <sup>b</sup>	<sup>6</sup> 100
100 <sup>6</sup>		14,317 <sup>a</sup>	100 <sup>b</sup>
<sup>9</sup> 9,000		2,034 <sup>c</sup>	-0-
2,900 <sup>7</sup>		-0-	Sales Discounts
9,000			758 <sup>7</sup>
			-0-
Merchandise Inventory			58 <sup>b</sup>
-0-			Purchases
<sup>a</sup> 2,000			12,000 <sup>1</sup>
-0- <sup>b</sup>			10,000 <sup>9</sup>
2,000			12,000
			12,000 <sup>b</sup>
			-0-
			Purch. Ret. & Allow.
			300 <sup>2</sup>
			<sup>a</sup> 300
			-0-
			Purchase Discounts
			17 <sup>3</sup>
			<sup>a</sup> 17
			-0-
			Transportation-In
			125 <sup>4</sup>
			125 <sup>b</sup>
			-0-

## 5.7.6 Opening Inventory



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Under the periodic inventory system, the ending inventory of one accounting time period becomes the opening inventory of the next accounting time period. Opening inventory is added to purchases each period and ending inventory is deducted to calculate cost of goods sold.

Assume that Excel Cars Corporation had the following transactions in 2017, its next accounting year:

<b>Opening inventory</b>	<b>1 vehicle at \$2,000</b>
<b>Plus: Purchases</b>	<b>6 vehicles at \$2,000 each</b>
<b>Less: Sales</b>	<b>(5) vehicles at \$3,000 each</b>
<b>Equals ending inventory</b>	<b>2 vehicles at \$2,000 each (verified by physical count)</b>

Journal entries are omitted in this example. The gross profit and net income calculations disclosed on the income statement for 2016 and 2017 are shown below. Note that the ending inventory at December 31, 2016 becomes the opening inventory at January 1, 2017.

**Excel Cars Corporation**  
**Income Statement**  
**For the Year Ended December 31, 2017**

	2016	2017
Sales	\$12,000	\$15,000
Less: Sales returns and allowances	(100)	-0-
Sales discounts	(58)	-0-
Net sales	<u>11,842</u>	<u>15,000</u>

*Cost of goods sold*

Opening inventory	-0-	2,000
Purchases	12,000	12,000
Transportation-in	125	-0-
Less: Purchase returns and allow.	(300)	-0-
Purchase discounts	(17)	-0-
Cost of goods available for sale	<u>11,808</u>	<u>14,000</u>
Less: ending inventory	<u>(2,000)</u>	<u>(4,000)</u>
Cost of goods sold	<u>9,808</u>	<u>10,000</u>
Gross profit and net income	<u>\$ 2,034</u>	<u>\$ 5,000</u>

Ending inventory for 2016 becomes the opening inventory for 2017.

In 2017, seven vehicles are available for sale – one remaining from 2016 and now included as opening inventory at January 1, 2017 plus six purchased in 2017. Cost of goods available for sale therefore equals \$14,000 for the 2017 fiscal year (7 x \$2,000). Two vehicles are not sold so are shown as ending inventory at the end of 2017. Their total cost of \$4,000 is deducted from cost of goods available for sale to arrive at cost



of goods sold for 2017 of \$10,000. As was done on 2016, ending inventory amounts would be determined by counting the vehicles on the lot at December 31, 2017 and determining from purchase invoices how much was paid for these.

The interrelationship of inventory disclosed in the income statement and balance sheet using the periodic inventory system can be illustrated as follows:

Excel Car Corporation			
Income Statement			
For the Year Ended December 31, 2017			
Sales			\$15,000
<i>Cost of goods sold</i>			
Opening inventory (Jan. 1, 2017)	\$2,000		
Cost of goods purchased	12,000		
Cost of goods available	14,000		
Less: Ending inventory (Dec. 31)	(4,000)		
Cost of goods sold		10,000	
Gross profit and net income		<u>\$ 5,000</u>	
Excel Car Corporation			
Balance Sheet			
At December 31, 2017			
	2016	2017	
<i>Assets</i>			
Cash	\$A,000	\$C,000	
Accounts receivable	B,000	D,000	
Merchandise inventory	2,000	4,000	

Closing entries for 2017 would be prepared using the same process as previously described.

#### Entry 1

(a)			
Dec. 31	Merchandise Inv. (ending)	150	4,000
	Sales	500	15,000
	Income Summary	360	19,000

*To close all income statement accounts with credit balances to the income summary and record ending inventory balance.*

#### Entry 2

		(b)	
Dec. 31	Income Summary	360	14,000
	Merch. Inv. (opening)	150	2,000
	Purchases	550	12,000
<i>To close all income statement accounts with credit balances to the income summary and remove opening inventory from the Merchandize Inventory account.</i>			

The combined effect of entries 1 and 2 on the Merchandize Inventory account is to adjust it to the actual ending balance at December 31, 2017 of \$4,000. At the end of this process, the Merchandize Inventory account in the general ledger will show:

		Merchandize Inventory	
Jan. 1	Opening balance	2,000	
	Add: Ending Inventory (closing entry posted)	4,000	
	Less: Opening Inventory (closing entry posted)		2,000
Dec. 31	Ending balance	4,000	

The usual entry is made to close the Income Summary account to the Retained Earnings account.

### Entry 3

		(c)	
Dec. 31	Income Summary	360	5,000
	Retained Earnings	340	5,000
<i>To close the Income Summary account to the Retained Earnings account.</i>			

## 5.8 Summary of Chapter 5 Learning Objectives



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**LO1 – Describe merchandizing and explain the financial statement components of sales, cost of goods sold, merchandize inventory, and gross profit; differentiate between the perpetual and periodic inventory systems.**

Merchandizers buy and resell products. Merchandize inventory, an asset, is purchased from suppliers and resold to customers to generate sales revenue. The cost of the merchandize inventory sold is an expense called cost of goods sold. The profit realized on the sale of merchandize inventory before considering any other expenses is called gross profit. Gross profit may be expressed as a dollar amount or as a percentage. To track merchandize inventory and cost of goods sold in real time, a perpetual inventory system is used; the balance in each of Merchandize Inventory and Cost of Goods Sold is always up-to-date. In a periodic inventory system, a physical count of the inventory

must be performed in order to determine the balance in Merchandize Inventory and Cost of Goods Sold.

**LO2 – Analyze and record purchase transactions for a merchandizer.**

In a perpetual inventory system, a merchandizer debits Merchandize Inventory regarding the purchase of merchandize for resale from a supplier. Any purchase returns and allowances or purchase discounts are credited to Merchandize Inventory as they occur to keep the accounts up-to-date.

**LO3 – Analyze and record sales transactions for a merchandizer.**

In a perpetual inventory system, a merchandizer records two entries at the time of sale: one to record the sale and a second to record the cost of the sale. Sales returns that are returned to inventory also require two entries: one to reverse the sale by debiting a sales returns and allowances account and a second to restore the merchandize to inventory by debiting Merchandize Inventory and crediting Cost of Goods Sold. Sales returns not restored to inventory as well as sales allowances are recorded with one entry: debit sales returns and allowances and credit cash or accounts receivable. Sales discounts are recorded when a credit customer submits their payment within the discount period specified.

**LO4 – Record adjustments to merchandize inventory.**

A physical count of merchandize inventory is performed and the total compared to the general ledger balance of Merchandize Inventory. Discrepancies are recorded as an adjusting entry that debits cost of goods sold and credits Merchandize Inventory.

**LO5 – Explain and prepare a classified multiple-step incomestatement for a merchandizer.**

A classified multiple-step income statement for a merchandizer is for internal use because of the detail provided. Sales, less sales returns and allowances and sales discounts, results in net sales. Net sales less cost of goods sold equals gross profit. Expenses are shown based on both their function and nature. The functional or group headings are: operating expenses, selling expenses, and general and administrative expenses. Within each grouping, the nature of expenses is detailed including: depreciation, salaries, advertizing, wages, and insurance. A specific expense can be divided between groupings.

**LO6 – Explain the closing process for a merchandizer.**

The steps in preparing closing entries for a merchandizer are the same as for a service company. The difference is that a merchandizer will need to close income statement accounts unique to merchandizing such as: Sales, Sales Returns and Allowances, Sales Discounts, and Cost of Goods Sold.

**LO7 – (Appendix) Explain and identify the entries for purchase and sales transactions in a periodic inventory system.**

A periodic inventory system maintains a Merchandize Inventory account but does not have a Cost of Goods Sold account. The Merchandize Inventory account is updated at the end of the accounting period as a result of a physical inventory count. Because a merchandizer using a period system does not use a Merchandize Inventory account to



record purchase or sales transactions during the accounting period, it maintains accounts that are different than under a perpetual system, namely, Purchases, Purchase Returns and Allowances, Purchase Discounts, and Transportation-in.

## 5.9 Assignment materials

### 5.9.1 Concept Self-check



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1. How does the income statement prepared for a company that sells goods differ from that prepared for a service business?
2. How is gross profit calculated? What relationships do the gross profit and gross profit percentage calculations express? Explain, using an example.
3. What is a perpetual inventory system?
4. How is the purchase of merchandize inventory on credit recorded in a perpetual system?
5. How is a purchase return recorded in a perpetual system?
6. What does the credit term of "1/15, n30" mean?
7. How is a purchase discount recorded in a perpetual system?
8. How is the sale of merchandize inventory on credit recorded in a perpetual system?
9. How is a sales return recorded in a perpetual system?
10. What is a sales discount and how is it recorded in a perpetual inventory system?
11. Why does merchandize inventory need to be adjusted at the end of the accounting period and how is this done in a perpetual inventory system?
12. What types of transactions affect merchandize inventory in a perpetual inventory system?
13. How are the closing entries for a merchandizer using a perpetual inventory system different than for a service company?
14. When reporting expenses on multi-step income statement, how is the function of an expense reported? The nature of an expense?
15. On a classified multiple-step income statement, what is reported under the heading 'Other revenues and expenses' and why?
16. (Appendix) Compare the perpetual and periodic inventory systems. What are some advantages of each?
17. (Appendix) What contra accounts are used in conjunction with purchases using the periodic inventory system?
18. (Appendix) How is cost of goods available for sale calculated using the periodic inventory system?
19. (Appendix) How is cost of goods sold calculated using the periodic inventory system?
20. (Appendix) Explain how ending inventory is recorded in the accounts of a business that sells goods using a periodic inventory system.

## 5.9.2 Comprehension Problems

### 5.9.2.1 CP 5-1



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Consider the following information of Jones Corporation over four years:

	2019	2018	2017	2016
Sales	\$10,000	\$9,000	\$ ?	\$7,000
Cost of goods sold	?	6,840	6,160	?
Gross profit	2,500	?	1,840	?
Gross profit percentage	?	?	?	22%

*Required:*

1. Calculate the missing amounts for each year.
2. What does this information indicate about the company?

### 5.9.2.2 CP 5-2



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Reber Corp. uses the perpetual inventory system. Its transactions during July 2016 are as follows:

July	6	Purchased \$600 of merchandize on account (for credit) form Hobson Corporation for terms 1/10, net 30
	9	Returned \$200 of defective merchandize
	15	Paid the amount owing to Hobson.

*Required:* Prepare journal entries to record the above transactions. Include general ledger account numbers and brief descriptions.

### 5.9.2.3 CP 5-3



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Boucher Corporation uses the perpetual inventory system. Its transactions during June 2015 are as follows:

- |      |    |  |
|------|----|--|
| June | 1  | Boucher purchased \$1,200 of merchandize inventory from a supplier for terms 1/10, n 60.                           |
|      | 3  | Boucher sold all of the inventory purchased on June 1 for \$1,500 on credit to Wright Inc. for terms 2/10, net 30. |
|      | 8  | Wright returned \$800 of defective merchandize purchased June 3 (cost to Boucher: \$600).                          |
|      | 13 | Boucher received payment from Wright Inc. for the balance owed.  |

*Required:* Prepare journal entries to record the above transactions. Include general ledger account numbers and brief descriptions.

### 5.9.2.4 CP 5-4



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Horne Inc. and Sperling Renovations Ltd. both sell goods and use the perpetual inventory system. The company had \$3,000 of merchandize inventory at the start of its fiscal year, January 1, 2016. During the year, the company had only the following transactions:

- |     |   |  |
|-----|---|--|
| May | 5 | Horne sold \$4000 of merchandize on account to Sperling Renovations Ltd. For terms 2/10, net 30. Cost of merchandize to Horne from its supplier was \$2,500. |
|     | 7 | Sperling returned \$500 of merchandize; Horne issued a credit memo. (Cost of merchandize to Horne was \$300)   |

- 15 Horne received the amount due from Sperling Renovations Ltd.

A physical count and valuation of merchandize inventory at May 31, the fiscal year-end, showed \$700 of goods on hand.

*Required:* Prepare journal entries to record the above transactions and adjustment(include general ledger account numbers and brief descriptions):

1. In the records of Horne Inc.
2. In the records of Sperling Renovations Ltd.

### 5.9.2.5 CP 5-5



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The following information is taken from the records of Smith Corp. at June 30, 2016, the fiscal year-end:

Advertizing expense	\$ 1,500
Commissions expense	4,000
Cost of goods sold	50,000
Delivery expense	1,000
Insurance expense	1,000
Rent expense	2,500
Salaries expense	5,000
Sales (gross)	72,000
Sales returns and allowances	2,000

*Required:*

1. Prepare a classified income statement. Assume all expenses not related to cost of goods sold are selling expenses.
2. Compute gross profit percentage.

### 5.9.2.6 CP 5-6



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Refer to the information in CP 5-5.

*Required:* Prepare all closing entries. Include general ledger account numbers as shown in the chapter – for example, Cost of Goods Sold: 570. Include a brief description for each entry.

### 5.9.2.7 CP 5-7 (Appendix)



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Consider the information for each of the following four companies.

	A	B	C	D
Opening inventory	\$ ?	\$ 184	\$ 112	\$ 750
Purchases	1,415	?	840	5,860
Transportation-in	25	6	15	?
Cost of goods available	1,940	534	?	6,620
Ending inventory	340	200	135	?
Cost of goods sold	?	?	?	5,740

*Required:* Calculate the missing amounts.

### 5.9.2.8 CP 5-8 (Appendix)



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Consider the following information:

Opening inventory	\$ 375
Purchases	2,930

Purchase discounts	5
Purchase returns and allowances	20
Transportation-in	105

Ending inventory amounts to \$440.

*Required:* Calculate cost of goods sold.

### 5.9.2.9 CP 5-9 (Appendix)



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The following information is taken from the records of four different companies in the same industry:

	<i>A</i>	<i>B</i>	<i>C</i>	<i>D</i>
Sales	\$ 300	\$ 150	\$ ?	\$ 90
Opening inventory	?	40	40	12
Purchases	240	?	?	63
Cost of goods available	320	?	260	?
Less: Ending inventory	?	(60)	(60)	(15)
Cost of goods sold	?	100	200	60
Gross profit	\$ 100	\$ ?	\$ 100	\$ ?
Gross profit percentage	?	?	?	?

*Required:*

1. Calculate the missing amounts.
2. Which company seems to be performing best? Why?

### 5.9.2.10 CP 5-10 (Appendix)



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The following balances are taken from the records of Mohan Corp. at December 31, 2016, its first year-end:

Transportation-in	\$ 500
Delivery expense	1,200

Sales	25,000
Purchases	20,000
Sales returns and allowances	2,000
Purchase returns and allowances	1,000
Sales Discounts	400
Purchase discounts	300
Interest expense	4,000

The inventory at December 31, 2016 amounted to \$7,900.

*Required:*

1. Calculate the gross profit.
2. What is the gross profit percentage?

### 5.9.2.11 CP 5–11 (Appendix)



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The following information is taken from the records of O'Donnell Corp. at June 30, 2016, its fiscal year-end:

Advertizing expense	\$ 1,500
Commissions expense	4,000
Delivery expense	1,000
Insurance expense	1,000
Opening inventory	6,000
Purchases	35,000
Purchase returns and allowance	2,000



Rent expense	2,500
Salaries expense	5,000
Sales (gross)	72,000
Sales returns and allowance	2,000
Transportation-in	1,000

The merchandize inventory at June 30, 2016 amounted to \$10,000.

*Required:*

1. Prepare a classified income statement. Assume all expenses not related to cost of goods sold are selling expenses.
2. Compute gross profit percentage.

### 5.9.2.12 CP 5-12 (Appendix)



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Refer to the information in CP 5-11.

*Required:* Prepare all closing entries. Include general ledger account numbers as shown in the chapter – for example, Purchases: 550. Include brief descriptions for each entry.

### 5.9.2.13 CP 5-13 (Appendix)



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Sherman Stores Ltd. had the following transactions:

Oct.	8	Purchased \$2,800 of merchandize on account from Morris Wholesalers Corp. for terms 1/10, net 30
	12	Received a credit memo from Morris Wholesalers Corp. for \$800 of defective merchandize included in the October 8 purchase and subsequently returned to Morris.

Additional Information: Morris Wholesalers Corp. uses the periodic inventory system.

*Required:*

1. Prepare journal entries in the records of Sherman, assuming that it paid the amount due on
  1. October 8
  2. October 25.
2. Prepare journal entries in the records of Morris Wholesalers Corp., assuming that it received payment on
  1. October 18
  2. October 25.

Omit general ledger account numbers and descriptions from the journal entries.

### 5.9.3 Problems

#### 5.9.3.1 P 5-1



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Salem Corp. was incorporated on July 2, 2016 to operate a merchandizing business. Salem uses the perpetual inventory system. All its sales on account are made according to the following terms: 2/10, n30. Its transactions during July 2016 are as follows:

July	2	Issued share capital for \$5,000 cash to George Salem, the incorporator and sole shareholder of the corporation
	2	Purchased \$3,500 merchandize on account from Blic Pens Ltd. for terms 2/10, n30
	2	Sold \$2,000 of merchandize on account to Spellman Chair Rentals Inc. (Cost to Salem: \$1,200)
	3	Paid Sayer Holdings Corp. \$500 for July rent
	5	Paid Easton Furniture Ltd. \$1,000 for equipment
	8	Collected \$200 for a cash sale made today to Ethan Matthews Furniture Ltd. (Cost: \$120)
	8	Purchased \$2,000 merchandize on account from Shaw Distributors Inc. for terms 2/15, n30

- 9 Received the amount due from Spellman Chair Rentals Inc. for the July 2 sale (less discount)
- 10 Paid Blic Pens Ltd. for the July 2 purchase (less discount)
- 10 Purchased \$200 of merchandize on account from Peel Products Inc. for terms n30
- 15 Sold \$2,000 of merchandize on account to Eagle Products Corp. (Cost: \$1,300)
- 15 Purchased \$1,500 of merchandize on account from Bevan Door Inc. for terms 2/10, n30
- 15 Received a memo from Shaw Distributors Inc. to reduce its account payable by \$100 for defective merchandize included in the July 8 purchase.
- 16 Eagle Products Corp. returned \$200 of merchandize: reduced related Account Payable. (Cost to Salem: \$150)
- 20 Sold \$3,500 of merchandize on account to Aspen Promotions Ltd. (Cost: \$2,700)
- 20 Paid Shaw Distributors Inc. for half the purchase made July 8 (less memo amount, less discount on payment)
- 24 Received half the amount due from Eagle Products Corp. in partial payment for the July 15 sale (less discount on payment)
- 24 Paid Bevan Doors Ltd. for the purchase made July 15 (less discount)
- 26 Sold \$600 merchandize on account to Longbeach Sales Ltd. (Cost: \$400)
- 26 Purchased \$800 of merchandize on account from Silverman Co. for terms 2/10, n30

- 31 Paid Speedy Transport Co. \$350 for transportation to Salem's warehouse during the month (all purchases are fob shipping point).

*Required:*

1. Prepare journal entries to record the July transactions. Include general ledger account numbers and a brief description.
2. Calculate the ending balance in merchandize inventory.
3. Assume the merchandize inventory is counted at July 31 and assigned a total cost of \$2,400. Prepare the July 31 adjusting entry. Show calculations.

### 5.9.3.2 P 5-2



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Randall Sales Corp. was incorporated on May 1, 2016 to operate a merchandizing business. All its sales on account are made according to the following terms: 2/10, n30. Its transactions during May 2016 are as follows:

- |     |   |  |
|-----|---|--|
| May | 1 | Issued share capital for \$2,000 cash to Harry Randall, the incorporator and sole shareholder of the corporation   |
|     | 1 | Received \$10,000 from the First Chance Bank as a demand bank loan   |
|     | 1 | Paid Viva Corp. \$1,500 for 3 months' rent in advance—\$500 for each of May, June, and July (recorded as an asset) |
|     | 1 | Paid Avanti Equipment Ltd. \$5,000 for equipment   |
|     | 1 | Purchased \$5,000 of merchandize on account from Renaud Wholesalers Ltd. for terms 2/10, n30                       |
|     | 1 | Sold \$2,500 of merchandize on account to North Vancouver Distributors. (Cost to Randall: \$1,700)                 |
|     | 2 | Purchased \$1,800 of merchandize on account from Lilydale Products Ltd. for terms n30                              |

- 2 Sold \$2,000 of merchandize on account to Tarrabain Sales Inc. (Cost: \$1,400)
- 3 Collected \$500 for a cash sale made today to Smith Weston Ltd.
- 5 Paid All West Insurance Inc. \$1,200 for a 1-year insurance policy, effective May 1 (recorded as an asset)
- 5 Sold \$1,000 of merchandize on account to Trent Stores Corporation. (Cost: \$700)
- 6 Tarrabain Sales Inc. returned \$500 of merchandize: reduced the related Account Payable. (Cost: \$300)
- 8 Received a memo from Renaud Wholesalers Ltd. to reduce its account payable by \$300 for defective merchandize included in the May 1 purchase and returned subsequently to Renaud
- 8 Purchased \$2,800 of merchandize on account from Pinegrove Novelties Ltd. for terms 2/15, n30
- 9 Received the amount due from North Vancouver Distributors from the May 1 sale (less discount)
- 9 Paid Renaud Wholesalers Corp. for the May 1 purchase (less discount)
- 10 Sold \$400 of merchandize on account to Eastern Warehouse. (Cost: \$250)
- 11 Received the amount due from Tarrabain Sales Inc. (less the May 6 memo and discount)
- 13 Paid Fast Delivery Corporation \$100 for Transportation-In
- 15 Purchased \$1,500 of merchandize on account from James Bay Distributors Inc. for terms 2/10, n30

- 
- 15 Sold \$1,500 of merchandize on account to Ransom Outlets Inc. (Cost: \$1,100)
- 15 Paid \$500 in commissions to Yvonne Smith, *re*: sales invoices nos. 1, 2, and 3
- 19 Paid Lilydale Products Inc. for the May 2 purchase
- 19 Purchased \$1,200 of merchandize on account from Midlife Stores Corp. for terms 1/10, n30
- 22 Purchased \$600 of merchandize on account from Speedy Sales Co. for terms n30
- 22 Paid to Pinegrove Novelties Inc. for the May 8 purchase (less discount)
- 24 Paid to In Transit Corporation \$150 for Transportation-In (fob shipping point)
- 25 Sold \$900 of merchandize on account to Timmins Centres Ltd. (Cost: \$650)
- 26 Received the amount due from Trent Stores Corporation
- 27 Paid \$200 to Intown Deliveries Ltd. for deliveries made to customers
- 28 Collected \$300 for a cash sale made today to Betty Regal. (Cost: \$250)
- 28 Made a \$200 cash purchase from Joe Balla Sales Inc.
- 28 Sold \$900 of merchandize on account to Sault Rapids Corp. . (Cost: \$700)
- 29 Purchased \$100 of merchandize on account from Amigos Inc.

- 29 Paid Intown Deliveries Ltd. \$300 for deliveries to customers (debited account 620)
- 29 Paid Main Force Advertizing Agency \$400 for advertizing materials used during May
- 29 Paid State Hydro \$100 for electricity
- 29 Paid Yvonne Smith \$350 commission, *re*: sales invoices nos. 4, 5, 6, and 7
- 30 Collected \$1,000 on account from Ransom Outlets Inc.
- 31 Paid Midlife Stores Corp. \$700 on account

Inventory on hand at May 31 was counted and valued at \$6,500.

*Required:* Prepare journal entries to record the May transactions and any month-end adjusting entries needed. Show calculations for shrinkage. Include general ledger account numbers and a brief description for each entry.

### 5.9.3.3 P 5-3



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The following closing entries were prepared for Whirlybird Products Inc. at December 31, 2016, the end of its fiscal year.

Dec.	31	Sales	510	37,800
		Income Summary	360	37,800
	31	Income Summary	360	32,800
		Cost of goods Sold	570	26,800
		Sales Returns and Allowances	508	690



	Sales Discounts	509	310
	Salaries Expenses	656	5,000
31	Income Summary	360	5,000
	Retained Earnings	340	5,000

*Required:*

1. Post the closing entries to general ledger T-accounts and calculate balances.
2. Calculate gross profit.

#### 5.9.3.4 P 5-4



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Southern Cross Corporation supplies you with the following information applicable to the current year, December 31, 2016. The company uses the perpetual inventory system.

Delivery expense	\$ 2,000
Sales	100,000
Merchandise inventory (Dec.31)	15,000
Cost of goods sold	70,000
Office supplies expense	7,000
Sales returns and allowance	10,000
Salaries expense	4,000
Unused supplies	5,000

*Required:*

1. Prepare an income statement. List expenses other than cost of goods sold as other expenses. Assume all accounts have normal balances.
2. Prepare all required closing entries. Include general ledger account numbers and a brief description for each entry.

### 5.9.3.5 P 5-5



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The following trial balance has been extracted from the records of Acme Automotive Inc. at December 31, 2015, its fiscal year-end. The company uses the perpetual inventory system.

<i>Account</i>	<i>Account Balances</i>	
	<i>Dr.</i>	<i>Cr.</i>
Cash	750	
Accounts receivable	12,000	
Merchandise inventory	56,000	
Unused supplies	-0-	
Equipment	4,400	
Bank loan (due May, 2016)		5,000
Accounts payable		12,540
Income taxes payable		2,400
Share capital		2,000
Retained earnings		600
Sales		100,000
Sales returns and allowances	1,500	
Sales discounts	500	
Cost of goods sold	34,000	
Advertising expense	1,700	
Commissions expense	4,800	
Delivery expense	650	
Insurance expense	450	
Interest expense	600	
Office supplies expense	250	
Rent expense	1,950	
Telephone expense	300	
Utilities expense	290	
Income taxes expense	2,400	
	<u>\$122,540</u>	<u>\$122,540</u>

*Required:*

1. Prepare adjusting entries, including general ledger account numbers and brief descriptions, for the following:
  1. \$1,000 of sales on account has not been recorded. (Cost to Acme: \$700)
  2. A physical count indicates that \$100 of office supplies is still on hand at year-end.
  3. A telephone bill for \$60 owing at December 31 has not yet been recorded.
  4. A physical count indicates that \$53,000 of merchandise inventory is on hand at December 31, 2015.

2. Prepare a multi-step income statement and statement of changes in equity for the year ended December 31, 2015, and a classified balance sheet at December 31.
3. Prepare closing entries.

### 5.9.3.6 P 5-6 (Appendix)



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Providence Corp. was incorporated on July 2, 2016 to operate a merchandizing business. All its sales on account are made according to the following terms: 2/10, n30. Its transactions during July 2016 are as follows:

July	2	Issued share capital for \$5,000 cash to Pam Providence, the incorporator and sole shareholder of the corporation
	2	Purchased \$3,500 merchandize on account from Blic Pens Ltd. for terms 2/10, n30
	2	Sold merchandize on account to Spellman Chair Rentals Inc. for \$2,000
	3	Paid Sayer Holdings Corp. \$500 for July rent
	5	Paid Easton Furniture Ltd. \$1,000 for equipment
	8	Collected \$200 for a cash sale made today to Ethan Matthews Furniture Ltd.
	8	Purchased \$2,000 merchandize on account from Shaw Distributors Inc. for terms 2/15, n30
	9	Received the amount due from Spellman Chair Rentals Inc. for the July 2 sale (less discount)
	10	Paid Blic Pens Ltd. for the July 2 purchase (less discount)
	10	Purchased \$200 of merchandize on account from Peel Products Inc. for terms n30

- 
- 15 Sold merchandize on account to Eagle Products Corp. for \$2,000
- 15 Purchased \$1,500 of merchandize on account from Bevan Door Inc. for terms 2/10, n30
- 15 Received a memo from Shaw Distributors Inc. to reduce its account payable by \$100 for defective merchandize included in the July 8 purchase.
- 16 Eagle Products Corp. returned \$200 of merchandize: reduced related Account Payable.
- 20 Sold merchandize on account to Aspen Promotions Ltd. for \$3,500
- 20 Paid Shaw Distributors Inc. for half the purchase made July 8 (less memo amount, less discount on payment)
- 24 Received half the amount due from Eagle Products Corp. in partial payment for the July 15 sale (less discount on payment)
- 24 Paid Bevan Doors Inc. for the purchase made July 15 (less discount)
- 26 Sold merchandize on account to Longbeach Sales Ltd. for \$600
- 26 Purchased \$800 of merchandize on account from Silverman Co. for terms 2/10, n30
- 31 Paid Speedy Transport Co. \$350 for transportation to Salem's warehouse during the month (all purchases are fob shipping point).
- 31 Inventory on hand was counted and valued at \$2,000

Assume Providence uses the periodic inventory system.

*Required:* Prepare journal entries to record the July transactions.

### 5.9.3.7 P 5-7 (Appendix)



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Robert Sales Corp. was incorporated on May 1, 2016 to operate a merchandizing business. All its sales on account are made according to the following terms: 2/10, n30. Its transactions during May 2016 are as follows:

May	1	Issued share capital for \$2,000 cash to Rob Robert, the incorporator and sole shareholder of the corporation
	1	Received \$10,000 from the First Chance Bank as a demand bank loan
	1	Paid Viva Corp. \$1,500 for 3 months' rent in advance—\$500 for each of May, June, and July (recorded as an asset)
	1	Paid Avanti Equipment Ltd. \$5,000 for equipment
	1	Purchased \$5,000 of merchandize on account from Renaud Wholesalers Ltd. for terms 2/10, n30
	1	Sold merchandize on account to North Vancouver Distributors for \$2,500
	2	Purchased \$1,800 of merchandize on account from Lilydale Products Ltd. for terms n30
	2	Sold merchandize on account to Tarrabain Sales Inc. for \$2,000
	3	Collected \$500 for a cash sale made today to Smith Weston Ltd.
	5	Paid All West Insurance Inc. \$1,200 for a 1-year insurance policy, effective May 1 (recorded as an asset)

- 
- 5 Sold merchandize on account to Trent Stores Corporation for \$1,000
- 6 Tarrabain Sales Inc. returned \$500 of merchandize: reduced the related Account Receivable
- 8 Received a memo from Renaud Wholesalers Ltd. to reduce its account payable by \$300 for defective merchandize included in the May 1 purchase and returned subsequently to Renaud
- 8 Purchased \$2,800 of merchandize on account from Pinegrove Novelties Ltd. for terms 2/15, n30
- 9 Received the amount due from North Vancouver Distributors from the May 1 sale (less discount)
- 9 Paid Renaud Wholesalers Corp. for the May 1 purchase (less discount)
- 10 Sold merchandize on account to Eastern Warehouse for \$400
- 11 Received the amount due from Tarrabain Sales Inc. (less the May 6 memo and discount)
- 13 Paid Fast Delivery Corporation \$100 for Transportation-In
- 15 Purchased \$1,500 of merchandize on account from James Bay Distributors Inc. for terms 2/10, n30
- 15 Sold merchandize on account to Ransom Outlets Inc. for \$1,500
- 15 Paid \$500 in commissions to Yvonne Smith, re: sales invoices nos. 1, 2, and 3
- 19 Paid Lilydale Products Inc. for the May 2 purchase
- 19 Purchased \$1,200 of merchandize on account from Midlife Stores Corp. for terms 1/10, n30



- 22 Purchased \$600 of merchandize on account from Speedy Sales Co. for terms n30
- 22 Paid to Pinegrove Novelties Inc. for the May 8 purchase (less discount)
- 24 Paid to In Transit Corporation \$150 for Transportation-In (fob shipping point)
- 25 Sold merchandize on account to Timmins Centres Ltd. for \$900
- 26 Received the amount due from Trent Stores Corporation
- 27 Paid \$200 to Intown Deliveries Ltd. for deliveries made to customers
- 28 Collected \$300 for a cash sale made today to Betty Regal
- 28 Made a \$200 cash purchase from Joe Balla Sales Inc. today; issued cheque #11 (debited purchases)
- 28 Sold merchandize on account to Sault Rapids Corp. for \$900
- 29 Purchased \$100 of merchandize on account from Amigos Inc.
- 29 Paid Intown Deliveries Ltd. \$300 for deliveries to customers (debited account 620)
- 29 Paid Main Force Advertizing Agency \$400 for advertizing materials used during May
- 29 Paid State Hydro \$100 for electricity
- 29 Paid Yvonne Smith \$350 commission, re: sales invoices nos. 4, 5, 6, and 7

- 30 Collected \$1,000 on account from Ransom Outlets Inc.
- 31 Paid Midlife Stores Corp. \$700 on account
- 31 Inventory on hand was counted and valued at \$5,000

Assume Robert uses the periodic inventory system.

*Required:* Prepare journal entries to record the May transactions and any month-end adjusting entries needed. Include general ledger account numbers and a brief description for each entry.

### 5.9.3.8 P 5–8 (Appendix)



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The following closing entries were prepared for Zenith Products Inc. at December 31, 2016, the end of its fiscal year.

Dec.	31	Merchandise Inventory	6,000	
		Sales	31,000	
		Purchase returns and Allowances	575	
		Purchase discounts	225	
		Income Summary		37,800
		Income Summary	32,800	
		Merchandise Inventory		4,000
		Sales Returns and Allowances		690
		Sales Discounts		310

Purchases	22,500
Transportation-In	300
Salaries Expenses	5,000
Income Summary	5,000
Retained Earnings	5,000

*Required:*

1. Post the closing entries to general ledger T-accounts and calculate balances.
2. Prepare a classified, partial income statement, showing sales, cost of goods sold calculations, and gross profit.

### 5.9.3.9 P 5-9 (Appendix)



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Northern Lights Corporation supplies you with the following information applicable to the current year, December 31, 2016.

Transportation-in	\$ 3,000
Delivery expense	2,000
Sales	100,000
Merchandize inventory (Jan. 1)	12,000
Merchandize inventory (Dec. 31)	15,000
Purchases	70,000
Office supplies expense	7,000
Purchase discounts	4,000

---

Purchase returns and allowances	6,000
Sales returns and allowances	10,000
Unused supplies	5,000

*Required:*

1. Prepare in proper form a classified, partial income statement including sales, cost of goods sold, and gross profit.
2. Prepare closing entries.
3. What is net income for the year?

### **5.9.3.10 P 5–10 (Appendix)**



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The following trial balance has been extracted from the records of om's Trucks Inc. at December 31, 2015, its fiscal year-end.

<i>Account</i>	<i>Account Balances</i>	
	<i>Debit</i>	<i>Credit</i>
Cash	750	
Accounts receivable	12,000	
Merchandise inventory (Jan. 1, 2015)	56,000	
Prepaid rent	-0-	
Unused supplies	-0-	
Equipment	4,400	
Bank loan (due Dec. 31, 2019)		5,000
Accounts payable		12,540
Income taxes payable		2,400
Share capital		2,000
Retained earnings		600
Sales		100,000
Sales returns and allowances	1,500	
Sales discounts	500	
Purchases	35,000	
Purchase returns and allowances		1,700
Purchase discounts		300
Transportation-in	1,000	
Advertising expense	1,700	
Commissions expense	4,800	
Delivery expense	650	
Insurance expense*	450	
Interest expense	600	
Supplies expense	250	
Rent expense*	1,950	
Telephone expense	300	
Utilities expense	290	
Income taxes expense	2,400	
	<u>\$124,540</u>	<u>\$124,540</u>

\*selling expenses

*Required:*

1. Prepare adjusting entries, including general ledger account numbers and a brief description for each entry, for the following:
  1. A telephone bill for \$60 owing at December 31 has not yet been recorded.
  2. \$600 of sales on account has not been recorded.
  3. A physical count indicates that \$100 of office supplies is still on hand at year-end.
  4. A physical count indicates that \$58,000 of merchandise inventory is on hand at December 31, 2015.

2. Prepare a classified income statement and statement of changes in equity for the year ended December 31, 2015, and a classified balance sheet at December 31.
3. Prepare all required closing entries. Include general ledger account numbers and a brief description for each entry.

## 5.9.4 Alternate Problems

### 5.9.4.1 AP 5-1



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The following information relates to the Pike Corporation for the fiscal year ended December 31, 2016:

- a. Merchandise inventory on hand at January 1 is \$100,000.  
  
During the year, the company purchased merchandise on credit from a single supplier for \$200,000; terms 2/10, n30.
- b. Half of the purchases were paid within the discount period. The other half has not yet been paid.
- c. The company paid \$8,000 in freight charges on merchandise purchased, fob shipping point.  
  
Damaged merchandise with an invoice price of \$4,000 was returned to the supplier. A cash refund for the returned amount less discount was received. This merchandise was
- d. part of the purchase in transaction *b* that had been paid within the discount period.
- e. Sold merchandise on credit to a customer for \$20,000. (Cost to Pike: \$14,000.)
- f. An allowance of \$2,750 was granted because merchandise sold in *e* was not satisfactory. (Cost: \$2,000.)
- g. A cheque for \$2,750 was issued to the customer referred to in *f*.
- h. The ending inventory was counted and valued at \$290,000.

Assume Pike uses the perpetual inventory system.

*Required:*

1. Prepare journal entries for each of the transactions. Include a brief description for each entry. Show calculations for shrinkage.
2. Prepare a partial income statement including sales, cost of goods sold, and gross profit. Calculate gross profit percentage.
3. Prepare the necessary closing entries. Include general ledger account numbers and a brief description for each entry.

**5.9.4.2 AP 5-2**

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Simple Products Inc. was incorporated on April 1, 2016 to operate a merchandizing business. The company uses the perpetual inventory system. All its sales on account are made according to the following terms: 2/10, n30. Its transactions during April 2016 were:

- |      |   |  |
|------|---|--|
| Apr. | 1 | Issued share capital for \$3,000 cash to Ross Sims, the incorporator and sole shareholder of the corporation   |
|      | 1 | Purchased \$4,000 of merchandize on account from Springfield Wholesalers Inc. for terms 2/10, n30              |
|      | 1 | Sold \$3,000 of merchandize on account to Authentic Products Corp. (Cost to Simple: \$2,000)                   |
|      | 2 | Collected \$500 for a cash sale made today to Georges Pierre Ltd. (Cost: \$400)                                |
|      | 2 | Purchased \$750 merchandize on account from White Whale Wholesalers Ltd. for terms n30                         |
|      | 2 | Sold \$1,200 of merchandize on account to Champagne Stores Inc. (Cost: \$800)                                  |
|      | 5 | Received half the amount due from Authentic Products Corp. for the April 1 purchase (less discount on payment) |
|      | 8 | Received the amount due from Champagne Stores Inc. for the April 2 purchase (less discount)                    |



- 
- 9 Paid Springfield Wholesalers Inc. for the April 1 purchase (less discount on payment)
- 10 Purchased \$2,000 of merchandize on account from Ritz Distributors Inc. for terms 2/15, n30
- 11 Sold \$500 of merchandize on account to Premier Sales Inc. (Cost: \$300)
- 12 Premier Sales Inc. returned \$100 of merchandize; adjusted the records accordingly. (Cost: \$80)
- 15 Received a notification from White Whale Wholesalers Ltd. That \$150 of defective merchandize included in the April 2 purchase and subsequently returned will not need to be paid.
- 15 Purchased \$1,500 of merchandize on account from Breakwater Distributors Inc. for terms 2/10, n30
- 19 Purchased \$1,250 of merchandize on account from Brown Gull Sales Ltd. for terms n30
- 20 Sold \$2,000 of merchandize on account to Salari Corp. (Cost: \$1,700)
- 20 Received the amount due from Premier Sales Inc. for the April 11 purchase (less return and less discount)
- 22 Paid Ritz Distributors Inc. for the April 10 purchase (less discount on payment)
- 24 Paid Breakwater Distributors Inc. for the April 15 purchase (less discount on payment)
- 27 Sold \$800 of merchandize on account to Rook Emporium Corp. (Cost: \$500)
- 30 Paid Rapide Delivery Inc. \$200 for deliveries made to customers during the month

- 30 Paid Fast Forwarders Ltd. \$500 for transportation to the warehouse during the month. (All purchases are fob shipping point.)

Assume ending inventory was counted on April 30 and valued at \$4,000.

*Required:* Prepare journal entries, including general ledger account numbers and a brief description for each entry, to record the April transactions and adjust the Merchandize Inventory account at month-end.

### 5.9.4.3 AP 5-3



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Wheaton Wholesalers Inc. was incorporated on March 1, 2016 to operate a merchandizing business. All its sales on account are made according to the following terms: 2/10, n30.

- |      |   |  |
|------|---|--|
| Mar. | 1 | Issued share capital for \$410,000 cash to Michael Wheaton, the incorporator and sole shareholder of the corporation |
|      | 1 | Paid Scotia Fixtures Inc. \$4,000 for equipment, with an estimated useful life of 10 years                           |
|      | 1 | Purchased \$2,100 of merchandize on account from Midlife Stores Corp. for terms 2/10, n30                            |
|      | 2 | Sold merchandize on account to Timmins Centres Ltd. For \$2,000 (cost to Wheaton: \$1,500)                           |
|      | 2 | Collected \$300 for a cash sale made today to Clayton David Inc. (cost: \$20)  |
|      | 3 | Purchased \$500 of merchandize on account from Speedy Sales Co. for terms 1/10, n30                                  |
|      | 4 | Sold merchandize on account to Northern Warehouse for \$2,500  |
|      | 4 | Timmins Centres Ltd. returned \$200 of merchandize. (cost: \$120)  |

- 
- 5 Purchased \$1,400 of merchandize on account from St Jean Wholesalers Corp. on account for terms n30
- 6 Received notification from Midlife Stores Corp. that \$100 of defective merchandize included in the March 1 purchase and subsequently returned to Midlife did not need to be paid
- 6 Sold merchandize on account to Sault Rapids Corp. for \$1,500 (cost: \$900)
- 7 Purchased \$600 of merchandize on account from Trent Stores Corporation for terms 2/15, n30
- 8 Received the amount due from Timmins Centres Ltd. (less adjustment, less discount)
- 10 Paid Speedy Sales Co. for the March 3 purchase (less discount)
- 11 Received \$7,500 from the Second National Bank as a demand bank loan
- 12 Paid Peace Realty Corp. \$1,000 for 2 months' rent, March and April (recorded as an asset)
- 12 Sold merchandize on account to James Bay Distributors Inc. for \$700 (cost: \$400)
- 13 Received the amount due from Northern Warehouse (less discount)
- 15 Paid Mitch Michaels \$350 for commissions earned to date (recorded as Commissions Expense)
- 15 Paid Midlife Stores Corporation \$1,000 on account
- 15 Purchased \$1,000 of merchandize on account from Lilydale Products Ltd. for terms 2/15, n30

- 18 Paid Trent Stores Corporation for half of the March 7 purchase (less discount on payment)
- 19 Collected \$100 for a cash sale made today to Margaret Smith (Cost: \$70)
- 20 Purchased \$1,200 of merchandise on account from Delta Centres Inc. for terms n30
- 20 Paid \$400 for a cash purchase from Copeland Distributors Inc.
- 20 Sold merchandise on account to Amigo Inc. (cost: \$350) for \$600
- 21 Paid St Jean Wholesalers Corp. \$700 on account
- 22 Received \$500 on account from Sault Rapids Inc.
- 23 Paid Tri City Insurance Ltd. \$2,400 for a 1-year insurance policy, effective March 1 (recorded as an asset)
- 24 Paid \$300 for a cash purchase from Buster's Emporium (debited Purchases)
- 25 Sold merchandise on account to Pinehurst Novelties Inc. for \$1,400 (cost: \$1,100)
- 26 Purchased \$700 of merchandise on account from Tres Bon Markets Ltd. for terms 2/10, n30
- 30 Paid Shelby Corp. \$500 for deliveries to customers
- 30 Paid Mitch Michaels \$400 for commissions earned to date
- 30 Paid PhoneU \$75 for the monthly telephone bill
- 30 Paid Vision Visuals Ltd. \$250 for advertising materials used during the month

The company uses the perpetual inventory system, Assume ending inventory was counted on March 31 and valued at \$1,500.

*Required:* Prepare journal entries to record the March transactions, including adjusting entries for insurance and rent. Include general ledger account numbers and a brief description for each entry.

#### 5.9.4.4 AP 5-4



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The following journal closing entries were prepared for James Services Ltd. at December 31, 2017, its fiscal year-end.

Dec.	31	Sales	43,000	
		Income Summary		43,000
	31	Income Summary	40,000	
		Sales Returns and Allowances		660
		Sales Discounts		340
		Cost of Goods Sold		31,000
		Salaries Expenses		8,000
	31	Income Summary	3,000	
		Retained Earnings		3,000

*Required:* Prepare a partial income statement including sales, cost of goods sold, and gross profit.

### 5.9.4.5 AP 5-5



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The following unadjusted trial balance has been extracted from the records of Van Loo Merchants Inc. at December 31, 2016, its fiscal year-end. The balances for share capital and retained earnings have not changed during the year. The company uses the perpetual inventory system.

<i>Account</i>	<i>Account Balances</i>	
	<i>Debit</i>	<i>Credit</i>
Cash	1,500	
Accounts receivable	5,000	
Merchandise inventory	11,000	
Prepaid insurance	1,300	
Prepaid rent	600	
Furniture	12,500	
Bank loan		10,000
Accounts payable		8,350
Income taxes payable		3,600
Share capital		3,000
Retained earnings		1,400
Sales		75,000
Sales returns and allowances	2,250	
Sales discounts	750	
Cost of goods sold	46,000	
Advertising expense*	1,800	
Commissions expense*	7,200	
Delivery expense	1,600	
Insurance expense	1,100	
Interest expense	1,200	
Rent expense*	3,300	
Telephone expense	550	
Utilities expense	100	
Income taxes expense	3,600	
	<u>\$101,350</u>	<u>\$101,350</u>

\*selling expenses

*Required:*

1. Prepare adjusting entries for the following:

1. The balance in the Prepaid Rent account consists of equal amounts of rent for the months of December 2016 and January 2017.
  2. Interest on the bank loan applicable to the month of December amounts to \$600 has not yet been recorded as interest payable.
  3. A December telephone bill owing of \$50 has not been recorded.
  4. The balance in the Prepaid Insurance account applies equally to each of the thirteen months ended December 31, 2017.
  5. A physical count indicates that \$10,000 of merchandize inventory is on hand at December 31, 2016.
2. Prepare an adjusted trial balance at December 31, 2016.
  3. Prepare a classified income statement and statement of changes in equity for the year ended December 31, 2016, and a classified balance sheet at December 31.
  4. Prepare closing entries. Include general ledger account numbers and a brief description for each entry.

#### 5.9.4.6 AP 5-6 (Appendix)



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The following information relates to the Marlin Corporation for the fiscal year ended December 31, 2016:

- a. Merchandize inventory on hand at January 1 is \$100,000.

During the year, the company purchased merchandize on credit from a single supplier for \$200,000; terms 2/10, n30.

- b. Half of the purchases were paid within the discount period. The other half has not yet been paid.
- c. The company paid \$8,000 in freight charges on merchandize purchased, fob shipping point.

Damaged merchandize with an invoice price of \$4,000 was returned to the supplier. A cash refund for the returned amount less discount was received. This merchandize was part of the purchase in transaction *b* that had been paid within the discount period.

- e. Sold merchandize on credit to a customer for \$20,000.
- f. An allowance of \$2,750 was set up because merchandize sold in ewas not satisfactory.



- g. A cheque for \$2,750 was issued to the customer referred to in f.
- h. The ending inventory was \$80,000.

*Required:*

1. Prepare journal entries where necessary for each of the transactions. (Omit explanation lines and assume the company uses periodic inventory method.)
2. Calculate the cost of goods sold.
3. Prepare closing entries based on the above information. Include general ledger account numbers and a brief description for each entry.

### 5.9.4.7 AP 5-7 (Appendix)



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Ample Products Inc. was incorporated on April 1, 2017 to operate a merchandizing business. All its sales on account are made according to the following terms: 2/10, n30. Its transactions during April 2017 were:

- |      |   |   |
|------|---|---|
| Apr. | 1 | Issued share capital for \$3,000 cash to Ross Ample, the incorporator and sole shareholder of the corporation |
|      | 1 | Purchased \$4,000 of merchandize on account from Springfield Wholesalers Inc. for terms 2/10, n30             |
|      | 1 | Sold merchandize on account to Authentic Products Corp. for \$3,000   |
|      | 2 | Collected \$500 for a cash sale made today to Georges Pierre Ltd.   |
|      | 2 | Purchased \$750 merchandize on account from White Whale Wholesalers Ltd. for terms n30                        |
|      | 2 | Sold merchandize on account to Champagne Stores Inc. for \$1,200  |

- 
- 5 Received half the amount due from Authentic Products Corp. for the April 1 purchase (less discount on payment)
- 8 Received the amount due from Champagne Stores Inc. for the April 2 purchase (less discount)
- 9 Paid Springfield Wholesalers Inc. for the April 1 purchase (less discount on payment)
- 10 Purchased \$2,000 of merchandize on account from Ritz Distributors Inc. for terms 2/15, n30
- 11 Sold merchandize on account to Premier Sales Inc. for \$500
- 12 Premier Sales Inc. returned \$100 of merchandize; adjusted the records accordingly.
- 15 Received a notification from White Whale Wholesalers Ltd. That \$150 of defective merchandize included in the April 2 purchase and subsequently returned will not need to be paid.
- 15 Purchased \$1,500 of merchandize on account from Breakwater Distributors Inc. for terms 2/10, n30
- 19 Purchased \$1,250 of merchandize on account from Brown Gull Sales Ltd. for terms n30
- 20 Sold merchandize on account to Salari Corp. for \$2,000
- 20 Received the amount due from Premier Sales Inc. for the April 11 purchase (less return and less discount)
- 22 Paid Ritz Distributors Inc. for the April 10 purchase (less discount on payment)
- 24 Paid Breakwater Distributors Inc. for the April 15 purchase (less discount on payment)

- 29 Sold merchandize on account to Rook Emporium Corp. for \$800
- 30 Paid Rapide Delivery Inc. \$200 for deliveries made to customers during the month
- 30 Paid Fast Forwarders Ltd. \$500 for transportation to the warehouse during the month. (All purchases are fob shipping point.)

*Required:* Prepare journal entries to record the April transactions. Include general ledger account numbers and a brief description for each entry.

#### 5.9.4.8 AP 5–8 (Appendix)



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City Retailers Inc. was incorporated on March 1, 2016 to operate a merchandizing business. All its sales on account are made according to the following terms: 2/10, n30.

- Mar. 1 Issued share capital for \$10,000 cash to Michael Smith, the incorporator and sole shareholder of the corporation
- 1 Paid Scotia Fixtures Inc. \$4,000 for equipment
- 1 Purchased \$2,100 of merchandize on account from Midlife Stores Corp. for terms 2/10, n30
- 2 Sold merchandize on account to Timmins Centres Ltd. For \$2,000
- 2 Collected \$300 for a cash sale made today to Clayton David Inc.
- 3 Purchased \$500 of merchandize on account from Speedy Sales Co. for terms 1/10, n30
- 4 Sold merchandize on account to Northern Warehouse for \$2,500

- 
- 4 Timmins Centres Ltd. returned \$200 of merchandize
- 5 Purchased \$1,400 of merchandize on account from St Jean Wholesalers Corp. on account for terms n30
- 6 Received notification from Midlife Stores Corp. that \$100 of defective merchandize included in the March 1 purchase and subsequently returned to Midlife did not need to be paid
- 6 Sold merchandize on account to Sault Rapids Corp. for \$1,500
- 7 Purchased \$600 of merchandize on account from Trent Stores Corporation for terms 2/15, n30
- 8 Received the amount due from Timmins Centres Ltd. (less adjustment, less discount)
- 10 Paid Speedy Sales Co. for the March 3 purchase (less discount)
- 11 Received a \$7,500 loan from Second National Bank, due in 2017
- 12 Paid Peace Realty Corp. \$1,000 for 2 months' rent, March and April (recorded as an asset)
- 12 Sold merchandize on account to James Bay Distributors Inc. for \$700
- 13 Received the amount due from Northern Warehouse (less discount)
- 15 Paid Mitch Michaels \$350 for commissions earned to date (recorded as Commissions Expense)
- 15 Paid Midlife Stores Corporation \$1,000 on account

- 15 Purchased \$1,000 of merchandize on account from Lilydale Products Ltd. for terms 2/15, n30
- 18 Paid Trent Stores Corporation for half of the March 7 purchase (less discount on payment)
- 19 Collected \$100 for a cash sale made today to Margaret Smith
- 20 Purchased \$1,200 of merchandize on account from Delta Centres Inc. for terms n30
- 20 Paid \$400 for a cash purchase from Copeland Distributors Inc.
- 20 Sold merchandize on account to Amigo Inc. for \$600
- 21 Paid St Jean Wholesalers Corp. \$700 on account
- 22 Received \$500 on account from Sault Rapids Inc.
- 23 Paid Tri City Insurance Ltd. \$2,400 for a 1-year insurance policy, effective March 1 (recorded as an asset)
- 24 Paid \$300 for a cash purchase from Buster's Emporium (debited Purchases)
- 25 Sold merchandize on account to Pinehurst Novelties Inc. for \$1,400
- 26 Purchased \$700 of merchandize on account from Tres Bon Markets Ltd. for terms 2/10, n30
- 30 Paid Shelby Corp. \$500 for deliveries to customers
- 30 Paid Mitch Michaels \$400 for commissions earned to date
- 30 Paid PhoneU \$75 for the monthly telephone bill

- 30 Paid Vision Visuals Ltd. \$250 for advertizing materials used during the month

*Required:* Prepare journal entries to record the March transactions and necessary adjusting entries. Include general ledger account numbers and a brief description for each entry.

#### 5.9.4.9 AP 5–9 (Appendix)



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The following journal closing entries were prepared for George Services Ltd. at December 31, 2017, its fiscal year–end.

Dec.	31	Merchandize Inventory	7,000
		Sales	34,000
		Purchase returns and Allowances	1,760
		Purchase discounts	240
		Income Summary	43,000
	31	Income Summary	40,000
		Merchandize Inventory	6,000
		Sales Returns and Allowances	660
		Sales Discounts	340
		Purchases	24,000
		Transportation–In	1,000
		Salaries Expenses	8,000

31	Income Summary	3,000
	Retained Earnings	3,000

*Required:* Prepare a partial income statement including sales, cost of goods sold, and gross profit.

#### 5.9.4.10 AP 5–10 (Appendix)



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The following unadjusted trial balance has been extracted from the records of Niven Shops Inc. at December 31, 2017, its fiscal year-end. The balances for share capital and retained earnings have not changed during the year.



<i>Account</i>	<i>Account Balances</i>	
	<i>Debit</i>	<i>Credit</i>
Cash	2,000	
Accounts receivable	4,000	
Merchandise inventory – Jan. 1, 2016	40,000	
Prepaid insurance	2,600	
Prepaid rent	1,800	
Unused supplies	300	
Equipment	23,000	
Bank loan		15,000
Accounts payable		4,000
Income taxes payable		3,600
Share capital		5,000
Retained earnings		10,000
Sales		140,000
Sales returns and allowances	3,250	
Sales discounts	750	
Purchases	80,000	
Purchase returns and allowances		9,400
Purchase discounts		600
Transportation-in	2,000	
Advertising expense*	3,800	
Commissions expense*	4,200	
Insurance expense*	1,100	
Interest expense	1,200	
Rent expense	3,300	
Supplies expense	5,600	
Telephone expense*	3,100	
Utilities expense	2,000	
Income taxes expense	3,600	
	<u>\$187,600</u>	<u>\$187,600</u>
*selling expenses		

Required:

1. Prepare adjusting entries, including general ledger account numbers and a brief description for each entry, for the following:
  1. The balance in Prepaid Rent consists of equal amounts of rent for the months of December 2017, and January and February 2018.
  2. Interest on the bank loan applicable to the month of December amounts to \$100 has not yet been recorded as Interest Payable.
  3. A December commission expense owing of \$500 has not been recorded.
  4. The balance in Prepaid Insurance applies equally to each of the thirteen months ended December 31, 2018.

5. A physical count of unused supplies indicated that there was \$2,000 on hand at year-end.
6. A physical count indicates that \$35,000 of merchandize inventory is on hand at December 31, 2017.
2. Prepare an adjusted trial balance at December 31, 2017.
3. Prepare a classified income statement and statement of changes in equity for the year ended December 31, 2017, and a classified balance sheet at December 31.
4. Prepare closing entries. Include general ledger account numbers and a brief description for each entry. Include general ledger account numbers and a brief description for each entry.

## 5.9.5 Decision Problem

### 5.9.5.1 DP 5-1



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Bill Davis Music Inc. is a store that sells musical instruments. After operating the store for one year, the owner prepared the following income statement for the fiscal year ended December 31, 2017:

**Bill Davis Music Inc.**  
**Statement of Profit**  
**For the Year Ended December 31, 2017**

Cash deposited in the bank and recorded as sales	\$35,000
Amounts paid by cheque and recorded as Merchandize Inventory	<u>32,000</u>
<b>Profit, and cash in bank at December 31, 2017</b>	<b><u>\$ 3,000</u></b>

Mr. Davis, the owner, has hired you as an accountant and financial consultant. In one of your first conversations with him, he says, "This business is fantastic. I never expected to make a profit until the second or third year of operations, but not once during the past year did we ever overdraw our chequing account." The items listed below come to your attention during the first few weeks on the job:

- a. On December 31, 2017, customers owed the company \$12,500 from the sale of instruments on credit.
- b. Mr. Davis has not paid rent for October, November, and December, 2017. Monthly rental for the retail space is \$1,000.

- 
- c. Mr. Davis financed the business with a \$10,000, loan from his father, repayable in five years. Accrued interest payable on the loan at December 31, 2017 is \$2,500.
  - d. The company issued share capital of \$100 to Mr. Davis for cash on January 1, 2017.
  - e. Merchandize inventory on hand at December 31, 2017 totalled \$500.

*Required:*

1. Based on Mr. Davis' statements and actions, how do you think he defines the term profit? Did Mr. Davis violate generally accepted accounting principles in preparing his statement of profit? Explain.
2. Prepare adjusting and closing entries needed at December 31, 2017 and post to general ledger T-accounts. Include general ledger account numbers and a brief description for each entry.
3. Prepare an income statement for the year ended December 31, 2017 and a balance sheet at December 31.
4. Comment on the revised results.

# Chapter 6 Assigning Costs to Merchandize



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Recording transactions related to the purchase and sale of merchandize inventory was introduced and discussed in Chapter 5. This chapter reviews how the cost of goods sold is calculated using various inventory cost flow assumptions. Additionally, issues related to merchandize inventory that remains on hand at the end of an accounting period are also explored.

## Learning Objectives

LO1 – Calculate cost of goods sold and merchandize inventory under specific identification, first-in first-out (FIFO), and weighted average cost flow assumptions, using the perpetual inventory system.

LO2 – Explain the impact on financial statements of inventory cost flows and errors.

LO3 – Explain and calculate lower of cost and net realizable value inventory adjustments.

LO4 – Estimate merchandize inventory using the gross profit method and the retail inventory method.

LO5 – Calculate cost of goods sold and merchandize inventory under specific identification, first-in first-out (FIFO), and weighted average cost flow assumptions, using the periodic inventory system.

## 6.1 Inventory Cost Flow Assumptions



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LO1 – Calculate cost of goods sold and merchandize inventory under specific identification, first-in first-out (FIFO), and weighted average cost flow assumptions using the perpetual inventory system.

Determining the cost of each unit of inventory, and thus the total cost of ending inventory on the balance sheet, can be challenging. Why? We know from Chapter 5 that the cost of inventory can be affected by discounts, returns, transportation costs,

and shrinkage. Additionally, the purchase cost of an inventory item can be different from one purchase to the next. For example, the cost of coffee beans could be \$5.00 a kilo in October and \$7.00 a kilo in November. Finally, some types of inventory flow into and out of the warehouse in a specific sequence, while others do not. For example, milk would need to be managed so that the oldest milk is sold first. In contrast, a car dealership has no control over which vehicles are sold because customers make specific choices based on what is available. So how is the cost of a unit in merchandize inventory determined? There are several methods that can be used. Each method may result in a different cost, as described in the following sections.

Assume a company sells only one product and uses the perpetual inventory system. It has no beginning inventory at June 1, 2015. The company purchased five units during June as shown in Figure 6.1.

<i>Date</i>	<i>Purchase Transaction</i>	
	<i>Number of units</i>	<i>Price per unit</i>
June 1	1	\$ 1
5	1	2
7	1	3
21	1	4
728	1	5
	5	\$15

Fig. 6.1: June Purchases and Purchase Price per Unit

At June 28, there are 5 units in inventory with a total cost of \$15 ( $\$1 + \$2 + \$3 + \$4 + \$5$ ). Assume four units are sold June 30 for \$10 each on account. The cost of the four units sold could be determined based on identifying the cost associated with the specific units sold. For example, a car dealership tracks the cost of each vehicle purchased and sold. Alternatively, a business that sells perishable items would want the oldest units to move out of inventory first to minimize spoilage. Finally, if large quantities of low dollar value items are in inventory, such as pencils or hammers, an average cost might be used to calculate cost of goods sold. A business may choose one of three methods to calculate cost of goods and the resulting ending inventory based on an assumed flow. These methods are: specific identification, FIFO, and weighted average, and are discussed in the next sections.

### 6.1.1 Specific Identification



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Under **specific identification**, each inventory item that is sold is matched with its purchase cost. This method is most practical when inventory consists of relatively few, expensive items, particularly when individual units can be identified with serial numbers—for example, motor vehicles.

Assume the four units sold on June 30 are those purchased on June 1, 5, 7, and 28. The fourth unit purchased on June 21 remains in ending inventory. Cost of goods sold would total \$11 (\$1 + \$2 + \$3 + \$5). Sales would total \$40 (4 @ \$10). As a result, gross profit would be

\$29 (\$40 - 11). Ending inventory would be \$4, the cost of the unit purchased on June 21.

The general ledger T-accounts for Merchandize Inventory and Cost of Goods Sold would show:

Merchandize Inventory			
Jun. 1	\$1		
5	2		
7	3		
21	4		
28	5		
End. Bal.	4	11	Jun. 30 <span style="font-size: 2em;">→</span> 11

Fig. 6.2: Cost of Goods Sold using Specific Identification

The entry to record the June 30 sale on account would be:

Accounts Receivable	110	40	
Sales	500	40	
<i>To record the sale of merchandize on account.</i>			

Cost of Goods Sold	570	11	
Merchandize Inventory	150	11	
<i>To record the cost of the sale.</i>			

It is not possible to use specific identification when inventory consists of a large number of similar, inexpensive items that cannot be easily differentiated. Consequently, a method of assigning costs to inventory items based on an assumed flow of goods can be adopted. Two such generally accepted methods, known as cost flow assumptions, are discussed next.

### 6.1.2 The First-in, First-out (FIFO) Cost Flow Assumption



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**First-in, first-out (FIFO)** assumes that the first goods purchased are the first ones sold. A FIFO cost flow assumption makes sense when inventory consists of perishable items such as groceries and other time-sensitive goods.



Using the information from the previous example, the first four units purchased are assumed to be the first four units sold under FIFO. The cost of the four units sold is \$10 (\$1 + \$2 + \$3 + \$4). Sales still equal \$40, so gross profit under FIFO is \$30 (\$40 – \$10). The cost of the one remaining unit in ending inventory would be the cost of the fifth unit purchased (\$5).

The general ledger T-accounts for Merchandize Inventory and Cost of Goods Sold as illustrated in Figure 6.3 would show:

Merchandize Inventory				Cost of Goods Sold	
Jun. 1	\$1				
5	2				
7	3				
21	4				
28	5				
		10	Jun. 30	→	10
End. Bal.	5				

Fig. 6.3: Cost of Goods Sold using FIFO

The entry to record the sale would be:

Accounts Receivable	110	40	
Sales	500		40
<i>To record the sale of merchandize on account.</i>			
Cost of Goods Sold	570	10	
Merchandize Inventory	150		10
<i>To record the cost of the sale.</i>			

### 6.1.3 The Weighted Average Cost Flow Assumption



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A **weighted average** cost flow is assumed when goods purchased on different dates are mixed with each other. The weighted average cost assumption is popular in practice because it is easy to calculate. It is also suitable when inventory is held in common storage facilities—for example, when several crude oil shipments are stored in one large holding tank. To calculate a weighted average, the total cost of all purchases of a particular inventory type is divided by the number of units purchased.

To calculate the weighted average cost in our example, the purchase prices for all five units are totalled (\$1 + \$2 + \$3 + \$4 + \$5 = \$15) and divided by the total number of units purchased (5). The weighted average cost for each unit is \$3 (\$15/5). The weighted average cost of goods sold would be \$12 (4 units @ \$3). Sales still equal \$40



resulting in a gross profit under weighted average of \$28 (\$40 - \$12). The cost of the one remaining unit in ending inventory is \$3.

The general ledger T-accounts for Merchandize Inventory and Cost of Goods Sold are:

Merchandize Inventory			
Jun. 1	\$1	} = \$15 total cost/5 units = \$3 avg. cost/unit	
5	2		
7	3		
21	4		
28	5		
End. Bal.	3	12	Jun. 30 → 12
		↑	
		4 units sold @ \$3 avg. cost/unit = \$12	

Fig. 6.4: Cost of Goods Sold using Weighted Average

The entry to record the sale would be:

Accounts Receivable	110	40	
Sales	500		40
<i>To record the sale of merchandize on account.</i>			

Cost of Goods Sold	570	12	
Merchandize Inventory	150		12
<i>To record the cost of the sale.</i>			

### 6.1.4 Cost Flow Assumptions: A Comprehensive Example



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Recall that under the perpetual inventory system, cost of goods sold is calculated and recorded in the accounting system at the time when sales are recorded. In our simplified example, all sales occurred on June 30 after all inventory had been purchased. In reality, the purchase and sale of merchandize is continuous. To demonstrate the calculations when purchases and sales occur continuously throughout the accounting period, let's review a more comprehensive example.

Assume the same example as above, except that sales of units occur as follows during June:

<u>Date</u>	<u>Number of units sold</u>
June 3	1
8	1
23	1
29	1

To help with the calculation of cost of goods sold, an **inventory record card** will be used to track the individual transactions. This card records information about purchases such as the date, number of units purchased, and purchase cost per unit. It also records cost of goods sold information: the date of sale, number of units sold, and the cost of each unit sold. Finally, the card records the balance of units on hand, the cost of each unit held, and the total cost of the units on hand.

A partially-completed inventory record card is shown in [Figure 6.5](#) below:

Date	Purchased			Sold			Balance in Inventory		
	Units	Unit Cost	Total \$	Units	Unit Cost	Total \$	Units	Unit Cost	Total \$
June 1	1						1		
3				1			0		
5	1						1		
7	1						2		
8				1			1		
21	1						2		
23				1			1		
28	1						2		
29				1			1		

The card tracks the flow of each type of inventory.

Ending Inventory is 1 unit.

**Fig. 6.5: Inventory Record Card**

In [Figure 6.5](#), the inventory at the end of the accounting period is one unit. This is the number of units on hand according to the accounting records. A **physical inventory count** must still be done, generally at the end of the fiscal year, to verify the quantities actually on hand. As discussed in Chapter 5, any discrepancies identified by the physical inventory count are adjusted for as shrinkage.

As purchases and sales are made, costs are assigned to the goods using the chosen cost flow assumption. This information is used to calculate the cost of goods sold amount for each sales transaction at the time of sale. These costs will vary depending on the inventory cost flow assumption used. As we will see in the next sections, the cost of sales may also vary depending on *when* sales occur.

## 6.1.5 Comprehensive Example—Specific Identification



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To apply specific identification, we need information about which units were sold on each date. Assume that specific units were sold as detailed below.

<i>Date of Sale</i>	<i>Specific Unit Sold</i>
June 3	The unit purchased on June 1 was sold on June 3
8	The unit purchased on June 7 was sold on June 8
23	The unit purchased on June 5 was sold on June 23
29	The unit purchased on June 28 was sold on June 29

Using the information above to apply specific identification, the resulting inventory record card appears in [Figure 6.6](#).

<i>Date</i>	<i>Purchased</i>			<i>Sold</i>			<i>Balance in Inventory</i>		
	<i>Units</i>	<i>Unit Cost</i>	<i>Total \$</i>	<i>Units</i>	<i>Unit Cost</i>	<i>Total \$</i>	<i>Units</i>	<i>Unit Cost</i>	<i>Total \$</i>
June 1	1	\$1	\$1				1	\$1	\$1
3				1	\$1	\$1	0	\$0	\$0
5	1	\$2	\$2				1	\$2	\$2
7	1	\$3	\$3				2	1@\$2 1@\$3	\$5
8				1	\$3	\$3	1	\$2	\$2
21	1	\$4	\$4				2	1@\$2 1@\$4	\$6
23				1	\$2	\$2	1	\$4	\$4
28	1	\$5	\$5				2	1@\$4 1@\$5	\$9
29				1	\$5	\$5	1	\$4	\$4

**Fig. 6.6: Inventory Record Card using Specific Identification**

Notice in [Figure 6.7](#) below that the number of units sold plus the units in ending inventory equals the total units that were available for sale ( $4 + 1 = 5$  units). As well, the cost of goods sold plus the cost of items in ending inventory equals the cost of goods available for sale ( $\$11 + \$4 = \$15$ ). This relationship will always be true for each of specific identification, FIFO, and weighted average.

Date	Purchased			Sold			Balance in Inventory		
	Units	Unit Cost	Total \$	Units	Unit Cost	Total \$	Units	Unit Cost	Total \$
June 1	1	\$1	\$1				1	\$1	\$1
3				1	\$1	\$1	0	\$0	\$0
5	1	\$2	\$2				1	\$2	\$2
7	1	\$3	\$3				2	1@\$2 1@\$3	\$5
8				1	\$3	\$3	1	\$2	\$2
21	1	\$4	\$4				2	1@\$2 1@\$4	\$6
23				1	\$2	\$2	1	\$4	\$4
28	1	\$5	\$5				2	1@\$4 1@\$5	\$9
29				1	\$5	\$5	1	\$4	\$4

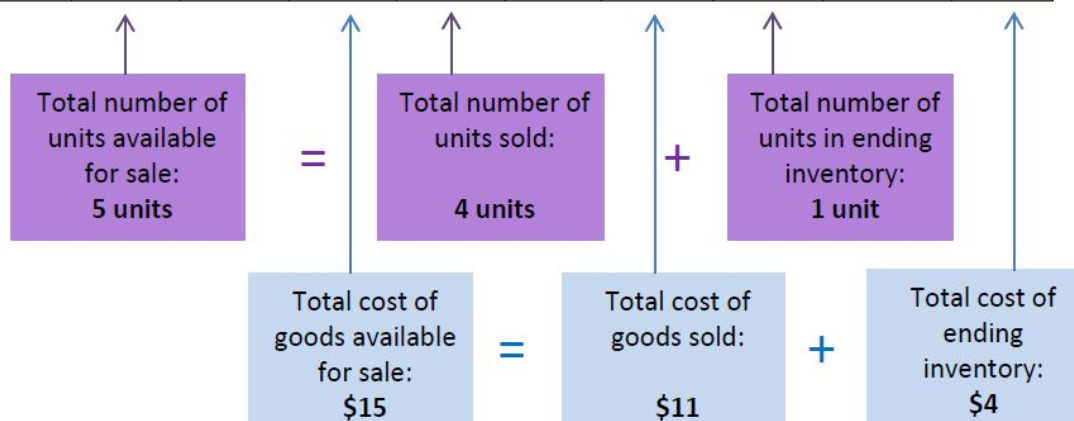


Fig. 6.7: Total Number (or Cost) of Units Sold plus Total Number (or Cost) of Units in Ending Inventory equals Total Number (or Cost) of Units Available for Sale

### 6.1.6 Comprehensive Example—FIFO (Perpetual)



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Using the same information, we now apply the FIFO cost flow assumption as shown in Figure 6.8.

Date	Purchased			Sold			Balance in Inventory		
	Units	Unit Cost	Total \$	Units	Unit Cost	Total \$	Units	Unit Cost	Total \$
June 1	1	\$1	\$1				1	\$1	\$1
3				1	\$1	\$1	0	\$0	\$0
5	1	\$2	\$2				1	\$2	\$2
7	1	\$3	\$3				2	1@\$2 1@\$3	\$5
8				1	\$2	\$2	1	\$3	\$3
21	1	\$4	\$4				2	1@\$3 1@\$4	\$7
23				1	\$3	\$3	1	\$4	\$4
28	1	\$5	\$5				2	1@\$4 1@\$5	\$9
29				1	\$4	\$4	1	\$5	\$5

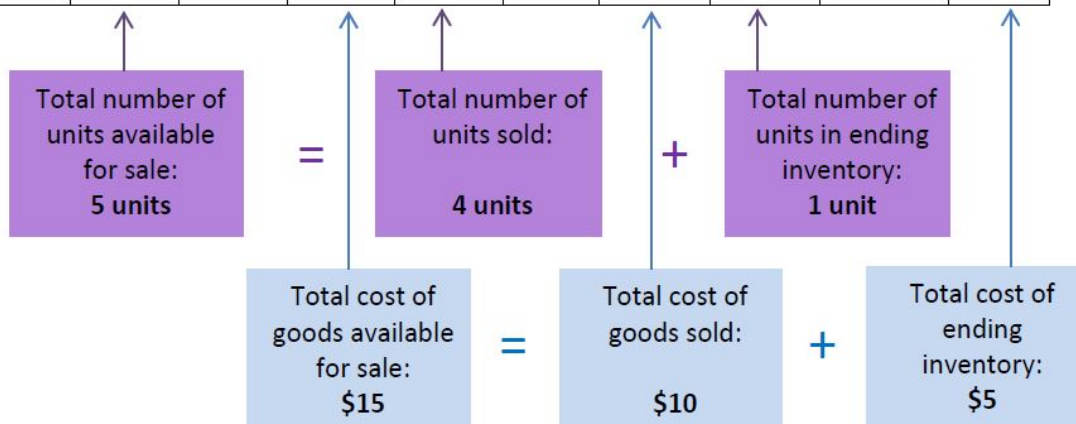


Fig. 6.8: Inventory Record Card using FIFO (Perpetual)

When calculating the cost of the units sold in FIFO, the oldest unit in inventory will always be the first unit removed. For example, in Figure 6.8, on June 8, one unit is sold when the previous balance in inventory consisted of 2 units: 1 unit purchased on June 5 that cost \$2 and 1 unit purchased on June 7 that cost \$3. Because the unit costing \$2 was in inventory first (before the June 8 unit costing \$3), the cost assigned to the unit sold on June 8 is \$2. Under FIFO, the first units into inventory are assumed to be the first units removed from inventory when calculating cost of goods sold. Therefore, under FIFO, ending inventory will always be the most recent units purchased. In Figure 6.8, there is one unit in ending inventory and it is assigned the \$5 cost of the most recent purchase which was made on June 28.

### 6.1.7 Comprehensive Example—Weighted Average (Perpetual)



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The inventory record card transactions using weighted average costing are detailed in Figure 6.9. For consistency, all weighted average calculations will be rounded to two decimal places. When a perpetual inventory system is used, the weighted average is calculated each time a purchase is made. For example, after the June 7 purchase, the balance in inventory is 2 units with a total cost of \$5.00 (1 unit at \$2.00 + 1 unit at \$3.00) resulting in an average cost per unit of \$2.50 ( $\$5.00 \div 2 \text{ units} = \$2.50$ ). When a



sale occurs, the cost of the sale is based on the most recent average cost per unit. For example, the cost of the sale on June 3 uses the \$1.00 average cost per unit from June 1 while the cost of the sale on June 8 uses the \$2.50 average cost per unit from June 7.

Date	Purchased			Sold			Balance in Inventory			Average Cost Calc.	
	Units	Unit cost	Total \$	Units	Unit cost	Total \$	Units	Unit cost	Total \$	Tot. \$ /Tot. units	Avg. cost /unit
June 1	1	\$1	\$1				1	\$1.00	\$1.00	\$1.00/1	\$1.00
3				1	\$1.00	\$1.00	0	\$0.00	\$0.00	\$0.00/0	\$0.00
5	1	\$2	\$2				1	\$2.00	\$2.00	\$2.00/1	\$2.00
7	1	\$3	\$3				2	\$2.50	\$5.00	\$5.00/2	\$2.50
8				1	\$2.50	\$2.50	1	\$2.50	\$2.50	\$2.50/1	\$2.50
21	1	\$4	\$4				2	\$3.25	\$6.50	\$6.50/2	\$3.25
23				1	\$3.25	\$3.25	1	\$3.25	\$3.25	\$3.25/1	\$3.25
28	1	\$5	\$5				2	\$4.13*	\$8.25	\$8.25/2	\$4.13*
29				1	\$4.13	\$4.13	1	\$4.12	\$4.12	\$2.12/1	\$4.12

\*rounded

Fig. 6.9: Inventory Record Card using Weighted Average Costing (Perpetual)

A common error made by students when applying weighted average occurs when the unit costs are rounded. For example, on June 28, the average cost per unit is rounded to \$4.13 ( $\$8.25 \div 2 \text{ units} = \$4.125/\text{unit}$  rounded to \$4.13). On June 29, the cost of the unit sold is \$4.13, the June 28 average cost per unit. Care must be taken to recognize that the total remaining balance in inventory after the June 29 sale is \$4.12, calculated as the June 28 ending inventory total dollar amount of \$8.25 less the June 29 total cost of goods sold of \$4.13. Students will often incorrectly use the average cost per unit, in this case \$4.13, to calculate the ending inventory balance. This produces an incorrect result. The cost of goods sold plus the balance in inventory must equal the goods available for sale ( $\$4.12 + \$4.13 = \$8.25$ ).

Figure 6.10 compares the results of the three cost flow methods. Goods available for sale, units sold, and units in ending inventory are the same regardless of which method is used. Because each cost flow method allocates the cost of goods available for sale in a particular way, the cost of goods sold and ending inventory values are different for each method.

Cost flow assumption	Total cost of goods available for sale	Total units available for sale	Total cost of goods sold	Total units sold	Total cost of ending inventory	Total units in ending inventory
Specific identification	\$15.00	5	\$11.00	4	\$4.00	1
FIFO	15.00	5	10.00	4	5.00	1
Weighted average	15.00	5	10.88	4	4.12	1

Fig. 6.10: Comparing Specific Identification, FIFO, and Weighted Average

## 6.1.8 Journal Entries



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In Chapter 5 the journal entries to record the sale of merchandize were introduced. Chapter 5 showed how the dollar value included in these journal entries is

determined. We now know that the information in the inventory record is used to prepare the journal entries in the general journal. For example, the credit sale on June 23 using weighted average costing would be recorded as follows (refer to Figure 6.9).

Accounts Receivable	110	10.00	
Sales	500		10.00
<i>To record the sale of merchandize on account at \$10 per unit.</i>			

Cost of Goods Sold	570	3.25	
Merchandize Inventory	150		3.25
<i>To record the cost of the sale.</i>			

Perpetual inventory incorporates an internal control feature that is lost under the periodic inventory system. Losses resulting from theft and error can easily be determined when the actual quantity of goods on hand is counted and compared with the quantities shown in the inventory records as being on hand. It may seem that this advantage is offset by the time and expense required to continuously update inventory records, particularly where there are thousands of different items of various sizes on hand. However, computerization makes this record keeping easier and less expensive because the inventory accounting system can be tied in to the sales system so that inventory is updated whenever a sale is recorded.

### 6.1.9 Inventory Record Card



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In a company such as a large drugstore or hardware chain, inventory consists of thousands of different products. For businesses that carry large volumes of many inventory types, the general ledger merchandize inventory account contains only summarized transactions of the purchases and sales. The detailed transactions for each type of inventory would be recorded in the underlying inventory record cards. The inventory record card is an example of a **subsidiary ledger**, more commonly called a *subledger*. The *merchandize inventory subledger* provides a detailed listing of type, amount, and total cost of all types of inventory held at a particular point in time. The sum of the balances on each inventory record card in the subledger would always equal the ending amount recorded in the Merchandize Inventory general ledger account. So a subledger contains the detail for each product in inventory while the general ledger account shows only a summary. In this way, the general ledger information is streamlined while allowing for detail to be available through the subledger.



## 6.2 Financial Statement Impact of Different Inventory Cost Flows



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LO2 – Explain the impact on financial statements of inventory cost flows and errors.

When purchase costs are increasing, as in a period of inflation (or decreasing, as in a period of deflation), each cost flow assumption results in a different value for cost of goods sold and the resulting ending inventory, gross profit, and net income.

Using information from the preceding comprehensive example, the effects of each cost flow assumption on net income and ending inventory for the month are shown in [Figure 6.11](#).

	<i>Spec. ident.</i>	<i>FIFO</i>	<i>Wtd. avg.</i>
Sales (4 units @ \$10)	\$40.00	\$40.00	\$40.00
Cost of goods sold	11.00	10.00	10.88
Gross profit and net income	<u>\$29.00</u>	<u>\$30.00</u>	<u>\$29.12</u>
Ending inventory (on the balance sheet)	<u>\$ 4.00</u>	<u>\$ 5.00</u>	<u>\$ 4.12</u>

**Fig. 6.11: Effects of Different Cost Flow Assumptions**

FIFO *maximizes* net income and ending inventory amounts when costs are rising. FIFO *minimizes* net income and ending inventory amounts when purchase costs are decreasing.

Because different cost flow assumptions can affect the financial statements, GAAP requires that the assumption adopted by a company be disclosed in its financial statements (full disclosure principle). Additionally, GAAP requires that once a method is adopted, it be used every accounting period thereafter (consistency principle) unless there is a justifiable reason to change. A business that has a variety of inventory items may choose a different cost flow assumption for each item. For example, Wal-Mart might use weighted average to account for its sporting goods items and specific identification for each of its various major appliances.

### 6.2.1 Effect of Inventory Errors on the Financial Statements



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There are two components necessary to determine the inventory value disclosed on a corporation's balance sheet. The first component involves calculating the quantity of

inventory on hand at the end of an accounting period by performing a physical inventory count. The second requirement involves assigning the most appropriate cost to this quantity of inventory.

An error in calculating either the quantity or the cost of ending inventory will misstate reported income for two time periods. Assume merchandize inventory at December 31, 2019, 2020, and 2021 was reported as \$2,000 and that merchandize purchases during each of 2020 and 2021 were \$20,000. There were no other expenditures. Assume further that sales each year amounted to \$30,000 with cost of goods sold of \$20,000 resulting in gross profit of \$10,000. These transactions are summarized below.

Merchandise Inventory				2020	2021
Beg. Bal.	2,000				
2020 Purch.	20,000	20,000	2020 COGS	\$30,000	\$30,000
2020 Bal.	2,000			20,000	20,000
2021 Purch.	20,000	20,000	2021 COGS	\$10,000	\$10,000
2021 Bal.	2,000				

Sales → \$30,000 (2020), \$30,000 (2021)  
 COGS → 20,000 (2020), 20,000 (2021)  
 Gross profit → \$10,000 (2020), \$10,000 (2021)

Fig. 6.12: Income Statement Effects, No Errors in Ending Inventory

Assume now that ending inventory was misstated at December 31, 2020. Instead of the \$2,000 that was reported, the correct value should have been \$1,000. The effect of this error was to understate cost of goods sold on the income statement—cost of goods sold should have been \$21,000 in 2020 as shown below instead of \$20,000 as originally reported above. Because of the 2020 error, the 2021 beginning inventory was incorrectly reported above as \$2,000 and should have been \$1,000 as shown below. This caused the 2021 gross profit to be understated by \$1,000—cost of goods sold in 2021 should have been \$19,000 as illustrated below but was originally reported above as \$20,000.

Merchandise Inventory				2020	2021
Op. Bal.	2,000				
2020 Purch.	20,000	20,000	2020 COGS	\$30,000	\$30,000
Ending inventory is incorrectly stated → 2020 Bal.	1,000	1,000	Inv. Adj.	21,000	19,000
2021 Purch.	20,000			\$ 9,000	\$11,000
Inv. Adj.	1,000	20,000	2021 COGS		
2021 Bal.	2,000				

Sales → \$30,000 (2020), \$30,000 (2021)  
 COGS → 21,000 (2020), 19,000 (2021)  
 Gross profit → \$ 9,000 (2020), \$11,000 (2021)

Fig. 6.13: Income Statement Effects, Error in 2020 Ending Inventory

As can be seen, income is misstated in both 2020 and 2021 because cost of goods sold in both years is affected by the adjustment to ending inventory needed at the end of 2020 and 2021. The opposite effects occur when inventory is understated at the end of an accounting period.

An error in ending inventory is offset in the next year because one year's ending inventory becomes the next year's opening inventory. This process can be illustrated by comparing gross profits for 2020 and 2021 in the above example. The sum of both years' gross profits is the same.

	<i>Overstated inventory</i>	<i>Correct inventory</i>
Gross profit for 2020	\$10,000	\$ 9,000
Gross profit for 2021	<u>10,000</u>	<u>11,000</u>
Total	<u>\$20,000</u>	<u>\$20,000</u>

Fig. 6.14: Gross Profit Effects Balance Out Over Two Years

### 6.3 Lower of Cost and Net Realizable Value (LCNRV)



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LO3 – Explain and calculate lower of cost and net realizable value inventory adjustments.

In addition to the adjusting entry to record the shrinkage of merchandize inventory (discussed in Chapter 5), there is an additional adjusting entry to be considered at the end of the accounting period when calculating cost of goods sold and ending inventory values for the financial statements. Generally accepted accounting principles require that inventory be valued at the lesser amount of its **laid-down cost** and the amount for which it can likely be sold—its **net realizable value**(NRV). This concept is known as the **lower of cost and net realizable** value, or *LCNRV*. Laid-down cost includes the invoice price of the goods (less any purchase discounts) plus transportation in, insurance while in transit, and any other expenditure made by the purchaser to get the merchandize to the place of business and ready for sale.

As an example of LCNRV, a change in consumer demand may mean that inventories become obsolete and need to be reduced in value below the purchase cost. This often occurs in the electronics industry as new and more popular products are introduced.

The lower of cost and net realizable value can be applied to individual inventory items or groups of similar items. Assume two types of inventory for a paper supply company, as shown in [Figure 6.15](#) below.

	Total cost	Total NRV	LCNRV	
			Unit basis	Group basis
White paper	\$1,250	\$1,200	\$1,200	
Coloured paper	1,400	1,500	1,400	
<b>Total</b>	<b>\$2,650</b>	<b>\$2,700</b>	<b>\$2,600</b>	<b>\$2,650</b>
<b>Ending inventory (LCNRV)</b>			<b>\$2,600</b>	<b>\$2,650</b>

Fig. 6.15: LCNRV Calculations

Depending on the calculation used, the valuation of ending inventory will be either \$2,600 or \$2,650. Under the unit basis, the lower of cost and net realizable value is selected for each item: \$1,200 for white paper and \$1,400 for coloured paper, for a total LCNRV of \$2,600. Because the LCNRV is lower than cost, an adjusting entry must be recorded as follows.

Cost of Goods Sold	570	50	
Merchandise Inventory	150		50
<i>To adjust inventory to LCNRV.</i>			

The purpose of the adjusting entry is to ensure that inventory is not overstated on the balance sheet and that income is not overstated on the income statement.

If white paper and coloured paper are considered a similar group, the calculations in Figure 6.15 above show they have a combined cost of \$2,650 and a combined net realizable value of \$2,700. LCNRV would therefore be \$2,650. In this case, the cost is equal to the LCNRV so no adjusting entry would be required if applying LCNRV on a group basis.

## 6.4 Estimating the Balance in Merchandise Inventory



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LO4 – Estimate merchandise inventory using the gross profit method and the retail inventory method.

A physical inventory count determines the quantity of items on hand. When costs are assigned to these items and these individual costs are added, a total inventory amount is calculated. Is this dollar amount correct? Should it be larger? How can one tell if the physical count is accurate? Being able to estimate this amount provides a check on the reasonableness of the physical count and valuation.



The two methods used to estimate the inventory dollar amount are the *gross profit method* and the *retail inventory method*. Both methods are based on a calculation of the gross profit percentage in the income statement. Assume the following information:

Sales		\$15,000	100%
<i>Cost of goods sold:</i>			
Opening inventory		\$ 4,000	
Purchases		<u>12,000</u>	
Cost of goods available for sale		16,000	
Less: Ending inventory		<u>(6,000)</u>	
Cost of goods sold		<u>10,000</u>	<u>67%</u>
Gross profit		<u>\$ 5,000</u>	<u>33%</u>

The gross profit percentage, rounded to the nearest whole percent, is 33% (\$5,000/15,000). This means that for each dollar of sales, an average of \$.33 is left to cover other expenses after deducting cost of goods sold.

Estimating ending inventory requires an understanding of the relationship of ending inventory with cost of goods sold.

Review the following cost of goods sold calculations.

<i>Cost of goods sold</i>		<i>Cost of goods sold</i>	
Opening inventory	\$ 4,000	Opening inventory	\$ 4,000
Purchases	<u>12,000</u>	Purchases	<u>12,000</u>
Cost of goods available for sale	16,000	Cost of goods available for sale	16,000
Less: Estimated ending inventory	<u>?</u>	Less: Estimated ending inventory	<u>6,000</u>
Cost of goods sold	<u>\$10,000</u>	Cost of goods sold	<u>?</u>

How much of the \$16,000 of goods that the company had available to sell is still not sold at December 31 (in other words, what is ending inventory)? You can calculate this as:		How much of the \$16,000 of goods that were available to be sold have been sold? Use the dollar amount of ending inventory to calculate this:	
Available for sale	\$16,000	Available for sale	\$16,000
Less inventory that was sold	<u>10,000</u>	Less inventory on hand	<u>6,000</u>
Equals what must still be on hand	<u>\$ 6,000</u>	Equals what must have been sold	<u>\$10,000</u>

The sum of cost of goods sold and ending inventory is always equal to cost of goods available for sale. Knowing any two of these amounts enables the third amount to be calculated. Understanding this relationship is the key to estimating inventory using either the gross profit or retail inventory methods, discussed below.

### 6.4.1 Gross Profit Method



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The **gross profit method** of estimating ending inventory assumes that the percentage of gross profit on sales remains approximately the same from period to period. Therefore, if the gross profit percentage is known, the dollar amount of ending inventory can be estimated. First, gross profit is estimated by applying the gross profit

percentage to sales. From this, cost of goods sold can be derived, namely the difference between sales and gross profit. Cost of goods available for sale can be determined from the accounting records (opening inventory + purchases). The difference between cost of goods available for sale and cost of goods sold is the estimated value of ending inventory.

To demonstrate, assume that Pete's Products Ltd. has an average gross profit percentage of 40%. If opening inventory at January 1, 2019 was \$200, sales for the six months ended June 30, 2019 were \$2,000, and inventory purchased during the six months ended June 30, 2019 was \$1,100, the cost of goods sold and ending inventory can be estimated as follows.

<b>Sales (given)</b>		\$2,000	
<b>Cost of goods sold</b>			
Opening inventory (given)	\$ 200		
Purchases (given)	1,100		
Cost of goods available for sale	1,300		
Less: Estimated ending inventory	(100)		
Cost of goods sold		1,200	
Gross profit		\$ 800	

**Step 1: Gross profit is estimated at \$800**  
 (\$2,000 x 40%).

**Step 2: Cost of goods sold can be derived**  
 (\$2,000 – 800 = \$1,200)

**Step 3: Ending inventory can be estimated**  
 (\$1,300 – 1,200 = 100)

The estimated ending inventory at June 30 must be \$100—the difference between the cost of goods available for sale and cost of goods sold.

The gross profit method of estimating inventory is useful in situations when goods have been stolen or destroyed by fire or when it is not cost-effective to make a physical inventory count.

## 6.4.2 Retail Inventory Method



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The **retail inventory method** is another means to estimate cost of goods sold and ending inventory. It can be used when items are consistently valued at a known percentage of cost, known as a *markup*. A **markup** is the ratio of retail value (or selling price) to cost. For example, if an inventory item had a cost of \$10 and a retail value of \$12, it was marked up to 120% ( $12/10 \times 100$ ). Mark-ups are commonly used in clothing stores.

First, the cost of goods available for sale is converted to its retail value (the selling price). To do this, the mark-up must be known. Assume the same information as above for Pete's Products Ltd., except that now every item in the store is marked up to 160% of its purchase price. That is, if an item is purchased for \$100, it is sold for \$160. Based on this, opening inventory, purchases, and cost of goods available can be restated at retail. Cost of goods sold can then be valued at retail, meaning that it will

equal sales for the period. From this, ending inventory (at retail) can be determined, then converted back to cost using the mark-up. These steps are illustrated below.

		Six Months Ended June 30, 2019	
		At retail	At cost
Sales (given)		\$2,000	\$2,000
<i>Cost of goods sold</i>			
{	Opening inventory (from records)	\$ 320	\$ 200
	Purchases (from records)	<u>1,760</u>	<u>1,100</u>
	Cost of goods available for sale	2,080	1,300
	Less: Estimated ending inventory	<u>(80)</u>	<u>(50)</u>
	Cost of goods sold	→ 2,000	← 1,250
	Gross profit	<u>\$ -0-</u>	<u>\$ 750</u>

**Step 1:** Opening inventory and purchases (and therefore cost of goods available for sale) are restated at retail (cost x 160%)

**Step 2:** Cost of goods sold is restated at retail (equal to sales).

**Step 3:** Ending inventory can be derived ( $\$2,080 - 2,000 = \$80$ ).

**Step 4:** Ending inventory is restated at cost (that is, divided by 160%). Cost of goods sold and gross profit can then be determined.

The retail inventory method of estimating ending inventory is easy to calculate and produces a relatively accurate cost of ending inventory, provided that no change in the average mark-up has occurred during the period.

## 6.5 Appendix: Inventory Cost Flow Assumptions Under the Periodic System



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LO5 – Calculate cost of goods sold and merchandize inventory under specific identification, first-in first-out (FIFO), and weighted average cost flow assumptions, using the periodic inventory system.

Recall from Chapter 5 that the *periodic inventory system* does not maintain detailed records to calculate cost of goods sold each time a sale is made. Rather, when a sale is made, the following entry is made:

Date	Accounts Receivable	110	XX	
	Sales	550		XX

No entry is made to record cost of goods sold and to reduce Merchandize Inventory, as is done under the perpetual inventory system. Instead, all purchases are expenses and recorded in the general ledger account "Purchases." A physical inventory count is conducted at year-end. An amount for ending inventory is calculated based on this count and the valuation of the items in inventory, and cost of goods sold is calculated in the income statement based on this total amount. The income statement format is:



Sales		\$10,000
<i>Cost of goods sold</i>		
Opening inventory	\$ 1,000	
Purchases	<u>5,000</u>	
Goods available for sale	6,000	
Less: Ending inventory	<u>(2,000)</u>	
Cost of goods sold		<u>4,000</u>
Gross profit		<u>\$6,000</u>

Even under the periodic inventory system, however, inventory cost flow assumptions need to be made (specific identification, FIFO, weighted average) when purchase prices change over time, as in a period of inflation. Further, different inventory cost flow assumptions produce different cost of goods sold and ending inventory values, just as they did under the perpetual inventory system. These effects have been explained earlier in this chapter. *Under the periodic inventory system, cost of goods sold and ending inventory values are determined as if the sales for the period all take place at the end of the period.* These calculations were demonstrated in our earliest example in this chapter.

Our original example using units assumed there was no opening inventory at June 1, 2015 and that purchases were made as follows.

<i>Date</i>	<i>Purchase Transaction</i>	
	<i>Number of units</i>	<i>Price per unit</i>
June 1	1	\$ 1
5	1	2
7	1	3
21	1	4
28	1	5

When recorded in the general ledger T-account "Purchases" (an income statement account), these transactions would be recorded as follows:

<i>Purchases</i>		<i>No. 570</i>
Jun. 1	\$1	
5	2	
7	3	
21	4	
28	5	

Sales of four units are all assumed to take place on June 30. Ending inventory would then be counted at the end of the day on June 30. One unit should be on hand. It

would be valued as follows under the various inventory cost flow assumptions, as discussed in the first part of the chapter:

Specific identification	\$4
FIFO	5
Weighted average	3

These values would be used to calculate cost of goods sold and gross profit on the income statement, as shown in [Figure 6.16](#) below:

	<i>Spec. ident.</i>	<i>FIFO</i>	<i>Wtd. avg.</i>
Sales	<u>\$40</u>	<u>\$40</u>	<u>\$40</u>
<i>Cost of goods sold</i>			
Opening inventory	-0-	-0-	-0-
Purchases	<u>15</u>	<u>15</u>	<u>15</u>
Goods available for sale	15	15	15
Less: Ending inventory	<u>(4)</u>	<u>(5)</u>	<u>(3)</u>
Cost of goods sold	<u>11</u>	<u>10</u>	<u>12</u>
Gross profit and net income	<u>\$29</u>	<u>\$30</u>	<u>\$28</u>
Ending inventory (balance sheet)	<u>\$ 4</u>	<u>\$ 5</u>	<u>\$ 3</u>

**Fig. 6.16: Effects of Different Cost Flow Assumptions: Periodic Inventory System**

Note that these results are the same as those calculated using the perpetual inventory system and assuming all sales take place on June 30 using specific identification ([Figure 6.2](#)), FIFO ([Figure 6.3](#)), and weighted average ([Figure 6.4](#)) cost flow assumptions, respectively.

As discussed in the appendix to Chapter 5, the ending inventory amount will be recorded in the accounting records when the income statement accounts are closed to the Income Summary general ledger account at the end of the year. The amount of the closing entry for ending inventory is obtained from the income statement. Using the example above and assuming no other revenue or expense items, the closing entries to adjust ending inventory to actual under the each inventory cost flow assumption would be as follows.

Entry 1

			<i>Spec. Ident.</i>	<i>FIFO</i>	<i>Wtd. Avg</i>
Dec. 31	Merchandise Inventory (ending)	150	4	5	3
	Sales	500	40	40	40
	Income Summary	360	44	45	43

To close all income statement accounts with credit balances to the Income Summary and record the ending inventory balance.

## 6.6 Summary of Chapter 6 Learning Objectives



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### **LO1 – Calculate cost of goods sold and merchandise inventory under specific identification, first-in first-out (FIFO), and weighted average cost flow assumptions, using the perpetual inventory system.**

Cost of goods available for sale must be allocated between cost of goods sold and ending inventory using a cost flow assumption. Specific identification allocates cost to units sold by using the actual cost of the specific unit sold. FIFO (first-in first-out) allocates cost to units sold by assuming the units sold were the oldest units in inventory. Weighted average allocates cost to units sold by calculating a weighted average cost per unit at the time of sale.

### **LO2 – Explain the impact on financial statements of inventory costflows and errors.**

As purchase prices change, particular inventory methods will assign different cost of goods sold and resulting ending inventory to the financial statements. Specific identification achieves the exact matching of revenues and costs while weighted average accomplishes an averaging of price changes, or smoothing. The use of FIFO results in the current cost of inventory appearing on the balance sheet in ending inventory. The cost flow method in use must be disclosed in the notes to the financial statements and be applied consistently from period to period. An error in ending inventory in one period impacts the balance sheet (inventory and shareholders' equity) and the income statement (COGS and net income) for that accounting period and the next. However, inventory errors in one period reverse themselves in the next.

### **LO3 – Explain and calculate lower of cost and net realizable value inventory adjustments.**

Inventory must be evaluated, at minimum, each accounting period to determine whether the net realizable value (NRV) is lower than cost, known as the lower of cost and net realizable value (LCNRV) of inventory. An adjustment is made if the NRV is lower than cost. LCNRV can be applied to groups of similar items or by item.

### **LO4 – Estimate merchandise inventory using the gross profit method and the retail inventory system.**

Estimating inventory using the gross profit method requires that estimated cost of goods sold be calculated by, first, multiplying net sales by the gross profit ratio. Estimated ending inventory at cost is then arrived at by taking goods available for sale at cost less the estimated cost of goods sold. To apply the retail inventory method, three calculations are required:

- retail value of goods available for sale less retail value of net sales equals retail value of ending inventory,
- goods available for sale at cost divided by retail value of goods available for sale equals cost to retail ratio, and
- retail value of ending inventory multiplied by the cost to retail ratio equals estimated cost of ending inventory.

**LO5 – Calculate cost of goods sold and merchandize inventory under specific identification, first-in first-out (FIFO), and weighted average cost flow assumptions, using the periodic inventory system.**

Periodic systems assign cost of goods available for sale to cost of goods sold and ending inventory at the end of the accounting period. Specific identification and FIFO give identical results in each of periodic and perpetual. The weighted average cost, periodic, will differ from its perpetual counterpart because in periodic, the average cost per unit is calculated at the end of the accounting period based on total goods that were available for sale.

## 6.7 Assignment Materials

### 6.7.1 Concept Self-check



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1. What three inventory cost flow assumptions can be used in perpetual inventory systems?
2. What impact does the use of different inventory cost flow assumptions have on financial statements?
3. What is meant by the laid-down cost of inventory?
4. What is the meaning of the term lower of cost and net realizable value, and how is it calculated?
5. How do rising costs affect ending inventory and cost of goods sold values using FIFO and weighted average cost flow assumptions?
6. Assume that you are the president of your company and paid a year-end bonus according to the amount of net income earned during the year. When prices are rising, would you choose a FIFO or weighted average cost flow assumption? Explain, using an example to support your answer. Would your choice be the same if prices were falling?
7. What inventory cost flow assumptions are permissible under GAAP?
8. The ending inventory of CBCA Inc. is overstated by \$5,000 at December 31, 2015. What is the effect on 2015 net income? What is the effect on 2016 net income assuming that no other inventory errors have occurred during 2016?

9. When should inventory be valued at less than cost?
10. What is the primary reason for the use of the LCNRV method of inventory valuation? What does the term net realizable value mean?
11. When inventory is valued at LCNRV, what does cost refer to?
12. Why is estimating inventory useful?
13. How does the estimation of ending inventory differ between the gross profit method and the retail inventory method? Use examples to illustrate.
14. When is the use of the gross profit method particularly useful?
15. Does the retail inventory method assume any particular inventory cost flow assumption?
16. (Appendix) What inventory cost flow assumptions can be used in a periodic inventory system?
17. (Appendix) Contrast the journal entries required under the periodic and perpetual inventory systems.

## 6.7.2 Comprehension Problems

### 6.7.2.1 CP 6-1



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Laplante Inc. uses the perpetual inventory system. The following transactions took place during January 2017

<i>Date</i>			<i>Units</i>	<i>Unit Cost</i>
Jan.	1	Opening Inventory	100	\$1
	7	Purchase #1	10	2
	9	Sale #1	80	
	21	Purchase #2	20	3
	24	Sale #2	40	

*Required:* Using the table below, calculate cost of goods sold for the January 9 and 24 sales, and ending inventory under the following inventory cost flow assumptions:

1. FIFO
2. Weighted average.

		<i>Purchased</i>			<i>Sold</i>			<i>Balance in Inventory</i>		
<i>Date</i>		<i>Units</i>	<i>Unit Cost</i>	<i>Total \$</i>	<i>Units</i>	<i>Unit Cost</i>	<i>Total \$</i>	<i>Units</i>	<i>Unit Cost</i>	<i>Total \$</i>
Jan.	1							100	\$1	\$100
	7									
	9									
	21									
	24									

### 6.7.2.2 CP 6-2



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ABBA uses the perpetual inventory system. The following transactions took place in January 2015.

<i>Date</i>			<i>Units</i>	<i>Unit Selling Price/Cost</i>
Jan.	1	Opening Inventory	2,000	\$0.50
	5	Sale #1	1,200	5.00
	6	Purchase #1	1,000	2.00
	10	Purchase #2	500	1.00
	16	Sale #2	2,000	6.00
	21	Purchase #3	1,000	2.50

Assume all sales are made on account.

*Required:*

1. Assume ABBA uses the FIFO inventory cost flow assumption
  1. Record the journal entry for the January 5 sale. Show calculations for cost of goods sold.
  2. Record the journal entry for the January 16 sale. Show calculations for cost of goods sold.
  3. Calculate ending inventory in units, cost per unit, and total cost.
2. Assume ABBA uses the weighted average inventory cost flow assumption
  1. Record the journal entry for the January 5 sale. Show calculations for cost of goods sold.
  2. Record the journal entry for the January 16 sale. Show calculations for cost of goods sold.
  3. Calculate ending inventory in units, cost per unit, and total cost.

**6.7.2.3 CP 6-3**

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The following information is taken from the records of East Oak Distributors Inc. The company uses the perpetual inventory system.

<i>Date</i>			<i>Units</i>	<i>Unit Cost</i>
May	1	Opening Inventory	100	\$1
	5	Sale #1	80	
	6	Purchase #1	200	5
	12	Purchase #2	125	3
	13	Sale #2*	300	
	19	Purchase #3	350	2
	29	Purchase #4	150	1
	30	Sale #3**	400	

\*for specific identification, sold 175 units of purchase #1 and all units of purchase #2.



\*\*for specific identification, sold 20 units of opening inventory, 300 units of purchase #3, and 80 units of purchase #4.

*Required:*

1. Calculate cost of goods sold and the cost of ending inventory under each of the following inventory cost flow assumptions:
  - a. FIFO
  - b. Specific identification
  - c. Weighted average.

Assume each unit was sold for \$5. Complete the following partial income statements :

	<i>FIFO</i>	<i>Spec. Ident.</i>	<i>Wtd. Avg.</i>
2. Sales	\$	\$	\$
Cost of goods sold	_____	_____	_____
Gross profit	=====	=====	=====

3. Which costing method would you choose if you wished to maximize net income? Maximize ending inventory value?

#### 6.7.2.4 CP 6-4



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*Required:* Choose the method of inventory valuation that corresponds to each of the statements that follow:

1. FIFO
2. Weighted average.
3. Specific identification

\_\_\_ Matches actual flow of goods with actual flow of costs in most cases

\_\_\_ Matches old costs with new sales prices

\_\_\_ Results in the lowest net income in periods of falling prices

\_\_\_ Does not assume any particular flow of goods

\_\_\_ Best suited for situations in which inventory consists of perishable goods

\_\_\_ Values ending inventory at approximate replacement cost

### 6.7.2.5 CP 6-5



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Listed below are four common accounting errors. Using the format shown, indicate the effect, if any, of each of the errors on the company's financial statements for the items shown. Assume the company uses the perpetual inventory system and that the ending inventory balance will be adjusted to the physical count at year-end.

Errors	2015 Statements				2016 Statements			
	Opening invent.	Ending invent.	2015 Total assets	2015 Net income	Opening invent.	Ending invent.	2016 Total assets	2016 Net income
1. Goods purchased in 2015 were included in December 31 inventory, but the transaction was not recorded until early 2016.	-0-							
2. Goods purchased in 2015 were included in December 31, 2015 inventory, and the transaction	-0-							

was recorded in 2015.								
3. Goods were purchased in 2015 and the transaction recorded in that year; however, the goods were not included in the December 31 inventory as they should have been.	-0-							
4. Goods purchased in 2015 were excluded from December 31 inventory, and the transaction was recorded early in 2016.	-0-							

*Required:* Use a + (plus sign) to denote that an item is too high as a *result* of the error, a - (minus sign) to denote that it is too low, and a -0- (zero) to indicate no effect. The answer for the 2015 opening inventory is shown.

### 6.7.2.6 CP 6-6



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Partial income statements of Lilydale Products Inc. are reproduced below:

	<i>2017</i>	<i>2018</i>	<i>2019</i>
Sales	\$30,000	\$40,000	\$50,000
Cost of Goods Sold	20,000	23,000	25,000
Gross Profit	\$10,000	\$17,000	\$25,000

*Required:*

1. Calculate the impact of the two errors listed below on the gross profit calculated for the three years:
  1. The 2017 ending inventory was understated by \$2,000.
  2. The 2019 ending inventory was overstated by \$5,000.
2. What is the impact of these errors on total assets?

### 6.7.2.7 CP 6-7



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Erndale Products Ltd. has the following items in inventory at year-end:

<i>Item</i>	<i>Units</i>	<i>Cost (FIFO)</i>	<i>NRV</i>
X	2	\$50	\$60
Y	3	150	75
Z	4	25	20

*Required:* Calculate the cost of ending inventory using LCNRV on

1. A unit-by-unit basis
2. A group inventory basis.

### 6.7.2.8 CP 6-8



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Windy City Insurance Ltd. has received a fire-loss claim of \$45,000 from Balton Corp. A fire destroyed Balton's inventory on May 25, 2016. Balton has an average gross profit of 33 1/3 per cent. You have obtained the following information:

Inventory, May 1, 2016	\$ 80,000
Purchases, May 1 – May 25	150,000
Sales, May 1 – May 25	300,000

*Required:*

1. Calculate the estimated amount of inventory lost in the fire.
2. How reasonable is Balton's claim?

### 6.7.2.9 CP 6-9



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The records of Renault Corporation showed that sales during the period were \$276,000, Opening inventory amounted to \$26,000 at cost, Purchases were \$90,000 at cost. The company paid \$4,000 for transportation-in. Mark-up on all items sold is 300%.

*Required:*

1. Calculate:
  - a. Cost of goods available for sale at retail
  - b. Cost of goods sold at retail
  - c. Ending inventory at retail
  - d. Ending inventory at cost
  - e. Cost of goods sold at cost
  - f. Gross profit at cost.
2. Demonstrate that your results maintain a 300% mark-up.

### 6.7.2.10 CP 6-10



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Midlife Corp. is in the process of preparing its financial statements as at May 31, 2016. It has a consistent mark-up of 200% on goods it sells. The following information is available for the five months ended May 31:

Opening inventory	\$ 10,000
Net purchases	140,000
Sales	250,000

*Required:* Estimate the cost of ending inventory at May 31.

### 6.7.2.11 CP 6-11 (Appendix)



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On March 15, 2015, Sudden Sales Co. purchased \$5,000 of merchandize for cash.

*Required:* Assuming that Sudden Sales uses the periodic inventory system, calculate the cost of goods sold in each of the following circumstances:

1. Opening inventory, -0-; ending inventory, \$2,000
2. Opening inventory, \$3,000; ending inventory, \$4,000
3. Opening inventory, \$1,000; ending inventory, \$1,500
4. Opening inventory, \$2,000; ending inventory, -0-.

### 6.7.2.12 CP 6-12 (Appendix)



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Bouchard Inc. uses a periodic inventory system. The following transactions took place during January 2017. The company sold 200 units during this month at \$6 per unit. For specific identification purposes, items sold were:

100 units of opening inventory

30 units of purchase #3

30 units of purchase #4

40 units of purchase #5

	<i>Units</i>	<i>Unit Cost</i>
Opening inventory	100	\$1
Purchase #1	10	1
Purchase #2	20	2
Purchase #3	30	3
Purchase #4	40	4
Purchase #5	50	5

*Required:* Using the income statement format shown below, calculate gross profit for each of:

1. FIFO
2. Specific identification
3. Weighted average.

	<u><i>FIFO</i></u>	<u><i>Spec. ident.</i></u>	<u><i>Wtd. average</i></u>
Sales	\$1,500	\$1,500	\$1,500
<i>Cost of goods sold</i>			
Opening inventory			
Purchases			
Cost of goods available			
<i>Less: Ending inventory</i>	_____	_____	_____
Cost of goods sold	_____	_____	_____
Gross profit	=====	=====	=====

### 6.7.2.13 CP 6-13 (Appendix)



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The following transactions took place in ABBA Limited in 2015.



Opening Inventory	2,000 units @ \$0.50
Purchase #1	1,000 units @ \$2.00
Purchase #2	500 units @ \$1.00
Purchase #3	1,000 units @ \$2.50
Sales	2,000 units

Assume a periodic inventory system is used. For specific identification purposes, items sold were:

800 units of opening inventory

200 units of purchase #3

1,000 units of purchase #4

*Required:* Calculate

1. Ending inventory under specific identification.
2. Ending inventory under FIFO.
3. Ending inventory under weighted average.
4. Cost of goods sold under specific identification.
5. Cost of goods sold under FIFO.
6. Cost of goods sold under weighted average.

#### 6.7.2.14 CP 6-14 (Appendix)



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The following information is taken from the records of West End Distributors Inc. The company uses the periodic inventory system.

		<i>Units</i>	<i>Unit cost</i>
May	Opening	100	\$1

1	Inventory	200	1
6	Purchase #1	125	2
12	Purchase #2	350	2
19	Purchase #3	150	3
29	Purchase #4		

At May 31, 200 units remain unsold. For specific identification purposes, items on hand were:

100 units of purchase #1

100 units of purchase #4

*Required:*

- Calculate the cost of ending inventory under each of the following costing methods:
  - FIFO
  - Specific identification
  - Weighted average.
- Complete the following partial income statements:

	<u>FIFO</u>	<u>Spec. ident.</u>	<u>Wtd. average</u>
Sales	\$1,500	\$1,500	\$1,500
<i>Cost of goods sold</i>			
Opening inventory			
Purchases			
Cost of goods available			
Less: Ending inventory			
Cost of goods sold			
Gross profit			

## 6.7.3 Problems

### 6.7.3.1 P 6-1



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The following sales and purchases of the same product were made during 2018 at Yang Corporation. The opening inventory consisted of 50 units at \$1 each.

<i>Purchases</i>				<i>Sales</i>		
		Units	\$ per unit		Units	Total \$
Apr. 15	Purch. #1	200	\$2	Apr. 25	Sale #1*	\$250
Oct. 15	Purch. #2	600	\$5	Oct. 25	Sale #2**	\$500

\*for specific identification, sold 50 units of opening inventory and 200 units of purchase #1

\*\*for specific identification, sold 500 units of purchase #2

*Required:*

1. Calculate cost of goods sold and the cost of ending inventory under each of FIFO, specific identification, and weighted average inventory cost flow assumptions. Set up a table as follows:

	<i>Purchased</i>			<i>Sold</i>			<i>Balance in inventory</i>		
<i>Date</i>	<i>Units</i>	<i>Unit cost</i>	<i>Total \$</i>	<i>Units</i>	<i>Unit cost</i>	<i>Total \$</i>	<i>Units</i>	<i>Unit cost</i>	<i>Total \$</i>
							50	\$1	\$50

2. Prepare calculations comparing the effect on gross profit of the three inventory cost flow assumptions.

3. The president wants to maximize the company's net income this year. What would you suggest that is in accordance with GAAP?

### 6.7.3.2 P 6-2



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Palermo Inc. uses the perpetual inventory system. All sales are made on account. The following data are taken from the company's for the year ended December 31, 2018:

<i>Purchases</i>				<i>Sales</i>			<i>Unit sell. price</i>
		<i>Units</i>	<i>Unit cost</i>		<i>Units</i>		
Jan. 1	Op. Inv.	25	\$1				
Feb. 15	Purchase #1	15	\$2	Feb. 28	Sale #1	30	\$2
Mar. 14	Purchase #2	10	\$3	Apr. 9	Sale #2	15	\$4
Oct. 28	Purchase #3	35	\$4	Dec. 21	Sale #3	50	\$6
Dec. 4	Purchase #4	40	\$5				

*Required:*

1. Show the journal entries to record the December 21 sale under a) FIFO and b) weighted average inventory cost flow assumptions.
2. Calculate the amount of gross profit for the year under FIFO and weighted average inventory cost flow assumptions. Which method matches cost of goods sold more closely with revenues? Why?
3. Given your answer to (2), what inventory cost flow assumption would be picked if management wanted to minimize income taxes?

### 6.7.3.3 P 6-3



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Southern Cross Company Limited made the following purchases and sales of Products A and B during the year ended December 31, 2016:

#### *Product A*

		<i>Units</i>	<i>Unit cost/ selling price</i>
Jan. 07	Purchase #1	8,000	\$12.00
Mar. 30	Sale #1	9,000	16.00
May 10	Purchase #2	12,000	12.10
Jul. 04	Sale #2	14,000	17.00

#### *Product B*

		<i>Units</i>	<i>Unit cost/ selling price</i>
Jan. 13	Purchase #1	5,000	\$13.81

Jul. 15	Sale #1	1,000	20.00
Oct. 23	Purchase #2	7,000	14.21
Dec. 14	Sale #2	8,000	21.00

Opening inventory at January 1 amounted to 4,000 units at \$11.90 per unit for Product A and 2,000 units at \$13.26 per unit for Product B.

*Required:*

1. Prepare inventory record cards for Products A and B for the year using the weighted average inventory cost flow assumption.
2. Calculate total cost of ending inventory at December 31, 2016.
3. Assume now that Southern Cross keeps over 1,000 types of inventory on hand. Why might staff prefer to use computerized accounting software if a perpetual inventory system is used?
4. (Appendix) What recommendations might you make to the president of Southern Cross regarding the use of the perpetual inventory system if only Products A and B are sold?

#### 6.7.3.4 P 6-4



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Northgate Products Corp. sells gadgets and uses the perpetual inventory system. During the month of January 2016, the number of gadgets purchased and sold was as follows:

		<i>Purchased</i>			<i>Sold</i>			<i>Balance in inventory</i>		
<i>Date</i>		<i>Units</i>	<i>Unit cost</i>	<i>Total \$</i>	<i>Units</i>	<i>Unit cost</i>	<i>Total \$</i>	<i>Units</i>	<i>Unit cost</i>	<i>Total \$</i>
Jan.	1							100	\$1	
	3	100	\$1							
	8	200	\$2							
	10				200*					

	15	300	\$3						
	20				400**				
	27	400	\$1						

Assume the January 10 units were sold on account for \$3 each, and the January 20 units were sold on account for \$5 each.

\*for specific identification, sold 50 units of opening inventory and 150 units of purchase #2

\*\*for specific identification, sold 100 units of purchase #1 and 300 units from purchase #3

*Required:*

- Complete the inventory record card, and calculate cost of goods sold and the cost of ending inventory under each of the following inventory cost flow assumptions:
  - FIFO
  - Specific identification
  - Weighted average.
- Prepare the journal entries required to record purchases and sales using the FIFO inventory cost flow assumption.
- Calculate the sum of cost of goods sold and ending inventory balances under each of the three assumptions. Explain the results.

### 6.7.3.5 P 6-5



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Partial income statements of Schneider Products Inc. are reproduced below:

	<i>2015</i>	<i>2016</i>
Sales	\$50,000	\$50,000
Cost of goods sold	20,000	23,000
Gross profit	<u>\$30,000</u>	<u>\$27,000</u>

The 2015 ending inventory was overstated by \$2,000 during the physical count and the accounting records were adjusted accordingly. The 2016 physical inventory count was done properly and the accounting records also adjusted to the appropriate balance.

*Required:*

- Calculate the impact of this error on the gross profit calculated for 2015 and 2016.

2. What is the impact of this error on total assets at the end of 2015 and 2016? Net assets?

### 6.7.3.6 P 6-6



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The year-end inventory of Goodall Inc. consisted of the following similar groups of items, priced at cost and at net realizable value:

<i>Item</i>	<i>Cost</i>	<i>NRV</i>
A	\$60	\$63
B	40	40
C	80	78
D	50	42

*Required:* Calculate ending inventory based on:

1. Cost
2. LCNRV (unit basis)
3. LCNRV (group basis).

### 6.7.3.7 P 6-7



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Reflex Corporation sells three products. The inventory valuation of these products is shown below for years 2016 and 2017.

	<u>2016</u>			<u>2017</u>		
	<i>Cost</i>	<i>Market</i>	<i>Unit basis (LCNRV)</i>	<i>Cost</i>	<i>Market</i>	<i>Unit basis (LCNRV)</i>
Product X	\$14,000	\$15,000	?	\$15,000	\$16,000	?
Product Y	12,500	12,000	?	12,000	11,500	?
Product Z	11,000	11,500	?	10,500	10,000	?
Total	?	?	?	?	?	?

The partial comparative income statements for the two years follow:



	<u>2016</u>	<u>2017</u>
Sales	\$1,500	\$1,500
<i>Cost of goods sold</i>		
Opening inventory		
Purchases		
Cost of goods available		
Ending inventory		
Cost of goods sold		
Gross profit		
	=====	=====

*Required:*

1. If Reflex values its inventory using LCNRV/unit basis, complete the 2016 and 2017 cost, net realizable value, and LCNRV calculations.
2. Complete the partial income statements for 2016 using cost, LCNRV/unit basis, and LCNRV/group basis to calculate ending inventory and cost of goods sold.
3. Complete the partial income statements for 2017 using cost, LCNRV/unit basis, and LCNRV/group basis to calculate ending inventory and cost of goods sold.
4. Which inventory valuation would yield the same gross profits for 2016 and 2017?
  1. Cost and LCNRV/unit basis
  2. Cost and LCNRV/group basis
  3. Cost basis.
5. Which methods yield the maximum combined profits for both years?

### 6.7.3.8 P 6-8



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The gross profit of Bellevue Widget Company Ltd. has consistently averaged 39%. The company's records were recently destroyed by fire. The following data are available:

Sales	\$305
Purchases	175
Opening inventory	25
Sales returns and allowances	5
Purchases returns and allowances	5
Delivery expenses	8

Transportation-in	3
Truck operating expenses	3
Selling commissions expense	6
Administrative expenses	3

*Required:* Calculate the estimated ending inventory.

### 6.7.3.9 P 6-9



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The president of Luna Sea Corporation is concerned that the year-end inventory amounting to \$5,000 at cost is less than expected. Although a physical count was made and the costing was accurately calculated using FIFO, the president asks you to estimate the year-end inventory using the following information for the year:

	<i>At retail</i>	<i>At cost</i>
Sales	\$160,000	
Sales returns and allowances	10,000	
Purchases	164,000	\$80,000
Purchases returns and allowances	4,000	2,000
Transportation-in		1,000
Opening inventory	20,000	11,000

*Required:*

1. Calculate the estimated ending inventory at cost using the retail inventory method. Assume mark-up is 200%.
2. Calculate the amount of inventory discrepancy at cost.
3. Why might this discrepancy occur?
4. What changes to the inventory system might you suggest to the president?

### 6.7.3.10 P 6-10 (Appendix)



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Zebra Corporation uses specific identification to cost inventory. During the first three years of operation ended December 31, 2016, the yearend inventory, computed by different methods for comparative purposes, was as follows:

	<i>Ending inventory</i>		
	<u>2016</u>	<u>2017</u>	<u>2018</u>
Spec. ident.	\$360	\$400	\$320
FIFO	300	320	280
Weighted average	340	420	300

Opening inventory on January 1, 2016 was zero. Sales and purchases for the three years were as follows:

	<u>2016</u>	<u>2017</u>	<u>2018</u>
Sales	<u>\$1,000</u>	<u>\$1,200</u>	<u>\$1,150</u>
Purchases	<u>1,280</u>	<u>1,100</u>	<u>1,010</u>

There were no other expenses or revenues.

*Required:* Using the format of the table below, determine net income under each method. Show calculations. Partial results using specific identification are shown:

	<u>2016</u>	<u>2017</u>	<u>2018</u>
Sales	\$1,000	\$1,200	\$1,150
<i>Cost of goods sold</i>			
Opening inventory	-0-	?	?
Purchases	1,280	?	?
Less: Ending inventory	<u>(360)</u>	<u>?</u>	<u>?</u>
Cost of goods sold	<u>920</u>	<u>?</u>	<u>?</u>
Gross profit/net income	<u>\$ 80</u>	<u>\$ 140</u>	<u>\$ 60</u>

### 6.7.3.11 P 6-11 (Appendix)



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The opening inventory of Tan Corporation at January 1, 2018 consisted of 50 units at \$1 each. The company uses the periodic inventory system. The following purchases were made during 2018.

		<i>Units</i>	<i>Unit Cost</i>
Apr.	15	200	\$2
May	25	200	\$3
June	7	200	\$4
Oct.	15	200	\$5

*Required:*

- Calculate the number of units available for sale. Then calculate the dollar amount of cost of goods available for sale at December 31, 2018. Set up a column for each of FIFO, specific identification, and weighted average inventory cost flow assumptions as follows:

	<i>Units</i>	<i>FIFO</i>	<i>Spec. ident.</i>	<i>Wtd. avg.</i>
Opening inventory				
Purchases				
Cost of goods available	_____	_____	_____	_____
	=====	=====	=====	=====

- If there are 200 units on hand at December 31, 2018, calculate the cost of ending inventory under each of FIFO, specific identification, and weighted average inventory cost flow assumptions. . For specific identification purposes, items sold were:

50 units of the April 15 purchases

200 units of the May 25 purchases

200 units of the June 7 purchases

200 units of the October 15 purchases

- Calculate the cost of goods sold under each of FIFO, specific identification, and weighted average inventory cost flow assumptions. Set up a table as follows:

	<i>Units</i>	<i>FIFO</i>	<i>Spec. ident.</i>	<i>Wtd. avg.</i>
Cost of goods available				
Ending inventory	_____	_____	_____	_____
Cost of goods sold	=====	=====	=====	=====

Based on the calculations in (3), the president of Tan Corporation has asked you to prepare some calculations comparing the effect on income of

4.
  - a. Using a weighted average cost flow method instead of specific identification;
  - b. Using a FIFO cost flow method instead of specific identification.
  
5. What method of cost flow would you recommend in this case? Why?

### 6.7.3.12 P 6-12 (Appendix)



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Western Produce Inc. uses the periodic inventory system. The following data are taken from the records of the company for the month of January 2018.

<i>Goods available for sale</i>			<i>Sales</i>		
	<i>Units</i>	<i>Unit cost</i>		<i>Units</i>	<i>Unit sell. price</i>
Opening Inventory	25	\$5			
Purchase #1	15	\$4	Sale #1	30	\$6
Purchase #2	10	\$3	Sale #2	20	\$4
Purchase #3	35	\$2	Sale #3	50	\$2
Purchase #4	40	\$1			

*Required:*

1. Calculate the amount of inventory at the end of January assuming that inventory cost is calculated using FIFO inventory cost flow assumption.
2. How would the ending inventory differ if it was cost is calculated using weighted average?
3. Calculate the amount of gross profit under each of the above costing methods. Which method matches inventory costs more closely with revenues? Why?
4. Would more income tax be payable under the FIFO or weighted average method in a period of rising prices? Explain why.

### 6.7.3.13 P 6-13 (Appendix)



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Southern Cross Company Limited made the following purchases during the year:

Jan.	7	8,000	units @	\$12.00 = \$ 96,000
Mar.	30	9,000	units @	\$12.40 = \$111,600
May	10	12,000	units @	\$12.00 = \$144,000
Jul.	4	16,000	units @	\$12.60 = \$201,600
Sept.	2	6,000	units @	\$12.80 = \$ 76,800
Dec.	14	7,000	units @	\$12.70 = \$ 88,900

Opening inventory at January 1 amounted to 4,000 units at \$11.90 per unit. Closing inventory at December 31 amounted to 15,000 units . For specific identification purposes, this consisted of 4,000 units of opening inventory, 8,000 units of the January 7 purchase, and 3,000 units of the March 30 purchase. Selling price during the year was stable at \$16 per unit.

*Required:*

1. Prepare a schedule of inventory as at December 31 based on FIFO, specific identification, and weighted average inventory cost flow assumptions. Assume a periodic inventory system is used.
2. Prepare an income statement showing sales, cost of goods sold, and gross profit based on each of these three assumptions.
3. Which method of inventory valuation matches revenues more closely with costs in this company under current conditions? Why?

### 6.7.3.14 P 6-14 (Appendix)



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The comptroller of Exeter Services Ltd. has asked you to forecast the effect of rising and falling prices on income when FIFO and weighted average costing methods are used. The following inventory data are made available:

Opening inventory	100 units at \$10 = \$1,000
Purchases	500 units at \$12 = \$6,000
Ending inventory	250 units

Partially completed income statements are as follows:

	<i>Rising prices</i>		<i>Falling prices</i>	
	<i>FIFO</i>	<i>Wtd. avg.</i>	<i>FIFO</i>	<i>Wtd. avg.</i>
Sales	\$5,000	\$5,000	\$5,000	\$5,000
<i>Cost of goods sold</i>				
Opening inventory	\$1,000			
Purchases	6,000			
Cost of goods avail.	7,000	?	?	?
Ending inventory*	3,000			
Cost of goods sold	4,000	?	?	?
Gross profit	\$1,000	\$ ?	\$ ?	\$ ?

\* 250 units at \$12 = \$3,000.

*Required:*

1. Complete the statement for weighted average rising prices using the data provided. (*Hint:* you need to recalculate the ending inventory cost.)
2. Complete the statement for FIFO falling prices. Assume that purchases were made at \$8 per unit.
3. Complete the statement for weighted average falling prices by assuming that purchases were made at \$8 per unit. (Note that this changes cost of purchases and ending inventory cost.)
4. Assume that income tax expense is calculated at 50 per cent of income before income taxes. Which costing method would be most tax-advantageous from the company's point of view when prices are rising? When prices are falling?



## 6.7.4 Alternate Problems

### 6.7.4.1 AP 6-1



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Zane Corporation uses the perpetual inventory system. The following sales and purchases of the same product were made during 2018. The opening inventory consisted of 200 units at \$1 each.

<i>Purchases</i>				<i>Sales</i>		
Apr. 15	Purch. #1	200	\$2	Jan. 25	Sale #1	150
Oct. 15	Purch. #2	300	5	May 25	Sale #2*	150
				Oct. 25	Sale #3**	300

\*for specific identification, sold 150 units April 15 purchase

\*\*for specific identification, sold 300 units of October 15 purchase

*Required:*

1. Calculate cost of goods sold and the cost of ending inventory under each of FIFO, specific identification, and weighted average inventory cost flow assumptions. Set up a table as follows:

<i>Date</i>	<i>Purchased</i>			<i>Sold</i>			<i>Balance in inventory</i>		
	<i>Units</i>	<i>Unit cost</i>	<i>Total \$</i>	<i>Units</i>	<i>Unit cost</i>	<i>Total \$</i>	<i>Units</i>	<i>Unit cost</i>	<i>Total \$</i>
Jan. 1							200	\$1	\$200

2. Prepare calculations comparing the effect on cost of goods sold of the three inventory cost flow assumptions.

3. The president wants to maximize the company's ending inventory this year. What would you suggest that is in accordance with GAAP?

### 6.7.4.2 AP 6-2



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Permion Inc. uses the perpetual inventory system. All sales are made on account. The following data are taken from the company's for the year ended December 31, 2018:

<i>Purchases</i>				<i>Sales</i>			
		<i>Units</i>	<i>Unit cost</i>			<i>Units</i>	<i>Unit sell. price</i>
Jan. 1	Op. Inv.	25	\$5				
Feb. 15	Purchase #1	15	4	Feb. 28	Sale #1	30	\$6
Mar. 14	Purchase #2	10	3	Apr. 9	Sale #2	20	4
Oct. 28	Purchase #3	35	3	Dec. 21	Sale #3	50	2
Dec. 4	Purchase #4	40	2				

Required:

1. Show the journal entries to record the December 31 sale under a) FIFO and b) weighted average inventory cost flow assumptions.
2. Which method maximizes ending inventory value? Why?
3. Assume that income taxes expense is calculated at 50 per cent of income before income taxes. Would more income taxes be payable under the FIFO or weighted average assumption? Explain why.

### 6.7.4.3 AP 6-3



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American Depress Limited made the following purchases and sales of Products A, B and C during the year ended December 31, 2016:

<i>Product A</i>			
		<i>Units</i>	<i>Unit cost/ selling price</i>
Jan. 07	Purchase #1	8,000	\$12.61
Mar. 15	Sale #1	9,000	16.00
Aug. 17	Purchase #2	12,000	12.84
Oct. 29	Sale #2	14,000	17.00

*Product B*

		<i>Units</i>	<i>Unit cost/ selling price</i>
Jan. 12	Purchase #1	5,000	\$9.68
May 5	Sale #1	1,000	20.00
Oct. 23	Purchase #2	7,000	10.06
Dec. 27	Sale #2	8,000	21.00

*Product C*

		<i>Units</i>	<i>Unit Cost/ Selling Price</i>
Jan. 4	Purchase #1	11,000	\$14.65
July 7	Purchase #2	15,000	13.26
Aug. 4	Sale #1	20,000	25.00
Oct. 5	Sale #2	5,000	26.00

Opening inventory at January 1 amounted to 4,000 units at \$11.90 per unit for Product A, 5,000 units at \$9.54 per unit for Product B, and 6,000 units at \$14.71 per unit for Product C.

*Required:*

1. Prepare inventory record cards for Products A, B, and C for the year using the FIFO inventory cost flow assumption.
2. Calculate total cost of ending inventory at December 31, 2016.
3. Assume now that American Depress keeps over 1,000 types of inventory on hand. Why might staff prefer to use computerized accounting software if a perpetual inventory system is used?

#### 6.7.4.4 AP 6-4



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Plamondon Products Corp. sells widgets and uses the perpetual inventory system. During the month of March 2016, the number of widgets purchased and sold was as follows:

<i>Date</i>	<i>Purchased</i>			<i>Sold</i>			<i>Balance in Inventory</i>		
	<i>Units</i>	<i>Unit cost</i>	<i>Total \$</i>	<i>Units</i>	<i>Unit cost</i>	<i>Total \$</i>	<i>Units</i>	<i>Unit cost</i>	<i>Total \$</i>
Mar. 1							1,000	\$11	\$1,000

3	1,000	\$10	\$10,000						
*8				1,500					
10	2,000	\$9	\$18,000						
15	3,000	\$8	\$24,000						
**20				5,000					
27	2,000	\$10	\$20,000						
***29				2,000					

\* for specific identification, sold 800 units of opening inventory and 700 units of the March 3 purchase

\*\*for specific identification, sold 200 units of the March 3 purchase, 1,800 units of the March 10 purchase, and 3,000 units of the March 15 purchase

\*\*\*for specific identification, sold 200 units of the March 10 purchase and 1,800 units of the March 27 purchase

Assume the January 8 units were sold on account for \$15 each, the January 20 units were sold on account for \$20 each, and the January 29 units were sold on account for \$18 each.

*Required:*

- Calculate cost of goods sold and the cost of ending inventory under each of the following inventory cost flow assumptions:
  - FIFO
  - Specific identification
  - Weighted average.
- Prepare the journal entries required to record purchases and sales using the FIFO inventory cost flow assumption.
- Calculate the sum of cost of goods sold and ending inventory balances under each of the three assumptions. Explain the results.

### 6.7.4.5 AP 6-5



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Hook Products Inc. sells television sets. The following perpetual inventory record card relates to January 2017 purchases and sales of Brand X [152 cm] high-definition television sets:

Date	Purchased			Sold			Balance in Inventory		
	Units	Unit cost	Total \$	Units	Unit cost	Total \$	Units	Unit cost	Total \$
Jan. 1							6	\$400	
2				1					
3	2	\$450							
7				2					
10				1					
15	3	\$500							
20				4					
25	1	\$550							
29				2					

*Required:*

1. Calculate the cost of the month-end inventory under each of
  1. FIFO
  2. Specific identification
  3. Weighted average.

2. Record the journal entries for the January 29 sale under each of the three cost flow assumptions. Assume each unit was sold on account for \$900. For specific identification, assume that the most recent purchases are sold first.

#### 6.7.4.6 AP 6-6



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Partial information from the Merchandize Inventory general ledger account for Belton Ltd. is as follows:

Merchandize Inventory	
Op. Bal.	12,000
2016 Purch.	2016 COGS
2016 Bal.	
2017 Purch.	2017 COGS
2017 Bal.	

The 2016 ending inventory was counted and valued incorrectly at \$13,000. This was overstated by \$3,000. The 2017 ending inventory was also valued incorrectly at \$9,000. This was overstated by \$4,000. Purchases for each year amounted to \$30,000. Sales totalled \$50,000 for each year.

*Required:*

- Fill in the missing general ledger account information assuming the ending inventory was correctly counted and valued each year; and the ending inventory was incorrectly counted and valued each year. Show necessary inventory adjustments.
- Prepare partial income statements based on the assumptions in (a). Calculate the cumulative effect of the 2016 and 2017 ending inventory errors on 2017 gross profit.

#### 6.7.4.7 AP 6-7



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The inventory of the Bateman Upholstering Corp. on December 31 consisted of the following items:

	Quantity	Unit	
		Cost	Market
Frames			
Type			
F-1	110	\$14.25	\$15.50

Type F-12	75	26.00	22.50
Type F-15	60	21.50	21.00
Springs (sets)			
Type S-1	760	7.28	8.50
Type S-12	625	10.50	11.50
Type S-15	340	8.60	6.00

*Required:*

- Calculate the ending inventory at the lower of cost and net realizable value, applied
  - to each item
  - to each category
  - to the entire inventory.
- What is the effect of each application of LCNRV on the gross profit in the current year? in the following year?

#### 6.7.4.8 AP 6-8



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The White Mall housed the premises of Dawn's Drapery Company Ltd. On the morning of November 1, fire gutted the shop. Dawn's Drapery had been a popular location for homeowners and had, as a result, consistently earned a gross profit of 40 per cent over the year. Appropriate information to date is as follows:

Sales	\$1,220
Purchases	700
Purchases returns and allowances	20
Sales returns and allowances	16
Delivery expense	30



Transportation-in	12
Administrative expense	8
Opening inventory (Jan.1)	100
Advertizing expense	20
Salaries	85
Sales discounts	4

*Required:* Calculate the estimated ending inventory.

#### 6.7.4.9 AP 6-9



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Meyer's Men's Shop Corp. takes a year-end physical inventory at marked selling prices and reduces the total to a cost basis for year-end statement purposes. Meyer's also uses the retail method to estimate the amount of inventory that should be on hand at year-end. By comparing the two totals, it is able to determine inventory shortages. The information at the end of December is as follows:

	<i>At retail</i>	<i>At cost</i>
Sales	\$234,680	
Sales returns and allowances	3,740	
Opening inventory	36,200	\$24,470
Purchases	239,800	166,770
Purchases returns and allowances	3,900	2,830
Ending inventory	40,900	

*Required:*

1. Calculate the estimated ending inventory at cost using the retail inventory method.
2. Calculate the amount of inventory discrepancy at cost.
3. Why might this discrepancy occur?

#### 6.7.4.10 AP 6-10 (Appendix)



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The following transactions took place during January 2016 at Dunes Corp. The opening inventory consisted of 100 units at a total cost of \$100.

			<i>Units</i>	<i>Total cost</i>
Jan.	5	Purchase #1	100	\$100
	9	Purchase #2	200	400
	16	Purchase #3	300	900
	26	Purchase #4	400	1,600

Units sold during the month were as follows:

			<i>Units</i>	<i>Amount</i>
Jan.	10	Sale #1	200	\$600
	17	Sale #2	500	1,500

Assume a periodic inventory system is used.

*Required:*

1. Calculate the cost of ending inventory and the cost of goods sold under each of the following inventory cost flow assumptions:
  1. FIFO
  2. Weighted average
  3. Specific identification (assume that the 700 units sold were 100 units from opening inventory, the 200 units purchased on January 9, and the 400 units purchased on January 26).
2. State your observations about the relative effects on ending inventory and net income using each of the cost flow assumptions in a period of rising prices.

### 6.7.4.11 AP 6-11 (Appendix)



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The Nanaimo Company Ltd. is considering the use of different methods of calculating its ending inventory. The following data are applicable to its December operations:

<i>Purchases</i>		<i>Sales</i>	
Dec. 4	1000 units @ \$2.50	Dec. 5	600 units
11	800 units @ \$2.60	12	500 units
23	1600 units @ \$2.30	17	500 units
29	900 units @ \$2.40	27	400 units
		31	600 units

Assume a periodic inventory system is used.

*Required:* Calculate the amount of ending inventory under each of

1. FIFO
2. Specific identification (assume the most recent purchases are sold first)
3. Weighted average.

### 6.7.4.12 AP 6-12 (Appendix)



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#### Part A

Cochrane Corporation began operating on January 2, 2016. The following table shows the valuation of its inventory, using three different inventory valuation methods:

	<i>Spec. ident.</i>	<i>Wtd. avg.</i>	<i>FIFO</i>
Dec. 31, 2016	\$ 9,200	\$ 9,400	\$9,600
Dec. 31, 2017	9,100	9,000	8,800
Dec. 31, 2018	10,300	11,000	12,000

Assume sales were \$100,000 each year, inventory purchases were \$80,000 each year, and there were no other expenses. The company uses the periodic inventory system.

*Required:*

1. Which inventory method shows the highest net income for 2016?
2. Are average costs for each unit of inventory rising or falling in 2016?
3. Which inventory method shows the highest net income for 2017?
4. Are average costs for each unit of inventory rising or falling in 2017?
5. What conclusions can be drawn from the answers to questions 1 to 4?

### **Part B**

In 2019, the company sold its entire inventory. As in the three prior years, 2019 sales were \$100,000, inventory purchases were \$80,000 and there were no other expenses.

*Required:*

6. Calculate net income for 2019 for the three cost flow assumptions.
7. Calculate total net incomes for each method over the four years. Which cost flow assumption produces the highest net income total for the four years? Why?

### 6.7.4.13 AP 6-13 (Appendix)



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The MegaPixel Company Ltd. had the following inventory transactions for the month of December:

Dec.	1	Opening Inventory	20 units @ \$4.60
	8	Purchased	80 units @ \$5.00
	15	Purchased	40 units @ \$5.30
	22	Purchased	60 units @ \$5.60
	31	Purchased	40 units @ \$5.50

By December 31, 190 of the units had been sold by MegaPixel. Assume the company uses the periodic inventory system.

*Required:* Calculate the cost of the ending inventory using each of

1. FIFO
2. Specific identification (assume the most recent purchases are sold first)
3. Weighted average.

### 6.7.4.14 AP 6-14 (Appendix)



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The following transactions took place in the month of May at Regal Corporation. The opening inventory consisted of 50 units at \$10. On May 2, the company purchased 60 units at \$12. On May 10, it sold 10 units. On May 22, it purchased an additional 100 units at \$15. On May 24, 150 units were sold.

*Required:*

1. Assume Regal uses the perpetual inventory system. Calculate the cost of goods sold and ending inventory for each of specific identification, FIFO, and weighted average inventory methods. For specific identification, assume the newest units are sold first.
2. Assume Regal uses the periodic inventory system. Calculate the cost of goods sold and ending inventory for each of specific identification, FIFO, and weighted average inventory methods. For specific identification, assume the newest units are sold first.

3. Comment on the results.

### 6.7.4.15 AP 6-15 (Appendix)



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The beginning inventory, purchases, and sales of an item by Patterson Corporation for the month of July were as follows:

July	1	Inventory on hand consisted of 100 units at \$3.15 each
	12	Sold 50 units
	15	Purchased 40 units at \$3.00 each
	17	Purchased 60 units at \$2.70 each
	19	Sold 30 units
	26	Purchased 50 units at \$3.45 each
	29	Sold 40 units.

*Required:* What was the value of the units on hand on July 31 under the following methods?

1. Perpetual inventory, weighted average
2. Periodic inventory, weighted average.

### 6.7.5 Supplementary Problems

#### 6.7.5.1 SP 6-1



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The records of the Newman Trading Corporation show the following data about item A. The selling price was \$15 per unit throughout the year.

	<i>Purchased</i>	<i>Sold</i>	<i>Balance in Inventory</i>

<i>Date</i>	<i>Units</i>	<i>Unit cost</i>	<i>Total \$</i>	<i>Units</i>	<i>Unit cost</i>	<i>Total \$</i>	<i>Units</i>	<i>Unit cost</i>	<i>Total \$</i>
Jan. 1							200	\$10	
12	100	\$11							
Feb. 1				200					
Apr. 16	200	\$12							
May 1				100					
July 15	100	\$14							
Nov. 10				100					
Dec. 5	200	\$17							

*Required:*

1. Calculate the cost of the ending inventory under the FIFO method when a perpetual inventory system is followed.
2. Calculate the cost of the ending inventory under the specific identification method when perpetual inventory records are maintained. Assume newest units are sold first.
3. The company has experienced a period of rapidly rising prices for its purchases during the year. If selling price has remained fairly constant during this period because of heavy competition in the marketplace, what effect will result from the use of FIFO, as compared to specific identification, on
  1. the income statement
  2. the balance sheet.
4. Assume that the February 1 sale was on credit to customer B, perpetual inventory records were maintained, and the specific identification method was used.



Prepare the required journal entries to record sales and cost of goods sold on February 1.

### 6.7.5.2 SP 6-2



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Donna Wood Corporation prepares monthly financial statements; it made a physical inventory count in January and February but intends to use the gross profit method to estimate inventory in March and April. Partial income statements appear below:

	<u>January</u>	<u>February</u>	<u>March</u>	<u>April</u>
Sales	\$50,000	\$60,000	\$70,000	\$75,000
<i>Cost of goods sold</i>				
Opening inventory	\$ ?	\$ ?	\$ ?	\$ ?
Purchases	50,000	30,000	20,000	40,000
Goods available for sale	?	?	50,000	60,000
Ending inventory	?	(30,000)	?	?
Cost of goods sold	20,000	36,000	?	?
Gross profit	\$ ?	\$ ?	\$ ?	\$ ?

*Required:*

1. Complete the partial income statements for January and February.
2. Calculate the gross profit percentage to be used in estimating March and April ending inventories based on January and February percentages.
3. Using the percentage calculated in question 2, complete the partial income statements for March and April.
4. A physical count was made at April 30 and the inventory cost was accurately established at \$10,000. Calculate the difference between the actual and estimated amounts.
5. The president attributes the difference calculated in question 4 to the use of an incorrect gross profit percentage used to estimate ending inventory. Do you agree?

### 6.7.5.3 SP 6-3



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#### Part A

The accountant of Upton Inc. is concerned about the inventory in its bookstore. A physical count at May 31, 2018 showed that \$10,000 inventory (at cost) was on hand. The following information for the year then ended is available

	<i>At retail</i>	<i>At cost</i>
Sales	\$62,500	
Sales returns and allowances	2,500	

Opening inventory	14,000	\$10,000
Purchases	55,000	39,000
Purchases returns and allowances	3,000	2,000
Transportation-in		1,000

*Required:*

1. Calculate the estimated ending inventory at retail.
2. Calculate the cost percentage.
3. Calculate the May 31, 2018 estimated ending inventory at cost, and gross profit.
4. Why is the inventory calculated in question 3 different from the physical count at May 31?

**Part B**

The comptroller of Clooney Corp. is calculating the amount of inventory lost during the year ended May 31, 2018. A physical count was not made at May 31 due to circumstances beyond his control. The following information for the year then ended is available from the general ledger.

Sales	\$50,000
Sales returns and allowances	5,000
Opening inventory	6,000
Purchases	35,000
Purchase returns and allowances	3,000
Purchases discounts	2,000
Transportation-in	1,500
Delivery expense	1,000
Utilities expense	400
Insurance expense	100

The following are partial income statements of Clooney Corp. for years 2015 to 2017 (amounts are in thousands of dollars):

	2015	2016	2017	Totals
Sales	\$20	\$30	\$40	\$
Cost of goods sold	10	20	30	
Gross profit	\$10	\$10	\$10	\$

*Required:* Using the gross profit method, calculate the May 31, 2018 estimated ending inventory at cost.

#### 6.7.5.4 SP 6-4



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The following data are taken from the records of the Harper Promotions Ltd.:

Opening inventory		Transportation-in	\$ 500
At retail	\$ 7,000	Purchase returns	
At cost	5,000	At retail	2,000
Purchases		At cost	1,500
At retail	25,000	Sales	22,000
At cost	16,000	Sales Returns	1,000

*Required:*

1. a. Calculate ending inventory at retail.
- b. Calculate the cost of goods available at cost divided by cost of goods available at retail.
- c. Calculate the ending inventory at cost.

2. Calculate the ending inventory at cost using the gross profit method. Assume a gross profit rate of 35 per cent.
3. Explain why the ending inventory is different under the two methods.

### 6.7.5.5 SP 6-5 (Appendix)



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The following transactions took place during January 2017 at Alabaster Corp.

Date	Purchased			Sold			Balance in Inventory		
	Units	Unit cost	Total \$	Units	Unit cost	Total \$	Units	Unit cost	Total \$
Jan. 1							200	\$1	
10	200	\$2							
15				200					
20	300	\$3							
25				400					
30	300	\$3							

Assume the units were sold on account for \$3 each on January 15 and \$4 each on January 25.

*Required:*

1. Calculate ending inventory and cost of goods sold under each of
  1. FIFO/perpetual
  2. Specific identification/perpetual (assume newest units are sold first)
  3. Weighted average/perpetual.
2. Prepare the journal entries required under the FIFO/perpetual costing method.

3. (Appendix) Prepare the journal entries required under the FIFO/periodic costing method, including the January 31 adjustment to record ending inventory.

### 6.7.5.6 SP 6-6 (Appendix)



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The following partial income statements have been prepared for Darwin's Video Inc.:

	<u>2016</u>	<u>2017</u>	<u>2018</u>
Sales	\$3,000	\$7,000	\$10,000
<i>Cost of goods sold</i>			
Opening inventory	\$1,000	\$ 4,000	\$ 8,000
Purchases	<u>5,000</u>	<u>9,000</u>	<u>11,000</u>
Goods available for sale	6,000	13,000	19,000
Ending inventory	<u>4,000</u>	<u>8,000</u>	<u>12,000</u>
Cost of goods sold	<u>2,000</u>	<u>5,000</u>	<u>7,000</u>
Gross profit	<u>\$1,000</u>	<u>\$2,000</u>	<u>\$ 3,000</u>

Subsequent to the preparation of these income statements, two inventory errors were found: (a) the 2016 ending inventory was overstated by \$1,000 and (b) the 2017 ending inventory was understated by \$1,000.

*Required:*

1. Prepare corrected income statements for the three years, using the comparative format above.
2. What is your explanation for the difference in the 2017 gross profit?
3. Is the balance of retained earnings at the end of 2018 affected by the errors?

### 6.7.5.7 SP 6-7 (Appendix)



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The following transactions took place during January 2019 at Ford Inc. The opening inventory consisted of 100 units of Brand X at \$10 per unit. The following purchases were made during the month:

		<i>Units</i>	<i>Unit cost</i>
Jan.	3	200	\$10
	11	400	9
	19	500	8
	24	600	7

---

30    200    6

During the month, 1700 units were sold for \$12 each.

*Required:*

1. Calculate the cost of ending inventory and cost of goods sold under each of FIFO/periodic, specific identification/periodic, and weighted average/periodic. For specific identification, assume newest units are sold first.
2. Calculate the gross profit under each of the above methods.
3. Under what circumstances will the cost of inventory under the specific identification assumption result in a lower net income than the FIFO assumption? in a higher net income than the FIFO assumption?

# Chapter 7 Cash and Receivables



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This chapter focuses on two types of current assets – cash and receivables. Internal control over cash involves processes and procedures that include the use of a petty cash fund and the preparation of a bank reconciliation. Receivables can be determined to be uncollectible. To match the cost of uncollectible accounts and the related revenue, bad debts must be estimated using either the income statement method or balance sheet method. Actual account receivables are written off when judged to be uncollectible. Write-offs can be subsequently recovered. The journalizing of short-term notes receivable and related interest revenue is also discussed in this chapter.

## Learning Objectives

- LO1 – Define internal control and explain how it is applied to cash.
- LO2 – Explain and journalize petty cash transactions.
- LO3 – Explain the purpose of and prepare a bank reconciliation, and record related adjustments.
- LO4 – Explain, calculate, and record estimated uncollectible accounts receivable and subsequent write-offs and recoveries.
- LO5 – Explain and record short-term notes receivable and calculate related interest.

## 7.1 Internal Control



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- LO1 – Define internal control and explain how it is applied to cash.

Assets are the lifeblood of a company. As such, they must be protected. This duty falls to managers of a company. The policies and procedures implemented by management to protect assets are collectively referred to as **internal controls**. An effective internal control program not only protects assets, but also aids in accurate recordkeeping, produces financial statement information in a timely manner, ensures compliance with laws and regulations, and promotes efficient operations. Effective internal control procedures ensure that adequate records are maintained, transactions are authorized, duties among employees are divided between



recordkeeping functions and control of assets, and employees' work is checked by others. The use of electronic recordkeeping systems does not decrease the need for good internal controls.

The effectiveness of internal controls is limited by human error and fraud. Human error can occur because of negligence or mistakes. Fraud is the intentional decision to circumvent internal control systems for personal gain. Sometimes, employees cooperate in order to avoid internal controls. This *collusion* is often difficult to detect, but fortunately, it is not a common occurrence when adequate controls are in place.

Internal controls take many forms. Some are broadly based, like mandatory employee drug testing, video surveillance, and scrutiny of company email systems. Others are specific to a particular type of asset or process. For instance, internal controls need to be applied to a company's accounting system to ensure that transactions are processed efficiently and correctly to produce reliable records in a timely manner. Procedures should be documented to promote good recordkeeping, and employees need to be trained in the application of internal control procedures.

Financial statements prepared according to generally accepted accounting principles are useful not only to external users in evaluating the financial performance and financial position of the company, but also for internal decision making. There are various internal control mechanisms that aid in the production of timely and useful financial information. For instance, using a chart of accounts is necessary to ensure transactions are consistently recorded in the appropriate account.

The design of accounting records and documents is another important means to provide financial information. Financial data is entered and summarized in records and transmitted by documents. A good system of internal control requires that these records and documents be prepared at the time a transaction takes place or as soon as possible afterward, since they become less credible and the possibility of error increases as time passes. Documents supporting financial transactions – for example, sales invoices – should also be consecutively prenumbered, to indicate whether any are missing.

Internal control also promotes the protection of assets. Cash is particularly vulnerable to misuse. A good system of internal control for cash should provide adequate procedures for protecting cash receipts and cash disbursements. Procedures to exercise control over cash vary from company to company and depend upon such variables as company size, number of employees, and cash sources. However, effective cash control generally requires the following:

- Separation of duties: People responsible for handling cash should not be responsible for maintaining cash records. By separating the custodial and recordkeeping duties, theft of cash and its concealment is less likely.
- Same-day deposits: All cash receipts should be deposited daily in the company's bank account. This prevents theft and personal use of the money before deposit.
- Payments made using non-cash means: Cheques or electronic funds transfer (EFT) provide separate external records to verify cash disbursements. For example, many businesses pay their employees using electronic funds transfer because it is more secure and efficient than using cash or even cheques.

Two forms of internal control over cash will be discussed in this chapter: the use of a petty cash account and the preparation of bank reconciliations.

## 7.2 Petty Cash



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LO2 – Explain and journalize petty cash transactions.

The payment of small amounts by cheque may be inconvenient and costly. For example, using cash to pay for postage on an incoming package might be less than the total cost of processing a cheque. A small amount of cash kept on hand to pay for small, infrequent expenses is referred to as a **petty cash fund**.

### 7.2.1 Establishing and Reimbursing the Petty Cash Fund



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To set up the petty cash fund, a cheque is prepared for the amount of the fund. The custodian of the fund cashes the cheque and places the coins and currency in a locked box. Responsibility for the petty cash fund should be delegated to only one person, who should be held accountable for its contents. Cash payments, supported by receipts, are made by this petty cash custodian out of the fund as required. When the amount of cash has been reduced to a pre-determined level, the receipts are compiled and submitted for entry into the accounting system. A cheque is then issued to reimburse the petty cash fund for the total amount of the receipts. At any given time, the petty cash amount should consist of cash and supporting receipts, all totalling the petty cash fund amount. To demonstrate the management of a petty cash fund, assume that a \$200 cheque is issued for the purpose of establishing a petty cash fund.

The journal entry is:

Petty Cash	100	200	
Cash		101	200
<i>To establish the \$200 petty cash fund.</i>			

Petty Cash is a current asset account. When reporting Cash on the financial statements, the balances in Petty Cash and Cash are usually added together and reported as one amount.

Assume the petty cash custodian has receipts totalling \$190 and \$10 in coin and currency remaining in the petty cash box. The receipts consist of the following: delivery charges, \$100; postage, \$35; and office supplies, \$55. The petty cash custodian submits the receipts to the accountant who records the following entry and issues a cheque for \$190.

Delivery Expense	620	100	
Postage Expense	652	35	
Office Supplies Expense <sup>1</sup>	650	55	
Cash	101		190
<i>To reimburse the petty cash fund.</i>			

<sup>1</sup> An expense is debited instead of an asset like Unused Office Supplies. The need to purchase supplies through petty cash assumes the immediate use of the items.

As an added internal control, petty cash receipts should be cancelled at the time of reimbursement in order to prevent their reuse for duplicate reimbursements. The petty cash custodian cashes the \$190 cheque. The \$190 plus the \$10 of coin and currency in the locked box immediately prior to reimbursement equals the \$200 total maintained in the petty cash fund.

Sometimes, the receipts plus the coin and currency in the petty cash locked box do not equal the required petty cash balance. To demonstrate, assume the same information above except that the coin and currency remaining in the petty cash locked box was \$8. This amount plus the receipts for \$190 equals \$198 and not \$200, indicating a shortage in the petty cash box. The entry at the time of reimbursement reflects the shortage and is recorded as:

Delivery Expense	620	100	
Postage Expense	652	35	
Office Supplies Expense	650	55	
Cash Over/Short Expense	614	2	
Cash	101		192
<i>To reimburse the petty cash fund and account for the \$2 shortage.</i>			

Notice that the \$192 credit to Cash plus the \$8 of coin and currency remaining in the petty cash box immediately prior to reimbursement equals the \$200 required total in the petty cash fund.

Assume, instead, that the coin and currency in the petty cash locked box was \$14. This amount plus the receipts for \$190 equals \$204 and not \$200, indicating an overage in the petty cash box. The entry at the time of reimbursement reflects the overage and is recorded as:

Delivery Expense	650	100
Postage Expense	652	35
Office Supplies Expense	650	55
Cash Over/Short Exp.	614	4
Cash	101	186

*To reimburse the petty cash fund and account for the \$4 overage.*

Again, notice that the \$186 credit to Cash plus the \$14 of coin and currency remaining in the petty cash box immediately prior to reimbursement equals the \$200 required total in the petty cash fund.

The size of the petty cash fund should not be large enough to become a potential theft issue. If a petty cash fund is too large, it may be an indicator that transactions that should be paid by cheque are not being processed in accordance with company policy.

## 7.3 Cash Collections and Payments



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LO3 – Explain the purpose of and prepare a bank reconciliation, and record related adjustments.

The widespread use of banks facilitates cash transactions between entities and provides a safeguard for the cash assets being exchanged. This involvement of banks as intermediaries between entities has accounting implications. At any point in time, the cash balance in the accounting records of a particular company usually differs from the bank cash balance of that company. Differences occur because some cash transactions recorded in the accounting records have not yet been recorded by the bank and, conversely, some cash transactions recorded by the bank have not yet been recorded in the company's accounting records.

The use of a **bank reconciliation** is one method of internal control over cash. A bank reconciliation proves the accuracy of both the company's and the bank's records, and reveals any errors made by either party. The bank reconciliation is a tool that can help detect attempts at theft and manipulation of records. An example of a bank reconciliation for Big Dog Carworks Corp. is shown in [Figure 7.1](#):

Big Dog Carworks Corp.  
Bank Reconciliation  
At March 31, 2015

<p>This balance is taken from the company's general ledger Cash account.</p> <p>Unreconciled general ledger Cash balance at March 31</p> <p style="text-align: right;">\$20,673</p> <p>Adjustments</p> <p style="text-align: right;">-0-</p> <p>Adjusted general ledger Cash balance at Mar. 31</p> <p style="text-align: right;"><u>\$20,673</u></p>		<p>This balance is taken from the company's bank statement.</p> <p>Unreconciled bank statement balance Mar. 31</p> <p style="text-align: right;">\$24,927</p> <p>Less: Outstanding cheques</p> <table style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="text-align: left;">Cheque No.</th> <th style="text-align: right;">Amount</th> </tr> </thead> <tbody> <tr> <td>580</td> <td style="text-align: right;">\$4,051</td> </tr> <tr> <td>599</td> <td style="text-align: right;">196</td> </tr> <tr> <td>600</td> <td style="text-align: right;"><u>7</u></td> </tr> <tr> <td></td> <td style="text-align: right;">(4,254)</td> </tr> </tbody> </table> <p>Adjusted bank balance at Mar. 31</p> <p style="text-align: right;"><u>\$20,673</u></p>	Cheque No.	Amount	580	\$4,051	599	196	600	<u>7</u>		(4,254)
Cheque No.	Amount											
580	\$4,051											
599	196											
600	<u>7</u>											
	(4,254)											
<p>These balances must agree.</p>												

**Fig. 7.1: Big Dog's Bank Reconciliation at March 31, 2015**

The bank reconciliation provides a simple method to show why the **bank statement** issued by the company's bank and the Cash balance in a company's general ledger differ on a given date like a month-end, and whether these differences are acceptable. In the example above, the difference (\$20,673 versus \$24,927) occurs because there are three cheques that have been recorded in BDCC's general ledger Cash account totalling \$4,254 that have not yet been presented and accepted for payment (or been *cleared*) by the bank. Cheques that are recorded in the company's general ledger but are not paid out of its bank account when the bank statement is prepared are referred to as **outstanding cheques**. Outstanding cheques cause the bank statement balance to be overstated compared to the company's records. These cheques must be subtracted from the bank balance on the bank reconciliation so that the Cash general ledger account and bank statement balances agree.

These outstanding cheques will likely be cashed by the bank a few days after the month end and appear on the next month's bank statement. As a result, these differences are reasonable, occurring only because of slight timing differences between transactions being recorded in the general ledger and on the bank statement.

The steps needed to prepare a bank reconciliation are discussed below.

### 7.3.1 The Bank Reconciliation



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Discrepancies between the cash balance reported on the bank statement and the cash balance reported in a business's Cash account in the general ledger at a particular date are known as *reconciling items* and are added or subtracted to either the general ledger Cash balance or the amount of cash shown at the end of the period on the bank statement. The cash balance prior to reconciliation is called the unreconciled cash balance. The balance after adding and subtracting the reconciling items is called the reconciled cash balance. The following is a list of potential reconciling items and their impact on the bank reconciliation.

*General ledger recording items*

- Collection of notes receivable (added)
- NSF cheques (subtracted)
- Bank charges (subtracted)
- Book errors (added or subtracted, depending on the nature of the error)

*Bank recording items*

- Outstanding deposits (added)
- Outstanding cheques (subtracted)
- Bank errors (added or subtracted, depending on the nature of the error)

### 7.3.2 General Ledger Reconciling Items



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The collection of notes receivable<sup>1</sup> may be made by a bank on behalf of the company. These collections are often unknown to the company until they appear as an addition on the bank statement. They cause the general ledger Cash account to be understated. As a result, the collection of a notes receivable is added to the unreconciled general ledger Cash balance on the bank reconciliation.

Cheques returned to the bank because there were not sufficient funds (NSF) to cover them appear on the bank statement as a reduction of cash. The company must then request that the customer pay the amount again. As a result, the general ledger Cash account is overstated by the amount of the NSF cheque. NSF cheques must therefore be subtracted from the unreconciled general ledger Cash balance of cash on the bank reconciliation.

Cheques received by a company and deposited into its bank account may be returned by the customer's bank for a number of reasons (for example, the cheque was "stale-dated" – issued too long ago; or was unsigned or illegible; or shows the wrong account number). Returned cheques cause the general ledger Cash account to be overstated compared to the bank statement. These cheques are therefore subtracted on the bank statement, and must be deducted from the unreconciled general ledger Cash balance the bank reconciliation.

Bank service charges are deducted from the customer's bank account. Since the service charges have not yet been recorded by the company, the general ledger Cash account is overstated. Therefore, service charges are subtracted from the unreconciled general ledger Cash balance on the bank reconciliation.

---

1. Recall that a note receivable is a formalized document arising from an account receivable transaction. It specifies the terms of repayment of the amount owing to the company by a customer, as well as any interest that will be paid.

A business may incorrectly record journal entries involving cash. For instance, a deposit or cheque may be recorded for the wrong amount in the company records. These errors are often detected when amounts recorded by the company are compared to the bank statement. Depending on the nature of the error, it will be either added to or subtracted from the unreconciled general ledger Cash balance on the bank reconciliation. For example, if the company issued a cheque for \$250 but recorded it in the records as \$520, the \$270 difference would be added to the unreconciled general ledger Cash balance of Cash on the bank reconciliation to correct the error, because the general ledger Cash balance is too low. As another example, if the company recorded a deposit as \$520 when the correct amount of the deposit was \$250, the \$270 difference would be subtracted from the unreconciled general ledger Cash balance on the bank reconciliation to correct the error because the general ledger Cash balance is too high. Each error must be analyzed to determine whether it will be added to or subtracted from the unreconciled general ledger Cash balance on the bank reconciliation.

### 7.3.3 Bank Reconciling Items



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Cash receipts are recorded as an increase of cash in the company's accounting records when they are received. These cash receipts are deposited by the company into its bank. The bank records an increase in cash only when these amounts are actually deposited with the bank. Not all cash receipts recorded by the company may have been recorded by the bank when the bank statement is prepared. There may be outstanding deposits (also called *deposits in transit*). Outstanding deposits cause the bank statement cash balance to be understated. Therefore, outstanding deposits are a reconciling item that must be added to the unreconciled bank balance on the bank reconciliation.

On the date that a cheque is prepared by a company, it is recorded as a reduction of cash in a company's general ledger. A bank statement will not record a cash reduction until a cheque clears the bank. Outstanding cheques mean that the bank statement balance is overstated. Therefore, outstanding cheques are a reconciling item that must be subtracted from the unreconciled bank balance on the bank reconciliation as shown in [Figure 7.1](#) above.

Bank errors sometimes occur and are not revealed until the transactions on the bank statement are compared to the company's accounting records. When an error is identified, the company notifies the bank to have it corrected. Depending on the nature of the error, it is either added to or subtracted from the unreconciled bank balance on the bank reconciliation. For example, if the bank cleared a cheque as \$520 that was correctly written for \$250, the \$270 difference would be added to the unreconciled bank balance on the bank reconciliation. The cash balance reported on the bank statement is understated by \$270 as a result of this error. As another example, if the bank recorded a deposit as \$520 when the correct amount was actually \$250, the \$270 difference would be subtracted from the unreconciled bank balance on the bank reconciliation. The cash balance reported on the bank statement



is overstated by \$270 as a result of this specific error. Each error must be carefully analyzed to determine how it will be treated on the bank reconciliation.

### 7.3.4 Illustrative Problem—Bank Reconciliation



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Now, a bank reconciliation will be prepared for BDCC for the next month-end, April 30. The general ledger Cash account shows an opening balance of \$20,673 at April 1 (note that this is the amount that is shown in [Figure 7.1](#) as the March 31 ending Cash balance. Assume cash receipts (debits) amount to \$9,482 in April and that cash disbursements (credits) amount to \$8,226. The ending balance general ledger Cash balance at April 30 is \$21,929. The general ledger for April is shown in [Figure 7.2](#).

**GENERAL LEDGER**

Cash Acct. No. 101

Date 2015		Description	Folio	Debit	Credit	DR	Balance
Mar.	31	Balance				DR	20,673
Apr.	30	April cash receipts	CRJ6	9,482		DR	30,155
	30	April cash payments	CDJ18		8,226	DR	21,929

The opening balance agrees to the March 31 general ledger balance shown on the bank reconciliation in Fig. 7-1

The ending balance is used as the unreconciled general ledger balance on the April 30 bank reconciliation.

**Fig. 7.2: Big Dog's General Ledger 'Cash' Account for April 30, 2015**

Assume further that April deposits made and cheques issued are as follows:

<i>Deposits</i>		<i>Cheques</i>	
<i>Date</i>	<i>Amount</i>	<i>No.</i>	<i>Amount</i>
April 5	\$1,570	601	\$ 24
10	390	602	1,720
23	5,000	603	230
28	1,522	604	200
30	1,000	605	2,220
		606	287
		607	1,364
		608	100
		609	40
		610	1,520
		611	124
		612	397
<b>Total</b>	<b><u>\$9,482</u></b>	<b>Total</b>	<b><u>\$8,226</u></b>

These totals agree to the Cash general ledger account debits and credits in Figure 7-2.

The bank statement issued by BDCC's bank is as follows:

Second Chartered Bank Big Dog Carworks Corp. Bank Statement Month Ended April 30, 2015				
Date	Type	Out	In	Balance
Apr. 1				\$24,927
2	Deposit		1,570	26,497
3	Ck. 580	(4,051)		22,446
4	Deposit		390	22,836
6	Ck. 599	(196)		22,640
7	Ck. 601	(24)		22,616
9	Ck. 603	(230)		22,386
11	Ck. 604	(200)		22,186
16	Ck. 611	(124)		22,062
17	Ck. 612	(397)		21,665
18	Ck. 600	(7)		21,658
19	Deposit		5,000	26,658
21	Ck. 605	(2,220)		24,438
22	NSF	(180)		24,258
24	Deposit		1,522	25,780
26	Ck. 602	(1,720)		24,060
28	Ck. 115	(31)		24,029
30	SC	(6)		24,023

Ck. = cheque SC = service charge  
 NSF = not sufficient funds

The opening balance agrees to the March 31 bank statement balance shown in Fig. 7-1

The ending balance is used as the unreconciled bank statement balance on the April 30 bank reconciliation.

Fig. 7.3: Big Dog's Bank Statement for the month of April, 2015

There are nine steps to follow in preparing a bank reconciliation:

### Step 1

List the ending general ledger cash balance (\$21,929 from [Figure 7.2](#)) on the bank reconciliation as the unreconciled general ledger Cash balance on April 30, similar to that shown in [Figure 7.1](#).

### Step 2

List the ending cash balance on the bank statement (\$24,023 from [Figure 7.3](#)) on the bank reconciliation as the unreconciled bank statement balance on April 30, similar to that shown in [Figure 7.1](#).

### Step 3

Compare clearing cheques shown on the bank statement with cheques recorded as cash disbursements in the company's records.

a. Review the prior month's bank reconciliation and ensure that outstanding cheques have cleared the bank in the subsequent month.

*In the company records:*

These cheques were recorded in March; therefore, the cash balance per the general ledger is correctly stated.

*In the bank statement:*

These outstanding March cheques may not have been paid by the bank in April. If some of the cheques have not yet been paid, the bank's balance is overstated at April 30 by the amount of these cheques.

The outstanding cheques on the March 31 bank reconciliation are shown in [Figure 7.1](#) and reproduced below. Cheques clearing the bank are marked with an 'x' on the prior month's outstanding cheque list and on the April bank statement, as follows:

<i>Cheque No.</i>	<i>Amount</i>
580	\$4,051 x
599	196 x
600	7 x

<i>Date</i>	<i>Type</i>	<i>Out</i>	<i>In</i>	<i>Balance</i>
Apr. 1				\$24,927
2	Deposit		1,570	26,497
3	Ck. 580	(4,051) x		22,446
4	Deposit		390	22,836
6	Ck. 599	(196) x		22,640
7	Ck. 601	(24)		22,616
9	Ck. 603	(230)		22,386
11	Ck. 604	(200)		22,186
16	Ck. 611	(124)		22,062
17	Ck. 612	(397)		21,665
18	Ck. 600	(7) x		21,658
19	Deposit		5,000	26,658
21	Ck. 605	(2,220)		24,438
22	NSF	(180)		24,258
24	Deposit		1,522	25,780
26	Ck. 602	(1,720)		24,060
28	115	(31)		24,029
30	SC	(6)		24,023

All the March outstanding cheques (# 580, 599, and 600) were paid by the bank in April; no adjustment is required in the April 30 bank reconciliation—the cash balance per the company's general ledger and the bank statement at April 30 are correctly stated in relation to these March outstanding cheques.

b. Compare the cheques clearing the bank in April with the cheques recorded as April cash disbursements. Cleared items are marked with an 'x' on the April cheque list and the April bank statement:



*Cheque*

<i>No.</i>	<i>Amount</i>	
601	\$ 24	x
602	1,720	x
603	230	x
604	200	x
605	2,220	x
606	287	}
607	1,364	
608	100	
609	40	
610	1,520	
611	124	x
612	397	x
<b>Total</b>	<u>\$8,226</u>	

These April  
cheques are still  
outstanding.

<i>Date</i>	<i>Type</i>	<i>Out</i>	<i>In</i>	<i>Balance</i>
Apr. 1				\$24,927
2	Deposit		1,570	26,497
3	Ck. 580	(4,051)	x	22,446
4	Deposit		390	22,836
6	Ck. 599	(196)	x	22,640
7	Ck. 601	(24)	x	22,616
9	Ck. 603	(230)	x	22,386
11	Ck. 604	(200)	x	22,186
16	Ck. 611	(124)	x	22,062
17	Ck. 612	(397)	x	21,665
18	Ck. 600	(7)	x	21,658
19	Deposit		5,000	26,658
21	Ck. 605	(2,220)	x	24,438
22	NSF	(180)		24,258
24	Deposit		1,522	25,780
26	Ck. 602	(1,720)	x	24,060
28	Ck. 115	(31)		24,029
30	SC	(6)		24,023

*In the company records:*

These cheques were recorded in April; therefore, the general ledger Cash balance is correctly stated.

*In the bank statement:*

These outstanding cheques were not paid by the bank in April. Therefore, the unreconciled bank balance on April 30 of \$24,023 is overstated.

The outstanding cheques must be deducted from the unreconciled bank statement balance on the bank reconciliation.

**Step 4**

Other disbursements made by the bank but not recorded in the company records are identified and marked with an 'x'.

<i>Date</i>	<i>Type</i>	<i>Out</i>		<i>In</i>	<i>Balance</i>
Apr. 1					\$24,927
2	Deposit			1,570	26,497
3	Ck. 580	(4,051)	x		22,446
4	Deposit			390	22,836
6	Ck. 599	(196)	x		22,640
7	Ck. 601	(24)	x		22,616
9	Ck. 603	(230)	x		22,386
11	Ck. 604	(200)	x		22,186
16	Ck. 611	(124)	x		22,062
17	Ck. 612	(397)	x		21,665
18	Ck. 600	(7)	x		21,658
19	Deposit			5,000	26,658
21	Ck. 605	(2,220)	x		24,438
22	NSF	(180)	x		24,258
24	Deposit			1,522	25,780
26	Ck. 602	(1,720)	x		24,060
28	Ck. 115	(31)			24,029
30	SC	(6)	x		24,023

a. An examination of the April bank statement shows that the bank had deducted the NSF cheque of John Donne for \$180.



*In the company records:*

The cheque of John Donne had originally been recorded as a cash receipt (a payment on account). During April, no entry was made regarding this returned cheque; therefore, the cash balance in the general ledger is overstated at April 30.

*In the bank statement:*

The bank has already made a deduction from the cash balance shown on the bank statement for this NSF cheque.

In reconciling the cash balances shown in the general ledger and on the bank statement, this returned cheque must be deducted from the unreconciled general ledger Cash balance of \$21,929 shown on the bank reconciliation. It also should be set up as an account receivable and a notice should be sent to Donne requesting payment again. The journal entry to do this will be discussed below.

b. An examination of the April 30 bank statement also shows that the bank has deducted a service charge of \$6 during April.

*In the company records:*

This service charge was not deducted from the cash balance in the general ledger during April. Therefore, the cash balance is overstated at April 30.

*In the bank statement:*

The service charges have already been deducted from the cash balance shown on the bank statement.

To reconcile the cash balance in the company records with the bank statement, this service charge must be deducted from the unreconciled general ledger Cash balance shown on the bank reconciliation.

**Step 5**

The April deposits shown on the bank statement are compared with the amounts recorded in the company general ledger Cash account and marked with an 'x' on each document.

<i>Date</i>	<i>Amount</i>	
April 5	\$1,570	x
10	390	x
23	5,000	x
28	1,522	x
30	1,000	←
<b>Total</b>	<u>\$9,482</u>	

This April deposit is still outstanding.

<i>Date</i>	<i>Type</i>	<i>Out</i>		<i>In</i>		<i>Balance</i>
Apr. 1						\$24,927
2	Deposit			1,570	x	26,497
3	Ck. 580	(4,051)	x			22,446
4	Deposit			390	x	22,836
6	Ck. 599	(196)	x			22,640
7	Ck. 601	(24)	x			22,616
9	Ck. 603	(230)	x			22,386
11	Ck. 604	(200)	x			22,186
16	Ck. 611	(124)	x			22,062
17	Ck. 612	(397)	x			21,665
18	Ck. 600	(7)	x			21,658
19	Deposit			5,000	x	26,658
21	Ck. 605	(2,220)	x			24,438
22	NSF	(180)	x			24,258
24	Deposit			1,522	x	25,780
26	Ck. 602	(1,720)	x			24,060
28	Ck. 115	(31)				24,029
30	SC	(6)	x			24,023

This comparison indicates that the April 30 cash receipt amounting to \$1,000 has not yet been included as a deposit in the bank statement.

*In the company records:*

The April cash receipts have been recorded correctly.

*In the bank statement:*

The April cash receipts have been deposited and recorded on the bank statement, except for the April 30 deposit.

To reconcile the cash balance in the company records with the bank statement, the outstanding deposit must be added to the bank statement ending cash balance of \$24,023 on the bank reconciliation.

### **Step 6**

The March bank reconciliation is reviewed for outstanding deposits at March 31.

*In the company records:*

The cash receipts for March have all been recorded in the general ledger.

*In the bank statement:*

Any outstanding deposits at March 31 should have been recorded by the bank in April. If any March deposits are outstanding at April 30, this should be investigated.

There were no outstanding deposits at March 31 according to the prior month's bank reconciliation, so no adjustments are needed. If a prior month's deposit is still outstanding at next month-end, the bank should be notified. This is an unusually long time for a deposit to not appear on the bank statement. The outstanding deposit should be added to the unreconciled bank statement balance on the bank reconciliation.

### **Step 7**

Any errors in the company records or in the bank statement that become apparent during the reconciliation process must be rectified. On the bank statement, these items should not yet have an 'x' by them.

<i>Date</i>	<i>Type</i>	<i>Out</i>	<i>In</i>	<i>Balance</i>
Apr. 1				\$24,927
2	Deposit		1,570 x	26,497
3	Ck. 580	(4,051) x		22,446
4	Deposit		390 x	22,836
6	Ck. 599	(196) x		22,640
7	Ck. 601	(24) x		22,616
9	Ck. 603	(230) x		22,386
11	Ck. 604	(200) x		22,186
16	Ck. 611	(124) x		22,062
17	Ck. 612	(397) x		21,665
18	Ck. 600	(7) x		21,658
19	Deposit		5,000 x	26,658
21	Ck. 605	(2,220) x		24,438
22	NSF	(180) x		24,258
24	Deposit		1,522 x	25,780
26	Ck. 602	(1,720) x		24,060
28	Ck. 115	(31) x		24,029
30	SC	(6) x		24,023

An examination of the April bank statement shows that the bank deducted a cheque issued by another company for \$31 from the BDCC bank account in error. (Assume that when notified, the bank indicated it would make a correction in May's bank statement.)

*In the company records:*

This cheque does not belong to Big Dog and does not require any change in its accounting records.

*In the bank statement:*

The cheque should not have been deducted from Big Dog's bank account. Therefore, the cash balance shown on the bank statement balance on the April 30 bank reconciliation is understated.

To reconcile the cash balance in the company records with the bank statement, the cheques deducted in error must be added to the unreconciled bank statement balance of \$24,023 shown on the bank reconciliation.

**Step 8**

Total both sides of the bank reconciliation. The result should be that the reconciled general ledger Cash balance and the bank statement balances are equal. The completed bank reconciliation is shown in Figure 7.4.

Big Dog Carworks Corp. Bank Reconciliation At April 30, 2015																																																																		
<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 40%;">Unreconciled general ledger Cash balance at Apr. 30</td> <td style="width: 10%; text-align: right;">\$21,929</td> <td style="width: 10%;"></td> <td style="width: 40%;"></td> </tr> <tr> <td>Less: Bank charges</td> <td style="text-align: right;">\$ 6</td> <td></td> <td></td> </tr> <tr> <td>NSF Cheque – J. Donne</td> <td style="text-align: right;"><u>180</u></td> <td style="text-align: right;"><u>(186)</u></td> <td></td> </tr> <tr> <td>Adjusted general ledger Cash balance at Apr. 30</td> <td style="text-align: right;"><u>\$21,743</u></td> <td></td> <td></td> </tr> </table>	Unreconciled general ledger Cash balance at Apr. 30	\$21,929			Less: Bank charges	\$ 6			NSF Cheque – J. Donne	<u>180</u>	<u>(186)</u>		Adjusted general ledger Cash balance at Apr. 30	<u>\$21,743</u>				<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 40%;">Unreconciled bank statement balance at Apr. 30</td> <td style="width: 10%;"></td> <td style="width: 10%;"></td> <td style="width: 40%; text-align: right;">\$24,023</td> </tr> <tr> <td>Add: Outstanding deposit</td> <td></td> <td></td> <td style="text-align: right;">1,000</td> </tr> <tr> <td>Cheque deducted in error</td> <td></td> <td></td> <td style="text-align: right;"><u>31</u></td> </tr> <tr> <td></td> <td></td> <td></td> <td style="text-align: right;">25,054</td> </tr> <tr> <td>Less: Outstanding cheques</td> <td></td> <td></td> <td></td> </tr> <tr> <td style="padding-left: 20px;"><i>Cheque No.</i></td> <td style="padding-left: 20px;"><i>Amount</i></td> <td></td> <td></td> </tr> <tr> <td style="padding-left: 20px;">606</td> <td style="padding-left: 20px;">\$ 287</td> <td></td> <td></td> </tr> <tr> <td style="padding-left: 20px;">607</td> <td style="padding-left: 20px;">1,364</td> <td></td> <td></td> </tr> <tr> <td style="padding-left: 20px;">608</td> <td style="padding-left: 20px;">100</td> <td></td> <td></td> </tr> <tr> <td style="padding-left: 20px;">609</td> <td style="padding-left: 20px;">40</td> <td></td> <td></td> </tr> <tr> <td style="padding-left: 20px;">610</td> <td style="padding-left: 20px;"><u>1,520</u></td> <td></td> <td style="text-align: right;"><u>(3,311)</u></td> </tr> <tr> <td>Adjusted bank balance at Apr. 30</td> <td></td> <td></td> <td style="text-align: right;"><u>\$21,743</u></td> </tr> </table>	Unreconciled bank statement balance at Apr. 30			\$24,023	Add: Outstanding deposit			1,000	Cheque deducted in error			<u>31</u>				25,054	Less: Outstanding cheques				<i>Cheque No.</i>	<i>Amount</i>			606	\$ 287			607	1,364			608	100			609	40			610	<u>1,520</u>		<u>(3,311)</u>	Adjusted bank balance at Apr. 30			<u>\$21,743</u>
Unreconciled general ledger Cash balance at Apr. 30	\$21,929																																																																	
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Adjusted bank balance at Apr. 30			<u>\$21,743</u>																																																															
<div style="border: 1px solid black; display: inline-block; padding: 2px 10px;">These balances must agree.</div>																																																																		
<p>Reconciling items in this section require journal entries to be made in the general journal to adjust the unreconciled Cash balance of \$21,929 in the general ledger to the reconciled balance of \$21,743.</p>		<p>Reconciling items in this section do not require journal entries. The outstanding deposits and cheques should clear the bank in May. The \$31 cheque deducted in error must be reported to the bank so it can make the necessary corrections to Big Dog's account in the next month.</p>																																																																

**Fig. 7.4: BDCC's April 30 Bank Reconciliation**

### Step 9

The adjusted balance of \$21,743 calculated in the bank reconciliation must be reflected in the company's general ledger Cash account. Adjusting entries must be prepared. The adjusting entries are based on the reconciling item on the left-hand side of the bank reconciliation and are as follows:



	Bank Charges Expense	632		6	
	Cash	101		6	
	Accounts Receivable – Donne	110	180		
	Cash	101		180	

*To record reconciling items from April 30 bank reconciliation.*

Once the adjustment is posted, the Cash general ledger account balance is correct, as illustrated in Figure 7-5.

**GENERAL LEDGER**

Cash				Acct. No. 101			
Date	2015	Description	Folio	Debit	Credit		Balance
Mar.	31	Balance				DR	20,673
Apr.	30	April cash receipts	CRJ6	9,482		DR	30,155
	30	April cash payments	CDJ18		8,226	DR	21,929
	30	Bank charge expense	Adj.		6	DR	21,923
	30	NSF cheque	Adj.		180	DR	21,743

This adjusted cash balance now agrees with the bank reconciliation.

**Fig. 7.5: Updated Cash Account in the General Ledger**

Big Dog does not make any adjusting entries for the reconciling items on the right (bank) side of the bank reconciliation since these items should eventually clear the bank or be corrected by the bank and appear on a later month's bank statement.

### 7.3.5 Debit and Credit Card Transactions



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Debit and credit cards are commonly accepted by companies when customers make purchases. Because the cash is efficiently and safely transferred directly into a company's bank account by the debit or credit card company, such transactions enhance internal control over cash. However, the seller is typically charged a fee for accepting debit and credit cards. For example, assume BDCC makes a \$1,000 sale to a customer who uses a credit card that charges BDCC a fee of 2%; the cost of the sale is \$750.

BDCC would record the following entries:

Cash	101	980	
Bank Charges Expense	632	20	
Sales	500		1,000
<i>To record sale and related credit card fee.</i>			

Cost of Good Sold	570	750	
Merchandise Inventory	150		750
<i>To record cost of sales.</i>			

The credit card fee is calculated as the \$1,000 sale  $\times$  2% = \$20. This means that BDCC collects net cash proceeds of \$980 (\$1,000 - \$20). The use of debit cards also involves fees. These entries are journalized in the same manner.

## 7.4 Accounts Receivable



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LO4 – Explain, calculate, and record estimated uncollectible accounts receivable and subsequent write-offs and recoveries.

Recall that the revenue portion of the operating cycle, as shown in [Figure 7.6](#), begins with a sale on credit and is completed with the collection of cash. Unfortunately, not all receivables are collected. This section discusses issues related to accounts receivable and their collection.

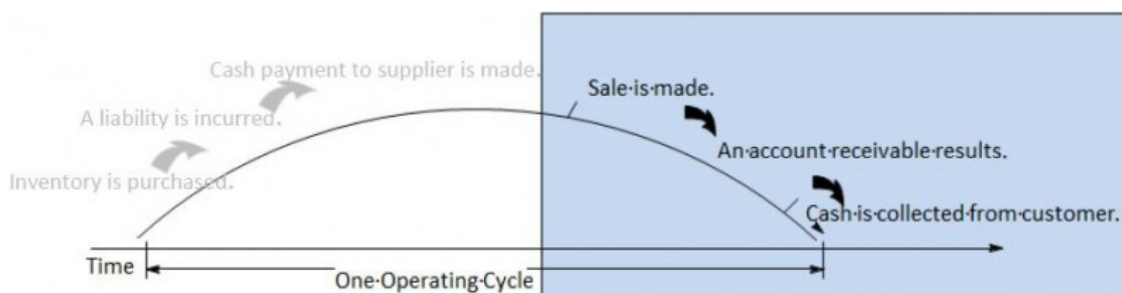


Fig. 7.6: Revenue Portion of Operating Cycle

### 7.4.1 Uncollectible Accounts Receivable



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Extending credit to customers results in increased sales and therefore profits. However, there is a risk that some accounts receivable will not be collected. A good internal control system is designed to minimize bad debt losses. One such control is to permit sales on account only to credit-worthy customers; this can be difficult to determine in advance. Companies with credit sales realize that some of these



amounts may never be collected. These **uncollectible accounts**, commonly known as **bad debts**, are an expense associated with selling on credit.

Bad debt expenses should be matched to the credit sales of the same period. For example, assume BDCC recorded a \$1,000 credit sale to XYA Company in April, 2015. Assume further that in 2016 it was determined that the \$1,000 receivable from XYA Company would never be collected. The bad debt arising from the credit sale to XYA Company should be matched to the period in which the sale occurred, namely, April, 2015. But how can that be done if it is not known which receivables will become uncollectible until a future date? A means of estimating and recording the amount of sales that will not be collected in cash is needed. This is done by establishing a contra current asset account called **Allowance for Doubtful Accounts** in the general ledger to record estimated uncollectible receivables. This account is a contra account to accounts receivable and is disclosed on the balance sheet as shown below using assumed values.

Accounts receivable	\$25,000	
Less: Allowance for doubtful accounts		
	1,400	\$23,600
OR		

Accounts receivable (net of \$1,400 allowance for doubtful accounts)	\$ 23,600
--	-----------

The Allowance for Doubtful Accounts contra account reduces accounts receivable to the amount that is expected to be collected—in this case, \$23,600.

## 7.4.2 Estimating Uncollectible Accounts Receivable



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The allowance for doubtful accounts is used to reflect how much of the total Accounts Receivable is estimated to be uncollectible. To record estimated uncollectible accounts, the following adjusting entry is made.

Bad Debts Expense	613	xxx	
Allow. For Doubt. Acct.	111		xxx
<i>To record estimated uncollectible accounts receivable.</i>			

The bad debt expense is shown on the income statement. Allowance for doubtful accounts appears on the balance sheet and is subtracted from accounts receivable resulting in the estimated net realizable accounts receivable.

Two different methods can be used to estimate uncollectible accounts. One method focuses on estimating Bad Debt Expense on the income statement, while the other focuses on estimating the desired balance in allowance for doubtful accounts on the balance sheet.

### 7.4.3 The Income Statement Method



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The objective of the **income statement method** is to estimate bad debt expense based on credit sales. Bad debt expense is calculated by applying an estimated loss percentage to credit sales for the period. The percentage is typically based on actual losses experienced in prior years. For instance, a company may have the following history of uncollected sales on account:

	<i>Amounts</i>	
<i>Year</i>	<i>Credit sales</i>	<i>not collected</i>
2015	\$150,000	\$1,000
2016	200,000	1,200
2017	250,000	800
	\$600,000	\$3,000

The average loss over these years is  $\$3,000/\$600,000$ , or  $\frac{1}{2}$  of 1%. If management anticipates that similar losses can be expected in 2018 and credit sales for 2018 amount to \$300,000, bad debts expense would be estimated as \$1,500 ( $\$300,000 \times 0.005$ ).

Under the income statement method, the \$1,500 represents estimated bad debt expense and is recorded as:

Bad Debts Expense	613	1,500	
Allow. For Doubt. Acct.	111		1,500
<i>To record estimated bad debts expense.</i>			

This estimated bad debt expense is calculated without considering any existing balance in the allowance for doubtful accounts.

*Allowance for doubtful account before posting adjustment*  
Assume the balance remaining in Allowance for doubtful accounts from the previous period is \$250.



*Allowance for doubtful account after posting adjustment*  
The adjustment estimating bad debt expense of \$1,500 is posted to allowance for doubtful accounts to get an adjusted balance of \$1,750.

Allowance for Doubtful Accounts		Allowance for Doubtful Accounts	
	Bal. 250		Bal. 250
			Adjust. 1,500
			Adj. bal. 1,750

## 7.4.4 The Balance Sheet Method



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Estimated uncollectible accounts can also be calculated by using the **balance sheet method** where a process called **aging of accounts receivable** is used. At the end of the period, the total of estimated uncollectible accounts is calculated by analyzing accounts receivable according to how long each account has been outstanding. An aging analysis approach assumes that the longer a receivable is outstanding, the less chance there is of collecting it. This process is illustrated in the following schedule.

Customer	Total	Number Of Days Outstanding				
		1-30	31-60	61-90	91-120	Over 120
Bendix Inc.	\$1,000					\$1,000
Devco Marketing Inc.	6,000	\$1,000	\$3,000	\$2,000		
Horngren Corp.	4,000	2,000	1,000		\$1,000	
Perry Co. Ltd.	5,000	3,000	1,000		1,000	
Others	9,000	4,000			5,000	
Totals	\$25,000	\$10,000	\$5,000	\$2,000	\$7,000	\$1,000

In this example, accounts receivable total \$25,000 at the end of the period. These are classified into five time periods: those receivables that 1-30 days past due; 31-60 days past due; 61-90 days past due; 91-120 days past due; and over 120 days past due.

Based on past experience, assume management estimates a bad debt percentage for each time period as follows:

Number Of Days Outstanding					
1-30	31-60	61-90	91-120	Over 120	
1%	3%	5%	10%	40%	

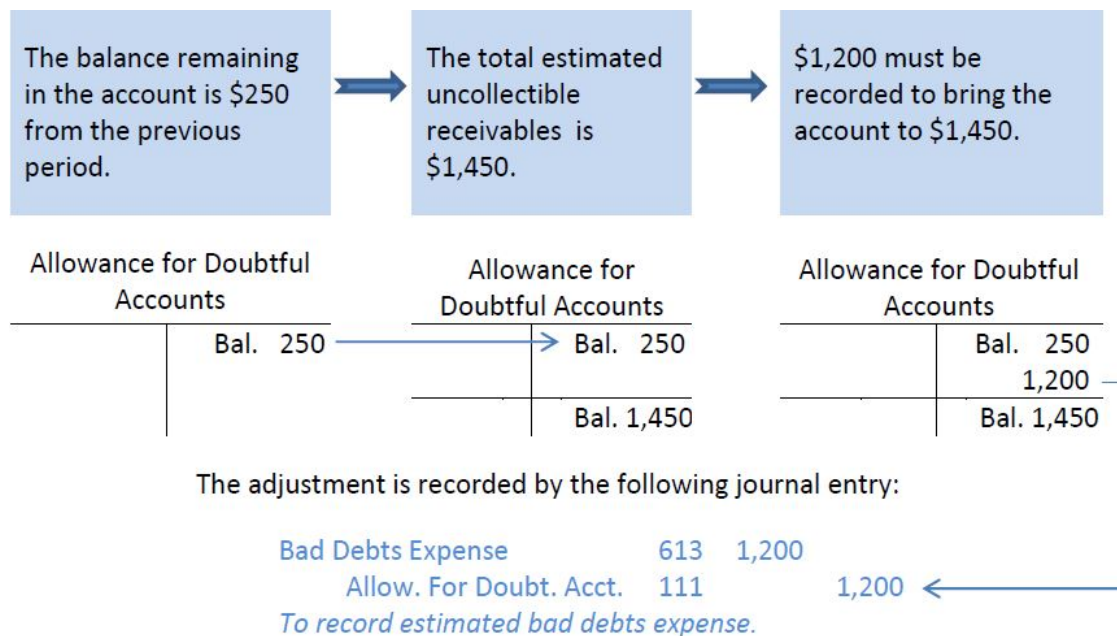
The calculation of expected uncollectible accounts receivable at December 31, 2015 would be as follows:

### Calculation of Uncollectible Amounts December 31, 2015

Age (days)	Accounts receivable	Estimated bad debt percentage	Estimated uncollectible amount
1-30	\$10,000	1%	\$ 100
31-60	5,000	3%	150
61-90	2,000	5%	100
91-120	7,000	10%	700
Over 120	1,000	40%	400
Totals	\$25,000		\$1,450

A total of \$1,450 of accounts receivable is estimated to be uncollectible at December 31, 2015.

Under the balance sheet method, the estimated bad debt expense consists of the *difference* between the opening allowance for doubtful accounts balance (\$250, as in the prior example) and the estimated uncollectible receivables (\$1,450) required at year-end.



As an alternative to using an aging analysis to estimate uncollectible accounts, a simplified balance sheet method can be used. The **simplified balance sheet method** calculates the total estimated uncollectible accounts as a percentage of the outstanding accounts receivables balance. For example, assume an unadjusted balance in the allowance for doubtful accounts of \$250 as in the preceding example. Also assume the accounts receivable balance at the end of the period was \$25,000 as in the previous illustration. If it was estimated that 6% of these would be uncollectible based on historical data, the adjustment would be:

Bad Debts Expense	613	1,250	
Allow. For Doubt. Acct.	111		1,250

*To record estimated bad debts expense.*

The total estimated uncollectible accounts was \$1,500 ( $\$25,000 \times 6\%$ ). Given an unadjusted balance in allowance for doubtful accounts of \$250, the adjustment to allowance for doubtful accounts must be a credit of \$1,250 ( $\$1,500 - \$250$ ).

Regardless of whether the income statement method or balance sheet method is used, the amount estimated as an allowance for doubtful accounts seldom agrees with the amounts that actually prove uncollectible. A credit balance remains in the allowance account if fewer bad debts occur during the year than are estimated. There is a debit balance in the allowance account if more bad debts occur during the year than are estimated. By monitoring the balance in the Allowance for Doubtful Accounts general ledger account at each yearend, though, management can determine whether the estimates of uncollectible amounts are accurate. If not, they can adjust these estimates going forward.



## 7.4.5 Writing Off Accounts Receivable



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When recording the adjusting entry to estimate uncollectible accounts receivable at the end of the period, it is not known which specific receivables will become uncollectible. When a specific account is determined to be uncollectible, it must be removed from the accounts receivable account. This process is known as a **write-off**. To demonstrate the write-off of an account receivable, assume that on January 15, 2016 the \$1,000 credit account for customer Bendix Inc. is identified as uncollectible because of the company's bankruptcy. The receivable is removed by this entry:

Allow. For Doubt. Acct.	111	1,000	
Acct. Rec. – Bendix Inc.	110		1,000
<i>To write-off Bendix Inc.'s account receivable</i>			

The \$1,000 write-off reduces both the accounts receivable and allowance for doubtful accounts. The write-off does not affect net realizable accounts receivable, as demonstrated below.

	<i>Before write- off</i>	<i>Write-off</i>	<i>After write- off</i>
Accounts receivable	\$25,000	Cr 1,000	\$24,000
Less: Allowance for doubtful accounts	1,450	Dr 1,000	450
Net accounts receivable	\$23,550		\$23,550

A write-off does not affect bad debt expense. Recall that the adjusting entry to estimate uncollectible accounts was:

Bad Debts Expense	613	xxx	
Allow. For Doubt. Acct.	111		xxx ←
<i>To record estimated uncollectible accounts receivable.</i>			

This adjustment was recorded because GAAP requires that the bad debt expense be matched to the period in which the sales occurred even though it is not known which receivables will become uncollectible. Later, when an uncollectible receivable is identified, it is written off as:

Allow. For Doubt. Acct.	111	xxx ←	
Accounts Receivable	110		xxx
<i>To record estimated uncollectible accounts receivable.</i>			

The allowance for doubtful accounts entries cancel each other out so that the net effect is a debit to bad debt expense and a credit to accounts receivable. The use of the allowance for doubtful accounts contra account allows us to estimate uncollectible

accounts in one period and record the write-off of bad receivables as they become known in a later period.

### 7.4.6 Recovery of a Write-Off



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When Bendix Inc. went bankrupt, its debt to Big Dog Carworks Corp. was written off in anticipation that there would be no recovery of the amount owed. Assume that later, an announcement was made that 25% of amounts owed by Bendix would be paid. This new information indicates that BDCC will be able to recover a portion of the receivable previously written off. A recovery requires two journal entries. The first entry reinstates the amount *expected* to be collected by BDCC — \$250 (\$1,000 x 25%) in this case — and is recorded as:

Accounts Rec. – Bendix Inc.     110   250  
 Allow. For Doubt. Acct.     111       250  
*To reverse write-off and reinstate collectible portion of account.*

This entry reverses the collectible part of the receivable previously written off. The effect of the reversal is shown below.

Accounts Receivable		Allowance for Doubtful Accounts	
Bal. \$25,000		Bal. 1,450	
	Write-off 1,000	Write-off 1,000	
Recovery 250		Recovery 250	

The second entry records the collection of the reinstated amount as:

Cash.     101   250  
 Acct. Rec. – Bendix Inc.     110       250  
*To record recovery of collectible portion of account previously written off.*

The various journal entries related to accounts receivable are summarized below.

Sale on account	{	Accounts Receivable     XXX		XXX
		Sales.....		XXX
		COGS.....		XXX
		Merchandise Inventory .....		XXX
Adjusting entry estimating uncollectible accounts	{	Bad Debts Expense.....		XXX
		Allow. For Doubt. Acct.....		XXX
Write-off of uncollectible account	{	Allow. For Doubt. Acct. ....		XXX
		Accounts Receivable.....		XXX
Recovery of account previously written off	{	Accounts Receivable .....		XXX
		Allow. For Doubt. Acct.....		XXX
		Cash .....		XXX
		Accounts Receivable.....		XXX

## 7.4.7 Notes Receivable



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LO5 – Explain and record short-term notes receivable and calculate related interest.

Notes receivable are formalized accounts receivable. They are recorded as current assets if they are due within twelve months of the date of issue. A note receivable is a signed, legally-enforceable document. The customer who owes the money promises to pay the company the *principal* plus *interest* on the due date. The **principal** is the amount of the account receivable. **Interest** is calculated as: (principal × annual interest rate × length of time outstanding).

Notes receivable can arise at the time of sale or when a customer's account receivable becomes overdue. For example, assume that BDCC provided \$4,000 of services to customer Woodlow on August 1, 2015, but this amount is still unpaid at November 30. Because of the length of time that has elapsed, BDCC and the customer agree to sign a 4%, 3-month note receivable on December 1. The journal entry on August 1 would be:

Account Rec. - Woodlow	110	4,000		
Service Revenue	470		4,000	
<i>To record service revenue from Woodlow.</i>				

Then entry on December 1 to record the conversion of the account receivable to a note receivable would be:

Note Receivable - Woodlow	120	4,000		
Account Rec. - Woodlow	110		4,000	
<i>To record conversion of the account receivable from Woodlow to a 4%, 3-month note receivable due February 28, 2016.</i>				

If a year-end occurred on December 31, 2015, an adjusting entry would be made to record accrued interest from December 1 to December 31:

Interest Receivable	116	13		
Interest Earned	430		13	
<i>To record interest accrued on the Woodlow note receivable at year-end (\$4,000 × 4% × 1/12 mos. = \$13).</i>				

The maturity date is three months from the date of issue, or February 28, 2016. On that date, BDCC would record the collection of the note receivable and related interest as:



Cash	101	4,040	
Note Rec. -Woodlow	120		4,000
Interest Receivable	116		13
Interest Earned	430		27

*To record the collection of the note receivable and interest from January 1 to February 28, 2016 ( $\$4,000 \times 4\% \times 2/12 \text{ mos.} = \$27$ ).*

## 7.5 Summary of Chapter 7 Learning Objectives



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### **LO1 – Define internal control and explain how it is applied to cash.**

The purpose of internal controls is to safeguard the assets of a business. Since cash is a particularly vulnerable asset, policies and procedures specific to cash need to be implemented, such as the use of cheques and electronic funds transfer for payments, daily cash deposits into a financial institution, and the preparation of bank reconciliations.

### **LO2 – Explain and journalize petty cash transactions.**

A petty cash fund is used to pay small, irregular amounts for which issuing a cheque would be inefficient. A petty cash custodian administers the fund by obtaining a cheque from the cash payments clerk. The cheque is cashed and the coin and currency placed in a locked box. The petty cash custodian collects receipts and reimburses individuals for the related amounts. When the petty cash fund is replenished, the receipts are compiled and submitted for entry in the accounting records so that a replacement cheque can be issued and cashed.

### **LO3 – Explain the purpose of and prepare a bank reconciliation, and record related adjustments.**

A bank reconciliation is a form of internal control that reconciles the bank statement balance to the general ledger Cash account, also known as the general ledger balance. Reconciling items that affect the bank statement balance are outstanding deposits, outstanding cheques, and bank errors. Reconciling items that affect the general ledger Cash balance are collections made by the bank on behalf of the company, NSF cheques, bank service charges, and errors. Once the book and bank statement balances are reconciled, an adjusting entry is prepared based on the reconciling items affecting the general ledger balance.

### **LO4 – Explain, calculate, and record estimated uncollectible accounts receivable and subsequent write-offs and recoveries.**

Not all accounts receivable are collected, resulting in uncollectible accounts. Because it is not known which receivables will become uncollectible, the allowance approach is used to match the cost of estimated uncollectible accounts to the period in which the related revenue was generated. The adjusting entry to record estimated uncollectible amounts is a debit to the Bad Debt Expense general ledger account and a credit to the

Allowance for Doubtful Accounts account. The income statement method and the balance sheet method are two ways to estimate and apply the allowance approach. The income statement method calculates bad debt expense based on a percentage of credit sales while the balance sheet method calculates total estimated uncollectible accounts in the Allowance for Doubtful Accounts using an aging analysis. When receivables are identified as being uncollectible, they are written off. If write-offs subsequently become collectible, a recovery is recorded using two entries: by reversing the write-off (or the portion that is recoverable), then recording the cash receipt.

### **LO5 – Explain and record short-term notes receivable and calculate related interest.**

A short-term note receivable is a promissory note that bears an interest rate calculated over the term of the note. Short-term notes receivable are considered current assets if they mature within twelve months from the date of issue. Notes can be issued to a customer at the time of sale, or a note receivable can replace an overdue account receivable.

## **7.6 Assignment Materials**

### **7.6.1 Concept Self-check**



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1. What is internal control?
2. What is an imprest petty cash system?
3. What is the difference between establishing and replenishing the petty cash fund?
4. How does the preparation of a bank reconciliation strengthen the internal control of cash?
5. What are some reconciling items that appear in a bank reconciliation?
6. What are the steps in preparing a bank reconciliation?
7. What is an NSF cheque?
8. How does use of allowance for doubtful accounts match expenses with revenue?
9. How does the income statement method calculate the estimated amount of uncollectible accounts?
10. What is an ageing schedule for bad debts, and how is it used in calculating the estimated amount of uncollectible accounts?
11. How are credit balances in accounts receivable reported on the financial statements?
12. What is an example of a journal entry to create a note receivable?

## 7.6.2 Comprehension Problems

### 7.6.2.1 CP 7-1



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The following transactions were made by Landers Corp. in March 2015.

Mar. 1	Established a petty cash fund of \$200	
12	Reimbursed the fund for the following:	
	Postage	\$10
	Office supplies	50
	Maintenance	35
	Meals (selling expenses)	<u>25</u>
		<u>\$120</u>
18	Increased the fund by an additional \$200	
25	Reimbursed the fund for the following:	
	Office supplies	\$75
	Delivery charges	<u>30</u>
		<u>\$105</u>
28	Reduced the amount of the fund to \$350.	

*Required:* Prepare journal entries to record these transactions.

### 7.6.2.2 CP 7-2



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The following information pertains to Ferguson Corp. at December 31, 2015, its year-end:

Cash per company records	\$5,005
Cash per bank statement	7,000
Bank service charges not yet recorded in company records	30
Note collected by bank not yet recorded in company records, including \$25 of interest	1,325
Fluet inc. cheque deducted in error by bank	200
December deposit recorded by the bank January 3, 2016	700
December cheques not yet paid by bank in December	
#631	\$354
#642	746
#660	200
#661	300
	\$1,600

*Required:* Prepare a bank reconciliation and all necessary adjusting journal entries at December 31, 2015.

### 7.6.2.3 CP 7-3



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The Cash general ledger account balance of Gladstone Ltd. was \$2,531 at March 31, 2015. On this same date, the bank statement had a balance of \$1,500. The following discrepancies were noted:

- a. A deposit of \$1,000 made on March 30, 2015 was not yet recorded by the bank on the March statement.
- b. A customer's cheque amounting to \$700 and deposited on March 15 was returned NSF with the bank statement.
- c. Cheque #4302 for office supplies expense, correctly made out for \$125 and clearing the bank for this amount, was recorded in the company records as \$152.
- d. \$20 for March service charges were recorded on the bank statement but not in the company records.
- e. A cancelled cheque for \$250 belonging to Global Corp. but charged by the bank to Gladstone Ltd. was included with the cancelled cheques returned by the bank.
- f. There were \$622 of outstanding cheques at March 31.

- g. The bank collected a note receivable for \$300 on March 31 including interest of \$50. The bank charged Gladstone Ltd. a \$10 service charge that also is not included in the company records.

*Required:* Prepare a bank reconciliation and record all necessary adjusting entries at March 31, 2015.

#### 7.6.2.4 CP 7-4



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Koss Co. Ltd. began operations on January 1, 2015. It had the following transactions during 2015, 2016, and 2017.

2015	Dec.	31	Estimated uncollectible accounts as \$5,000 (calculated as 2% of sales)
2016	Apr.	15	Wrote off the balance of N. Lang, \$700
	Aug.	8	Wrote off \$3,000 of miscellaneous customer accounts as uncollectible
	Dec.	31	Estimated uncollectible accounts as \$4,000 (1½% of sales)
2017	Mar.	6	Recovered \$200 from N. Lang, whose account was written off in 2016; no further recoveries are expected
	Sept.	4	Wrote off as uncollectible \$4,000 of miscellaneous customer accounts
	Dec.	31	Estimated uncollectible accounts as \$4,500 (1½% of sales).

*Required:*

1. Prepare journal entries to record the above transactions.
2. Assume that management is considering a switch to the balance sheet method of calculating the allowance for doubtful accounts. Under this method, the

allowance at the end of 2017 is estimated to be \$2,000. Comment on the discrepancy between the two methods of estimating allowance for doubtful accounts.

### 7.6.2.5 CP 7-5



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Impulse Inc. had the following unadjusted account balances at December 31, 2015, its year-end.

	<i>Account Balances</i>	
	<i>Debit</i>	<i>Credit</i>
Accounts Receivable	\$125,000	
Allowance for Doubtful Accounts		\$ 3,000
Sales		750,000

Impulse estimates its uncollectible accounts as five per cent of its December 31 accounts receivable balance.

*Required:*

1. Calculate the amount of estimated uncollectible accounts that will appear on Impulse's balance sheet at December 31, 2015.
2. Calculate the amount of bad debt expense that will appear on Impulse's income statement at December 31, 2015.
3. Prepare a partial balance sheet at December 31, 2015 showing accounts receivable, allowance for doubtful accounts, and the net accounts receivable.

### 7.6.2.6 CP 7-6



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The following information is taken from the records of Salzl Corp. at its December 31 year-end:

	2016	2017
Accounts written off		
During 2016	\$2,400	
During 2017		\$1,000
Recovery of accounts written off		

Recovered in 2017	300
Allowance for doubtful accounts (adjusted balance)	
At December 31, 2015	8,000
At December 31, 2016	9,000

Salzi had always estimated its uncollectible accounts at two per cent of sales. However, because of large discrepancies between the estimated and actual amounts, Hilroy decided to estimate its December 31, 2016 uncollectible accounts by preparing an ageing of its accounts receivable. An amount of \$10,000 was considered uncollectible at December 31, 2017.

*Required:*

1. Calculate the amount of bad debt expense for 2016.
2. Calculate the amount of bad debt expense for 2017.

### 7.6.2.7 CP 7-7



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Sather Ltd. had the following unadjusted account balances at December 31, 2015:

Accounts Receivable	\$150,000
Allowance for Doubtful Accounts	3,000
Sales	750,000

*Required:*

1. Assume that Sather Ltd. estimated its uncollectible accounts at December 31, 2015 to be two per cent of sales.
  1. Prepare the appropriate adjusting entry to record the estimated uncollectible accounts at December 31, 2015.
  2. Calculate the balance in the Allowance for Doubtful Accounts account after posting the adjusting entry.
2. Assume that Sather Ltd. estimated its uncollectible accounts at December 31, 2015 to be ten per cent of the net accounts receivable balance.



1. Prepare the appropriate adjusting entry to record the estimated uncollectible accounts at December 31, 2015.
2. Calculate the balance in the Allowance for Doubtful Accounts account after posting the adjusting entry.
3. Why is there a difference in the calculated estimates of doubtful accounts in questions 1 and 2?

### 7.6.2.8 CP 7-8



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Elliot Inc. has the following unadjusted account balances at December 31, 2015:

	<i>Account Balances</i>	
	<i>Debit</i>	<i>Credit</i>
Accounts Receivable	\$50,000	
Allowance for Doubtful Accounts	1,000	
Sales		\$200,000

*Required:*

1. Assume Elliot estimates that two per cent of its sales will not be collected.
  1. What amount of bad debt expense will be reported on Elliot's income statement at December 31, 2015?
  2. What amount of allowance for doubtful accounts will be reported on Elliot's balance sheet at December 31, 2015?
2. Assume Elliot estimates that five per cent of accounts receivable will not be collected.
  1. What amount of bad debt expense will be reported on Elliot's income statement at December 31, 2015?
  2. What amount of allowance for doubtful accounts will be reported on Elliot's balance sheet at December 31, 2015?
3. Which calculation provides better matching: that made in question 1 or in question 2? Why?

### 7.6.2.9 CP 7-9



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A \$12,000 account receivable owing from Smith Co. to Jones Inc. was converted into a 6%, 3-month note receivable on November 1, 2015.

*Required:*

1. Prepare the entry needed to record the note receivable in Jones' accounting records.
2. Prepare the entry needed to record accrued interest on the note receivable in Jones' accounting records at December 31, 2015.

3. Record the cash received from the note in Jones' accounting records on February 1, 2016.

## 7.6.3 Problems

### 7.6.3.1 P 7-1



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The following transactions were made by Simpson Corp. in December 2015.

- |      |    |   |      |
|------|----|---|------|
| Dec. | 1  | Established a petty cash fund of \$100.             |      |
|      | 14 | Reimbursed the fund for receipts as follows:        |      |
|      |    | Office supplies                                     | \$50 |
|      |    | Maintenance   | 35   |
|      |    | Petty cash on hand prior to reimbursement was \$46. |      |
|      | 29 | Reimbursed the fund for the following:              |      |
|      |    | Office supplies                                     | \$10 |
|      |    | Delivery charges                                    | 20   |
|      |    | Petty cash on hand prior to reimbursement was \$72. |      |
|      | 31 | Reduced the amount of the fund to \$50.             |      |

*Required:*

1. Prepare journal entries to record these transactions.
2. Suggest improvements to the internal controls of Simpson's petty cash fund.

### 7.6.3.2 P 7-2



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The reconciliation of the cash balance per bank statement with the balance in the Cash account in the general ledger usually results in one of five types of adjustments. These are

- a. Additions to the reported general ledger cash balance
- b. Deductions from the reported general ledger cash balance
- c. Additions to the reported cash balance per the bank statement
- d. Deductions from the reported cash balance per the bank statement
- e. Information that has no effect on the current reconciliation.

*Required:*

1. Using the above letters *a* to *e* from the list, indicate the appropriate adjustment for each of the following items that apply to Goertzen Ltd. for December, 2015:

\_\_\_\_\_ The company has received a \$3,000 loan from the bank that was deposited into its bank account but was not recorded in the company records.

\_\_\_\_\_ A \$250 cheque was not returned with the bank statement though it was paid by the bank.

\_\_\_\_\_ Cheques amounting to \$4,290 shown as outstanding on the November reconciliation still have not been returned by the bank.

- \_\_\_\_\_ A collection of a note receivable for \$1,000 made by the bank has not been previously reported to Goertzen. This includes interest earned of \$50.
- \_\_\_\_\_ The bank has erroneously charged Goertzen with a \$1,100 cheque, which should have been charged to Gagetown Ltd.
- \_\_\_\_\_ A \$350 cheque made out by Fynn Company and deposited by Goertzen has been returned by the bank marked NSF; this is the first knowledge Goertzen has of this action.
- \_\_\_\_\_ A cheque for \$840 was erroneously recorded as \$730 in the company records.
- \_\_\_\_\_ A \$600 bank deposit of December 31 does not appear on the bank statement.
- \_\_\_\_\_ Bank service charges amounting to \$75 were deducted from the bank statement but not yet from the company records.
2. Prepare a bank reconciliation using the data given above. On December 31, the Cash account in the general ledger of Goertzen Ltd. showed a balance of \$84,293. The bank statement showed a balance of \$90,568.
3. Prepare journal entries required to adjust the general ledger Cash account of Goertzen Ltd. to the reconciled balance.

### 7.6.3.3 P 7-3



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Gibson Energy Ltd. controls its cash by depositing receipts on a daily basis and making all disbursements by cheque. After all the posting for the month of November 2016 was completed, the Cash balance in the general ledger account at November 30 was \$4,213. The bank statement for the month ended November 30 received from the First National Bank showed the balance to be \$4,440. The following data are available for the purpose of reconciling these balances:

- a. Cash receipts for November 30 amounting to \$611 have been placed in the night depository and do not appear on the bank statement.

- b. Bank memos previously not available to Gibson Energy are included with the bank statement. A memo for an NSF cheque, originally received as payment for an account receivable of \$130, is included. A memo for bank charges of \$10 is also included. Another memo advises Gibson Energy Ltd. that \$494 has been deposited to the account, (\$500 less a bank charge of \$6). This represents the net proceeds of a collection the bank had made on behalf of Gibson Energy Ltd. on a \$500 note receivable.

- c. Cheques written during November but not included with the bank statement are no. 1154, \$32; no. 1192, \$54; no. 1193, \$83; no. 1194, \$109.

- d. Cheque no. 1042 is returned with the bank statement. The cheque was made for \$494, the correct amount owing for office expense. The cheque was recorded in the company records as \$548.

- e. Cheques outstanding at the end of October included cheques no. 1014 for \$152 and no. 1016 for \$179. Cheque no. 1016 was paid in the bank statement; cheque no. 1014 was not.

*Required:*

1. Prepare a bank reconciliation at November 30.
2. Prepare the necessary adjusting journal entries required to make the Cash account in the general ledger agree with the adjusted cash balance on the November 30 bank reconciliation.

**7.6.3.4 P 7-4**



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The balance of the accounts receivable account of Griffin Ltd. At December 31, 2015 was \$74,460. Included in this balance are the credit balances of two customers, amounting to \$3,200 and \$1,800.

*Required:*

1. What amount for accounts receivable would be shown as assets on the balance sheet?
2. How would the credit balances in the customers' accounts be disclosed?

### 7.6.3.5 P 7-5



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The following balances appear in the unadjusted trial balance of Lapointe Inc. at its year-end, December 31, 2015.

	<i>Account Balances</i>	
	<i>Debit</i>	<i>Credit</i>
Accounts Receivable	\$100,000	
Allowance for Uncollectible Accounts		\$ 5,000
Sales (all on credit)		600,000

Lapointe uses the balance sheet method of calculating its allowance for doubtful accounts account. At December 31, 2015, it estimates that three per cent of accounts receivable would not be collected.

Lapointe had the following transactions during 2016:

- a. Accounts receivable worth \$9,000 were written off.
- b. Credit sales amounted to \$800,000.
- c. Collections of accounts receivable amounted to \$700,000.
- d. Lapointe collected \$2,000 in 2016 that was previously written off in 2015. This amount is not included in the collection of accounts receivable described in c.
- e. At year-end, Lapointe estimated that the amount of doubtful accounts at December 31, 2016 was \$10,000.

*Required:*

1. Prepare all journal entries required for 2015 and 2016.
2. If Lapointe had used the income statement method of estimating uncollectible accounts, calculate the balance in the Allowance for Doubtful Accounts general ledger account at December 31, 2015 and 2016. Assume that Lapointe estimated doubtful accounts to be one per cent of sales for both years.

### 7.6.3.6 P 7-6



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The following balances are taken from the unadjusted trial balance of Penner Inc. at its year-end, December 31, 2015.

	<i>Account Balances</i>	
	<i>Debit</i>	<i>Credit</i>
Accounts Receivable	\$150,000	
Allowance for Doubtful Accounts		\$ 1,500
Sales	500,000	
Sales Returns and Allowances		50,000

An ageing of accounts receivable at December 31, 2015 reveals the following information:

<i>Age (days)</i>	<i>Accounts receivable</i>	<i>Estimated loss percentage</i>
1-30	\$ 50,000	2%
31-60	27,000	4%
61-90	40,000	5%
91-120	30,000	10%
Over 120	3,000	50%
<b>Total</b>	<b>\$150,000</b>	

The balance for R. Laws of \$1,000 is over 90 days past due. It is included in the ageing of accounts receivable balance and has not yet been written off.

#### Part A: 2015

*Required:* Prepare journal entries to record:

1. The write-off of R. Laws' account of \$1,000 on December 31, 2015. (*Hint:* Recalculate the accounts receivable balance after the writeoff.)
2. The appropriate adjusting entry to set up the required balance in the Allowance for Doubtful Accounts general ledger account at December 31, 2015. (*Hint:* Remember that R. Laws' account has been written off.)

#### Part B: 2016

The following transactions were made in 2016.

- a. Sales on account were \$700,000.



- b. Collections of accounts receivable amounted to \$599,000.
- c. Penner wrote off \$10,000 of accounts receivable.
- d. An ageing of accounts receivable at December 31, 2016 revealed the following information:

<i>Age (days)</i>	<i>Accounts receivable</i>	<i>Estimated loss percentage</i>
1-30	\$170,000	2%
31-60	35,000	3%
61-90	-0-	4%
91-120	27,000	25%
Over 120	8,000	50%
<b>Total</b>	<u><u>\$240,000</u></u>	

*Required:* Prepare the appropriate adjusting entry to set up the required Allowance for Doubtful Accounts general ledger account balance at December 31, 2016.

### 7.6.3.7 P 7-7



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Tarpon Inc. made \$1,000,000 in sales during 2016. Thirty per cent of these were cash sales. During the year, \$25,000 of accounts receivable were written off as being uncollectible. In addition, \$15,000 of the accounts that were written off in 2015 were unexpectedly collected. At its year-end, December 31, 2016, Tarpon had \$250,000 of accounts receivable. The balance in the Allowance for Doubtful Accounts general ledger account was \$15,000 credit at December 31, 2015.

<i>Age (days)</i>	<i>Accounts receivable</i>
1-30	\$100,000
31-60	50,000
61-90	25,000
91-120	60,000
Over 120	15,000
<b>Total</b>	<u><u>\$250,000</u></u>

*Required:*

1. Prepare journal entries to record the following 2016 transactions:
  1. The write-off of \$25,000
  2. The recovery of \$15,000.
2. Recalculate the balance in the Allowance for Doubtful Accounts general ledger account at December 31, 2016.
3. Prepare the adjusting entry required at December 31, 2016 for each of the following scenarios:
  1. The estimated uncollectible accounts at December 31, 2016 is three per cent of credit sales.
  2. The estimated uncollectible accounts at December 31, 2016 is estimated at five per cent of accounts receivable.
  3. The estimated uncollectible accounts at December 31, 2016 are calculated as follows:

Age (days)	Estimated loss percentage
1-30	2%
31-60	4%
61-90	5%
91-120	10%
Over 120	50%

**7.6.3.8 P 7-8**

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The Arcand Co. Ltd. has estimated its bad debts at 1 per cent of net credit sales. During 2016, Arcand decided to calculate the required balance for the allowance for doubtful accounts at year-end, December 31, by ageing its accounts receivable. The review suggested a required balance of \$7,200. The following data, which already have been recorded in the company's general ledger, are also available:

2015                  2016

Accounts written off

On March 14, 2015 (Boven)	\$600
On March 30, 2016 (Seaton)	\$300
Recoveries of accounts written off	
On June 5, 2016 (Boven)	400

The Allowance for Doubtful Accounts general ledger account reported the following balances: January 1, 2015—\$1,500 credit; January 1, 2016—\$3,900 credit.

*Required:* Prepare journal entries to record

1. The amount of bad debt expense for the year 2015
2. The bad debt expense on December 31, 2016
3. The collection from Boven on June 5, 2016.

### 7.6.3.9 P 7-9



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At December 31, 2016, the Elias Paper Company Ltd. balance sheet had a balance of \$1,268,800 in accounts receivable. In addition, a contra account showed an allowance for doubtful accounts balance of \$32,400. Credit sales for 2017 were \$8,540,000, with collections of the receivables amounting to \$8,262,560, including \$15,600 that Elias had written off as uncollectible in December 2016 from Huron Supplies Ltd. During 2017, Elias wrote off \$33,660 as uncollectible.

On November 1, 2017, a customer with a \$720,000 balance in accounts receivable sent \$200,000 in cash (included in the cash collections) and a note receivable for the balance. The account was considered to be collectible.

At December 31, 2017, Elias' year-end, the balance in accounts receivable included \$200,580 of past due accounts, which management estimated would result in a 10 per cent loss, based on past experience. In addition, it was management's policy to set up an allowance on remaining accounts receivable equal to 2 per cent of the balance outstanding.

*Required:*

1. Prepare general journal entries for all 2017 transactions relating to notes and accounts receivable.
2. Prepare all adjusting entries at December 31, 2017.
3. Show the amount that should appear in the 2017 income statement as bad debt expense.
4. What is the total for the allowance for doubtful accounts at December 31, 2017?

### 7.6.3.10 P 7-10



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The accounts receivable listing of Grant Corporation shows the following on December 31, 2015. The general ledger showed a \$200 credit balance in Allowance for Doubtful Accounts before adjustment.

<i>Name of customer</i>	<i>Invoice date</i>	<i>Amount</i>
Greenwood Fruit Packers Ltd.	May 2	\$ 600
Granville Ltd.	August 15	335
Kutcher Inc.	October 2	720
Kutcher Inc.	December 8	275
Lamb Fruit Inc.	March 3	445
Grimm Fruit Company	November 11	822
Fehr Produce Corp.	November 20	250
Fehr Produce Corp.	September 4	465
Fehr Produce Corp.	July 10	922
Golden Fruit Ltd.	December 5	500

*Required:*

1. Prepare an aging of accounts receivable at December 31, 2015, divided into five time periods as follows:

*Age (days)*

1-30

31-60

61-90

91-120

121-150

Over 150

2. Compute the estimated loss (rounded to two decimal places) based on the following:

<i>Age(days)</i>	<i>Estimated loss percentage</i>
1-30	0.05%
31-60	1%
61-90	3%
91-120	10%
121-150	25%
Over 150	50%

3. Prepare the journal entry to record the bad debt expense for the year.

### 7.6.3.11 P 7-11



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Zajic Corp. had the following transactions relating to uncollectible accounts during 2016:

Feb. 15 Wrote off F. Young's account of \$200 as uncollectible

Apr.	30	Collected from G. Yopek Inc. \$100 that had been written off in 2015
June	26	Received \$300 from Wong Machine Ltd. (Wong's previous balance was \$700); no further payments are expected and the balance was written off
Sept.	7	Wrote off H. Wolfe's account of \$350
Dec.	31	Analysed accounts receivable, revealing the following:

a. Accounts to be written off:

S. Wuff	\$300
P. Levesque	400
T. White	100

b. Ageing of accounts receivable:

<i>Age (days)</i>	<i>Accounts receivable</i>	<i>Estimated loss percentage</i>
1-30	\$ 20,000	2%
31-60	12,000	4%
61-90	5,000	5%
91-120	3,000	10%
Over 120	10,000	50%
<b>Total</b>	<u><u>\$ 50,000</u></u>	

*Required:*

1. Assume that there was a credit balance of \$1,735 in the Allowance for Doubtful Accounts general ledger account at December 31, 2015. Prepare the entry to write off the uncollectible accounts at December 31, 2016.
2. Prepare the appropriate adjusting entry to set up the required balance in the Allowance for Doubtful Accounts general ledger account at December 31, 2016.

### 7.6.3.12 P 7-12



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A \$120,000 account receivable owing from Baron Cabinets Ltd. To Glimmer Enterprises was converted into a 12%, 12-month note receivable on August 1, 2015. Principal of \$10,000 per month plus accrued interest on the outstanding balance was to be paid on the note on the last day of each month.

*Required:*

1. Prepare the entry needed to record the note receivable in Glimmer's accounting records on August 1.
2. Prepare the entry needed to record accrued interest on the note receivable in Glimmer's accounting records at December 31, 2015.
3. Record the cash received from the note in Glimmer's accounting records on February 28, 2016.

## 7.6.4 Alternate Problems

### 7.6.4.1 AP 7-1



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The following transactions were made by Mortimer Corp. in November 2015.

Nov.	1	Established a petty cash fund of \$1,000.	
	17	Reimbursed the fund for receipts as follows:	
		Office supplies	\$500
		Maintenance	350
		Meals (selling expenses)	100
		Petty cash on hand prior to reimbursement was \$10.	
	19	Increased the fund by \$1,000.	



28 Reimbursed the fund for the following:

Office supplies	\$1,500
Delivery charges	300

Petty cash on hand prior to reimbursement was \$50.

*Required:*

1. Prepare journal entries to record these transactions.
2. Suggest improvements to the internal controls of Mortimer's petty cash fund.

### 7.6.4.2 AP 7-2



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The preparation of the bank reconciliation is an important internal control function of the accountant at Edison Life Ltd. Normally, five types of adjustments are used:

- a. Additions to the reported general ledger cash balance
- b. Deductions from the reported general ledger cash balance
- c. Additions to the reported cash balance per the bank statement
- d. Deductions from the reported cash balance per the bank statement
- e. Information that has no effect on the current bank reconciliation.

*Required:*

1. Using the letters *a* to *e* from the list, indicate the appropriate adjustments for each of the following pieces of information derived from Edison Life Ltd.'s January 2017 bank statement.

- A collection of a \$2,000 note receivable was not previously reported to Edison Life. This included interest earned of \$50.
  - A certified cheque amounting to \$500 and dated January 15 was not returned with the January bank statement.
  - The January 31 deposit of \$1,000 arrived too late at the bank to be included in the January bank statement.
  - A \$225 cheque from Go-Slow Truckers was returned with the bank statement, marked NSF. This is the first knowledge Edison Life has of this.
  - A cheque received for \$540 was recorded as \$450 in the company records.
  - Service charges of \$13 were deducted on the bank statement. These have not yet been recorded in the company records.
  - A \$10,000 loan received from the bank was included in the bank statement but not in the company's general ledger.
  - A \$150 December cheque had still not cleared the bank.
  - The bank credited Edison Life with a \$2,000 deposit that should have been credited to Alva Life Insurance.
2. Prepare a bank reconciliation using the data given above. On January 31, the Cash account in the general ledger of Edison Life Ltd. showed a balance of \$24,848. The bank statement showed a balance of \$37,850.

### 7.6.4.3 AP 7-3



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The following is information for the Bittman Company Ltd.:

- a. Balance per the bank statement for December 31, 2017 is \$25,430.
- b. Balance of the Cash account in the general ledger at December 31 is \$11,040.
- c. A cheque for \$840 that had been deposited in the bank was incorrectly recorded in the general ledger as \$930.
- d. A cheque for \$2,100 deposited on December 21 was returned by the bank marked NSF; no entry has been made on the company records to reflect the returned cheque.
- e. Among the cancelled cheques is one for \$345 given in payment of an account payable; the cheque has been recorded as \$480 in the company records.
- f. Bank service charges for December amount to \$50. These were not yet recorded in the company records.
- g. The bank erroneously charged the Bittman Company account for a \$10,000 cheque of the Pittman Company.
- h. The bank had collected a \$15,000 note plus accrued interest amounting to \$75; \$15,075 was credited to Bittman's account; a collection fee of \$10 was debited to Bittman Company's account. None of these transactions were recorded in the company records.
- i. The bank deposit made December 3 for \$1,570 does not appear on the bank statement
- j. Outstanding cheques at December 31 were no. 197, \$4,000, and no. 199, \$9,000.

*Required:*

1. Prepare a bank reconciliation statement at December 31, 2017.
2. Prepare the necessary adjusting journal entries to make the Cash account in the general ledger agree with the bank reconciliation adjusted cash balance at December 31.

### 7.6.4.4 AP 7-4



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The following items relate to the activities of Doke Company Ltd. during June 2018:

- a. At June 30, the cash account shows a balance of \$1,200.
- b. The June bank statement shows a balance of \$64.  
  
Of four cheques not returned by the bank in May, one still
- c. has not been returned in June: cheque no. 208 in the amount of \$80.  
  
Doke deposited cash received on June 29 (in the amount of \$1,000) and June 30 (in the amount of \$200) in the night
- d. depository on June 29 and 30, a Saturday and Sunday, respectively; these deposits do not appear on the bank statement.  
  
On reviewing the cheques returned with the bank statement, Doke found the following: cheque no. 214, properly made out for \$45, was coded as a debit to Office
- e. Supplies Expense and a credit to the Cash general ledger account for \$54; a cheque of Poke Company in the amount of \$200 was incorrectly processed through Doke's bank account by the bank.
- f. Bank service charges for the month totalled \$5.
- g. Cheque no. 261 for \$180 written in June was not returned with the cancelled cheques.

*Required:*

1. Prepare a bank reconciliation at June 30, 2018.
2. Prepare the necessary adjusting journal entries to make the Cash general ledger account agree with the bank reconciliation adjusted cash balance at June 30.

### 7.6.4.5 AP 7-5



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The Accounts Receivable general ledger account of the Pure Springs Corporation shows a balance of \$370,500 on June 30, 2017. A summary of the analysis of accounts receivable by age shows:

<i>Age (days)</i>	<i>Accounts receivable</i>	<i>Estimated loss percentage</i>
1-30	\$300,000	0.5%
31-60	25,000	4%
61-90	30,000	5%
91-120	12,500	15%
Over 120	3,000	40%
<b>Total</b>	<b>\$370,500</b>	

On June 30, Allowance for Doubtful Accounts in the general ledger has a debit balance of \$310 before adjustments.

*Required:* Prepare the necessary adjusting entry.

### 7.6.4.6 AP 7-6



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Montana Inc. had the following transactions relating to uncollectible accounts during 2016:

Jan.	22	Wrote off J. Asanti's account of \$400 as uncollectible
Mar.	6	Collected from Z. Byrd \$200 that had been written off in 2015
July	4	Received \$600 from M. Peron (Peron's previous balance was \$1,400); no further payments are expected and the balance was written off
Sept.	7	Wrote off R. Ngeun's account for \$700

Dec. 31      Analysed accounts receivable, revealing the following:

a.              Accounts to be written off:

R. Bouchard      \$600

S. O'Malley      800

C. Macintosh      200

b.              Ageing of accounts receivable:

<i>Age (days)</i>	<i>Accounts receivable</i>	<i>Estimated loss percentage</i>
1-30	\$ 40,000	2%
31-60	24,000	4%
61-90	10,000	5%
91-120	6,000	10%
Over 120	20,000	50%
<b>Total</b>	<b><u>\$100,000</u></b>	

*Required:*

1. Assume that there was a credit balance of \$3,000 in the Allowance for Doubtful Accounts general ledger account at December 31, 2015. Prepare the entry to write off the uncollectible accounts at December 31, 2016.
2. Prepare the appropriate adjusting entry to set up the required balance in the Allowance for Doubtful Accounts general ledger account at December 31, 2016.

#### 7.6.4.7 AP 7-7



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The following balances are taken from the unadjusted trial balance of Sperling Corp. at its year-end, December 31, 2015:

	<i>Account Balances</i>	
	<i>Debit</i>	<i>Credit</i>
Accounts Receivable	\$ 300,000	
Allowance for Doubtful Accounts		\$ 3,000
Sales	1,000,000	
Sales Returns and Allowances		100,000

An ageing of accounts receivable at December 31, 2015 reveals the following information:

<i>Age (days)</i>	<i>Accounts receivable</i>	<i>Estimated loss percentage</i>
1-30	\$100,000	2%
31-60	54,000	3%
61-90	80,000	4%
91-120	60,000	25%
Over 120	6,000	50%
<b>Total</b>	<u><u>\$300,000</u></u>	

The balance for J. Nelson of \$2,000 is over 90 days past due. It is included in the ageing of accounts receivable chart and has not yet been written off.

**Part A: 2015**

*Required:* Prepare journal entries to record:

1. The write-off of J. Nelson's account on December 31, 2015
2. The appropriate adjusting entry to set up the required balance in the Allowance for Doubtful Accounts general ledger account at December 31, 2015. (Hint: Remember that J. Nelson's account has been written off.)

**Part B: 2016**

The following transactions were made in 2016:

- a. Sales on account were \$1,400,000.
- b. Collections of accounts receivable amounted to \$1,198,000.
- c. Sperling wrote off \$20,000 of accounts receivable.
- d. An ageing of accounts receivable at December 31, 2016 revealed the following information:



<i>Age (days)</i>	<i>Accounts receivable</i>	<i>Estimated loss percentage</i>
1-30	\$340,000	2%
31-60	70,000	3%
61-90	-0-	4%
91-120	54,000	25%
Over 120	16,000	50%
<b>Total</b>	<b><u>\$480,000</u></b>	

*Required:* Prepare the journal entries required for parts a. through d. and the entry necessary to adjust the Allowance for Doubtful Accounts general ledger account balance at December 31, 2016.

#### 7.6.4.8 AP 7-8



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Clarke Auto Sales Ltd. reported the following balances on its December 31, 2015 year-end financial statements:

<b>Accounts receivable</b>	<b>\$104,400</b>
<b>Less: Allowance for doubtful accounts</b>	<b><u>2,000</u></b>
<b>Net accounts receivable</b>	<b>\$102,400</b>

The following occurred in January 2016:

- a. Accounts of \$1,200 were written off as uncollectible.
- b. An account for \$300 previously written off was collected.

- c. An analysis of the aged accounts receivable indicated a need for an allowance of \$3,500 to cover the possibility of uncollectible accounts.

*Required:* Reconstruct the journal entries to record the above items.

### 7.6.4.9 AP 7-9



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On January 1, 2016 the Accounts Receivable general ledger account balance of Chapel Cycle Works Inc. was \$265 and the balance in the Allowance For Doubtful Accounts general ledger account was \$7. The firm's credit sales during the year were \$2,105 and cash collections from customers amounted to \$2,025. Among these collections was the recovery in full of a \$3 receivable from K. Lush, a customer whose account had been written off as uncollectible in the previous year. During the current year it was necessary to write off as uncollectible customers' accounts totalling \$8.

At December 31, the accounts receivable included \$40 of past-due accounts. After careful study of all past-due accounts, the management estimated that the probable loss contained therein was 20 per cent and that, in addition, 2 per cent of the current accounts receivable might prove uncollectible.

*Required:*

1. Calculate the balance of the accounts receivable account at December 31.
2. Prepare the necessary adjusting entry for the bad debts at December 31.
3. What amount should appear in this year's income statement as bad debt expense?
4. Show the balance sheet presentation of accounts receivable at December 31.

### 7.6.4.10 AP 7-10



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Caton China Corporation had credit sales of \$610,000 for the year ended December 31, 2016, accounts receivable of \$60,500, and a credit balance of \$250 in the Allowance for Doubtful Accounts general ledger account at the end of the year.

*Required:*

1. Record the bad debt expense for the year, using each of the following methods for the estimate:
  - a. The allowance for doubtful accounts is to be increased to 4 per cent of accounts receivable.
  - b. Bad debt expense is estimated to be 0.45 per cent of credit sales.
  - c. The allowance for doubtful accounts is to be increased to \$3,700, as indicated by an ageing schedule.
2. Which method would you choose and why?

### 7.6.4.11 AP 7-11



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The following balances appear in the unadjusted trial balance of Fleming Corp. at its year-end, December 31, 2016:

	<i>Account Balances</i>	
	<i>Debit</i>	<i>Credit</i>
Accounts Receivable	\$200,000	
Allowance for Uncollectible Accounts		\$ 10,000
Sales (70% on credit)		1,200,000

Fleming uses the balance sheet method of calculating its allowance for doubtful accounts. At December 31, 2016, it estimated that three per cent of accounts receivable would not be collected. Fleming had the following transactions during 2017:

- a. It wrote off \$18,000 of accounts receivable.
- b. Credit sales amounted to \$1,600,000.
- c. Collections of accounts receivable amounted to \$1,400,000.
- d. Fleming collected \$4,000 that was previously written off in 2016. This amount is not included in the collections described in transaction c.
- e. At year-end, it was estimated that the amount of doubtful accounts at December 31, 2017 was \$10,000.

*Required:*

1. Prepare all journal entries required for 2016 and 2017.
2. If Fleming had used the income statement method of estimating uncollectible accounts, calculate the balance in the Allowance for Doubtful Accounts general ledger account at December 31, 2016 and 2017. Assume that Fleming estimates doubtful accounts to be one per cent of sales for both years.

### 7.6.4.12 AP 7-12



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Zane Corp. had \$2,000,000 in sales during 2017. Thirty per cent of these were cash sales. During the year, \$50,000 of accounts receivable were written off as being

uncollectible. In addition, \$30,000 of the accounts that were written off in 2016 were unexpectedly collected. Accounts receivable at the year-end of Zane, December 31, 2017 amounted to \$500,000, as shown below. The balance in the Allowance for Doubtful Accounts account was \$30,000 credit at December 31, 2016.

	<i>Accounts Receivable</i>
<i>Age (days)</i>	
1-30	\$200,000
31-60	100,000
61-90	50,000
91-120	120,000
Over 120	30,000
<b>Total</b>	<u><u>\$500,000</u></u>

*Required:*

1. Prepare journal entries to record the following 2016 transactions:
  1. The write-off of \$50,000
  2. The recovery of \$30,000.
2. Prepare an adjusting entry required at December 31, 2017 for each of the following scenarios:
  1. On the basis of experience, the uncollectible accounts at December 31, 2016 are estimated at 1% of credit sales.
  2. On the basis of experience, the uncollectible accounts at December 31, 2017 are estimated at 6% of accounts receivable.
  3. On the basis of experience, the estimated uncollectible accounts at December 31, 2017 are calculated as follows:

	<i>Estimated loss percentage</i>
<i>Age (days)</i>	
1-30	1%
31-60	3%
61-90	4%
91-120	5%
Over 120	30%

### 7.6.4.13 AP 7-13



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Grove Refrigeration Ltd. sold \$10,000 of goods to Redlac Pump Services Inc. on January 28, 2016. The account receivable was converted to a note receivable on

August 1, 2016. Redlac agreed to pay Grove \$1,000 per month plus accrued interest on the outstanding balance on the last day of each month.

*Required:*

1. Prepare the entry needed to record the note receivable in Grove's accounting records on August 1, 2016.
2. Record the cash received from the note in Grove's accounting records on August 31, 2016.

## 7.6.5 Decision Problem

### 7.6.5.1 DP 7-1



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The internal control procedures for cash transactions in the Gallagher Corporation were inadequate. Sam Sly, the cashier/bookkeeper, handled cash receipts, made small disbursements from petty cash, maintained accounting records, issued and signed cheques, and prepared the monthly reconciliations of the bank account. At November 30, 2019, the bank statement showed a balance of \$17,500. The outstanding cheques were as follows:

<i>Cheque No.</i>	<i>Amount</i>
7062	\$268.55
7183	170.00
7284	261.45
8621	175.19
8623	341.00
8632	172.80

There was also an outstanding deposit of \$3,347.20 at November 30.

The balance in the general ledger Cash account at November 30 was \$20,258.31, which included some cash on hand. The bank statement for November included \$200 arising from the collection of a note receivable; the company's general ledger did not include an entry to record this collection.

Recognising the weakness existing in internal control over cash transactions, Sly prepared the following bank reconciliation and then wrote a cheque to himself, which he cashed:

Cash per general ledger	Cash per bank	\$17,500.00
	<i>Add: Outstanding deposit</i>	<u>3,347.30</u>
		\$20,847.30
	<i>Less: Outstanding cheques</i>	
	<i>Cheque</i>	
	<i>no.</i>	<i>Amount</i>
	8621	\$175.19
	8623	341.00
	8632	<u>172.80</u>
		(588.99)
<u>\$20,258.31</u>	Adjusted cash balance	<u>\$20,258.31</u>

*Required:*

1. Calculate the amount of cash taken by Sly.
2. Explain how Sly attempted to conceal his theft of cash.

## Chapter 8 Long-lived Assets



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*Long-lived* or *capital* assets are used in the normal operating activities of the business and are expected to provide benefits for a period in excess of one year. Long-lived assets covered in this chapter consist of three types: (a) property, plant, and equipment (PPE); (b) intangible assets; and (c) goodwill. Also discussed are *depreciation* and *amortization*, techniques to allocate the cost of most long-lived assets over their estimated useful lives.

### Learning Objectives

LO1 – Describe how the cost of property, plant, and equipment (PPE) is determined, and calculate PPE.

LO2 – Explain, calculate, and record depreciation using the units-of-production, straight-line, and double-declining balance methods.

LO3 – Explain, calculate, and record depreciation for partial years.

LO4 – Explain, calculate, and record revised depreciation for subsequent capital expenditures.

LO5 – Explain, calculate, and record the impairment of long-lived assets.

LO6 – Account for the derecognition of PPE assets.

LO7 – Explain and record the acquisition and amortization of intangible assets.

LO8 – Explain goodwill and identify where on the balance sheet it is reported.

LO9 – Describe the disclosure requirements for long-lived assets in the notes to the financial statements.

### 8.1 Establishing the Cost of Property, Plant, and Equipment (PPE)



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LO1 – Describe how the cost of property, plant, and equipment (PPE) is determined, and calculate PPE.



**Property, plant, and equipment (PPE)** are long-lived assets that are acquired for the purpose of generating revenue either directly or indirectly. They are held for use in the production or supply of goods and services, have been acquired for use on a continuing basis, and are not intended for sale in the ordinary course of business. Examples of PPE assets include land, office and manufacturing buildings, production machinery, trucks, ships or aircraft used to deliver goods or transport passengers, salespersons' automobiles owned by a company, or a farmer's production machinery such as tractors and field equipment. PPE assets are **tangible assets** because they can be physically touched. There are other types of non-current assets that are **intangible**—existing only as legal concepts—such as copyrights and patents. These will be discussed later in this chapter.

A long-term asset can be considered a bundle of future benefits that will be used up over a period of years. Each year, a pre-determined portion of these benefits is allocated to expense on the income statement. This concept was briefly introduced in Chapter 3. It will be examined more fully in this chapter.

### 8.1.1 Capital Expenditures



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Any cash disbursement is referred to as an **expenditure**. A **capital expenditure** results in the acquisition of a non-current asset, including any additional costs involved in preparing the asset for its intended use. Examples of various costs that may be incurred to prepare PPE for use are listed below.

		<i>Capital expenditures</i>		
		<i>Land</i>	<i>Building</i>	<i>Equipment</i>
Costs to acquire PPE	}	Purchase price	Purchase price	Invoice cost
		Commission to real estate agent	Commission to real estate agent	Transportation
		Legal fees	Legal fees	Insurance (during transportation)
Costs to prepare PPE for use	}	Costs of draining, clearing, and landscaping; demolition	Repair and remodelling costs before use	Assembly
		Assessments for streets and sewage system	Payments to tenants for premature termination of lease	Installation (including wages paid to company employees)
				Special floor foundations or supports
				Wiring
				Inspection
				Test run costs

To demonstrate, assume that equipment is purchased for \$20,000. Additional costs include transportation costs \$500, installation costs \$1,000, construction costs for a cement foundation \$2,500, and test run(s) costs to debug the equipment \$2,000. The total capitalized cost of the asset to put it into use is \$26,000.

Determining whether an outlay is a capital expenditure or a *revenue expenditure* is a matter of judgment. A **revenue expenditure** does not have a future benefit beyond one year. The concept of materiality enters into the distinction between capital and revenue expenditures. As a matter of expediency, an expenditure of \$20 that has all the characteristics of a capital expenditure would probably be expensed rather than capitalized, because the time and effort required by accounting staff to capitalize and then depreciate the item over its estimated useful life is much greater than the benefits derived from doing so. Capitalization policies are established by many companies to resolve the problem of distinguishing between capital and revenue expenditures. For example, one company's capitalization policy may state that all capital expenditures equal to or greater than \$1,000 will be capitalized, while all capital expenditures under \$1,000 will be expensed when incurred. Another company may have a capitalization policy limit of \$500.

Not all asset-related expenditures incurred after the purchase of an asset are capitalized. An expenditure made to maintain PPE in satisfactory working order is a revenue expenditure and recorded as a debit to an expense account. Examples of these expenditures include: (a) the cost of replacing small parts of an asset that normally wear out (in the case of a truck, for example: new tires, new muffler, new battery); (b) continuing expenditures for maintaining the asset in good working order (for example, oil changes, antifreeze, transmission fluid changes); and (c) costs of renewing structural parts of an asset (for example, repairs of collision damage, repair or replacement of rusted parts).

Although some expenditures for repair and maintenance may benefit more than one accounting period, they may not be material in amount or they may have uncertain future benefits. They are therefore treated as expenses. These three criteria must all be met for an expenditure to be considered capital in nature.

1. Will it benefit more than one accounting period?
2. Will it enhance the service potential of the asset, or make it more valuable or more adaptable?
3. Is the dollar amount material?

If the expenditure does not meet all three criteria, then it is a revenue expenditure and is expensed.

### 8.1.2 Land



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The purchase of land is a capital expenditure when the land is used in the operation of a business. In addition to the costs listed in the schedule above, the cost of land should be increased by the cost of removing any unwanted structures on it. This cost is reduced by the proceeds, if any, obtained from the sale of the scrap. For example, assume that the purchase price of land is \$100,000 before an additional \$15,000 cost to raze an old building: \$1,000 is expected to be received for salvaged materials. The cost of the land is calculated as \$114,000 (\$100,000 + \$15,000 - \$1,000).

Frequently, land and useful buildings are purchased for a *lump sum*. That is, one price is negotiated for their entire purchase. A lump sum purchase price must be apportioned between the PPE assets acquired on the basis of their respective market values, perhaps established by a municipal assessment or a professional land appraiser. Assume that a lump sum of \$150,000 cash is paid for land and a building, and that the land is appraised at 25% of the total purchase price. The Land account would be debited for \$37,500 ( $\$150,000 \times 25\%$ ) and the Building account would be debited for the remaining 75% or \$112,500 ( $\$150,000 \times 75\% = \$112,500$  or  $\$150,000 - \$37,500 = \$112,500$ ) as shown in the following journal entry.

Land	37,500	
Building	112,500	
Cash		150,000

*To record the purchase of land and building for a lump sum of \$150,000; land:  $\$150,000 \times 25\% = \$37,500$ ; building:  $\$150,000 \times 75\% = \$112,500$ .*

### 8.1.3 Building and Equipment



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When a capital asset is purchased, its cost includes the purchase price plus all costs to prepare the asset for its intended use. However, a company may construct its own building or equipment. In the case of a building, for example, costs include those incurred for excavation, building permits, insurance and property taxes during construction, engineering fees, the cost of labour incurred by having company employees supervise and work on the construction of the building, and the cost of any interest incurred to finance the construction during the construction period.

### 8.1.4 Depreciation



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LO2 – Explain, calculate, and record depreciation using the units-of-production, straight-line, and double-declining balance methods.

The role of **depreciation** is to allocate the cost of a PPE asset (except land) over the accounting periods expected to receive benefits from its use. Depreciation begins when the asset is in the location and condition necessary for it to be put to use. Depreciation continues even if the asset becomes idle or is retired from use, unless it is fully depreciated. Land is not depreciated, as it is assumed to have an unlimited life.

Depreciation is an application of the matching principle.

According to generally accepted accounting principles, a company should select a method of depreciation that represents the way in which the asset's future economic benefits are estimated to be used up.

There are many different ways to calculate depreciation. The most frequently used methods are usage-based and time-based. Regardless of depreciation method, there are three factors necessary to calculate depreciation:

- cost of the asset
- residual value
- estimated useful life or productive output.

**Residual value** is the estimated worth of the asset at the end of its estimated useful life. This concept was not introduced when depreciation was briefly discussed in Chapter 3. A long-lived asset is not depreciated below its residual value.

**Useful life** is the length of time that a long-lived asset is estimated to be of benefit to *the current owner*. This is not necessarily the same as the asset's economic life. If a company has a policy of replacing its delivery truck every two years, its useful life is two years even though it may be used by the next owner for several more years.

**Productive output** is the amount of goods or services expected to be provided. For example, it may be measured in units of output, hours used, or kilometres driven.

### 8.1.5 Usage-Based Depreciation Method – Units-of-Production



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**Usage-based depreciation methods**, such as the units-of-production method, are used when the output of an asset varies from period to period.

Usage methods assume that the asset will contribute to the earning of revenues in relation to the amount of output during the accounting period. Therefore, the depreciation expense will vary from year to year.

To demonstrate, assume that Big Dog Carworks Corp. purchased a \$20,000 piece of equipment on January 1, 2015 with a \$2,000 residual value and estimated productive life of 10,000 units. If 1,500 units were produced during 2015, the depreciation expense for the year ended December 31, 2015 would be calculated using the following formula:

$$\frac{\text{Cost} - \text{residual value}}{\text{Estimated units output}} = \text{Depreciation per unit} \times \text{Number of units produced} = \text{Depreciation expense}$$

$$\frac{\$20,000 - 2,000}{10,000 \text{ units}} = \$1.80 \text{ per unit} \times 1,500 \text{ units} = \$2,700$$

The following adjusting entry would be made on December 31, 2015 :

2015

Dec. 31	Depreciation Expense	2,700	
	Accumulated Depreciation		2,700

*To record depreciation expense using the units-of-production method;  $(\$20,000 - \$2,000)/10,000 \text{ units} = \$1.80/\text{unit}$ ;  $\$1.80/\text{unit} \times 1,500 \text{ units} = \$2,700$ .*

The **carrying amount** or *net book value* of the asset is its cost less accumulated depreciation. On the December 31, 2015 balance sheet, the carrying amount would be \$17,300 (\$20,000 - 2,700).

Note that the residual value is only used to calculate depreciation expense. It is not recorded in the accounts of the company or included as part of the carrying amount on the balance sheet.

If 2,000 units were produced during 2016, depreciation expense for that year would be \$3,600 (\$1.80 per unit x 2,000 units). At December 31, 2016, the following adjusting entry would be recorded:

2016

Dec. 31	Depreciation Expense	3,600	
	Accumulated Depreciation		3,600

*To record depreciation expense using the units-of-production method;  $(\$20,000 - \$2,000)/10,000 \text{ units} = \$1.80/\text{unit}$ ;  $\$1.80/\text{unit} \times 2,000 \text{ units} = \$3,600$ .*

The carrying amount at December 31, 2016 would be \$13,700 (\$20,000 - 2,700 - 3,600). If the equipment produces 1,000 units in 2017, 2,500 units in 2018, and 3,000 units in 2019, depreciation expense and carrying amounts would be as follows each year:



(a)	(b)	(c)	(d)	(e)	(f)
Year	Carrying amount at start of year	Usage (units)	Rate*	Dep'n expense	Carrying amount at end of year (b) – (e)
2015	\$20,000	1,500	\$1.80	\$2,700	\$17,300
2016	17,300	2,000	1.80	3,600	13,700
2017	13,700	1,000	1.80	1,800	11,900
2018	11,900	2,500	1.80	4,500	7,400
2019	7,400	3,000	1.80	5,400	2,000
		<u>10,000</u>		<u>\$18,000</u>	

\* $(\$20,000 - 2,000)/10,000$  units = \$1.80 per unit

If the equipment produces exactly 10,000 units over its useful life and is then retired, depreciation expense over all years will total \$18,000 (10,000 units x \$1.80) and the carrying amount will equal residual value of \$2,000 (\$20,000 - 18,000).

It is unlikely that the equipment will produce exactly 10,000 units over its useful life. Assume instead that 4,800 units were produced in 2019. Depreciation expense and carrying amounts would be as follows each year:

(a)	(b)	(c)	(d)	(e)	(f)
Year	Carrying amount at start of year	Usage (units)	Rate	Dep'n expense	Carrying amount at end of year (b) – (e)
2015	\$20,000	1,500	\$1.80	\$2,700	\$17,300
2016	17,300	2,000	1.80	3,600	13,700
2017	13,700	1,000	1.80	1,800	11,900
2018	11,900	2,500	1.80	4,500	7,400
2019	7,400	4,800	1.80	<b>5,400</b>	2,000
		<u>11,800</u>		<u>\$18,000</u>	

Although the 2019 depreciation expense would otherwise be \$8,640 (4,800 units x \$1.80), only \$5,400 is recorded to bring the carrying amount of the asset down to its residual value of \$2,000.

## 8.1.6 Time-Based Depreciation Method - Straight-Line



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A simplified method of **straight-line depreciation** was introduced in Chapter 3. This method assumes that the asset will contribute to the earning of revenues equally each

time period. Therefore, equal amounts of depreciation are recorded during each year of the asset's useful life.

Straight-line depreciation is calculated as:

$$\frac{(\text{Cost} - \text{residual value})}{\text{Useful life}} = \text{Depreciation expense each period}$$

To demonstrate, assume the same \$20,000 piece of equipment used earlier, with a useful life of five years and a residual value of \$2,000. Straight-line depreciation would be \$3,600 per year calculated as:

$$\frac{(\$20,000 - \$2,000)}{5 \text{ years}} = \$3,600 \text{ depreciation expense each year}$$

Over the five-year useful life of the equipment, depreciation expense and carrying amounts will be as follows:

<u>(a)</u>	<u>(b)</u>	<u>(c)</u>	<u>(d)</u>
<i>Year</i>	<i>Carrying amount at start of year</i>	<i>Dep'n expense</i>	<i>Carrying amount at end of year (b) – (c)</i>
2015	\$20,000	\$3,600	\$16,400
2016	16,400	3,600	12,800
2017	12,800	3,600	9,200
2018	9,200	3,600	5,600
2019	5,600	3,600	2,000
		<u>\$18,000</u>	

The carrying amount at December 31, 2015 will be the residual value of \$2,000.

Under the straight-line method, depreciation expense for each accounting period remains the same dollar amount over the useful life of the asset.

### 8.1.7 Accelerated Time-Based Depreciation Method – Double-Declining Balance (DDB)



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An **accelerated depreciation** method assumes that a capital asset will contribute more to the earning of revenues in the earlier stages of its useful life than in the later



stages. This means that more depreciation is recorded in earlier years with the depreciation expense decreasing each year. This approach is most appropriate where assets experience a high degree of obsolescence (such as computers) or where the value of the asset is highest in the first years when it is new and efficient and declines significantly each year as it is used and becomes worn (such as mining equipment).

Under an accelerated depreciation method, depreciation expense decreases each year over the useful life of the asset.

One type of accelerated depreciation is the **double-declining balance (DDB) method**. To calculate, the percentage cost of the asset (100%) is divided by its estimated useful life, *without regard to residual value*. The resulting rate is doubled. The doubled rate is applied at the end of each year to the carrying amount of the asset.

For example, assume the same \$20,000 equipment with an estimated useful life of five years. The straight-line rate is 20 per cent, calculated by dividing 100 per cent by five years, the useful life ( $100\%/5 = 20\%$ ). This straight-line rate of 20% is then doubled to 40%.

Regardless of which depreciation method is used, a capital asset cannot be depreciated below its carrying amount, which in this case is \$2,000. The DDB depreciation for the five years of the asset's useful life follows:

(a)	(b)	(c)	(d)	(e)
<i>Year</i>	<i>Carrying amount at start of year</i>	<i>DDB rate</i>	<i>Dep'n expense (b) x (c)</i>	<i>Carrying amount at end of year (b) – (d)</i>
2015	\$20,000	40%	\$8,000	\$12,000
2016	12,000	40%	4,800	7,200
2017	7,200	40%	2,880	4,320
2018	4,320	40%	1,728	2,592
2019	2,592	40%	592	2,000
			\$18,000	

Although the 2019 depreciation expense would otherwise be \$1,037 ( $\$2,592 \times 40\%$ ), only \$592 is recorded to bring the carrying amount of the asset down to its residual value of \$2,000.

## 8.2 Partial Year Depreciation



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LO3 – Explain, calculate, and record depreciation for partial years.

Assets may be purchased or sold at any time during a fiscal year. Should depreciation be calculated for a whole year in such a case? The answer depends on corporate accounting policy. There are many alternatives. One is to calculate depreciation to the nearest whole month. Another, often called the **half-year rule**, records half a year's depreciation regardless of when a capital asset is purchased or sold during the year. The half-year rule is used in this textbook.

To demonstrate the half-year approach to calculating depreciation for partial periods, assume again that on January 1, 2015 Big Dog Carworks Corp. purchases equipment for \$20,000 with a useful life of five years and a residual value of \$2,000. Recall that depreciation expense for 2015 was \$3,600 using the straight-line method. Because of the half-year rule, depreciation expense for 2015 would be \$1,800 ( $\$3,600 \times \frac{1}{2}$ ) even though the asset was purchased on the first day of the fiscal year. Using the double-declining balance method, depreciation expense for 2015 under the half-year rule would be \$4,000 ( $\$8,000 \times \frac{1}{2}$ ). *The half-year rule does not apply to the units-of-production depreciation method* because the method is usage-based and not time-based. Presumably, usage would be less if the asset is purchased or sold partway through a year, so this depreciation method already takes this into account.

## 8.3 Revising Depreciation



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LO4 – Explain, calculate, and record revised depreciation for subsequent capital expenditures.

Both the useful life and residual value of a depreciable asset are estimated at the time it is purchased. As time goes by, these estimates may change for a variety of reasons. In these cases, the depreciation expense is recalculated from the date of the change in the accounting estimate and applied going forward. *No change is made to depreciation expense already recorded.*

Consider the example of the equipment purchased for \$20,000 on January 1, 2015, with an estimated useful life of five years and residual value of \$2,000. If the straight-line depreciation method and the half-year rule are used, the depreciation expense is \$1,800 in 2015 and \$3,600 in 2016. The carrying amount at the end of 2016 is \$14,600 ( $\$20,000 - 1,800 - 3,600$ ). Assume that on December 31, 2017, management estimates

the remaining useful life of the equipment to be six years, and the residual value to be \$5,000.

Depreciation expense for the remaining six years would be calculated as:

$$\begin{aligned} & \frac{\text{(Remaining carrying amount – residual value)}}{\text{Remaining useful life}} \\ &= \frac{\$14,600 - 5,000}{6 \text{ years}} \\ &= \$1,600 \text{ per year} \end{aligned}$$

### 8.3.1 Subsequent Capital Expenditures



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As noted earlier, recurring expenditures that relate to day-to-day servicing of depreciable assets are not capitalized, but rather are expensed when incurred. Oil changes and new tires for vehicles are examples of recurring expenditures that are expensed. Expenditures that are material, can be reliably measured, and enhance the future economic benefit provided by the asset are added to the cost of the asset rather than being expensed when incurred. Subsequent capital expenditures can take two forms:

1. Additions (for example, adding new room in an existing building or regular inspection costs of a capital asset)
2. Replacement (for example, replacing the engine in a truck or putting new windows in a building).

Additions to existing depreciable assets affect future depreciation expense in the same manner as changes in accounting estimates discussed above. Recall our original example: Equipment is purchased on January 1, 2015 for \$20,000. It has a useful life of five years and a residual value of \$2,000. It is depreciated on the straight-line basis and using the half-year rule. Assume that a \$5,000 device is added to the equipment on January 10, 2018 to reduce pollution emissions. Further, assume that the addition of the device will increase the residual value of the equipment to \$3,000 but will not extend its useful life. The journal entry to record the addition is:

**2018**

<b>Jan. 10</b>	<b>Equipment</b>	<b>5,000</b>	
	<b>Cash</b>		<b>5,000</b>

*To record addition to equipment.*

The carrying amount of the equipment at December 31, 2018 prior to calculating depreciation expense is \$16,000 (\$20,000 – 1,800 – 3,600 – 3,600 + 5,000). Depreciation expense for 2018 and 2019 will be \$6,500, calculated:

(Remaining carrying amount – revised residual value)

Remaining useful life

$$= \frac{\$16,000 - 3,000}{2 \text{ years}}$$

2 years

$$= \$6,500 \text{ per year}$$

Note that the ½ year rule does not apply to additions to existing depreciable assets.

At the end of December 31, 2019, the carrying amount will equal the revised residual value of \$3,000 (\$20,000 – 1,800 – 3,600 – 3,600 + 5,000 – 6,500 – 6,500).

If the double-declining balance method of depreciation is used, the same calculation is performed as before. In our example, the 2018 carrying amount using the double-declining balance method and prior to the additional \$5,000 capital expenditure is \$4,320, as follows:

<u>(a)</u>	<u>(b)</u>	<u>(c)</u>	<u>(d)</u>	<u>(e)</u>
Year	Carrying amount at start of year	DDB rate	Dep'n expense (b) x (c)	Carrying amount at end of year (b) – (d)
2015	\$20,000	40%	\$8,000	\$12,000
2016	12,000	40%	4,800	7,200
2017	7,200	40%	2,880	4,320

Depreciation expense for the next two years will be as follows:

<u>(a)</u>	<u>(b)</u>	<u>(c)</u>	<u>(d)</u>	<u>(e)</u>
Year	Carrying amount at start of year	DDB rate	Dep'n expense (b) x (c)	Carrying amount at end of year (b) – (d)
2018	\$9,320 ←	40%	\$3,728	\$5,592
2019	5,592	40%	2,237	3,355 ←

This amount is the \$4,320 carrying amount at December 31, 2017 plus the \$5,000 addition on January 10, 2018.

The carrying amount of the asset at the end of 2019 (\$3,355) is still above its new residual value of \$3,000, so full depreciation is claimed in 2019.

The accounting for a replacement part of a depreciable asset is more involved. The cost of the replaced item and its related accumulated depreciation must be removed from the accounting records when the replacement is capitalized. A *gain* or *loss on disposal* must be calculated. Let's demonstrate, again using our original examples: \$20,000 equipment purchased on January 1, 2015 with a five-year useful life and \$2,000 residual value. Assume that on January 5, 2018 the engine in the equipment burned out and needed to be replaced. Detailed records of the equipment showed that the engine had an original cost of \$8,000, useful life of five years, and residual value of \$1,000 resulting in a carrying amount as at January 5, 2018 of \$4,500.



Cost			\$8,000
Acc. dep'n	2015	(\$8,000 – 1,000)/5 yrs. x ½	\$700
	2016		1,400
	2017		<u>1,400</u>
Carrying amount, January 5, 2018			<u>\$4,500</u>

The entry to dispose of the old engine and remove it from the accounting records is:

2018

Jan. 5	Accum. Dep. – Equip.	3,500	
	Loss on Disposal	4,500	
	Equipment		8,000

*To record disposal of destroyed engine.*

Notice in the entry above that the cost of the old engine and the accumulated depreciation must be individually removed from the general ledger accounts. Losses (as well as gains) are reported on the income statement as *Other Revenues and Expenses*.

Now assume that a replacement engine was installed on January 8 for \$10,000 and had a useful life of two years. The revised residual value of the entire piece of equipment is now \$4,000. The entry to record the new engine is:

2018

Jan. 8	Equipment (Engine)	10,000	
	Cash		10,000

*To record the new engine with estimated useful life of 2 years and estimated residual value of zero.*

The revised depreciation for 2018 is calculated in the same way as an addition:

$$\begin{aligned} & \frac{(\text{Remaining carrying amount} - \text{revised residual value})}{\text{Remaining useful life}} \\ &= \frac{(20,000 - 8,000 + 10,000) - 4,000}{2 \text{ years}} \\ &= \$9,000 \text{ per year} \end{aligned}$$

As with additions, the ½ year rule does not apply to replacements. The adjusting entry at December 31, 2018 to record depreciation expense is:

2018

Dec. 31	Dep'n. Expense – Equip.	9,000	
	Acc. Dep'n – Equip.		9,000

*To record depreciation expense on equipment.*

### 8.3.2 Subsequent Capital Expenditures



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Each **major component** with a different estimated useful life from the rest of the asset must be recorded and depreciated separately. For instance, assume a commercial airliner is purchased for \$100 million (\$100M) on January 1, 2015 with the following components: airframe, engines, landing gear, interior, and other parts. The cost of each major component as well as its related accumulated depreciation should be recorded separately in the company's records. Yearly depreciation expense is also calculated separately for each component as shown in the last column below (straight-line depreciation is assumed; ½ year rule is ignored), but these expenses are usually combined into one amount when reported on the income statement (\$13.6M in this case).

(a)	(b)	(c)	(d)	(e)
<i>Component</i>	<i>Component cost</i>	<i>Residual value</i>	<i>Useful life (years)</i>	<i>Annual dep'n. expense [(b) – (c)]/(d)</i>
Airframe	\$60M	\$4M	20	\$2.8M
Engines	20M	2M	5	3.6M
Landing Gear	10M	-0-	2	5M
Interior	2M	-0-	10	.2M
Other	8M	-0-	4	2M
<b>Total</b>	<b>\$100M</b>			<b>\$13.6M</b>

Components that have the same estimated useful life, residual value, and depreciation method can be grouped together. In the above, example, engines are considered one major component, even though there may be several on the aircraft.

### 8.4 Impairment of Long-lived Assets



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LO5 – Explain, calculate, and record the impairment of long-lived assets.

Under generally accepted accounting principles, management must compare the **recoverable amount** of a depreciable asset with its carrying amount at the end of each reporting period. The recoverable amount is the estimated fair value of the asset at the time less any estimated costs to sell it. If the recoverable amount is lower than the carrying amount, an **impairment loss** must be recorded.

An impairment loss may occur for a variety of reasons: technological obsolescence, an economic downturn, or a physical disaster, for example. When an impairment is recorded, subsequent years' depreciation expense must also be revised.

Recall again our \$20,000 equipment purchased January 1, 2015 with an estimated useful life of five years and a residual value of \$2,000. Assume straight-line depreciation has been recorded for 2015 amounting to \$1,800. At December 31, 2016 and before 2016 depreciation is calculated, the carrying amount of the equipment is \$18,200 (\$20,000 – 1,800). At that point management determines that new equipment with equivalent capabilities can be purchased for much less than the old equipment due to technological changes. As a result, the recoverable value of the original equipment at December 31, 2016 is estimated to be \$7,000, with no residual value. Because the recoverable amount is less than its carrying amount of \$18,200, an impairment loss of \$11,200 (\$18,200 – 7,000) is recorded in the accounting records as follows:

2016

Dec. 31	Impairment Loss	.	11,200	
	Acc. Dep'n – Equip.			11,200

*To record impairment loss on equipment.*

This reduces the carrying amount of the equipment to \$7,000 (\$20,000 – 1,800 – 11,200). Revised depreciation expense of \$2,333 per year would be recorded at the end of 2017, 2018, and 2019, calculated as follows, assuming no change to original useful life and residual value:

$$\begin{aligned} & \frac{\text{(Revised carrying amount – revised residual value)}}{\text{Remaining useful life}} \\ & = \frac{\$7,000 - 0}{3 \text{ years}} \\ & = \$2,333 \text{ per year (rounded)} \end{aligned}$$

## 8.5 Derecognition of Property, Plant, and Equipment



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LO6 – Account for the derecognition of PPE assets.

Property, plant, and equipment is **derecognized** when it is sold or when no future economic benefit is expected. The cost and any related accumulated depreciation are removed from the accounting records. To account for the disposal of a PPE asset, the following must occur:



1. If the disposal occurs part way through the accounting period, depreciation must be updated to the date of disposal by this type of adjusting entry:

Depreciation Expense	XXX	
Accumulated Depreciation.		XXX
<i>To adjust depreciation to date of disposal.</i>		

2. The disposal, including any resulting gain or loss, is recorded by this type of adjusting entry:

	Cash (or other assets received)	XXX	
	Accumulated Depreciation	XXX	
OR	[	Loss on Disposal	XXX
		Gain on Disposal	XXX
		PPE Asset (such as Equipment)	XXX
<i>To record disposal of asset.</i>			

A loss results when the carrying amount of the asset is greater than the proceeds received. A gain results when the carrying amount is less than proceeds received.

### 8.5.1 Sale or Retirement of PPE



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When a PPE asset is sold or has reached the end of its useful life, the asset's cost and accumulated depreciation must be removed from the records, after depreciation expense has been recorded up to the date of disposal.

Recall the calculation of straight-line depreciation for the equipment purchased for \$20,000 with an estimated useful life of five years and a residual value of \$2,000. Assume that the equipment is sold on November 30, 2019. First, depreciation would be calculated to the date of disposal. The  $\frac{1}{2}$  year rule applies, so the depreciation expense would be \$1,800 in 2019 ( $\$3,600 \times \frac{1}{2}$ ). After this entry is posted, the general ledger T-accounts at December 31, 2019 for Equipment and Accumulated Depreciation would show the following entries:

Equipment		Accumulated Depreciation - Equipment	
2015	20,000	2015	1,800*
		2016	3,600
		2017	3,600
		2018	3,600
		2019	1,800*
			14,600

\* ½ year rule applies

The carrying amount at this date is \$5,600 (\$20,000 cost – 14,400 accumulated depreciation). Three different situations are possible.

### Sale at carrying amount

Assume the equipment is sold for its carrying amount of \$5,600. No gain or loss on disposal would occur.

1.	Cost	\$ 20,000	The adjusting entry would be:		
	Accumulated depreciation	<u>(14,400)</u>	2019		
	Carrying amount	5,600	Nov. 30	Cash	5,600
	Proceeds of disposition	<u>(5,600)</u>		Accum. Dep'n – Equip.	14,400
	Gain on disposal	<u>\$ -0-</u>		Equipment	20,000

### Sale above carrying amount

Assume the equipment is sold for \$7,000. A gain of \$1,400 would occur.

2.	Cost	\$ 20,000	The adjusting entry would be:		
	Accumulated depreciation	<u>(14,400)</u>	2019		
	Carrying amount	5,600	Nov. 30	Cash	7,000
	Proceeds of disposition	<u>(7,000)</u>		Accum. Dep'n – Equip.	14,400
	Gain on disposal	<u>\$ (1,400)</u>		Gain on Disposal	1,400
				Equipment	20,000

### Sale below carrying amount

Assume the equipment is sold for \$500. A loss on disposal of \$5,100 would occur.

3.	Cost	\$ 20,000	The adjusting entry would be:		
	Accumulated depreciation	<u>(14,400)</u>	2019		
	Carrying amount	5,600	Nov. 30	Cash	500
	Proceeds of disposition	<u>(500)</u>		Accum. Dep'n – Equip.	14,400
	Loss on disposal	<u>\$ 5,100</u>		Loss on Disposal	5,100
				Equipment	20,000

In each of these cases, the cash proceeds must be recorded (by a debit) and the cost and accumulated depreciation must be removed from the accounts. A credit difference represents a gain on disposal while a debit difference represents a loss.

## 8.5.2 Disposal Involving Trade-In



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It is a common practice to exchange a used PPE asset for a new one. This is known as a **trade-in**. The value of the trade-in agreed by the purchaser and seller is called the **trade-in allowance**. This amount is applied to the purchase price of the new asset, and the purchaser pays the difference. For instance, if the cost of a new asset is \$10,000 and a trade-in allowance of \$6,000 is given for the old asset, the purchaser will pay \$4,000 (\$10,000 – 6,000).

Sometimes as an inducement to the purchaser, the trade-in allowance is higher than the fair value of the used asset on the open market. Regardless, the cost of the new asset must be recorded at its fair value, calculated as follows:

$$\text{Cost of new asset} = \text{Cash paid} + \text{Fair value of asset traded}$$

If there is a difference between the fair value of the old asset and its carrying value, a gain or loss results. For example, assume again that equipment was purchased for \$20,000 on January 1, 2015. At that time, it had a residual value of \$2,000 and a useful life of five years. It is traded on November 30, 2019 for new equipment with a list price of \$25,000. A trade-in allowance of \$2,500 is given on the old equipment, so cash paid is \$22,500 (\$25,000 – 2,500). At the time, the old asset has a fair value of only \$1,800. In this case, the cost of the new asset is calculated as follows:

$$\begin{aligned} \text{Cost of new asset} &= \text{Cash paid} + \text{Fair value of asset traded} \\ &= \$22,500 + 1,800 \\ &= \$24,300 \end{aligned}$$

There will be a loss on disposal of \$200 on the old equipment, calculated as follows:

Cost	\$ 20,000
Accumulated dep'n	<u>(14,400)</u>
Carrying amount	5,600
Fair value	<u>(1,800)</u>
Loss on disposal	<u>\$ 3,800</u>

The journal entry on November 30, 2019 to record the purchase of the new equipment and trade-in of the old equipment is:

2019

Nov. 30	Equipment (new)	24,300	
	Acc. Dep'n –Equip (old)	14,400	
	Loss on Disposal	3,800	
	Equipment (old)		20,000
	Cash		22,500
	<i>To record purchase of new equipment and trade-in of old equipment</i>		

By this entry, the cost of the new equipment (\$24,300) is entered into the accounts, the accumulated depreciation and cost of the old equipment is removed from the accounts, and the amount of cash paid is recorded. The debit difference of \$3,800 represents the loss on disposal of the old equipment.

## 8.6 Intangible Assets



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LO7 – Explain and record the acquisition and amortization of intangible assets.

Another major category of long-lived assets is **intangible assets**. These arise from legal rights. They do not have physical substance. The characteristics of various types of intangible assets are discussed below.

### 8.6.1 Patents



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A **patent** grants a company an exclusive legal privilege to produce and sell a product or use a process for a specified period. This period varies depending on the nature of the product or process patented, and on the legislation in effect. Modifications to the original product or process can result in a new patent being granted, in effect extending the life of the original patent.

Patents are recorded at cost. If purchased from an inventor, the patent's cost is easily identified. If developed internally, the patent's capitalized costs include all

expenditures incurred in the development of the product or process, including salaries and benefits of staff involved.

## 8.6.2 Copyrights



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A **copyright** confers on the holder an exclusive legal privilege to publish a literary or artistic work. In this case, the state grants control over a published or artistic work for the life of the copyright holder (usually the original artist) and for a specified period afterward. This control extends to the reproduction, sale, or other use of the copyrighted material.

## 8.6.3 Trademarks



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A **trademark** is a symbol or a word used by a company to identify itself or one of its products in the marketplace. Symbols are often logos printed on company stationery or displayed at company offices, on vehicles, or in advertizing. A well-known example is Coke®. The right to use a trademark can be protected by registering it with the appropriate government agency. The symbol '®' denotes that a trademark is registered. Its use by others is thereby restricted.

## 8.6.4 Franchises



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A **franchise** is a legal right granted by one company (the franchisor) to another company (the franchisee) to sell particular products or to provide certain services in a given region using a specific trademark or trade name. In return, the franchisee pays a fee to the franchisor. McDonald's® is an example of a franchised fast-food chain.

In addition to the payment of an initial franchise fee, which is capitalized, a franchise agreement usually requires annual payments. These payments are considered operating expenses.

## 8.6.5 Computer Software



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Computer software programs may be developed by a company, patented, and then sold to customers for use on their computers. Productivity software like Microsoft Office® is an example. The cost of acquiring and developing computer software programs is recorded as an intangible asset, even if it is stored on a physical device like a computer. However, computer software that is integral to machinery—for



instance, software that is necessary to control a piece of production equipment—is included as the cost of the equipment and classified as PPE.

## 8.6.6 Capitalization of Intangible Assets



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Normally, intangible assets are measured at cost at the time of acquisition and are reported in the asset section of a company's balance sheet under the heading "Intangible Assets." The cost of an acquired intangible asset includes its purchase price and any expenditures needed to directly prepare it for its intended use. Only rarely are subsequent expenditures added to the initial cost of a purchased intangible asset. Instead, these are expensed as they are incurred.

## 8.6.7 Amortization of Intangible Assets



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Plant and equipment assets are depreciated. Intangible assets are also depreciated but the term used is *amortization* instead of depreciation. **Amortization** is the systematic process of allocating the cost of intangible assets over their estimated useful lives. The straight-line method is usually used.

Like PPE, useful life and residual value of intangible assets are estimated by management and must be reviewed annually for reasonableness. As well, any effects on amortization expense because of changes in estimates are accounted for prospectively. That is, prior accounting periods' expenses are not changed.

To demonstrate the accounting for intangibles, assume a patent is purchased for \$20,000 on April 1, 2015. The entry to record the purchase is:

2015			
Apr. 1	Patent	20,000	
	Cash		20,000

*To record the purchase of a patent as an intangible asset.*

Assuming the patent will last 40 years with no residual value and the ½ year rule applies, amortization expense will be recorded at the December 31, 2015 year-end as:

2015			
Dec. 31	Amortization Expense	250	
	Patent		250

*To record patent amortization: ( $\$20,000/40$  yrs. =  $\$500 \times \frac{1}{2}$  =  $\$250$ ).*

Notice that the Patent general ledger account is credited and not Accumulated Amortization. There is no accumulated amortization account maintained for intangible assets.

In other respects, impairment losses, and gains and losses on disposal of intangible assets are calculated and recorded in the same manner as for property, plant, and equipment.

## 8.7 Goodwill



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LO8 – Explain goodwill and identify where on the balance sheet it is reported.

Assume that Big Dog Carworks Corp. purchases another company for \$10 million (\$10M). BDCC takes over all operations, including management and staff. There are no liabilities. The fair values of the purchased assets consist of the following:

Patents	\$2M
Machinery	<u>\$7M</u>
Total	<u>\$9M</u>

Why would BDCC pay \$10M for assets with a fair value of only \$9M? The extra \$1M represents *goodwill*. **Goodwill** is the excess paid over the fair value of the net assets when one company buys another. It is an estimate of the ability of the company to generate superior earnings in the future compared to other companies in the same industry.

Goodwill is the combination of the acquired company's assets which cannot be separately identified—such as a well-trained workforce, better retail locations, superior products, or excellent senior managers—the value of which is recognized only when a significant portion of the business is purchased by another company.

Recall that among other characteristics, intangible assets must be separately identifiable. Because components of goodwill are not separately identifiable, goodwill is not considered an intangible asset. However, it does have future value and therefore is recorded as a long-lived asset under its own heading of “Goodwill” on the balance sheet.

### 8.7.1 Disclosure



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LO9 – Describe the disclosure requirements for long-lived assets in the notes to the financial statements.



When long-lived assets are presented on the balance sheet, the notes to the financial statements need to disclose the following:

- details of each class of assets (e.g., land; equipment including separate parts; patents; goodwill)
- measurement basis (usually historical cost)
- type of depreciation and amortization methods used, including estimated useful lives
- cost and accumulated depreciation at the beginning and end of the period, including additions, disposals, and impairment losses
- whether the assets are constructed by the company for its own use (if PPE) or internally developed (if intangible assets).

Examples of appropriate disclosure of long-lived assets were shown in notes 3(d) and 4 of BDCC's financial statements in Chapter 4.

## 8.8 Summary of Chapter 8 Learning Objectives



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### **LO1 – Describe how the cost of property, plant, and equipment (PPE) is determined, and calculate PPE.**

Property, plant, and equipment (PPE) are tangible, long-lived assets that are acquired for the purpose of generating revenue either directly or indirectly. A capital expenditure is debited to a PPE asset account because it results in the acquisition of a non-current asset and includes any additional costs involved in preparing the asset for its intended use at or after initial acquisition. A revenue expenditure does not have a future benefit beyond one year so is expensed. The details regarding a PPE asset are maintained in a PPE subsidiary ledger.

### **LO2 – Explain, calculate, and record depreciation using the units-of-production, straight-line, and double-declining balance methods.**

Depreciation allocates the cost of a PPE asset (except land) over the accounting periods expected to receive benefits from its use. A PPE asset's cost, residual value, and useful life or productive output are used to calculate depreciation. There are different depreciation methods. Units-of-production is a usage-based method. Straight-line and double-declining balance are time-based methods. The formulas for calculating yearly depreciation expense using these methods are:

Units of production:

$$\frac{\text{(Cost – residual value)}}{\text{Estimated total output}} \times \text{units of actual output for year}$$

Straight-line:

$$\frac{(\text{Cost} - \text{residual value})}{\text{Useful life}}$$

Double-declining balance:

$$\text{Carrying amount} \times \left[ \frac{100\%}{\text{Useful life}} \times 2 \right]$$

Under DDB, depreciation expense in subsequent years is calculated based on the prior year's carrying amount.

Under all methods, carrying amount cannot be less than residual value.

**LO3 – Explain, calculate, and record depreciation for partial years.**

When assets are acquired or derecognized partway through the accounting period, partial period depreciation is recorded. There are several ways to account for partial period depreciation. The half-year rule assumes six months of depreciation in the year of acquisition and year of derecognition regardless of the actual date these occur.

**LO4 – Explain, calculate, and record revised depreciation for subsequent capital expenditures.**

When there is a change that impacts depreciation (such as a change in the estimated useful life or estimated residual value, or a subsequent capital expenditure) revised depreciation is applied prospectively –that is, prior accounting periods' expenses are not changed. The calculation is:

$$\frac{(\text{Remaining carrying amount} - \text{revised residual value})}{\text{Revised useful life}}$$

**LO5 – Explain, calculate, and record the impairment of long-lived assets.**

The recoverable amount of a long-lived asset must be compared with its carrying amount at the end of each reporting period. The recoverable amount is the fair value of the asset at the time less any estimated costs to sell it. If the recoverable amount is lower than the carrying amount, an impairment loss is recorded as:

Impairment Loss	.	XXX	
Equipment...	.		XXX
<i>To record impairment loss.</i>			

**LO6 – Account for the derecognition of PPE assets.**

Property, plant, and equipment is derecognized when it is sold or when no future economic benefit is expected. To account for the disposal of a PPE asset, the following must occur:

1. If the disposal occurs part way through the accounting period, depreciation must be updated to the date of disposal by this type of adjusting entry:

Depreciation Expense .....	XXX	
Accumulated Depreciation.		XXX
<i>To adjust depreciation to date of disposal.</i>		

2. The disposal, including any resulting gain or loss, is recorded by this type of adjusting entry:

	Cash (or other assets received)	XXX	
	Accumulated Depreciation	XXX	
OR {	Loss on Disposal	XXX	
	Gain on Disposal		XXX
	PPE Asset (such as Equipment)		XXX

A loss results when the carrying amount of the asset is greater than the proceeds received, if any. A gain results when the carrying amount is less than any proceeds received.

It is a common practice to exchange a used PPE asset for a new one, known as a trade-in. The value of the trade-in is called the trade-in allowance and is applied to the purchase price of the new asset so that the purchaser pays the difference. Sometimes the trade-in allowance is higher than the fair value of the used asset. The cost of the new asset must be recorded at its fair value, calculated as:

$$\text{Cost of new asset} = \text{Cash paid} + \text{Fair value of asset traded}$$

If there is a difference between the fair value of the old asset and its carrying value, a gain or loss results.

#### **LO7 - Explain and record the acquisition and amortization of intangible assets.**

Intangible assets are long-lived assets that arise from legal rights and do not have physical substance. Examples include patents, copyrights, trademarks, and franchises. Intangibles are amortized using the straight-line method. The entry to record amortization is a debit to amortization expense and a credit to the intangible asset—there is no accumulated amortization account.

#### **LO8 - Explain goodwill and identify where on the balance sheet it is reported.**

Goodwill is a long-lived asset that does not have physical substance but it is *not* an intangible. When one company buys another company, goodwill is the excess paid over the fair value of the net assets purchased and represents the ability to generate superior future earnings compared to other companies in the same industry. Goodwill

appears in the asset section of the balance sheet under its own heading of "Goodwill." It is not amortized.

### **LO9 – Describe the disclosure requirements for long-lived assets in the notes to the financial statements.**

When long-lived assets are presented on the balance sheet, the notes to the financial statements need to disclose the following:

- details of each class of assets (e.g., land; equipment including separate parts; patents; goodwill)
- measurement basis (usually historical cost)
- type of depreciation and amortization methods used, including estimated useful lives
- cost and accumulated depreciation at the beginning and end of the period, including additions, disposals, and impairment losses
- whether the assets are constructed by the company for its own use (if PPE) or internally developed (if intangible assets).

## **8.9 Assignment Materials**

### **8.9.1 Concept Self-check**



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1. The cost of a long-lived asset is said to be capitalized. What does this mean?
2. How does a capital expenditure differ from a revenue expenditure?
3. Assume that you have purchased a computer for business use; illustrate, using examples, capital and revenue expenditures associated with its purchase.
4. A company purchases land and buildings for a lump sum. What does this mean? What is the acceptable manner of accounting for a lump sum purchase?
5. How does the concept of materiality affect the recording of an expenditure as a capital or revenue item?
6. List the three criteria used to determine whether a replacement part for equipment is considered a capital or revenue expenditure.
7. When one long-lived asset is exchanged for another, how is the cost of the newly-acquired asset determined?
8. What is depreciation?
9. Long-lived assets can be considered future benefits to be used over a period of years. The value of these benefits in the first years may not be the same as in later years. Using a car as an example, indicate whether you agree or disagree.
10. Assume that you have recently purchased a new sports car. Is a usage or a time-based method preferable for recording depreciation? Why?
11. What is the effect on the carrying amount of an asset over its useful life when it is depreciated using the declining balance method? the straight-line method?
12. What is the double-declining balance rate of depreciation for an asset that is expected to have a ten-year useful life?
13. How is partial-year depreciation expense calculated?

14. What changes in estimates affect calculation of depreciation expense using the straight-line method? Explain the appropriate accounting treatment when there is a revision of an estimate that affects the calculation of depreciation expense.
15. Explain the effect on the calculation of depreciation expense for capital expenditures made subsequent to the initial purchase of property, plant, or equipment.
16. Explain the process for determining whether the value of a longlived asset has been impaired, and the required adjustments to the accounting records.
17. Your friend is concerned that the calculation of depreciation and amortization relies too much on the use of estimates. Your friend believes that accounting should be precise. Do you agree that the use of estimates makes accounting imprecise? Why or why not?
18. Why are the significant parts of property, plant, and equipment recorded separately?
19. When does the derecognition of PPE not result in a gain or loss on disposal?
20. What is a trade-in? Explain whether a trade-in is the same as the sale of an asset.
21. Why might a trade-in allowance, particularly in the case of a car, be unrealistic? Why would a dealer give more trade-in allowance on a used car than it is worth?
22. How is the cost of a new capital asset calculated when a trade-in is involved?
23. How are intangible assets different from property, plant, and equipment? the same?
24. What is a patent? Assume a patent's legal life is twenty years. Does a patent's useful life correspond to its legal life? Why or why not? Support your answer with an example.
25. How does a copyright differ from a trademark? Give an example of each.
26. How are intangible assets valued, and what are their financial statement disclosure requirements?
27. What is goodwill? How does it differ from an intangible asset? Why is a company's internally-generated goodwill not recorded in its accounting records?

## 8.9.2 Comprehension Problems

### 8.9.2.1 CP 8-1



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Accountants distinguish between capital and revenue expenditures for some types of transactions. The entries for such transactions can be made to any one of the following accounts:

#### *Balance sheet accounts*

- a. Land
- b. Buildings

- c. Equipment
- d. Trucks
- e. Automobiles
- f. Accumulated depreciation

*Income statement accounts*

- g. A revenue account
- h. An expense account.

*Required:* For each transaction below, indicate the account to be adjusted. Explain your answers and state any assumptions you make.

*Example:*

- Architect fees to design building
- Battery purchased for truck
- Cash discount received on payment for equipment
- Commission paid to real estate agent to purchase land
- Cost of equipment test runs
- Cost to remodel building
- Cost to replace manual elevator with automatic elevator
- Cost of sewage system
- Equipment assembly expenditure
- Expenditures for debugging equipment
- Installation of air-conditioner in automobile
- Insurance paid during construction of building
- Legal fees associated with court case to defend title to land purchased
- Oil change for truck
- Payment for landscaping
- Proceeds received on demolition of derelict building on land purchased
- Expenditures for removal of derelict structures

- \_\_\_ Repair made to building after moving in
- \_\_\_ Repair of collision damage to truck
- \_\_\_ Repair of torn seats in automobile
- \_\_\_ Replacement of rusted fender on automobile
- \_\_\_ Replacement of transmission in automobile
- \_\_\_ Special floor foundations for installation of equipment
- \_\_\_ Tires purchased for truck
- \_\_\_ Transportation expenditures to bring equipment to plant.

### 8.9.2.2 CP 8-2



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Ekman Corporation purchased a new laser printer to be used in its business. The printer had a list price of \$4,000, but Ekman was able to purchase it for \$3,250. The company expects it to have a useful life of five years, with an estimated residual value of \$250. Ekman is paying the delivery costs of \$100, set-up and debugging costs of \$300, and the costs of purchasing an appropriate table for \$50. There was sales tax of 10 per cent on the purchase price of the printer but not on the other costs.

*Required:*

1. Calculate the total cost of the laser printer.
2. Ekman management asks you whether the straight-line or double-declining balance method of depreciation would be most appropriate for the printer. Provide calculations to support your answer. Assume the company uses the  $\frac{1}{2}$  year rule to calculate depreciation expense in the year of acquisition and disposal.

### 8.9.2.3 CP 8-3



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Freeman Inc. purchased a piece of agricultural land several years ago for \$125,000. The land has a fair value of \$200,000 now. The company plans to exchange this land for equipment owned by a land developer that has a fair value of \$240,000. The equipment was originally purchased for \$325,000, and \$80,000 of depreciation has been recorded to the date of the sale on April 30, 2016.

*Required:*

1. Assume each party values the acquired asset based on the fair value of the asset given up. Prepare the journal entry on the books of
  - a. Freeman
  - b. the developer.



- Why would the developer give up an asset with a fair value of \$240,000 in exchange for an asset with a fair value of only \$200,000?

#### 8.9.2.4 CP 8-4



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Mayr Inc. purchased a machine for its factory on June 6, 2016 for \$110,000. The machine is expected to have an estimated useful life of ten years with a residual value of \$10,000. Assume the company uses the ½ year rule to calculate depreciation expense in the year of acquisition and disposal.

*Required:* Compute the depreciation for 2016 and 2017 using

- The straight-line method
- The double-declining balance method.

#### 8.9.2.5 CP 8-5



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Penny Corp. purchased a new car on March 1, 2016 for \$25,000. The estimated useful life of the car was five years or 500,000 kms. Estimated residual value was \$5,000. The car was driven 120,000 kms. in 2016 and 150,000 kms. in 2017.

*Required:* Calculate the depreciation for 2016 and 2017 using

- The straight-line method
- Usage method (kms.)
- Double-declining balance method.

Assume where applicable that the company uses the ½ year rule to calculate depreciation expense in the year of acquisition and disposal.

#### 8.9.2.6 CP 8-6



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Global Flow Inc. purchased a computer on January 1, 2016 for \$3,000 cash. It had an estimated useful life of three years and no residual value. Global Flow made the following changes to the computer:

Mar. 1, 2016	Added storage capacity at a cost of \$1,000. This had no effect on residual value or estimated useful life.
Apr. 1, 2017	Added a new processing board for \$2,000, which extended the estimated useful life of

the computer another three years but did not affect residual value.

*Required:*

1. Prepare a journal entry to record each of the above expenditures. Assume all amounts are material. Descriptions are not necessary.
2. Calculate and prepare journal entries to record depreciation expense for 2016 and 2017 using the double-declining balance method. Assume a December 31 fiscal year-end and that the company uses the  $\frac{1}{2}$  year rule to calculate depreciation expense in the year of acquisition and disposal.

### 8.9.2.7 CP 8-7



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Refer to the information in CP 8-4. At December 31, 2018, Mayr revised its estimate of the machine's useful life to four years.

*Required:* Calculate the depreciation for 2018 using

1. The straight-line method
2. The double-declining balance method.

### 8.9.2.8 CP 8-8



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Refer to the information in CP 8-4 and 8-7. Assume Mayr disposed of the machine on May 31, 2019.

*Required:* Using the straight-line method of depreciation, record the disposal assuming

1. The equipment was sold for \$60,000
2. The equipment was sold for \$85,000
3. The equipment was sold for \$71,250.

Show all calculations.

### 8.9.2.9 CP 8-9



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Refer to the information in CP 8-4 and 8-7. Assume that on May 31, 2019 Mayr traded in the machine on an improved model with a listed selling price of \$150,000. The company received a trade-in allowance of \$100,000 on the old machine. The fair value of the old machine was \$95,000.

*Required:* Prepare the journal entry to record the trade-in on the equipment. Assume the straight-line method of depreciation is used.

### 8.9.2.10 CP 8-10



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Murphy Limited purchased a \$30,000 asset with a five-year life expectancy and no residual value. Two alternative methods of calculating depreciation expense are presented below.

	<i>Method A</i>	<i>Method B</i>
<i>Year</i>		
1	\$3,000	\$6,000
2	6,000	9,600
3	?	?

*Required:*

1. Identify the method of depreciation and compute the depreciation expense for the third year under each method.
2. The chief financial officer of Murphy considers depreciation to be nothing more than an arbitrary calculation, based on unreliable estimates. She proposes to use method B for years 1 and 2 and method A for years 3, 4, and 5. In this way, she can deduct the maximum depreciation each year over the life of the asset. Is her proposal acceptable? Why or why not?
3. What factors should be considered in choosing a method of depreciation?

### 8.9.2.11 CP 8-11



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The Savage Corporation purchased three milling machines on January 1, 2013 and immediately placed them in service. The following information relates to these purchases:

	<i>Machine1</i>	<i>Machine2</i>	<i>Machine3</i>
Cost	\$7,500	\$7,500	\$7,500

Residual value	-0-	1,200	300
Useful life	5 Years	6 Years	8 Years

The company uses the straight-line method of depreciation, and records  $\frac{1}{2}$  year depreciation in the years of acquisition and disposal. On January 1, 2018, machine 1 was sold for \$500. On the same day, management re-evaluated the estimated useful lives and the residual values of the remaining machines. They came to the conclusion that machine 2 had a remaining useful life of two years (that is, to December 31, 2019), while residual value remained unchanged. Machine 3 had a remaining useful life of five years (that is, to December 31, 2022) but now no residual value.

*Required:* Prepare journal entries

1. To record the sale of machine 1 on January 1, 2018.
2. To record the revised 2018 depreciation expense for machine 2.
3. To record the revised 2018 depreciation expense for machine 3.

### 8.9.2.12 CP 8-12



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The following Equipment and Accumulated Depreciation accounts appear in the general ledger of the Sadler Corporation at December 31, 2016.

#### GENERAL LEDGER

##### Equipment

Acct. No. 183

Date		Description	Folio	Debit	Credit		Balance
2014							
Aug.	1	Purchase	GJ7	15,000		DR	15,000

##### Accumulated Depreciation – Equipment

Acct. No. 193

Date		Description	Folio	Debit	Credit		Balance
2016							
		Balance forward				CR	2,250
Dec.	31	Depreciation 2016	GJ9		1,500	CR	3,750

The company uses the  $\frac{1}{2}$  year rule to calculate depreciation expense in the years of acquisition and disposal. At the time of purchase, the equipment had an estimated useful life of ten years with no residual value. The straight-line method of depreciation is used. On January 1, 2017, it was estimated that the equipment would last only four more years (to December 31, 2020).

*Required:*

1. Calculate the depreciation expense for 2017.

2. Prepare the journal entry to record 2017 depreciation expense.
3. Post the accumulated depreciation part of the entry in 2 above to the general ledger and calculate the new balance in the account.
4. How much should the depreciation amount have been in each year if the actual four-year useful life of the equipment had been known in 2016?
5. Given the substantial difference between the depreciation amounts in 2016 and 2017, is the information conveyed to the reader of Sadler Corporation's 2017 financial statements reasonable?

### 8.9.2.13 CP 8-13



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St. Laurent Limited purchased a truck for cash on January 1, 2016. The company's fiscal year-end is December 31. The company uses the  $\frac{1}{2}$  year rule to calculate depreciation in the year of acquisition and disposal. The following details apply:

<i>Cost</i>	<i>Useful life</i>	<i>Residual value</i>	<i>Depreciation method</i>
\$10,500	5 years	\$500	Double-declining balance

On March 1, 2017, the company paid \$3,500 for gas and oil, a tune-up, new tires, and a battery. It also paid \$4,000 to install a lift on the back of the truck. The latter amount is material.

*Required:*

1. Prepare journal entries to record
  1. the purchase of the truck
  2. depreciation for 2016
  3. the 2017 expenditures relating to the truck
  4. depreciation for 2017.
2. Prepare the journal entries to record the sale of the truck on March 3, 2018 for \$8,000 cash, including 2018 depreciation expense.

### 8.9.2.14 CP 8-14



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Brown Company paid \$900,000 cash to purchase the following tangible and intangible assets of Coffee Company on January 1, 2016:

Land	\$300,000
Building	200,000
Patents	100,000

Machinery	250,000
-----------	---------

The building is depreciated using the double-declining balance method, has an estimated useful life of ten years, and a residual value of \$10,000. The machinery has an estimated useful life of five years and a residual value of 10% of cost. Depreciation expense is calculated on the basis of productive output. The machinery's productive output was estimated to be 60,000 units. Actual production was as follows:

2016	10,000
2017	15,000
2018	20,000

The patents have an estimated useful life of twenty years and are amortized on a straight-line basis. They have no residual value. On December 31, 2017, the value of the patents was estimated to be \$80,000. The machinery was sold on December 2, 2018 for \$100,000. The company uses the ½ year rule to calculate depreciation and amortization expense in the years of acquisition and disposal. Its fiscal year-end is December 31.

*Required:* Prepare journal entries to record in the records of Brown:

1. The \$900,000 purchase
2. Depreciation and amortization expense for 2016
3. The decline in value of the patents at December 31, 2017
4. The sale of the machinery.

## 8.9.3 Problems

### 8.9.3.1 P 8-1



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Arrow Construction Company Ltd. purchased a farm from K. Jones. Arrow and Jones completed the transaction under the following terms: a cheque from Arrow to Jones for \$140,000; bank loan assumed by Arrow, \$100,000. Legal, accounting, and brokerage fees amounted to \$20,000. It was Arrow's intention to build homes on the property after sub-dividing. Crops on the farm were sold for \$6,000; a house was sold for \$1,600; barns were razed at a cost of \$6,000. Salvaged lumber was sold for \$4,400. The property was cleared and levelled at a cost of \$10,000. The necessary property was turned over to the township for roads, schools, churches, and playgrounds. Riverside still expected to secure a total of 500 identical lots from the remaining land.

*Required:* Prepare a schedule showing the cost to Arrow of the 500 lots.

### 8.9.3.2 P 8-2



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The following items relate to the acquisition of a new machine by the Bohn Group Inc. On the right-hand side are a number of possible accounting treatments; on the left-hand side are a number of independent accounting situations:

<i>Situation</i>	<i>Accounting treatment</i>
_____ Invoice price of new machine, net of cash discount offered	(1) Debit Machinery account
_____ Cash discount on the above, which has not yet been taken	(2) Debit an expense account for the current period
_____ Anticipated first year's savings in operating costs from use of new machine	(3) Debit an asset other than the machine and write-off the asset separately from the machine
_____ Two-year service contract on operations of new machine paid in full	(4) Credit Machinery account
_____ Cost of materials used while testing new machine	(5) None of the above; explain what account would be appropriate, if applicable.
_____ Cost of installing sound insulation in wall near machine so that nearby office employees will not be disturbed by it	
_____ Cost of removing machine that new machine replaces.	

*Required:* Indicate the appropriate accounting treatment for each situation. Record any assumptions that you think might be necessary for any given situation.



### 8.9.3.3 P 8-3



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Northland Shows Ltd. acquired a new amusement ride on July 1. The following details apply to the purchase:

Cost per supplier's invoice	\$20,000
(The invoice provided a 1% cash discount if paid within 30 days. It was paid on July 15.)	
Cash payment on July 4 to Dalton Construction Ltd. For cement base for new ride	4,000
Transportation paid on purchase, July 5	520
Insurance for operation of ride paid in cash on July 5 for three-year term, commencing July 6	90
Alterations to new ride paid in cash July 5 (25% of this will be reimbursed by the vendor)	900
Installation costs paid in cash July 6	188

*Required:*

1. Prepare journal entries to record the acquisition of Northland's new ride.
2. Calculate the carrying amount of the asset.

### 8.9.3.4 P 8-4



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Janz Corporation purchased a piece of machinery on January 1, 2015. The company's year-end is December 31. The following information is applicable:

<i>Cost</i>	<i>Useful life</i>	<i>Residual value</i>	<i>Depreciation method</i>
\$90,000	9,000 units	-0-	Usage

Output during 2016 and 2017 was 2,000 and 3,000 units, respectively.

*Required:*

1. Calculate the depreciation expense for 2016 and 2017.
2. What is the balance of accumulated depreciation at the end of 2017?
3. What is the carrying amount of the machinery shown on the balance sheet at the end of 2017?
4. Prepare a partial comparative balance sheet for Janz Corporation at the end of 2017.

### 8.9.3.5 P 8-5



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Livingston Corp. purchased printer on January 1, 2016. The company year-end is December 31. The following information is applicable:

<i>Cost</i>	<i>Estimated useful life</i>	<i>Residual value</i>	<i>Usage (units)</i>	
\$5,000	4 years	\$1,000	2016	10,000
			2017	15,000
			2018	20,000
			2019	5,000

*Required:*

Calculate the depreciation expense for the four-year period under each of these depreciation methods: straight-line, double-declining balance, and usage. Assume the company uses the  $\frac{1}{2}$  year rule to calculate depreciation expense in the year of acquisition and disposal where applicable. Present your solution in the following format:

1.	<i>Year</i>	<i>Depreciation expense</i>		
		<i>Straight-line</i>	<i>Double-declining balance</i>	<i>Usage</i>
	2016			
	2017			
	2018			
	2019			
	Total			

2. The president has asked you to describe one factor that might affect depreciation rate and residual value estimates, and how these changes to estimates will be accommodated should they occur. How would you respond?

3. Which method of depreciation would you recommend in this case? Why?

### 8.9.3.6 P 8-6



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Roberto Trucks Inc. purchased a delivery van on January 1, 2016. Assume this was the company's only capital asset and that the company uses the  $\frac{1}{2}$  year rule in the year of acquisition and disposal for straight-line and double-declining balance depreciation methods. The following information is available.

<u>Cost</u>	<u>Estimated useful life</u>	<u>Residual value</u>
\$11,000	4 years or 75,000 kms.	\$2,000

The truck was driven 20,000 km in 2016.

*Required:*

- Calculate the depreciation for 2016 under each of the following methods:
  - Usage
  - Straight-line
  - Double-declining balance
- Compare the depreciation expense and carrying amount for 2016 under each of these methods.
- If one of management's objectives is to maximize 2016 net income, what method should be adopted?

### 8.9.3.7 P 8-7



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Wynne Ltd. purchased a machine on January 1, 2016 for \$23,000. Transportation charges paid by Wynne amounted to \$600 and another \$1,400 cost was incurred for installation. Useful life is three years. The residual value of the machine is \$1,000.

*Required:*

- Calculate the amount of the machine on which depreciation will be calculated (that is, the depreciable amount not the carrying amount).
- In journal entry form, record the depreciation for each year of the expected useful life of the machine under
  - straight-line method

b. double-declining balance method

Assume that the  $\frac{1}{2}$  year rule is not used in the years of acquisition and disposal.

3. On January 1, 2017, Wynne changed the estimated useful life on the machine from a total of three years to a total of five years from the date of purchase. Residual value remains at \$1,000. Calculate the depreciation that should be recorded in 2017 and each year thereafter assuming the company used the straight-line method.

### 8.9.3.8 P 8-8



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On January 1, 2011, Young Inc. purchased a machine for \$30,000. Its engineers had estimated useful life for the machine at twenty years. The residual value was estimated to be 10 per cent of the original cost. Seven years later, on January 1, 2018, experts were hired to review the expected useful life and residual value of the machine. Here are the findings:

Estimated useful life as of January 1, 2018	8 years
New residual value	\$6,000

Depreciation has not yet been recorded in 2018. Assume that the straight-line method of depreciation is used and the company uses the  $\frac{1}{2}$  year rule in the years of acquisition and disposal.

*Required:*

1. Calculate the carrying amount of the machine at December 31, 2017.
2. Calculate the cost of the machine that remains to be depreciated at January 1, 2018 based on the new estimates.
3. Calculate the amount of depreciation expense to be recorded at December 31, 2018, and prepare the necessary journal entry.
4. Record the journal entries if the machine is sold on March 31, 2019 for \$22,000.

### 8.9.3.9 P 8-9



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## Part A

Davies Fabricating Inc. started business on May 1, 2016. The year-end of the company is December 31. On May 5, 2016, the company purchased equipment for \$130,000 cash. The equipment had an estimated useful life of four years, an estimated total production output of 100,000 units, and a residual value of \$10,000. The equipment was depreciated using the units-of-production (usage) method. Actual units of output over three years were: 2016— 12,000; 2017—30,000; and 2018—20,000.

On January 1, 2019, the company traded in the original equipment for new equipment. The company paid an additional \$140,000 cash for the new equipment. The company had used the units-of-output (usage) method to calculate depreciation on the old manufacturing equipment. The fair value of the original equipment was \$60,000 at the date of the trade.

*Required:* Prepare journal entries to record the transactions on the following dates:

1. May 1, 2016
2. January 1, 2019

### Part B

On January 1, 2017, Davies Fabricating Inc. was able to buy a nearby warehouse for the storage of its finished product. The cost included land, \$50,000 and building, \$300,000. The company signed a ten-year bank loan for \$320,000 and paid the balance in cash. The building had an estimated useful life of fifty years with no residual value. On June 28, 2021, the warehouse was totally destroyed by fire. On July 31, the company was notified that it would receive \$270,000 from the insurance company as settlement in full for the building at a later date. The building was depreciated on the straight-line basis. Assume the company uses the ½ year rule to calculate depreciation expense in the year of acquisition and disposal.

*Required:* Prepare journal entries to record the transactions on the following dates:

1. January 1, 2017
2. June 28, 2021.

### 8.9.3.10 P 8-10



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Robbins Inc. purchased the following assets of Marine Company for \$500,000 cash on September 30, 2016:

Land	\$300,000
Building	100,000
Computer software	75,000

The building will be depreciated using the straight-line method. It has an estimated useful life of forty years and a residual value of 10% of cost.

The computer software has an estimated useful life of three years and no residual value. It will be amortized using the double-declining balance method. On January 2, 2017, the value of the computer software was estimated at \$50,000. The computer software was sold on September 15, 2018 for \$65,000.

Robbins Inc. uses the  $\frac{1}{2}$  year rule to calculate depreciation and amortization expense in the year of acquisition and disposal. Its fiscal year-end is December 31.

*Required:*

1. Prepare journal entries to record
  1. the \$500,000 purchase
  2. depreciation and amortization expense for 2016
  3. the change in the value of the computer software at January 2, 2017
  4. the sale of the computer software on September 15, 2018.
2. Calculate the carrying amounts of the assets at December 31, 2018.

## 8.9.4 Alternate Problems

### 8.9.4.1 AP 8-1



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McPherson Ltd. commenced construction of a new plant on July 1, 2015. All construction activities were completed by March 31, 2017, after which time the plant went into operation. Total cost incurred during the construction period included

	(000s)
<i>Cost of land</i> (includes the cost of an old building on it)	<u>\$ 55</u>
<i>Engineering fees:</i>	
Analysis of sub-soil	\$ 8
Construction supervision	50
Analysis of the electrical system design	30
Planning of a new production process (required in order to use new equipment that will be installed in the new building)	<u>45</u>
	<u>\$ 133</u>
<i>Subcontractor's charges:</i>	
Demolition of the old building	\$ 3
Wages and material for building (excluding landscaping)	531
Landscaping	<u>4</u>
	<u>\$ 538</u>
<i>Charges included in the company's operating accounts:</i>	
Wages of employees on construction site	\$ 460
Construction materials	1,267
Property taxes payable in advance for the fiscal year commencing July 1, 2016	<u>18</u>
	<u>\$1,745</u>

*Required:* As comptroller of McPherson Ltd., determine which of the above costs should properly be included in the cost of the new plant accounts. Briefly explain why you would include or exclude each cost item.

### 8.9.4.2 AP 8-2



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Rhodes Corp. operates a plant in a building adjacent to its office building. The plant building is old and requires continuous maintenance and repairs. During the year, the following cash expenditures relating to the plant building were incurred:

- a. Continuing, frequent, and low-cost repairs \$26,000



b.	Overhaul of the plumbing system (old costs unknown)	17,000
c.	Construction of a new storage shed attached to the plant building (estimated useful life, ten years)	48,000
d.	Replacement of old shingle roof with a new tile roof (cost of the old shingle roof was \$30,000; accumulated depreciation was \$5,000)	60,000
e.	Inspection of heating furnaces (prior inspection costs totalled \$4,000; 1/2 of these amounts had been depreciated)	10,000

*Required:* Prepare journal entries to record each of items *a* to *e*. Assume all listed costs are material in amount.

### 8.9.4.3 AP 8-3



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Sheren Limited purchased the following equipment on January 1, 2016.

<u>Cost</u>	<u>Estimated useful life</u>	<u>Residual value</u>
\$6,000	5 years	\$300

*Required:*

- Calculate the total depreciation for the five-year period 2016-2020, under the straight-line and double-declining balance methods. Assume the company uses the 1/2 year rule to calculate depreciation expense in the year of acquisition and disposal.
- List the advantages of
  - The straight-line method of depreciation
  - The double-declining balance method.

### 8.9.4.4 AP 8-4



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Stahn Inc., an oil production company, purchased a machine on April 1, 2016. The following information applies:

<i>Cost</i>	<i>Estimated useful life</i>	<i>Residual value</i>
\$40,000	3 years (100,000 tonnes)	\$4,000

The machine has an estimated useful life in production output of 100,000 tonnes. Actual output was: 2016 — 40,000 tonnes; 2017 — 20,000 tonnes; 2018 — 10,000 tonnes. The year-end of the company is December 31. Assume the company uses the  $\frac{1}{2}$  year rule to calculate depreciation expense in the year of acquisition and disposal.

*Required:*

1. Calculate the depreciation expense and the carrying amount at year-end for the three-year period under each of these depreciation methods: straight-line, double-declining balance, and usage.
2. Assume depreciation has been recorded based on machine usage as calculated above. The machine is obsolete at the end of three years and must be sold, even though the president believes that it could have been used to process an additional 30,000 tonnes of output. He thinks that too little depreciation expense has been charged against income during the three years and that the company has therefore issued inaccurate financial statements. Do you agree? Why or why not?

#### 8.9.4.5 AP 8-5



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Spellman Inc. purchased its first piece of equipment on January 1, 2016. The following information pertains to this machine:

<i>Cost</i>	<i>Estimated useful life</i>	<i>Residual value</i>
\$11,000	5 years	\$1,000

As the chief accountant for the company, you need to choose the depreciation method to be used.

*Required:*

1. Calculate the straight-line and double-declining balance method depreciation for 2016, 2017, and 2018. Assume the  $\frac{1}{2}$  year rule does not apply to any of these years.
2. Using the format provided, complete comparative partial income statements and balance sheets at December 31 for both the straight-line and declining balance methods of depreciation.

<i>Partial income statement</i>	2016	2017	2018
Income before depreciation and income taxes	\$30,000	\$25,000	\$35,000
Depreciation expense	?	?	?
Income before income taxes	<u>\$ ?</u>	<u>\$ ?</u>	<u>\$ ?</u>
<i>Partial balance sheet</i>			
Equipment	\$ ?	\$ ?	\$ ?
Less: Accumulated depreciation	?	?	?
Carrying amount	<u>\$ ?</u>	<u>\$ ?</u>	<u>\$ ?</u>

3. Which depreciation method should be used to maximize income before income taxes? to maximize the equipment's carrying amount at December 31, 2018? Explain.

### 8.9.4.6 AP 8-6



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Fox Creek Machining Ltd. purchased a cutting machine at the beginning of 2016 for \$46,000. Fox Creek paid additional charges of \$1,200 and \$2,800 for freight and installation, respectively. It paid \$1,000 to have the building in which the machine was housed suitably altered. Residual value was \$2,000. The company uses the ½ year rule for calculating depreciation expense in the year of acquisition and disposal.

*Required:*

- Calculate the capitalized cost of the machine.
- Record the adjusting entry for depreciation expense that would be calculated for 2016, 2017, and 2018 using
  - straight-line method (with a useful life of three years)
  - double-declining balance method.
- On January 1, 2017 Fox Creek revised the estimated useful life of the machine from a total of three years to a total of five years. Residual value remained at \$2,000. Calculate the depreciation that should be recorded in 2017, 2018, 2019 and 2020 using the straight-line method of depreciation.

### 8.9.4.7 AP 8-7



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On January 1, 2016, Kencor Trucking Ltd. purchased for \$12,000 cash a new truck from a local dealer. Records indicated it should have a ten-year life span but no residual value. During the first week of January, 2020, the truck's engine was rebuilt for \$2,400. This is equal to the original engine's cost and is considered material. The new engine increased the residual value of the truck to \$1,000. The useful life remained unchanged. New tires were purchased for \$800. All expenditures were paid in cash.

On April 1, 2021, the truck was completely wrecked. Alpha Insurance Co. has indicated that it will settle the claim for \$4,000 in the near future.

Assume the company calculates depreciation expense based on kilometres driven. The estimated total usage was 800,000 kms., including 100,000 in 2021. Actual usage was as follows:

2016:	100,000
2017:	120,000
2018:	80,000
2019:	120,000
2020:	150,000
2021:	30,000

*Required:* Prepare journal entries to record the following entries. State any necessary assumptions.

1. Purchase of the truck.
2. 2019 depreciation expense.
3. 2020 engine rebuild and tire replacement.
4. 2020 depreciation expense.
5. 2021 depreciation expense, write-off of the truck, and receipt of the insurance proceeds.

#### 8.9.4.8 AP 8-8



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The following accounts appear in the general ledger of the Bruce Corp. at December 31, 2014.

## GENERAL LEDGER

## Machines

Acct. No. 183

Date 2014		Description	Folio	Debit	Credit		Balance
Feb.	1	Machine 1	GJ21	6,400		DR	6,400

## Accumulated Depreciation – Machines

Acct. No. 193

Date 2014		Description	Folio	Debit	Credit		Balance
Dec.	31	Depreciation 2014	GJ24		500	CR	500
2015							
Dec.	31	Depreciation 2015	GJ31		1,000	CR	1,500

Machine 1 was estimated to have a useful life of six years, with a residual value of \$400. On January 31, 2016 machine 1 was traded in for machine 2. The purchase price of machine 2 was \$8,000 and Bruce Corp. received a trade-in allowance of \$4,500.

Machine 2 is estimated to have a useful life of eight years, with a residual value of \$1,000. The fair value of machine 1 was \$4,000 at the date of the trade-in. Assume the company uses the  $\frac{1}{2}$  year rule to calculate depreciation expense in the year of acquisition and disposal.

*Required:*

1. Prepare a journal entry to record the trade-in of machine 1 for machine 2.
2. Post the appropriate parts of the entry prepared in 1 above to the general ledger accounts and calculate the new balance in each account.
3. The installation cost of machine 2 amounted to \$500 and was recorded in the Repairs and Maintenance Expense account when paid. Assume this amount is material. Prepare an adjusting entry at December 31, 2016.
4. Prepare the entry to record the depreciation expense for 2016. (Assume the adjusting entry required in 3 above has already been made.) Post the appropriate part of this entry to the Accumulated Depreciation account and calculate the new balance in that account.

### 8.9.4.9 AP 8-9



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Listed below are three long-lived assets:

- a. Trademarks
- b. Patents

## c. Goodwill.

*Required:* Explain the accounting treatment you would suggest for each including amortization method, with reasons. Explain how an impairment in value would be recorded.

### 8.9.4.10 AP 8-10



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Four machines were acquired by Gold Star Co. Ltd. during 2016 and 2017. Machine A was placed in use at the end of August 2016. Its cost was \$26,400, the estimated useful life eight years, and the residual value \$2,400. Depreciation was to be calculated on the straight-line basis. The company year-end is December 31. Machine A was valued at \$12,000 by management on December 31, 2018 prior to calculation and recording of depreciation expense. Estimated disposal costs were \$1,000. Residual value was zero. It was sold on March 31, 2019 for \$10,000.

Machine B was purchased on October 1, 2016. The cost was \$23,600, with a five-year life expectancy and a residual value of \$3,600. Depreciation was to be calculated on a units-of-production basis. Estimated production over the five years is 50,000 units. In 2016, 3,000 units were produced, 11,500 in 2017 and 12,000 during 2018. Machines C and D were purchased on April 15, 2017 and were in production by September 1 of that year.

The following additional information about machines C and D:

<i>Machine</i>	<i>Purchase price</i>	<i>Residual value</i>	<i>Estimated life</i>	<i>Installation cost</i>	<i>Depreciation method</i>
C	\$16,000	\$1,000	6 Years	\$ 500	Straight-line
D	20,000	1,600	10 Years	1,000	Double-declining balance

The company uses the  $\frac{1}{2}$  year rule to calculate depreciation expense in the year of acquisition and disposal as applicable. Assume installation costs are material and were paid on the date the machines were placed in service.

*Required:*

1. For each of the four machines, calculate depreciation expense for 2016 and 2017.
2. Prepare the 2018 and 2019 journal entries for machine A.

# Chapter 9 Debt Financing: Current and Non-current Liabilities



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A corporation often has liabilities – amounts owing to creditors. These liabilities must be classified on the balance sheet as current or noncurrent. Current liabilities can include known liabilities such as payroll liabilities, interest payable, and bank loans that must be paid in the near future, and estimated liabilities related to warranties, for instance. Non-current debt includes amounts owing to creditors that will be paid over many years, like some kinds of bank loans.

## Learning Objectives

LO1 – Identify and explain the difference between current and noncurrent liabilities.

LO2 – Record and disclose known current liabilities.

LO3 – Record and disclose estimated current liabilities.

LO4 – Explain, calculate, and record non-current debt.

## 9.1 Current versus Non-current Liabilities



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LO1 – Identify and explain the difference between current and non-current liabilities.

**Current** or *short-term liabilities* are a form of debt that is expected to be paid within the longer of one year of the balance sheet date or the next operating cycle, whichever is longer. Examples include accounts payable, salaries payable, unearned revenues, notes payable, and short-term bank loans.

**Non-current liabilities** are forms of debt expected to be paid beyond one year of the balance sheet date or the next operating cycle, whichever is longer. Long-term bank loans secured by real estate (mortgages) are examples of non-current liabilities.

As discussed in Chapter 4, current and non-current liabilities must be shown separately on the balance sheet. Doing so helps financial statement readers assess the **liquidity** of a corporation – its ability to satisfy current liabilities (generally with cash) as they come due.



## 9.2 Known Current Liabilities



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LO2 – Record and disclose known current liabilities.

**Known current liabilities** are those where the payee, amount, and timing of payment are known. Examples include accounts payable, unearned revenues, and payroll liabilities. These are different from **estimated current liabilities** where the amount is not known and must be estimated. These may arise when a supplier's invoice has not been received by the time the financial statements have been prepared, for instance. Estimated current liabilities are discussed later in this chapter.

### 9.2.1 Payroll Liabilities



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Short-term bank loans, accounts payable and unearned revenues were introduced in previous chapters. Payroll liabilities are amounts owing to various agencies on behalf of employees. These include items withheld from employees' pay cheques. Common withholdings are personal income taxes, employment insurance, pension and health insurance contributions, and union dues. These withheld amounts are remitted by the employer to agencies like the government, a private pension plan administrator, a union, or a health care provider, and usually within a few days of being deducted.

**Gross pay** is the amount of salaries or wages<sup>1</sup> to which employees are entitled before any deductions. **Net pay** is the actual cash payment that the employees receive at the end of a pay period after deductions are made.

In most countries, the employer is required by law to also contribute to certain government programs designed to aid workers. In Canada, for example, the employer generally must contribute 1.4 times as much to an employment insurance program as employees contribute, and contribute the same amount to a government pension plan that employees are required to contribute. The employer may also contribute to a private pension plan or private health insurance plan under the terms of a collective agreement, for instance.

Assume a company has two employees. Each employee is required to have the following amounts deducted from their gross pay each period:

Personal income taxes	15%
Employment insurance	2%

1. Salaries are fixed amounts paid to an employee on a regular basis (for example, monthly). Wages are calculated based on an hourly rate times the actual hours worked each day.

Government pension	5%
Union dues	1%
Company pension plan	3%

In addition, each employee contributes \$55 per pay period to a company health plan.

To demonstrate the journal entries to record a business's payroll liabilities for the period December 1-15, 2015, refer to the payroll records in [Figure 9.1](#) (Emp'ee = employee; Emp'er = employer). Assume that in addition to amounts that it withholds from employees' pay as shown in row 3, the company also must contribute 1.4 times as much as its employees to an employment insurance plan, must match government pension contributions, and must contribute one-half as much to the company pension plan as its employees. The company therefore incurs additional expenses as shown in row 4. These are calculated as follows:

Employment insurance (\$50.70 x 1.4)	\$70.98
Government pension plan (\$113.66 x 1.0)	\$113.66
Company pension plan (\$76.05 x 1/2)	\$38.03

Usually, companies do not have to contribute anything towards personal income taxes and union dues paid by their employees. Additionally in this example, the company does not contribute to the company health plan.

Row	Employee	Gross pay	Payroll Deductions						Total deduct.	Net pay
			Income taxes (15%)	Employ. insur. (2%)	Gov't pension (5%)	Comp. health plan	Union dues (1%)	Comp. pension (3%)		
1.	S. Smith	1,560.00	234.00	31.20	78.00	55.00	15.60	46.80	460.60	1,099.40
2.	J. Jones	975.00	146.25	19.50	48.75	55.00	9.75	29.25	308.50	666.50
3.	Emp'ee deductions		380.25	50.70	126.75	110.00	25.35	76.05	769.10	
4.	Emp'er contributions		-0-	70.98	126.75	-0-	-0-	38.03		
5.	Total remittances		380.25	121.68	253.50	110.00	25.35	114.08		

**Fig. 9.1: December 15-31, 2015 Payroll Record Example**

The journal entry to record the cheque paid to S. Smith would be:

This is the same as gross pay in Figure 9-1.	→	Dec. 31	Salaries Expense	1,560.00
			Employee Inc. Taxes Pay.	234.00
			Employment Insur. Pay.	31.20
			Gov't Pension Payable	78.00
			Company Health Plan Pay.	55.00
			Union Dues Payable	15.60
			Company Pension Payable	46.80
			Cash	1,099.40
			<i>To record payment to S. Smith, net of deductions.</i>	

The journal entry to record the cheque paid to J. Jones would be:

Dec. 31	Salaries Expense	975.00
	Employee Inc. Taxes Pay.	146.25
	Employment Insur. Pay.	19.50
	Gov't Pension Payable	48.75
	Company Health Plan Pay.	55.00
	Union Dues Payable	9.75
	Company Pension Payable	29.25
	Cash	666.50
	<i>To record payment to J. Jones, net of deductions.</i>	

The journal entry to record the company's matching contributions would be:

These are additional, salary-related expense categories on the income statement.	{	Dec. 31	Employment Insur. Expense	70.98
			Gov't Pension Expense	126.75
			Company Pension Expense	38.03
			Employment Insur. Pay.	70.98
			Gov't Pension Payable	126.75
			Company Pension Payable	38.03
			<i>To record employer contributions for December.</i>	

The deductions payable accounts would be recorded as current liabilities on the December 31, 2016 balance sheet since they will be remitted to various agencies within the next few weeks. When these payments are made, say on January 15, 2016, the following four entries would be made to eliminate these current liability accounts:

2016

Jan. 15	Employee Inc. Taxes Pay.	380.25	
	Employment Insur. Pay.	121.68	
	Gov't Pension Payable	253.50	
	Cash		755.43
	<i>To record remittances for December 31, 2015 paid to Government of Canada.</i>		
Jan. 15	Company Health Plan Payable	110.00	
	Cash		110.00
	<i>To record payment of employee deductions to ABC Healthcare.</i>		
Jan. 15	Union Dues Payable	25.35	
	Cash		25.35
	<i>To record payment of employee deductions to Union X, Local 251.</i>		
Jan. 15	Company Pension Payable	114.08	
	Cash		114.08
	<i>To record payment of employee deductions and employer contributions to Greenview Private Pension Plan Administrator.</i>		

## 9.2.2 Sales Taxes



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Another type of known current liabilities is a **sales tax**. Sales taxes are common sources of government revenues in most countries. An example of a Canadian sales tax is the federal **Goods and Services Tax (GST)**. This is calculated as 5% of the selling price of most goods and services.<sup>2</sup> GST does not apply to salaries, wages and benefits paid to employees.

To demonstrate how a sales tax like GST is recorded, assume that a Joe's Cars Corporation operates in Canada. The company purchased a vehicle for \$20,000 cash from a supplier on December 15, 2015. It must pay the supplier \$21,000: \$20,000 for the vehicle GST of \$1,000 ( $20,000 \times 5\% = \$1,000$ ). The entry to record the purchase would be:

2. GST is also not applied to goods like prescription drugs, groceries, and medical supplies or services such as education, health care, and finance.

2015

Dec. 15	Merchandise Inventory	20,000	
	GST Payable	1,000	
	Cash		21,000

*To record purchase of vehicle plus 5% GST.*

Assume the company then sold the vehicle to a customer on December 20 for \$25,000 cash. The customer must pay Joe's Cars \$26,250: \$25,000 for the vehicle plus GST of \$1,250 ( $\$25,000 \times 5\% = \$1,250$ ). If the company uses the perpetual inventory method, the entry to record the sale would be:

2015

Dec. 20	Cash	26,250	
	Sales		25,000
	GST Payable		1,250
	Cash		26,250
	Cost of Goods Sold	20,000	
	Merchandise Inventory		20,000

*To record sale of vehicle plus 5% GST.*

There is no GST effect related to cost of goods sold. This has been recorded when the vehicle was originally purchased on December 15. The balance sheet at December 31 would show a current liability, GST Payable, amounting to \$250 ( $\$1,250 - 1,000$ ). No expense would be recorded on the company's income statement. The GST Payable liability of \$250 would be paid to the government soon after the balance sheet date. Assuming this payment is made on January 15, 2016, the following journal entry would be made:

2016

Jan. 15	GST Payable	250	
	Cash		250

*To record payment of GST owing at December 31.*

### 9.2.3 Short-term Notes Payable



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Short-term notes receivable were discussed in Chapter 7. A note receivable can arise when an account receivable is overdue and the debtor and creditor agree to enter into a formal legal agreement for payment. A **short-term note payable** is the flip side of a note receivable. It is an arrangement to formalize repayment of an account from the creditor's point of view. It is recorded as a current liability if it is expected to be paid within one year from the balance sheet date.

In Chapter 7, BDCC provided \$4,000 of services on August 1, 2015 to customer Woodlow. Woodlow was unable to pay this amount in a timely manner. The receivable



was converted in BDCC's accounting records on December 1, 2015 to a 4%, three-month note receivable, meaning that the \$4,000 was to be repaid with interest on February 28, 2016.

The following example compares the entries recorded by BDCC for the note receivable to the entries recorded by Woodlow to establish and then satisfy a note payable for the same transaction.

	<i>BDCC records</i>	<i>Woodlow records</i>																														
2015 Dec. 1	<table border="0"> <tr> <td>Note Rec. – Woodlow</td> <td style="text-align: right;">4,000</td> <td></td> </tr> <tr> <td>    Account Rec. – Woodlow</td> <td></td> <td style="text-align: right;">4,000</td> </tr> <tr> <td colspan="3">To record conversion of the account receivable from Woodlow to a 4%, 3-month note receivable due February 28, 2016.</td> </tr> </table>	Note Rec. – Woodlow	4,000		Account Rec. – Woodlow		4,000	To record conversion of the account receivable from Woodlow to a 4%, 3-month note receivable due February 28, 2016.			<table border="0"> <tr> <td>Account Payable – BDCC</td> <td style="text-align: right;">4,000</td> <td></td> </tr> <tr> <td>    Note Payable – BDCC</td> <td></td> <td style="text-align: right;">4,000</td> </tr> <tr> <td colspan="3">To record conversion of the account payable to BDCC to a 4%, 3-month note payable due February 28, 2016.</td> </tr> </table>	Account Payable – BDCC	4,000		Note Payable – BDCC		4,000	To record conversion of the account payable to BDCC to a 4%, 3-month note payable due February 28, 2016.														
Note Rec. – Woodlow	4,000																															
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Note Payable – BDCC		4,000																														
To record conversion of the account payable to BDCC to a 4%, 3-month note payable due February 28, 2016.																																
Dec. 31	<table border="0"> <tr> <td>Interest Receivable</td> <td style="text-align: right;">13</td> <td></td> </tr> <tr> <td>    Interest Earned</td> <td></td> <td style="text-align: right;">13</td> </tr> <tr> <td colspan="3">To record interest revenue accrued on the Woodlow note receivable at year-end (\$4,000 x 4% x 1/12 mos. = \$13).</td> </tr> </table>	Interest Receivable	13		Interest Earned		13	To record interest revenue accrued on the Woodlow note receivable at year-end (\$4,000 x 4% x 1/12 mos. = \$13).			<table border="0"> <tr> <td>Interest Expense</td> <td style="text-align: right;">13</td> <td></td> </tr> <tr> <td>    Interest Payable</td> <td></td> <td style="text-align: right;">13</td> </tr> <tr> <td colspan="3">To record interest expense accrued on the BDCC note payable at year-end (\$4,000 x 4% x 1/12 mos. = \$13).</td> </tr> </table>	Interest Expense	13		Interest Payable		13	To record interest expense accrued on the BDCC note payable at year-end (\$4,000 x 4% x 1/12 mos. = \$13).														
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Notice that the dollar amounts in the entries for BDCC are mirrors of those for Woodlow. BDCC records interest earned; Woodlow records interest expense. BDCC will report two current assets in its balance sheet at December 31 (note receivable; interest receivable); Woodlow will report two current liabilities (note payable; interest payable).

## 9.2.4 Income Tax Liabilities



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Besides sales taxes and payroll deductions, a company must also remit corporate income taxes to the government. A company's income taxes are based on the amount of income, net of expenses, reported on its annual income statement.<sup>3</sup> It is one of the last adjusting entries made at a company's year-end.

For instance, assume BDCC reported revenues of \$500,000 and expenses before corporate income taxes of \$400,000 for the year ended December 31, 2015. If the corporate income tax rate is 20%, BDCC would pay corporate income taxes of \$20,000 [(\$500,000 – 400,000) x 20% = \$20,000].

Often, profitable companies are required to remit income tax instalments to the government on a monthly or quarterly basis. Instalment calculations are beyond the scope of this text but are often influenced by the amount of corporate income taxes paid in the prior year by a company.

Assume that BDCC is required to make monthly corporate income tax instalments during 2015 of \$1,500 and that these amounts must be paid to the government by the

3. Corporate income taxation is complex and covered more thoroughly in advanced accounting courses.

15th day of the following month. If the payment for January 2015 was made by February 15, the journal entry would be:

2015

Feb. 15	Corporate Income Taxes Payable	1,500	
	Cash		1,500

*To record payment of January income tax instalment.*

After the payment on December 15, 2015, the balance in the Corporate Income Taxes Payable general ledger account would be a \$16,500 debit balance (\$1,500 x 11 mos.). Various adjusting entries would be made to prepare the BDCC financial statement for the year ended December 31, 2015, resulting in income before income taxes of \$100,000 as noted above. This figure is used as a basis to prepare the corporate tax return for the year. Assuming a tax rate of 20%, BDCC's corporate income taxes payable will amount to \$20,000. Since the company has already paid \$16,500 in corporate income tax instalments for the 2015 fiscal year, it only owes an additional \$3,500 at December 31, 2015. The adjusting entry to record the corporate income taxes expense and adjust the amount owing would be:

2015

Dec. 31	Corporate Income Taxes Expense	20,000	→	20,000	Corp. Inc. Tax Exp
	Corporate Inc. Taxes Payable	20,000	→	20,000	Corp. Inc. Tax. Pay.
					16,500
					<u>3,500</u>

*To record 2015 corporate income tax expense.*

The condensed BDCC income statement at December 31 would show:

**Big Dog Carworks Corp.**  
**Income Statement**  
**For the Year Ended December 31, 2015**

Revenue	\$500,000
Operating expenses	<u>400,000</u>
Income before income taxes	100,000
Income taxes	<u>20,000</u>
Net income	<u><u>\$80,000</u></u>

The \$3,500 balance in the Corporate Income Taxes Payable general ledger account would be shown as a current liability on the balance sheet at December 31, 2015. BDCC will pay this amount in cash sometime in 2016 after the income tax return has been assessed by the government.



## 9.3 Estimated Current Liabilities



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LO3 – Record and disclose estimated current liabilities.

An **estimated current liability** is an obligation that exists at the balance sheet date. However, its amount can only be approximated – for because an invoice has not yet been received from a supplier. Two common examples of estimated liabilities are warranties and fees for services rendered by professionals like lawyers and auditors related to year-end financial statement preparation.

### 9.3.1 Warranty Liabilities



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A **warranty** is a guarantee offered by the seller to replace or repair defective products. Warranties typically apply for a limited period of time. The seller does not know which product will require warranty work, when it might occur, or the amount. However, based on past experience, warranty expense can be estimated. Often this is based on a percentage of sales revenue. The adjustment is done at year –end. Doing this matches warranty expenses with revenue in the year of sale.

As an example, assume High Road Appliances Corp. estimated its warranty expense to be 5% of its sales revenue. Sales amounted to \$500,000 for its first year ended December 31, 2015. To match the warranty expense to the period in which the revenue was realized, the following adjusting entry would be recorded at the year-end:

2015

Dec. 31	Warranty Expense	25,000	
	Estimated Warranty Liability		25,000
	<i>To record estimated warranty expense for the year (\$500,000 x 5% = \$25,000).</i>		

Prior to this year-end adjusting entry, parts and labour are used to perform warranty work during the year. The following type of entry is recorded many times as each piece of warranty work is completed:

Estimated Warranty Liability	XXX	
Parts Inventory		XXX
Wages Payable		XXX

*To record the actual costs of parts and labour for warranty work, job 1234.*

These many small entries gradually increase the debit balance in the Estimated Warranty Liability account until the estimated liability account is adjusted as above to record the estimated expense.

Over time, the year-end balance in the Estimated Warranty Liability account should be stable if actual expenditures are equal to estimated expenditures. If the balance gradually increases or decreases, the estimate of warranty expense as a percentage of sales revenue needs to be reviewed and perhaps adjusted.

### 9.3.2 Professional Fess



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An accounting firm may be contracted to prepare or audit the annual financial statements. Services of lawyers and pension actuaries may also be needed. Precise fees for these services will be unknown until an invoice is rendered by the supplier. However, this usually occurs after the financial statements have been issued. To match the expense to the year in which the services apply, the fees are estimated and recorded as part of the Estimated Current Liabilities general ledger account at year-end.

Assume BDCC estimates that the audit fee for the 2015 financial statements will be \$10,000. The following adjusting entry would be made (GST would not be recorded until the fees were actually invoiced by the supplier).

2015

Dec. 31	Professional Fees	10,000	
	Estimated Current Liabilities		10,000
	<i>To record estimated audit fees for the year.</i>		

### 9.3.3 Contingent Liabilities



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An estimated liability is recorded when the liability is probable and the amount can be reliably estimated. A **contingent liability** exists as a result of a past occurrence, but only if possible (not probable) or is probable but the amount of the liability is not known at the date the financial statements are issued. A contingent liability is just disclosed in a note to the financial statement. A liability with only a remote likelihood of success is neither recorded nor disclosed in a note. The following is a summary of the treatment of these types of liabilities:

	<i>Outcome</i>		
	<i>Remote</i>	<i>Possible</i>	<i>Probable</i>
<i>Amount can be estimated</i>	Do not report	Note to financial statements	Record in financial statements
<i>Amount cannot be estimated</i>	Do not report	Note to financial statements	Note to financial statements

As an example, assume a lawsuit is commenced in 2015 against Jones Corp. claiming damages of \$100,000. At December 31, 2015, lawyers for the company indicate that it is probable that the lawsuit will be successful but the damages cannot be reasonably estimated. In this case, a note to the financial statements might state:

**Note X** A lawsuit has been commenced during the year against the company related to the alleged sale of defective merchandize. Legal counsel has advized that this action will likely be successful. The amount of award cannot be reasonably estimated at this time. The lawsuit seeks compensation for damages amounting to \$100,000.

Assume now that it is probable that the lawsuit will be successful and that full damages will be awarded. The following entry would be recorded in the company's records:

2015

Dec. 31	Lawsuit Damages Expense	100,000	
	Estimated Current Liabilities		100,000
	<i>To record estimated lawsuit award.</i>		

If this amount is relatively large, it would be reported in the Other Income (Expenses) section of the income statement.

## 9.4 Non-current Liabilities



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LO4 – Explain, calculate, and record non-current debt.

A corporation often incurs long-term debt to acquire property, plant, and equipment. These borrowing are repayable over many years. There are three main types of non-current borrowings:

1. **Bonds** pay *only interest* at regular intervals to *bondholders*. The original investment is repaid to bondholders when the bond *matures* (or comes due),

usually after a number of years. Bonds issued by a company are generally purchased by many investors, including individuals, financial institutions, and other corporations. Bonds are discussed in detail in a later chapter.

2. **Loans** are also sums of money lent for interest. They differ from bonds in that they are repaid in equal payments on a regular basis, often monthly. The repayments usually consist of both *interest* and *principal* paid to creditors. Such payments are said to be *blended*. That is, each payment contains repayment of a certain amount of the original amount of the loan (the principal), as well as interest on the remaining principal balance. Loans are usually received from only one or a small number of financial institutions. After obtaining a loan, a company often purchases long-lived assets from a third party with the cash proceeds. The loan in turn may be *secured* by these purchased assets to reduce the risk of non-repayment to the lender. If the loan is not repaid, the lender can seize and legally sell the secured assets, and retain the funds owed to it. For instance a *mortgage* is a loan secured by specified real estate of the company, usually land with buildings on it.
3. A **finance lease** is similar to a loan in that a series of cash payments are also made over a specified period of time. However, these are not quite the same as repayment of a bank loan. Instead of payments to the bank, the payments are made to a leasing company, called the *lessor*. The payments give the *lessee* (the company making the payments) the right to use a long-lived asset owned by the leasing company for a specified period of time. Unlike a short-term rental agreement, the amount of the payments is so large as a percentage of the value of the related long-lived asset and the period of time over which they are made is so long that the lessee in effect purchases the asset, even though legal title may not be transferred from the leasing company to the lessee.

Non-current loans and finance leases are discussed further below.

### 9.4.1 Loans Payable



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As noted above, a loan is another form of long-term debt that can be used by a corporation to finance its operations.

Assume BDCC obtained a \$100,000, 10% loan on January 1, 2015 from First Bank to acquire a piece of production equipment. When the loan proceeds are deposited into the bank account of BDCC, the company would make the following journal entry:

2015			
Jan. 1	Cash	100,000	
	Loan-Payable – First Bank		100,000
	<i>To record 10% loan from First Bank.</i>		

When the equipment is purchased (assumed here to be the same day), this journal entry would be made:

2015

Jan. 1	Equipment	100,000
	Cash	100,000

*To record purchase of equipment with loan proceeds.*

BDCC will depreciate this long-lived asset as usual over its estimated useful life, as discussed in a previous chapter. Interest is calculated on the unpaid balance of the loan. This balance decreases over the life of the loan because each payment contains part interest and part principal payments. In the example above, assume the \$100,000 loan is repayable in three annual blended payment of \$40,211. Each payment is made on December 31, commencing in 2015. While the payments remain the same each year, the amounts of interest paid decrease while the amount of principal repaid increases. [Figure 9.2](#) illustrates this effect. Note particularly columns B, C, and D.

	A	B	C	D
<i>Year ended</i>	<i>Beginning loan balance</i>	<i>Interest expense (A x 10%)</i>	<i>Reduction of principal (\$40,211 – B)</i>	<i>Ending loan balance (A – C)</i>
Dec. 31 2015	\$100,000	\$10,000	\$30,211	\$69,789
2016	69,789	6,979	33,232	36,557
2017	36,557	3,654	36,557	-0-
			\$100,000	

Interest expense decreases with each loan payment, because the remaining principal has decreased.

**Fig. 9.2: Effect of blended interest and principal payments**

[Figure 9.2](#) can be used to construct the journal entries to record the loan payments at the end of each year:



2015			
Dec. 31	Interest Expense (col. B)	10,000	
	Loan Payable (col. C)	30,211	
	Cash		40,211
2016			
Dec. 31	Interest Expense (col. B)	6,979	
	Loan Payable (col. C)	33,232	
	Cash		40,211
2017			
Dec. 31	Interest Expense (col. B)	3,654	
	Loan Payable (col. C)	36,557	
	Cash		40,211

The amounts in Figure 9.2 can also be used to present the related information on the financial statements of BDCC at each year-end. Recall that assets and liabilities need to be classified as current and non-current on the balance sheet. Current liabilities are amounts paid within one year of the balance sheet date. Part of the loan payable to First Bank will be paid in the upcoming year. Therefore, it needs to be classified as a current liability on the balance sheet even though the full amount of the loan outstanding is reported in a single general ledger account called Loan Payable – First Bank. The amount of the total loan outstanding at December 31, 2015, 2016, and 2017 and the current and non-current portions are shown in Figure 9.3:

A	B	C	D
Year ended	Ending loan balance per general ledger (Fig. 9-2, Col. D)	Current portion (Fig. 9-2, col. C)	(B – C) Non-current portion
2015	\$69,788	\$33,232	\$36,557
2016	36,557	36,557	-0-
2017	-0-	-0-	-0-

Fig. 9.3: Allocation of current and non-current portions of loan principal

Balance sheet presentation would be as follows at each year-end:

	2015	2016	2017
<i>Current liabilities</i>			
Current portion of borrowings	\$33,232	\$36,557	\$ -0-
<i>Non-current liabilities</i>			
Borrowings (Note X)	36,557	-0-	-0-

Details of the loan would be disclosed in a note to the financial statements. Only the *principal* amount of the loan is reported on the balance sheet. The *interest* expense portion is reported on the income statement as an expense. Because these payments are made at BDCC's year-end (December 31), no interest payable is accrued or reported on the balance sheet in this example.

## 9.4.2 Finance Leases



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After obtaining a long-term loan, a company often purchases long-lived assets from a third party with the cash proceeds. The mechanics of recording a finance lease are much the same as that of a loan. The value of the finance lease is determined by calculating the amount of a similar loan that could be paid off, given the period of time, interest rate, and amount of payments stated in the lease agreement, and the fair value of the leased asset.

For instance, assume that on January 1, 2015 Big Dog Carworks Corp. agrees to pay First Leasing Company annual payments of \$40,211 on December 31 for the next three years for the use of a large truck that could be purchased elsewhere for \$100,000. BDCC is responsible for insuring, maintaining, and repairing the truck, though title to the truck remains with the leasing company.

Even though BDCC does not legally own the truck, the substance of the lease agreement is the same as if the company received a 10% loan from a bank and then purchased the truck from a third party (recall the example above). As a result, BDCC is required under GAAP to record the finance lease as a liability and the truck as a long-lived asset on its balance sheet. When the lease agreement is signed on January 1, 2015 the following journal entry is made:

2015

Jan. 1	Truck	100,000	
	Finance Lease		100,000
	<i>To record First Leasing Company lease of a truck.</i>		

As in the first example, the truck asset is depreciated over its estimated useful life.

To record the loan payments, the *implicit* rate of interest within the lease agreement needs to be established. In the BDCC example, this is 10% – the amount of annual interest that would need to be paid to a bank for a similar loan.

When each of the three payments is made on December 31 of 2015, 2016, and 2017, much the same journal entries are recorded as in the previous bank loan example:



2015			
Dec. 31	Interest Expense	10,000	
	Finance Lease	30,211	
	Cash		40,211
2016			
Dec. 31	Interest Expense	6,979	
	Finance Lease	33,232	
	Cash		40,211
2017			
Dec. 31	Interest Expense	3,654	
	Finance Lease	36,557	
	Cash		40,211

Balance sheet presentation of the finance lease liability would also be similar. The same current and non-current portions would be presented each year as in the bank loan example above.

## 9.5 Demonstration Problem



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The following unadjusted trial balance has been taken from the records of Rockfish Rentals Corp at December 31, 2015:

No.	Account	Unadjusted TB		Adjustments		Adjusted TB	
		Debit	Credit	Debit	Credit	Debit	Credit
101	Cash	2,000					
110	Accounts receivable	3,000					
150	Merch. inventory	30,000					
151	Parts inventory	20,000					
180	Land	246,400					
181	Building	214,700					
191	Acc. dep'n – bldg.		170,000				
210	Accounts payable		10,000				
212	Est. current liab.		-0-				
213	Est. warranty liab.	10,000					
220	Note payable		10,000				
221	Dividends payable		-0-				
222	Interest payable		-0-				
226	Salaries payable		-0-				
227	Emp'ee inc. tax pay.		-0-				
228	Emp. insur. pay.		-0-				
229	Gov't pension pay.		-0-				
230	Co. health ins. pay.		-0-				
231	Union dues pay.		-0-				
232	Co. pension pay.		-0-				
238	GST payable		1,000				
242	Unearn. comm. rev.		500				
260	Corp. inc. tax pay.	11,000					
275	Mortgage payable		200,000				
276	Finance lease		20,000				
320	Share capital		2,000				
340	Retained earnings		40,000				
350	Dividends declared		-0-				
410	Commiss. earned		23,000				
500	Sales		477,000				
570	Cost of goods sold	135,000					
621	Dep'n exp. – bldg.		-0-				
632	Interest expense	15,000					
653	Professional fees		-0-				
656	Salaries expense	240,000					
658	Gov't emp. insur. ex.	6,000					
659	Gov't pension exp.	4,800					
660	Co. health insur. exp.	3,600					
661	Co. pension exp.	12,000					
678	Warranty exp.		-0-				
830	Corp. inc. tax exp.		-0-				
		<u>953,500</u>	<u>953,500</u>				

The company uses the perpetual inventory method. GST applies only when indicated. The following additional information is available:

- a. Unearned commission revenue at December 31 is \$800.
- b. A \$1,000 invoice for parts was received from a supplier at December 31 that has not yet been recorded. GST of 5% was added to the cost of parts, for a total of \$1,050.
- c. A December 31 sale on account for \$3,000 was not recorded. GST of 5% was also charged on the sale. Related cost of goods sold was \$2,500.
- d. The \$10,000 note payable was issued on December 1, 2015. It bears interest at 4% per year and is due November 30, 2016. No interest expense has been recorded.
- e. A warranty repair has not been correctly recorded at December 31. \$500 of parts was recorded incorrectly as cost of goods sold, and salary expenditures of \$100 were recorded incorrectly as salaries expense.
- f. Warranty expense for the year is estimated at 3% of sales revenue.
- g. Unpaid salaries for the week of December 24-31 were as follows:

<i>Gross pay</i>	<i>Payroll Deductions</i>						<i>Total deduct.</i>	<i>Net pay</i>
	<i>Income taxes</i>	<i>Employ. insur.</i>	<i>Gov't pension</i>	<i>Comp. health</i>	<i>Union dues</i>	<i>Comp. pension</i>		
5,000	1,000	125	100	50	200	250	1,725	3,275

The company's portion of contributions is:

Government employment insurance	1.4 times
Government pension	1 time
Company health insurance	1.5 times
Company pension	2 times

h. Audit fees for the 2015 financial statements are estimated to be \$5,000. The auditor will add GST to the amount that is eventually billed.

i. Payments on the mortgage and finance lease, including interest, were made on December 31. Payments during 2016 will be made as follows:

	<i>Interest</i>	<i>Reduction of principal</i>	<i>Total payments</i>
Mortgage	\$7,000	\$3,000	\$10,000
Finance lease	1,500	2,500	4,000

j. It is possible that the company will lose a lawsuit filed against it during the year. The estimated award is \$5,000.

k. Depreciation on the building is calculated on the double-declining balance basis. The useful life is ten years. Residual value is \$5,000. There were no additions or disposals during the year.

l. Share capital of \$500 was issued for cash on August 31 and is included in the accounting records.

m. The corporate income tax rate is 20% calculated on income before income taxes.

n. Dividends of \$2,000 were declared on December 31, 2015. These will be paid on January 31, 2016.

*Required:*

1. Prepare necessary adjusting entries at December 31, 2015. Include general ledger account numbers and appropriate descriptions.
2. Post the entries to the "Adjustments" column of the worksheet. Total the worksheet.
3. Prepare a classified income statement and statement of changes in equity for the year ended December 31, 2015 and a classified balance sheet at December 31.

4. Assume the salaries, employee deductions, and company payroll expenses were paid on January 5, 2016. Record the journal entries. Assume payments were made as applicable to employee J. Smith, Government of Canada, Union Local 151, Purple Cross Healthcare, and Fidelity Mutual Pension Administration.
5. Assume amounts owing for 2015 corporate income taxes payable and GST payable are remitted in cash to the Government of Canada on January 15, 2016. Record the journal entries.
6. Assume the estimated warranty liability reported on the December 31, 2014 balance sheet was \$30,000. Should this be a concern when Rockfish management reviews the 2015 financial statements?
7. What types of information should be disclosed in the notes to the financial statements related to the various liability accounts?

### 9.5.1 Solution to Demonstration Problem



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1. Prepare necessary adjusting entries at December 31, 2015. Include general ledger account numbers and appropriate descriptions.

- a. 2015

	Dec. 31	Commissions Earned	410	300	
		Unearned Comm. Rev.	242		300

*To adjust unearned commissions revenue to actual at December 31.*

- b. 2015

	Dec. 31	Parts Inventory	151	1,000	
		GST Payable	238	50	
		Accounts Payable	210		1,050

*To record invoice from supplier.*

- c. 2015

Dec. 31	Accounts Receivable	110	3,150
	Sales	500	3,000
	GST Payable	238	150
	Cost of Goods Sold	570	2,500
	Merchandise Inventory	150	2,500

*To record missing sales on account. (GST would have been paid when the inventory was originally purchased, so there is no GST effect related to cost of goods sold.)*

d. 2015

Dec. 31	Interest Expense	632	34
	Interest Payable	222	34

*To record interest on note payable [ $\$10,000 \times 4\% \times 31/365$  days = \$34 (rounded)]*

e. 2015

Dec. 31	Estimated Warranty Liability	213	600
	Cost of Goods Sold	570	500
	Salaries Expense	656	100

*To reallocate warranty repair expenditures.*

f. 2015

Dec.  
31

Warranty Expense	678	14,400	
Estimated Warranty Liab.	213		14,400

*To record estimated warranty expense for 2015 [(\$477,000 + 3,000<sup>1</sup>) x 3% = \$14,400]*

<sup>1</sup> See c. above

g. 2015

Dec. 31

Salaries Expense	656	5,000	
Gov't Employment Ins. Exp.	658	175	
Gov't Pension Expense	659	100	
Company Health Insur. Exp.	660	75	
Company Pension Expense	661	500	
Salaries Payable	226		3,275
Emp'ee Income Tax. Pay.	227		1,000
Employment Insur. Pay.	228		300
Gov't Pension Payable	229		200

Co. Health Plan Payable	230	125
Union Dues Payable	231	200
Co. Pension Payable	232	750

To record Dec. 24-31 salaries and benefits payable as follows:

	Gross pay	Payroll Deductions						Total deduct.	Net pay
		Income taxes	Employ. insur.	Gov't pension	Comp. health	Union dues	Comp. pension		
Employees	5,000	1,000	125	100	50	200	250	1,725	3,275
Employer		-0-	175	100	75	-0-	500		
Remittance		1,000	300	200	125	200	750		

h. 2015

Dec. 31	Professional Fees	653	5,000
	Estimated Current Liab.	212	5,000

To record estimated audit fees. (No GST will be recorded until the actual invoice is received.)

i. No entry. This only affects balance sheet presentation between current and non-current liabilities.

j. No entry. The event would only be recorded if the outcome was probable, even if the amount to be awarded can be reasonably estimated.

k. 2015

Dec. 31	Depreciation Expense – Bldg.	621	8,940
	Accum. Dep'n – Bldg.	191	8,940



*To record depreciation expense for the year[(100%/10 yrs.) = 10% x 2 = 20%; (\$214,700 - 170,000) x 20% = \$8,940].*

l. No entry. This should be shown on the statement of changes in equity, though.

m. 2015

Dec. 31	Corporate Income Taxes Exp.	830	10,035
	Corporate Inc. Tax. Pay.	260	10,035

*To record corporate income taxes for the year[(50,1761 x 20% = \$10,035 (rounded))]*

1 See income statement. This entry is recorded after the partial income statement is prepared up to the income before income taxes amount. The income statement can be completed after this entry is recorded.

n. 2015

Dec. 31	Dividends Declared	350	2,000
	Dividends Payable	221	2,000

*To record dividend declared, payable January 31, 2016.*

2. Post the entries to the "Adjustments" column of the worksheet. Total the worksheet.

No.	Account	Unadjusted TB		Adjustments		Adjusted TB	
		Debit	Credit	Debit	Credit	Debit	Credit
101	Cash	2,000				2,000	
110	Accounts receivable	3,000		c. 3,150		6,150	
150	Merch. inventory	30,000			2,500 c.	27,500	
151	Parts inventory	20,000		b. 1,000		21,000	
180	Land	246,400				246,400	
181	Building	214,700				214,700	
191	Acc. dep'n – bldg.		170,000		8,940 k.		178,940
210	Accounts payable		10,000		1,050 b.		11,050
212	Est. current liab.		-0-		5,000 h.		5,000
213	Est. warranty liab.	10,000		e. 600	14,400 f.		3,800
220	Note payable		10,000				10,000
221	Dividends payable				2,000 n.		2,000
222	Interest payable		-0-		34 d.		34
226	Salaries payable		-0-		3,275 g.		3,275
227	Emp'ee inc. tax pay.		-0-		1,000 g.		1,000
228	Emp. insur. pay.		-0-		300 g.		300
229	Gov't pension pay.		-0-		200 g.		200
230	Co. health ins. pay.		-0-		125 g.		125
231	Union dues pay.		-0-		200 g.		200
232	Co. pension pay.		-0-		750 g.		750
238	GST payable		1,000	b. 50	150 c.		1,100
242	Unearn. comm. rev.		500		300 a.		800
260	Corp. inc. tax pay.	11,000			10,035 m.		965
275	Mortgage payable		200,000				200,000
276	Finance lease		20,000				20,000
320	Share capital		2,000				2,000
340	Retained earnings		40,000				40,000
350	Dividends declared			n. 2,000		2,000	
410	Commiss. earned		23,000	a. 300			22,700
500	Sales		477,000		3,000 c.		480,000
570	Cost of goods sold	135,000		c. 2,500	500 e.	137,000	
621	Dep'n exp. – bldg.	-0-		k. 8,940		8,940	
632	Interest expense	15,000		d. 34		15,034	
653	Professional fees	-0-		h. 5,000		5,000	
656	Salaries expense	240,000		g. 5,000	100 e.	244,900	
658	Gov't emp. insur. ex.	6,000		g. 175		6,175	
659	Gov't pension exp.	4,800		g. 100		4,900	
660	Co. health insur. exp.	3,600		g. 75		3,675	
661	Co. pension exp.	12,000		g. 500		12,500	
678	Warranty exp.	-0-		f. 14,400		14,400	
830	Corp. inc. tax exp.	-0-		m.10,035		10,035	
		<u>953,500</u>	<u>953,500</u>	<u>53,859</u>	<u>53,859</u>	<u>983,274</u>	<u>983,274</u>

Rockfish Rentals Corp.  
Income Statement  
For the Year Ended December 31, 2015

<i>Revenue</i>	
Sales	\$480,000
Commissions earned <sup>4</sup>	22,700
	<u>502,700</u>
Cost of goods sold	137,000
Gross profit	<u>365,700</u>
<i>Operating expenses</i>	
Selling	
Salaries	\$244,900
Employment insurance	6,175
Government pension	4,900
Company health insurance	3,675
Company pension	12,500
Warranty	14,400
Total selling	<u>286,550</u>
General and administrative	
Depreciation - building	8,940
Professional fees	5,000
Total general and administrative	<u>13,940</u>
Total operating expenses	<u>300,490</u>
Income before interest and income taxes	65,210
Interest expense	15,034
Income before income taxes	50,176
Income taxes	10,035
Net income	<u>\$40,141</u>

3.

<sup>4</sup> Alternately, commission earned could be reported separately from gross profit calculations. Many presentation formats are acceptable.

Rockfish Rentals Corp.  
Statement of Changes in Equity  
For the Year Ended December 31, 2015

	<i>Share capital</i>	<i>Retained earnings</i>	<i>Total equity</i>
Balance at January 1, 2015	\$1,500	\$ 40,000	\$41,500
Shares issued	500		500
Net income		39,741	39,741
Dividends declared		(2,000)	(2,000)
Balance at December 31, 2015	\$2,000	\$78,141	\$80,141

Rockfish Rentals Corp.  
Balance Sheet  
At December 31, 2015

<i>Assets</i>		<i>Liabilities</i>	
<i>Current</i>		<i>Current</i>	
Cash	\$ 2,000	Accounts payable	\$ 11,050
Accounts receivable	6,150	Estimated liabilities	5,000
Merchandise inventories	27,500	Estimated warranty liabilities	3,800
Parts inventories	21,000	Note payable	10,000
Corporate income taxes receivable	1,065	Dividends payable	2,000
	57,615	Interest payable	34
		Salaries and benefits payable	5,850 <sup>5</sup>
		GST payable	1,100
		Unearned commissions revenue	800
		Current portion of debt <sup>6</sup>	5,500
			45,134
<i>Property and plant</i>		<i>Non-current</i>	
Land	246,400	Mortgage payable	200,000
Building, at carrying amount	35,760	Finance lease	20,000
	282,160	Less: Current portion <sup>6</sup>	(5,500)
			214,500
		Total liabilities	259,634
		<i>Shareholders' Equity</i>	
		Share capital	2,000
		Retained earnings	78,141
		Total shareholders' equity	80,141
Total assets	\$339,775	Total liabilities and equity	\$339,775

<sup>5</sup> \$3,275 + 1,000 + 300 + 200 + 125 + 200 + 750. These amounts could be disclosed separately. Many presentation formats are acceptable.

<sup>6</sup> See requirement 1(i).

The journal entry to record payment of salaries and benefits payable would be:

2016

4.	Jan. 5	Salaries Payable	226	3,275	
		Emp'ee Income Tax. Pay.	227	1,000	
		Gov't Employ. Insur. Pay.	228	300	
		Gov't Pension Payable	229	200	
		Co. Health Plan Payable	230	125	
		Union Dues Payable	231	200	
		Co. Pension Payable	232	750	
		Cash	101	5,850	

*To record payments of salaries and benefits owed at  
December 31, 2015 to:*

J. Smith	\$3,275
Government of Canada	1,500
Union Local 151	200
Purple Cross	125
Fidelity Mutual	750
	\$5,850

(Alternately, five separate entries could be made.)

The journal entry to record the GST payment would be:

2016

5.	Jan. 15	GST Payable	238	1,100	
		Cash	101	1,100	

*To record payments of GST owing at December 31,  
2015.*

No payment would be made for corporate income taxes. There is an amount receivable of \$965 from the government at December 31, 2015 represented by:

Instalments paid during the year	\$11,000
Less 2015 corporate income tax expense	<u>(10,035)</u>
Overpayment of 2015 income taxes	<u>\$ 965</u>

This amount will be refunded to Rockfish when its corporate income tax return is filed and assessed.

6. The estimated warranty liability at December 31, 2014 was \$30,000. It is only \$3,800 at December 31, 2015. Management should review this. It may be that the estimated warranty expense of 3% of sales revenue is too low. Alternately, the amount of warranty claims in 2015 might have been abnormally high.

A note should disclose more information about the note payable, the mortgage payable, and the finance lease – due dates, interest rates, repayment terms, and any assets pledged as security.

7. A note should also disclose the details of the contingent liability related to the outstanding lawsuit. This should include the likelihood of success (possible) and the estimated amount of the award.

Significant accounting policies should also be stated. These include depreciation rates and estimated useful lives of plant and equipment, and estimates used to establish some liabilities. The estimated warranty expense rate (3% of sales) should be disclosed, for instance.

## 9.6 Summary of Chapter 9 Learning Objectives



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### **LO1 – Identify and explain the difference between current and non-current liabilities.**

A current or short-term liability is a form of debt that is expected to be paid within the longer of one year of the balance sheet date or one operating cycle. A non-current liability is a form of debt that is expected to be paid beyond one year of the balance sheet date or the next operating cycle, whichever is longer. Current and non-current liabilities must be shown separately on the balance sheet.

### **LO2 – Record and disclose known current liabilities.**

Known current liabilities are those where the payee, amount, and timing of payment are well-established and documented. Accounts payable and payroll liabilities are types of known current liabilities. Employers are responsible for withholding from

employees amounts including Employment Insurance (EI), Canada Pension Plan (CPP), and income taxes, and then remitting the amounts to the appropriate authority. Sales tax like the Goods and Services Tax (GST) in Canada must be remitted to the government on a regular basis, often monthly or quarterly. Current notes payable may require interest to be accrued.

### **LO3 – Record and disclose estimated current liabilities.**

An estimated liability occurs when amounts owing can be reasonably estimated, but the invoice has not yet been received at the date financial statements are issued, for example. Professional fees incurred to prepare year-end financial statements are an example. An estimated liability can also arise based on past experience of claims against the company. Warranty liabilities are an example. A contingent liability exists when it is possible but not probable that a debt will arise as a result of a past occurrence, or the event is probable but the amount cannot be reliably estimated. A contingent liability is disclosed in the notes to the financial statements. Events with a remote likelihood of occurrence are not disclosed or recorded.

### **LO4 – Explain, calculate, and record non-current debt.**

A loan is a form of long-term debt that can be used by a corporation to finance its operations. Long-term loans can be secured and are typically obtained from a bank. Loans are often repaid over many years in equal blended payments containing both interest and principal. Finance leases are like loans in that they are generally repaid in equal blended payments over a number of years. However, payments are made to a leasing company (the lessor) for the right to use a long-lived asset owned by the leasing company. Unlike loans and finance leases, bonds pay only interest at regular intervals to bondholders. The original investment is repaid to bondholders when the bond matures (or comes due), usually after a number of years.

## **9.7 Assignment Materials**

### **9.7.1 Concept Self-check**



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1. What is the difference between a current and non-current liability?
2. What are some examples of current liabilities?
3. How are known current liabilities different from estimated current liabilities?
4. What are some examples of estimated current liabilities?
5. How is an estimated current liability different from a contingent liability?
6. How is a loan payable similar to a bond? How is it different?
7. How is a finance lease similar to a long-term loan from a bank? How is it different?

## 9.7.2 Comprehension Problems

### 9.7.2.1 CP 9-1



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The following unadjusted accounts are taken from the records of Brown Corp. at December 31, 2016:

Bank Loan	201	Interest Expense	632	Interest Payable	222
	12,000	200			100

Additional Information: The bank loan bears interest at 6% per year. It was obtained on April 1, 2016. Payment in full is due on March 31, 2017.

*Required:* Prepare the adjusting entry at December 31, 2016.

### 9.7.2.2 CP 9-2



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An extract from the trial balance of Selby Corp. at December 31, 2016 is reproduced below:

	<i>Account</i>	<i>Amount in unadjusted trial balance</i>	<i>Amount in adjusted trial balance</i>
a.	Accounts payable (re. supplies)	\$ 60	\$ 100
b.	Interest payable	-0-	100
c.	Unearned rent revenue	1,000	500

*Required:* Prepare in general journal format the adjusting entries that were posted, including plausible descriptions. General ledger account numbers are not necessary.

### 9.7.2.3 CP 9-3



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An extract from the trial balance of Paragon Corporation at December 31, 2016 is reproduced below:

	<i>Account</i>	<i>Amount in unadjusted trial balance</i>	<i>Amount in adjusted trial balance</i>
a.	Salaries expense (re. J. Smith)	\$50,000	\$52,000
b.	Employee income taxes payable	-0-	500
c.	Employment insurance payable	1,000	96
d.	Government pension payable	-0-	160

Additional Information: Employees pay 2% of their gross salaries to the government employment insurance plan and 4% of gross salaries to the government pension plan. The company matches employees' government pension contributions 1 to 1, and employment insurance contributions 1.4 to 1.

*Required:*

1. Prepare the adjusting entry that was posted, including a plausible description.
2. Prepare the journal entries to record the payments on January 5, 2017 to employee J. Smith and the Government of Canada. Provide descriptions for journal entries. General ledger account numbers are not necessary.

### 9.7.2.4 CP 9-4



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Smith Corporation purchases merchandize on account from a supplier on June 30, 2016 for \$4,000 plus GST (5%). On July 5, merchandize is sold for \$5,000 plus GST to Customer A on account. Assume that the perpetual inventory method is used.



*Required:*

1. Prepare the journal entry to record the \$4,000 purchase from the supplier.
2. Prepare the journal entry to record the sale to Customer A.
3. Prepare the journal entry to record payment of GST on these two transactions to the Government of Canada on July 31.
4. How much GST expense will Smith Corporation report on its income statement for these two transactions?

Descriptions and general ledger account numbers are not necessary for journal entries.

### 9.7.2.5 CP 9-5



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Paul's Roofing Corporation paid monthly corporate income tax instalments of \$500 commencing February 15, 2016. The company's income before income taxes for the year ended December 31, 2016 was \$15,000. The corporate income tax rate is 40%. Paul's Roofing paid the 2016 corporate income taxes owing on January 31, 2017.

*Required:*

1. Record the February 15, 2016 payment.
2. Record the 2016 corporate income tax expense.
3. Record the January 31, 2017 payment.

Descriptions and general ledger account numbers are not necessary. Show calculations where applicable.

### 9.7.2.6 CP 9-6



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On November 1, 2016 Branch Corporation converted a \$10,000 account payable owing to Tree Corp. to a note payable bearing interest at 10% per year due on January 31, 2017.

*Required:*

1. Record the November 1, 2016 transaction in the records of Branch.
2. Record the adjusting entry needed on December 31, 2016.
3. Record the journal entry for the January 31 payment.
4. Record the above journal entries in the records of Tree Corp.

Provide descriptions for journal entries. General ledger account numbers are not necessary.

### 9.7.2.7 CP 9-7



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Zebra Corp. commenced operations on January 1, 2016. It estimates warranty expense as 1% of yearly sales. During June 2016 it satisfied warranty claims as follows:

Parts from inventory	\$2,000
Salaries paid in cash	500

The 2016 warranty claims amounted to \$22,000 (including the entry above) and 2016 sales revenue was \$2 million.

*Required:*

1. Record the June warranty claims of \$2,500.
2. Record the 2016 warranty expense.
3. Calculate the balance in the estimated warranty liability account at December 31, 2016. Comment on your calculations.

Descriptions and general ledger account numbers are not necessary. Show calculations where applicable.

### 9.7.2.8 CP 9-8



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ClaimsRUs Corp. is the defendant in three lawsuits:

Claim 1:	It is possible that the lawsuit will be successful. Damages are estimated at \$1.5 million.
Claim 2:	It is probable that this lawsuit will be successful. Damages cannot be reasonably estimated as yet.
Claim 3:	It is probable that this lawsuit will be successful. Damages are estimated at \$1 million.

*Required:* Identify the accounting treatment for each claim.

### 9.7.2.9 CP 9-9



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Rosedale Corp. obtained a \$50,000 loan from Second Capital Bank on January 1, 2019. It purchased a piece of heavy equipment for \$48,000 on the same day. The loan bears interest at 6% per year on the unpaid balance and is repayable in three annual blended payments of \$18,705 on December 31 each year.

*Required:*

1. Prepare the journal entries to record the following transactions:
  - a. Receipt of loan proceeds from the bank
  - b. Purchase of the equipment.
2. Prepare the loan repayment schedule.
3. Prepare the journal entry to record the first loan payment.

Provide descriptions for journal entries. General ledger account numbers are not necessary.

### 9.7.2.10 CP 9-10



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Day Corp. entered into a finance lease agreement with Night Leasing Ltd. on January 1, 2016. Day Corp. agreed to pay Night annual payments of \$24,154 on December 31 for the next three years to lease a vehicle with a fair value of \$80,000. The interest rate implicit in the lease agreement was 8%.

*Required:*

1. Prepare the journal entries to record the assumption of the lease on January 1, 2016.
2. Prepare the lease repayment schedule.
3. Prepare the partial balance sheet of Day Corp. at December 31, 2016. Assume the first lease payment has been made.

Provide descriptions for journal entries. General ledger account numbers are not necessary.

## 9.7.3 Problems

### 9.7.3.1 P 9-1



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Latex Paint Corporation started operations on January 1, 2016. It had the following transactions during the year.

- a. Jan. 1 Issued \$20,000 share capital to the shareholders in return for cash.
- b. Jan. 1 Obtained a bank loan totalling \$30,000. The interest rate is 4%. The loan will be repaid in one year.
- c. Jan. 2 Purchased merchandize on account from a supplier for \$20,000 plus GST (5%).
- d. Jan. 8 Sold \$8,000 of paint to a customer on credit and added GST. Cost of the pain sold was \$3,000. Latex uses the perpetual inventory method.
- e. Jan. 15 Paid an employee J. Jones \$1,560 cash for January 1-15 salary, calculated as follows:

<i>Deductions</i>					
<i>Gross pay</i>	<i>Income taxes</i>	<i>Employ. insur.</i>	<i>Gov't pension</i>	<i>Total deduct.</i>	<i>Net pay</i>
2,000	300	40	100	440	1,560

The company's portion of contributions is:

Employment insurance	1.4 times
Government pension	1 time

- f. Unrecorded liabilities at January 31 include:
- i. Salaries payable to J. Jones for January 16-31, amounting to \$1,560 (net). Employer contributions are as shown in e. above.
- ii. Corporate income taxes amounting to 20% of income before income taxes.

*Required:*

1. Prepare journal entries to record the above transactions. Show necessary calculations.
2. Prepare all adjusting entries needed at January 31, 2016. Show necessary calculations.
3. Calculate total current liabilities at January 31, 2016.

Descriptions and general ledger account numbers are not necessary.

### 9.7.3.2 P 9-2



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Refer to P 9-1.

*Required:*

1. Post all entries to general ledger T-accounts.
2. Prepare a classified income statement and statement of changes in equity for the month ended January 31, 2016 and a classified balance sheet at January 31.  
Consider salaries and benefits to be selling expenses.

### 9.7.3.3 P 9-3



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The following unadjusted trial balance has been taken from the records of Mudryk Wholesalers Corp. at December 31, 2016:

No.	Account	Unadjusted TB		Adjustments		Adjusted TB	
		Debit	Credit	Debit	Credit	Debit	Credit
101	Cash	12,000					
110	Accounts receivable	30,000					
150	Merch. inventory	70,000					
151	Parts inventory	10,000					
210	Accounts payable		40,000				
212	Est. current liab.		-0-				
213	Est. warranty liab.	3,000					
226	Salaries payable		-0-				
227	Emp'ee inc. tax pay.		-0-				
228	Emp. insur. pay.		-0-				
229	Gov't pension pay.		-0-				
230	Co. health ins. pay.		-0-				
238	GST payable		1,000				
248	Unearn. rent rev.		-0-				
260	Corp. inc. tax pay.		-0-				
320	Share capital		100				
340	Retained earnings		3,000				
440	Rent earned		13,000				
500	Sales		791,900				
570	Cost of goods sold	263,500					
653	Professional fees	-0-					
656	Salaries expense	400,000					
658	Gov't emp. insur. ex.	8,000					
659	Gov't pension exp.	20,000					
660	Co. health insur. exp.	12,000					
678	Warranty exp.	4,000					
830	Corp. inc. tax exp.	16,500					
		<u>849,000</u>	<u>849,000</u>				

The following additional information is available at the year-end. GST of 5% only applies when indicated.

- a. The company has sublet space in its leased facilities to another company for \$1,000 per month since January 1.
- b. A review of warranty claims indicates that the following amounts have been incorrectly recorded in income statement general ledger accounts:
- |                    |       |
|--------------------|-------|
| Cost of goods sold | \$500 |
| Salaries expense   | \$100 |
- c. A \$4,000 purchase of parts inventory on account plus GST has not been recorded.
- d. Warranty expense for the year is estimated at 1% of sales.
- e. Unpaid gross salaries amount to \$5,000. Deductions from gross pay are as follows:

Employee income taxes	15%
Government employment insurance	2%
Government pension	5%
Company health insurance	3%

The company matches employee contributions to the employment insurance, government pension, and company health insurance plans on a 1 to 1 basis.

- f. Audit fees are estimated to be \$8,000.
- g. The corporate income tax rate is 25% of income before income taxes. Corporate income tax instalments during the year have been recorded as income taxes expense in the records.

*Required:*

1. Prepare necessary adjusting entries at December 31, 2016. Include descriptions and general ledger account numbers, and calculations if necessary.
2. Post the entries to the worksheet and prepare an adjusted trial balance.
3. Prepare a classified income statement and statement of changes in equity for the year ended December 31, and a classified balance sheet at December 31. Consider salary, benefits, and warranty expenses to be selling expenses. No shares were issued during the year.

### 9.7.3.4 P 9-4



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Zinc Corp. obtained a \$100,000 loan from First Capital Bank on December 31, 2016. It purchased a piece of heavy equipment for \$95,000 on January 2, 2017. The loan bears interest at 8% per year on the unpaid balance and is repayable in four annual blended payments of \$30,192 on December 31 each year, starting in 2017.

*Required:*

1. Prepare the journal entries to record the following transactions:
  - a. Receipt of loan proceeds from the bank
  - b. Purchase of the equipment.

Prepare the loan repayment schedule in the following format:

**Zinc Corp.**  
**Loan Repayment Schedule**

		A	B	C	D	E
				<i>(D – B)</i>		<i>(A – C)</i>
2.	<i>Year ended</i>	<i>Beginning loan balance</i>	<i>Interest expense</i>	<i>Reduction of loan payable</i>	<i>Total loan payment</i>	<i>Ending loan balance</i>
	<i>Dec. 31</i>					
	2017					
	2018					
	2019					
	2020					

3. Prepare the journal entry to record the last loan payment.
4. Prepare a partial balance sheet showing the loan liability at December 31, 2018.

### 9.7.3.5 P 9-5



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East Corp. entered into a finance lease agreement with West Leasing Ltd. on April 1, 2016. East Corp. agreed to pay West an initial payment of \$10,000 on that date and annual payments of \$71,081 on March 31 for the next three years to lease a piece of



equipment with a fair value of \$200,000. The interest rate implicit in the lease agreement was 6%.

Required:

1. Prepare the journal entry to record the purchase of the equipment and assumption of the lease on April 1, 2016.

Prepare the lease repayment schedule as follows:

East Corp.						
Lease Repayment Schedule						
	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>E</u>	
2.	<i>Year ended</i> <i>Dec. 31</i>	<i>Beginning</i> <i>lease</i> <i>balance</i>	<i>(A x 6%)</i> <i>interest</i> <i>expense</i>	<i>(D - B)</i> <i>Reduction of</i> <i>finance lease</i>	<i>Total</i> <i>lease</i> <i>payment</i>	<i>(A - C)</i> <i>Ending lease</i> <i>balance</i>
	2017					
	2018					
	2019					

3. Prepare the partial balance sheet of East Corp. at December 31, 2018 showing the finance lease balance assuming the December 31 lease payment has been made.

## 9.7.4 Alternate Problems

### 9.7.4.1 AP 9-1



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Franny's Fabrics Corporation started operations on January 1, 2016. It had the following transactions during the year.

- a. Jan 1 Issued \$10,000 share capital to the shareholders in return for cash.
- b. Jan 1 Obtained a bank loan totalling \$40,000. The annual interest rate is 5%. The loan will be repaid in equal yearly instalments of \$10,000 plus interest starting on January 1, 2017.
- c. Jan 1 Obtained the use of land valued at \$20,000 and buildings valued at \$80,000 through a finance lease. The implicit interest rate is 10% per year. Under the terms of the agreement, Franny's will pay yearly lease payments of \$40,211 for three years commencing December 31, 2016. Useful life of the building is 40 years with no residual value.

Franny's uses the straight-line method of depreciation and the  $\frac{1}{2}$  year rule for calculating depreciation in the year of acquisition and disposal.

- d. Jan 2 Purchased merchandise on account from a supplier for \$40,000 plus GST (5%).
- e. Jan.8 Sold \$10,000 of fabric to a customer on credit and added GST. Cost of the fabric sold was \$6,000. Franny's uses the perpetual inventory method.
- f. Jan 15 Paid an employee S. Smith net salary for Jan. 1-15. Gross salary for the period is \$1,500. Deductions from gross pay are as follows:
- |                          |     |
|--------------------------|-----|
| Employee income taxes    | 15% |
| Government pension       | 4%  |
| Company pension plan     | 10% |
| Company health insurance | 5%  |
- g. Jan 21 Purchased merchandise inventory on account for \$6,000 plus GST.
- h. Jan 22 Paid supplier in cash re. transaction d. above.
- i. Jan 23 Sold \$60,000 of fabric to a customer plus \$3,000 GST. The customer paid in cash. Cost of goods sold was \$15,000.
- j. Jan 31 Paid S. Smith salary for January 16-31, less deductions calculated as in f. above.
- k. Feb 15 Paid payroll deductions for January.
- l. Feb 15 Paid GST owing at January 31.
- m. Dec 31 Paid the first finance lease payment in cash.
- n. Dec 31 A lawsuit was filed against Franny's. It is possible that the lawsuit will be successful. If so, the estimated award is \$10,000.
- o. Dec 31 An invoice was received by Franny's from its lawyer. Fees to the year-end amounted to \$5,000 plus GST.

Additional information: The corporate income tax rate is 30% of income before income taxes.

*Required:*

1. Prepare journal entries to record the transactions. Show necessary calculations. Descriptions and general ledger account number are not necessary.
2. Post the entries to general ledger T-accounts.
3. Prepare adjusting entries at December 31, 2016 and post these to general ledger T-accounts.
4. Prepare a classified income statement and statement of changes in equity for the year ended December 31, 2016 and a classified balance sheet at December 31, 2016. Consider payroll expenses and depreciation to be selling expenses.

### 9.7.4.2 AP 9-2



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The following unadjusted trial balance has been taken from the records of Grant Retailers Corp. at December 31, 2016:

No.	Account	Unadjusted TB		Adjustments		Adjusted TB	
		Debit	Credit	Debit	Credit	Debit	Credit
101	Cash	5,000					
110	Accounts receivable	6,000					
150	Merch. inventory	100,000					
151	Parts inventory	5,000					
180	Land	300,000					
181	Building	100,000					
183	Equipment	50,000					
191	Acc. dep'n – bldg.		10,000				
193	Acc. dep'n – equip.		5,000				
210	Accounts payable		37,000				
212	Est. current liab.		-0-				
220	Note payable		-0-				
213	Est. warranty liab.	25,000					
222	Interest payable		-0-				
226	Salaries payable		2,000				
227	Emp'ee inc. tax pay.		300				
228	Emp. insur. payable		120				
229	Gov't pension payable		300				
231	Union dues payable		200				
238	GST payable		2,000				
242	Unearn. commiss. rev.		3,000				
260	Corp. inc. tax payable	22,000					
275	Mortgage payable		200,000				
276	Finance lease		40,000				
320	Share capital		8,000				
340	Retained earnings		13,000				
350	Dividends	10,000					
410	Commissions earned		5,000				
500	Sales		911,080				
570	Cost of goods sold	482,500					
621	Dep'n exp. – bldg.	-0-					
623	Dep'n exp. – equip.	-0-					
632	Interest expense	17,500					
653	Professional fees	-0-					
656	Salaries expense	100,000					
658	Gov't emp. insur. exp.	4,000					
659	Gov't pension expense	10,000					
678	Warranty expense	-0-					
830	Corp. inc. tax expense	-0-					
		<u>1,237,000</u>	<u>1,237,000</u>				

The following additional information is available at the year-end. GST of 5% only applies when indicated.

- a. Unearned commission revenue should be \$5,000.
- b. An account payable of \$10,000 was converted to a 3% note payable on November 1. The accounting records have not been adjusted yet, nor has any interest been recorded.
- c. A \$10,000 purchase of merchandize inventory on account plus GST has not been recorded.
- d. Warranty expense for the year is estimated at 3% of sales.

- e. Additional unpaid gross salaries amount to \$6,000.  
Deductions from gross pay are as follows:

Employee income taxes	15%
Government employment insurance	2%
Government pension	5%
Union dues	10%

The company matches employee contributions to the government employment insurance and government pension plans on a 2 to 1 basis.

- f. Legal fees related to the 2016 financial statements amounted to \$8,000 plus GST have been invoiced but amounts have not yet been recorded.

- g. Payments on the mortgage and finance lease, including interest, were made on December 1. Payments during 2016 will be made as follows:

	<i>Interest</i>	<i>Reduction of principal</i>	<i>Total payments</i>
Mortgage (6%)	\$11,708	\$5,385	\$17,093
Finance lease (10%)	3,631	6,520	10,151

- h. It is probable that the company will lose a lawsuit filed against it during the year. The estimated award is \$100,000, which likely will be paid in 2017.

Depreciation on the building is calculated on the double-declining balance basis. The useful life at acquisition was twenty years, and residual value \$10,000. There were no additions or disposals during the year.

- i. Depreciation on the equipment is calculated on the straight-line basis. The remaining useful life is two years. Residual value is \$10,000. There were no additions or disposals during the year.
- j. Audit fees are estimated to be \$20,000.
- k. The corporate income tax rate is 30% of income before income taxes. Corporate income tax instalments have been made during the year.

*Required:*

1. Prepare necessary adjusting entries at December 31, 2016. Include descriptions and general ledger account numbers, and calculations if necessary.
2. Post the entries to the worksheet and prepare an adjusted trial balance.
3. Prepare a classified income statement and statement of changes in equity for the year ended December 31, and a classified balance sheet at December 31. Consider salary, benefits, and warranty expenses to be selling expenses. No shares were issued during the year.
4. Comment on the reasonableness of the estimated warranty expense rate (3% of sales).

### 9.7.4.3 AP 9-3



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Copper Corp. obtained a \$500,000 loan from Last Chance Bank on January 1, 2016. It purchased a piece of heavy equipment for \$450,000 on January 2, 2016 and paid some accounts payable with the balance on the same day. The loan bears interest at 4% per year on the unpaid balance and is repayable in three annual blended payments of \$187,381 on December 31 each year, starting in 2017 (that is, no payments are required until two years after receiving the loan). Assume interest accrues in the meantime.

*Required:*

1. Prepare the journal entries to record the following transactions:
  - a. Receipt of loan proceeds from the bank
  - b. Purchase of the equipment and payment of the accounts payable.
2. Prepare the loan repayment schedule.

3. Prepare the journal entry to record the first loan payment.
4. Prepare a partial balance sheet showing the loan liability at December 31, 2016.

#### 9.7.4.4 AP 9-4



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North Corp. entered into a finance lease agreement with South Leasing Ltd. on April 1, 2016. North Corp. agreed to pay South an initial payment of \$20,000 on that date and annual payments of \$33,308 for the next three years commencing on March 31, 2017, to lease a piece of equipment with a fair value of \$100,000. The interest rate implicit in the lease agreement was 12%.

*Required:*

1. Prepare the journal entries to record April 1, 2016 transactions.
2. Prepare the lease repayment schedule.
3. Prepare the partial balance sheet of North Corp. at December 31, 2018 showing the finance lease balance assuming the December 31 lease payment has been made.



# Chapter 10 Debt Financing: Bonds



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A corporation often incurs long-term debt in order to finance the acquisition of property, plant, and equipment or other capital assets. This debt may take the form of a bond issue, a bank loan, or a finance lease. Bank loans and finance leases were covered in Chapter 9. This chapter discusses in more detail the means to finance operations by issuing bonds.

## Learning Objectives

LO1 – Describe the nature of bonds and the rights of bondholders.

LO2 – Describe how bonds, premiums and discounts are recorded in the accounting records and disclosed on the balance sheet.

LO3 – Describe and calculate how bond premiums and discounts are amortized.

LO4 – (Appendices) Describe and calculate the effective interest method of amortization and explain how this differs from the straight-line amortization method.

## 10.1 The Nature of Bonds and the Rights of Bondholders



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LO1 – Describe the nature of bonds and the rights of bondholders.

A **bond** is a debt instrument generally issued to many investors that requires future repayment of the original amount at a fixed date, as well as periodic interest payments during the intervening period. A contract called a **bond indenture** is prepared between the corporation and the future bondholders. It specifies the terms with which the corporation will comply, such as how much interest will be paid and when. Another of these terms may be a restriction on further borrowing by the corporation in the future. A **trustee** is appointed to be an intermediary between the corporation and the bondholder. The trustee administers the terms of the indenture.

Ownership of a bond certificate carries with it certain rights. These rights are printed on the actual certificate and vary among bond issues. Individual bondholders always acquire two rights.

The right to receive the face value of the bond at a specified date in the future, called the maturity date, and

The right to receive periodic interest payments, usually semi-annually, at a specified percent of the bond's face value.

Every corporation is legally required to follow a well-defined sequence in **authorizing** a bond issue. The bond issue is presented to the board of directors by management and must be approved by shareholders. Legal requirements must be followed and disclosure is required in the financial statements of the corporation.

Shareholder approval is an important step because bondholders are creditors with a prior claim on the assets of the corporation if liquidation occurs. Further, dividend distributions may be restricted during the life of the bonds. Affected shareholders usually need to approve this. These restrictions are reported to the reader of financial statements through note disclosure.

There are as well several additional considerations related to the decision to issue bonds.

### 10.1.1 Cash Required in the Immediate and the Foreseeable Future



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Most bond issues are sold in their entirety when market conditions are favourable. However, more bonds can be authorized in a particular bond issue than will be immediately sold. Authorized bonds, like authorized share capital, can be issued whenever cash is required.

### 10.1.2 Important Terms of the Bonds



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The interest rate of the bonds, their maturity date, and other important provisions — such as convertibility into share capital and restrictions on future dividend distributions of the corporation — are also considered. The success of a bond issue often depends on the proper combination of these and other similar features.

### 10.1.3 Assets of the Corporation to Be Pledged



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Whether long-lived assets like property, plant, and equipment are pledged as security is an important consideration for bondholders because it helps to safeguard their

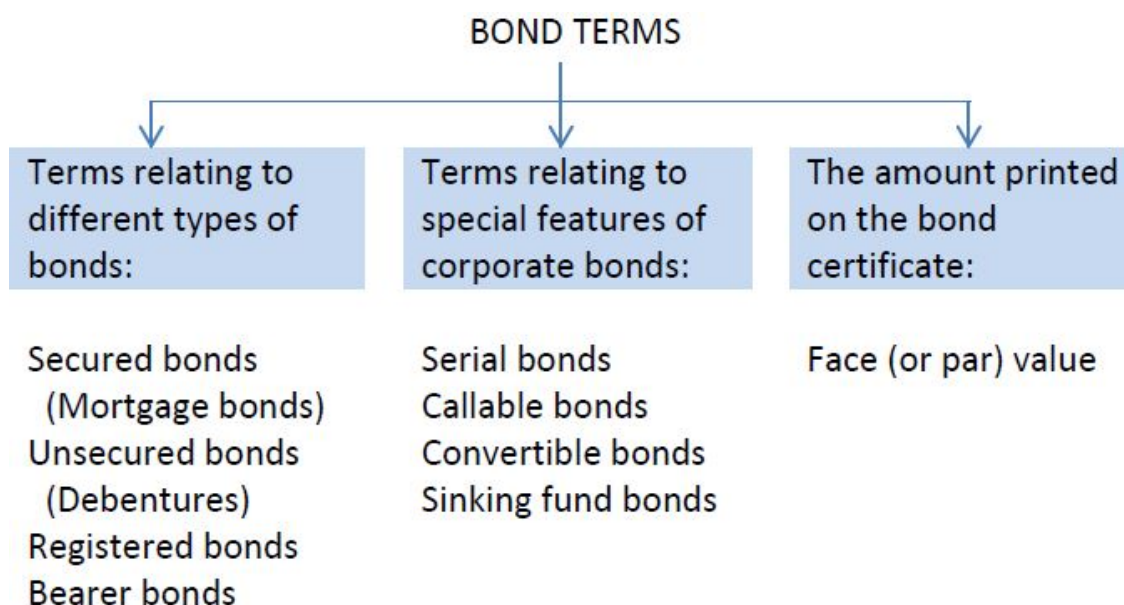
investments. It is important to the corporation because the pledging of all these assets may restrict future borrowings. The total amount of authorized bonds is usually a fraction of the pledged assets, for example, 50%. The difference represents a margin of safety to bondholders. The value of these assets can shrink substantially but still permit reimbursement of bondholders should the company be unable to pay the bond interest or principal, and need to sell the pledged assets.

### 10.1.4 Bond Characteristics and Terminology



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There are three main categories of bond terms. These are shown in [Figure 10.1](#).



**Fig. 10.1: Bond Terms**

Each corporation issuing bonds has unique financing needs and attempts to satisfy various borrowing situations and investor preferences. Many types of bonds have been created to meet these varying needs. Some of the common types are described below.

**Secured bonds** are backed by physical assets of the corporation. These are usually long-lived assets. When real property is legally pledged as security for the bonds, they are called **mortgage bonds**.

Unsecured bonds are commonly referred to as **debentures**. A debenture is a formal document stating that a company is liable to pay a specified amount with interest. The debt is not backed by any collateral. As such, debentures are usually only issued by large, well-established companies. Debenture holders are ordinary creditors of the corporation. These bonds usually command a higher interest rate because of the added risk for investors.

**Registered bonds** require the name and address of the owner to be recorded by the corporation or its trustee. The title to **bearer bonds** passes on delivery of the bonds to

new owners and is not tracked. Payment of interest is made when the bearer clips coupons attached to the bond and presents these for payment.

Special features can be attached to bonds in order to make them more attractive to investors.

When **serial bonds** are issued, the bonds have differing maturity dates, as indicated on the bond contract. Investors are able to choose bonds with a term that agrees with their investment plans. For example, in a \$30 million serial bond issue, \$10 million worth of the bonds may mature each year for three years.

The issue of bonds with a **call provision** permits the issuing corporation to redeem, or call, the bonds before their maturity date. The bond indenture usually indicates the price at which bonds are callable. Corporate bond issuers are thereby protected in the event that market interest rates decline below the bond contract interest rate. The higher interest rate bonds can be called to be replaced by bonds bearing a lower interest rate.

Some bonds allow the bondholder to exchange bonds for a specified type and amount of the corporation's share capital. Bonds with this feature are called **convertible bonds**. This feature permits bondholders to enjoy the security of being creditors while having the option to become shareholders if the corporation is successful.

When **sinking fund bonds** are issued, the corporation is required to deposit funds at regular intervals with a trustee. This feature ensures the availability of adequate cash for the redemption of the bonds at maturity. The fund is called "sinking" because the transferred assets are tied up or "sunk," and cannot be used for any purpose other than the redemption of the bonds.

The corporation issuing bonds may be required to restrict its Retained Earnings, thereby limiting the amount of dividends that can be paid and protecting bondholders..

Investors consider the interest rates of bonds as well as the quality of the assets, if any, that are pledged as security. The other provisions in a bond contract are of limited or no value if the issuing corporation is in financial difficulties. A corporation in such difficulties may not be able to sell its bonds, regardless of the attractive provisions attached to them.

Each bond has an amount printed on the face of the bond certificate. This is called the **face value** of the bond; it is also commonly referred to as the **par-value** of the bond. When the cash received is the same as a bond's face value, the bond is said to be issued at *par*. A common face value of bonds is \$1,000, although bonds of other denominations exist. A \$30 million bond issue can be divided into 30,000 bonds, for example. This permits a large number of individuals and institutions to participate in corporate financing.

## 10.2 The Bond Accounting Process



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LO2 – Describe how bonds, premiums and discounts are recorded in the accounting records and disclosed on the balance sheet.

Assume that Big Dog Carworks Corp. decides to issue \$30 million of 7% bonds to finance its expansion. The bonds are repayable three years from the date of issue, January 1, 2015. The amount of authorized bonds, their interest rate, and their maturity date can be shown in the general ledger as follows:

GENERAL LEDGER							
Bonds Payable – Long-term						Acct. No. 272	
Date		Description	Folio	Debit	Credit		Balance
2015							
Jan.	1	Memorandum: Authorized to issue \$30M of 7%, 3 yr. bonds, due Jan. 1, 2018.					

If the bonds are also sold at face value the same day, the journal entry is straight forward:

2015

Jan. 1	Cash		30,000,000
	Bonds Payable, 7%		30,000,000

*To record the issue of 7% bonds at par.*

Although different bond issues may be combined and disclosed on the balance sheet as one amount, the characteristics of each bond issue are disclosed in a note the financial statements. This includes the interest rate and maturity date of the bond issue. Also disclosed in a note are any restrictions imposed on the corporation's activities by the terms of the bond indenture and the assets pledged, if any.

If interest is paid once a year on December 31, the 2015 entry would be:

2015

Dec. 31	Bond Interest Expense		2,100,000
	Bonds Payable, 7%		2,100,000

*To record 2015 interest expense on bonds (\$30M x 7% - \$2.1M).*

The partial balance sheet of BDCC at December 31, 2015 would show:

## Liabilities

### Non-current

Bonds payable, 7% (Note X)	30,000,000
----------------------------	------------

Note X could state:

On January 1, 2015 the corporation was authorized to issue \$30M of bonds. The terms of the bond indenture are administered by a trustee, Fidelity Mutual. The bonds bear interest at 7% per year on the face value. Interest is paid on December 31 of each year. The bonds are secured by a mortgage on some of the corporation's property. The bonds are non-convertible and non-callable. Dividends may not be paid to shareholder until bond interest has been paid to bondholders. The corporation issued the entire bond issue at face value on January 1, 2015.

### 10.2.1 Premiums and Discounts



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A bond is sold at a **premium** when it is sold for more than its face value. This usually results when the bond interest rate is higher than the market interest rate at the date of issue.

For instance, assume Big Dog Carworks Corp. issues a bond on January 1, 2015 with a face value of \$1,000, a maturity date of one year, and a stated interest rate of 8% per year, at a time when bonds with similar terms, features, and risk are earning only a 7% return. Potential investors will bid up the bond price on the bond market to the point at which the price paid will equal the interest and return of the original investment at the end of the year as if the bond actually yielded 7%. This works out to about \$1,009 because an investor who buys the 8% bonds will receive \$80 (\$1,000 x 8%) interest plus the original \$1,000 investment back at December 31, 2018, for a total of \$1,080. The amount that would need to be invested at the market rate of 7% to return back \$1,080 at the end of one year would be about \$1,009 (\$1,080/1.07). The price of the 8% bond will be bid up to this price.

The difference between the selling price of the bond (\$1,009) and the face value (\$1,000) is the premium of \$9. The journal entry to record the sale of the bond is:

2018

Jan. 1	Cash	1,000	
	Premium on Bonds Payable		9
	Bonds Payable, 8%		1,000
	<i>To record the issue of 8% bonds at a premium.</i>		



Because the bonds mature in one year, the \$9 amount is added to the value of the bonds and recorded in the current liabilities section of the balance sheet. The net amount is referred to as the **bond carrying amount**. The balance sheet just before the bond redemption would show:

<i>Liabilities</i>	
<i>Current</i>	
Bonds payable, 8%	1,000
Premium on bonds	<u>9</u>
Carrying amount	1,009

On December 31, 2018, the interest expense of \$80 is paid, the bond matures, bondholders are repaid, and the premium is written off as a reduction of interest expense.

These three journal entries would be made:

2018

Dec. 31	Interest Expense	80	
	Cash		80
	<i>To record interest on bonds.</i>		

Dec. 31	Bonds Payable, 8%	1,000	
	Cash		1,000
	<i>To record retirement of 8% bonds.</i>		

Dec. 31	Premium on Bonds Payable	9	
	Interest Expense		9
	<i>To record write-off of premium on bonds.</i>		

Note that the interest expense recorded on the income statement would be \$71 (\$80 – 9) or about 7% (rounded). This is equal to the market rate of interest at the time of bond issue.

If the bond is sold for less than \$1,000, then the bond has been sold at a **discount**. This usually results when the bond interest rate is lower than the market interest rate.

Assume now that the same \$1,000, one-year, 8% bond is issued by BDCC. If similar bonds are earning a return of 9% at the date of issue, the selling price of the bond will fall on the market until the point at which the amount of interest to be paid at the end of 2018 (\$80) plus the original \$1,000 investment produces a return of 9% to the bonds' purchasers. This selling amount will be about \$991 (\$1,080/1.09). The difference between the face value of the bond (\$1,000) and the selling price of the bond (\$991) is \$9. This is the *discount*.

The journal entry to record the transaction on January 1, 2018 is:



2018

Dec. 31	Cash	991	
	Discount on Bonds Payable	9	
	Bonds Payable		1,000
	<i>To record issue of 8% bonds at a discount.</i>		

The \$9 amount is a contra liability account and is *deducted* from to the value of the bonds recorded in the current liabilities section of the balance sheet just before the bond redemption would show:

### *Liabilities*

#### *Current*

Bonds payable, 8%	1,000
Discount on bonds	<u>(9)</u>
Carrying amount	991

These three journal entries would be made on December 31, 2018:

2018

Dec. 31	Interest Expense	80	
	Cash		80
	<i>To record interest on bonds.</i>		

Dec. 31	Bonds Payable, 8%	1,000	
	Cash		1,000
	<i>To record retirement of 8% bonds.</i>		

Dec. 31	Interest Expense	9	
	Discount on Bonds Payable		9
	<i>To record write-off of discount on bonds.</i>		

The interest expense recorded on the income statement would be \$89 (\$80 + 9) or about 9% (rounded). This is equal to the market rate of interest at the time of bond issue.

These are simplified examples, and the amounts of bond premiums and discounts are insignificant. In reality, bonds may be issued partway through a fiscal year and may be outstanding for a number of years. Related premiums and discounts can be significant when millions of dollars of bonds are issued and these amounts need to be reduced systematically over the life of a bond issue. Accounting for these considerations is discussed below.

## 10.3 Bond Amortization and Interest



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LO3 – Describe how bond premiums and discounts are amortized.

The mechanisms whereby the market establishes a price for a bond issue are complex. Some of the considerations include *present value* calculations. These are explained further in appendix 1.

In order to focus on the accounting process associated with bonds covered in this section, any applicable premiums or discounts will be provided, and a simplified method of **amortizing** the bond premium or discount presented. Under GAAP, the *effective interest* method of amortizing bond premiums and discounts must be used. This technique is discussed in appendix 2.

In this section, assume the following three scenarios:

Big Dog Carworks Corp. issues \$100,000 of 3-year, 12% bonds on January 1, 2015. Market value is the same as face value (\$100,000). The journal entry to record the sale would be:

1.	2015				
	Jan. 1	Cash		100,000	
			Bonds Payable, 12%		100,000
			<i>To record sale of 12% bonds at par.</i>		

BDCC's bonds are issued at a premium because the market rate of interest is 8% at the date of issue for similar bonds offered in the market. (The difference between the 12% rate on the BDCC bonds and the market rate of 8% is exaggerated for purposes of illustration. In reality, these differences are generally fractions of a%.) As a result, market value is \$110,485. The premium is \$10,485 (\$110,485 – 100,000). The journal entry to record the sale would be:

2.	2015				
	Jan. 1	Cash		110,845	
			Premium on Bonds Payable		10,485
			Bonds Payable, 12%		100,000
			<i>To record sale of 12% bonds at a premium.</i>		

3. BDCC's bonds are issued at a discount. Market value is \$90,754 because the market rate of interest is 16%. The discount is \$9,246 (\$100,000 – 90,754). The journal entry to record the sale on would be:

2015		
Jan. 1	Cash	90,754
	Discount on Bonds Payable	9,246
	Bonds Payable, 12%	100,000
	<i>To record sale of 12% bonds at a discount.</i>	

Interest begins to accumulate from the previous interest payment date of the bond and is usually paid semi-annually regardless of when the bond is actually sold. Interest paid to bondholders is always calculated based on the face value of the bond, regardless of whether the bonds are issued at par, at a premium, or at a discount. BDCC's \$100,000 bond issue with an interest rate of 12% pays \$12,000 interest each year. This interest is usually paid semi-annually, that is, individual bondholders would receive \$6,000 every six months.

As noted previously, any premium or discount is assumed to be amortized over the life of the bond in equal amounts. An entry is made at each point interest is paid. BDCC's bonds are issued for three years and interest will be paid twice each year, on June 30 and December 31 for a total of six payment dates. For our purposes, the premium or discount will be amortized on a straight-line basis over these six periods, in the following amounts:

Premium: (\$10,485/6)	<u>\$1,747</u> (rounded)
Discount (\$9,246/6)	<u>\$1,541</u>

The journal entries to record interest payments for the first year of BDCC's \$100,000 bond issue, together with the appropriate amortization entry, are recorded below.

2015		
Jun. 30	Interest Expense	6,000
	Cash	6,000
	<i>To record payment of semi-annual interest (\$100,000 x 12% x 6/12 mos.)</i>	
Dec. 31	Interest Expense	6,000
	Cash	6,000
	<i>To record payment of semi-annual interest (\$100,000 x 12% x 6/12 mos.)</i>	

The additional adjusting entries to record the 2015 amortization of the bond premium under scenario 2 are:

2015

Jun. 30	Bond Premium	1,747	
	Interest Expense		1,747
	<i>To record amortization of bond premium (\$10,485/6 periods)</i>		

Dec. 31	Bond Premium	1,747	
	Interest Expense		1,747
	<i>To record amortization of bond premium (\$10,485/6 periods)</i>		

The additional adjusting entries to record the 2015 amortization of the bond discount under scenario 3 are:

2015

Jun. 30	Interest Expense	1,541	
	Bond Discount		1,541
	<i>To record amortization of bond discount (\$9,246/6 periods)</i>		

Dec. 31	Interest Expense	1,541	
	Bond Discount		1,541
	<i>To record amortization of bond discount (\$9,246/6 periods)</i>		

Similar entries are made each June 30 and December 31 until the bonds are retired in three years. At maturity on December 31, 2017, the bonds are retired by the payment of cash to bondholders.

The usual entries would be made to record the payment of semiannual interest and amortization of the premium or discount, as well as this final entry:

2017

Dec. 31	Bonds Payable, 12%	100,000	
	Cash		100,000
	<i>To record retirement of 12% bonds.</i>		

The bonds payable would be recorded as non-current liabilities at December 31, 2015. The balance sheet presentation under each of the three scenarios would be:

<i>Scenario 1</i>	<i>Scenario 2</i>	<i>Scenario 3</i>
<i>Non-current liabilities</i>	<i>Non-current liabilities</i>	<i>Non-current liabilities</i>
Bonds payable \$100,000	Bonds payable \$100,000	Bonds payable \$100,000
	Premium on bonds payable 6,991 <sup>1</sup>	Discount on bonds payable (6,164) <sup>2</sup>
	Carrying amount 106,991	Carrying amount 93,836
	<sup>1</sup> (\$10,485 - 1,747 - 1,747) = \$6,990	<sup>2</sup> (\$9,246 - 1,541 - 1,541) = \$6,164

Alternately, just carrying amounts could be shown on the balance sheet. If so, details about face value and unamortized premiums or discounts would be disclosed in a note to the financial statements along with other pertinent details like interest rate, maturity date, and bond indenture provisions.

The bonds mature on December 31, 2017. When the bonds become payable within one year from the balance sheet date, they are classified as current liabilities. This

would be done on the December 31, 2016 BDCC balance sheet, along with any unamortized premium or discount.

### 10.3.1 Amortization

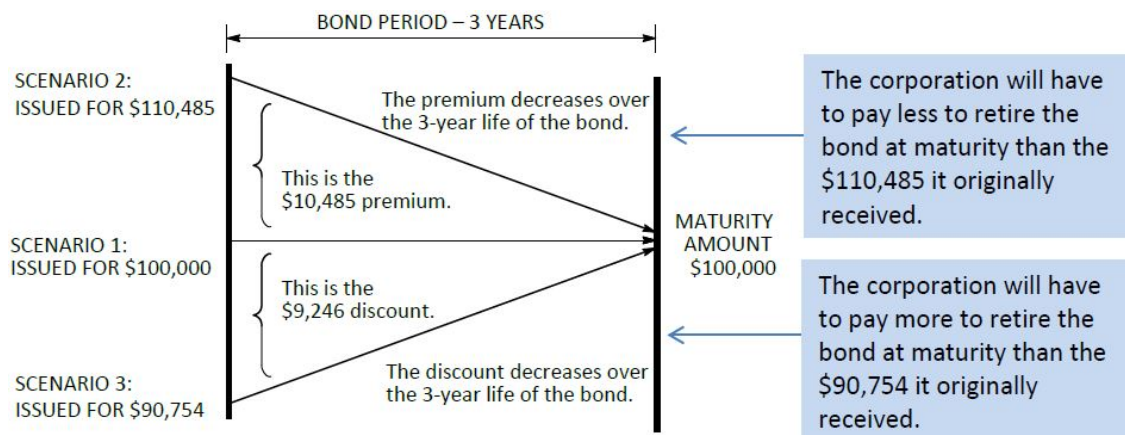


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The effect of amortizing a premium is to reduce interest expense (note the credit to interest expense in the middle journal entry above). This is appropriate, because the market rate of interest was lower than the face value of the bonds actually issued in scenario 2 above (8% vs. 12%).

Amortizing a discount increases interest expense (note the debit to interest expense in the right-hand entry above). This is also appropriate, because in scenario 3 the market rate of interest was higher than the face value of the bonds (16% vs. 12%).

The effect of amortizing a premium or discount is to gradually change the carrying amount of the bonds to the retirement (face) value of the bonds. At retirement, carrying amount is equal to face value under each scenario, as shown in [Figure 10.2](#) below.

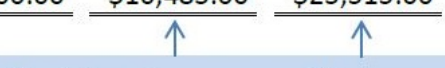


**Fig. 10.2: Straight-line Amortization of Bond Premium or Discount Over the Life of the Bond Issue**

The combined effect on interest expense and carrying amount of issuing the bonds at a premium and amortizing this premium over the life of the bonds is shown in [Figure 10.3](#) below:



Issue of \$100,000 Bonds Payable for \$110,485						
Amortization Table						
		A	B	C	D	E
	Six-month period ending	Beginning bond carrying amount	Cash interest paid	Periodic premium amortization	(B - C) Periodic interest expense	(A - C) Ending bond carrying value
2015	Jun. 30	\$110,485.00	\$ 6,000.00	\$ 1,747.50	\$ 4,252.50	\$108,737.50
	Dec. 31	108,737.50	6,000.00	1,747.50	4,252.50	106,990.00
2016	Jun. 30	106,999.00	6,000.00	1,747.50	4,252.50	105,242.50
	Dec. 31	105,242.50	6,000.00	1,747.50	4,252.50	103,495.00
2017	Jun. 30	103,495.00	6,000.00	1,747.50	4,252.50	101,747.50
	Dec. 31	101,747.50	6,000.00	1,747.50	4,252.50	100,000.00
			<u>\$36,000.00</u>	<u>\$10,485.00</u>	<u>\$25,515.00</u>	




The interest expense on the income statement will be decreased by the amount of the premium amortization.

**Fig. 10.3: Effect of Straight-line Amortization of Bond Premium at Each Interest Payment Date**

The similar combined effect of a discount is shown in [Figure 10.4](#):

Issue of \$100,000 Bonds Payable for \$90,754						
Amortization Table						
		A	B	C	D	E
	Six-month period ending	Beginning bond carrying amount	Cash interest paid	Periodic discount amortization	(B - C) Periodic interest expense	(A - C) Ending bond carrying value
2015	Jun. 30	\$90,754	\$ 6,000	\$ 1,541	\$ 7,541	\$92,295
	Dec. 31	92,295	6,000	1,541	7,541	93,836
2016	Jun. 30	93,836	6,000	1,541	7,541	95,377
	Dec. 31	95,377	6,000	1,541	7,541	96,918
2017	Jun. 30	96,918	6,000	1,541	7,541	98,459
	Dec. 31	98,459	6,000	1,541	7,541	100,000
			<u>\$36,000</u>	<u>\$9,246</u>	<u>\$45,246</u>	



The interest expense on the income statement will be increased by the amount of the discount amortization.

**Fig. 10.4: Effect of Straight-line Amortization of Bond Discount at Each Interest Payment Date**

In the case of bonds issued at a discount, the interest rate consists of the 12% bond rate plus the amortized bond discount. The expense reported on the income statement is higher than the cash interest paid. Thus, whenever a corporation sells a

bond for less than its face value, its total cost of borrowing is increased because of discount amortization.

### 10.3.2 Bond Redemption



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A bond issue can also be retired in whole, or in part, before its maturity date. As discussed above, there are several different possibilities:

1. The bonds can be repurchased on the open market if the purchase is financially advantageous to the issuer.
2. A **call provision** is sometimes included in a bond indenture permitting early redemption at a specified price, usually higher than face value. The issuer may decide to exercise this call provision if it is financially advantageous.
3. The bondholder may be able to exercise a **conversion provision** if one was provided for in the bond indenture; in this case, the bonds can be converted into specified shares at the option of the bondholder.

Whenever bonds are retired before their maturity date, the amount payable to bondholders is the face amount of the bonds or the amount required by the call provision. Any unamortized premium or discount must be removed from the accounts. The accounting required for BDCC's January 1, 2015 issue of \$100,000, 12% bonds has been illustrated. Suppose that  $\frac{1}{2}$ , or \$50,000 of face value bonds, are redeemed for cash at 102 (that is, for  $\$50,000 \times 102\% = \$51,000$ ) on December 31, 2015, when the account balances are as follows:

2015	Bonds Payable	Premium on Bonds
Jan. 1	100,000	10,485.00
Jun. 30		1,747.50
Dec. 31		1,747.50
		6,990.00 Bal.

Since \$50,000 of the bonds is redeemed, only half of the \$6,990 premium balance (\$3,495) is removed from the accounting records. The journal entry would be:

2015			
Dec. 31	Bonds Payable, 12%	50,000	
	Premium on Bonds	3,495	
	Cash		51,000
	Gain on Retirement		2,495
	<i>To record retirement of 12% bonds at 102.</i>		

In this case, retirement results in a gain. Under different market conditions, a loss may result. If  $\frac{1}{2}$  of the outstanding bonds are redeemed at 97, cash of \$48,500 would be received ( $\$50,000 \times 97\%$ ) and this journal entry would be recorded:



2015

Dec. 31	Bonds Payable, 12%	50,000	
	Premium on Bonds	3,495	
	Loss on Retirement	4,995	
	Cash		48,500

*To record retirement of 12% bonds at 97.*

The BDCC retirement occurred on an interest payment date, December 31, 2018. If the retirement had occurred between interest payment dates, accrued interest also would be paid to the bondholders (this will be covered below) and the proportionate write-off of the remaining premium or discount would be recorded at that date.

### 10.3.3 Sale of Bonds between Interest Dates



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Not all bonds are issued on the date when interest begins to accumulate. For example, consider the sale of an additional \$50,000 of 12% BDCC bonds on April 1, 2015. Interest began to accumulate on January 1 per the terms of the bond indenture and, regardless of the date on which the bonds were issued, a six-month interest payment is made to the bondholders on June 30. This \$3,000 payment ( $\$50,000 \times 12\% \times 6/12 \text{ mos.}$ ) is owing to the bondholders even though the bond has been issued for only three months, from April 1 to June 30.

If the bond is sold between interest dates, the purchaser pays the accrued interest at the date of purchase to the issuer, since the purchaser will get the full six months of interest in cash on June 30, having only held the bonds for three months. In this case, \$1,500 of interest has accrued on the bond from January 1 to April 1 ( $\$50,000 \times 12\% \times 3/12 \text{ mos.}$ ). Assuming the bonds are issued at par, the purchasers would pay a total of \$51,500. The corporation would record the bond issue as follows:

2015

Apr. 1	Cash	51,500	
	Bond Interest Payable		1,500
	Bond Payable		50,000

*To record issue of 12% bonds at par on April 1.*

The regular semi-annual interest payment on the \$100,000 of issued bonds is then made on June 30. It is recorded as follows:

2015

Jun. 30	Bond Interest Expense	4,500	
	Bond Interest Payable	1,500	
	Cash		6,000

*To record payment of interest on 12% bonds outstanding ( $\$100,000 \times 12\% \times 6/12 \text{ mos.} = \$6,000$ ).*

In this way, interest expense is recorded on \$50,000 of the bonds for three months ( $\$50,000 \times 12\% \times 3/12 \text{ mos.} = \$1,500$ ) and for the remaining \$50,000 of bonds for six months ( $\$50,000 \times 12\% \times 6/12 \text{ mos.} = \$3,000$ ), for a total of \$4,500.

If the bond has interest payment dates that do not coincide with the year-end of the issuing corporation, an adjusting journal entry is required at year-end to record interest owing at that date. Assume a corporation issued \$200,000, 6% bonds on October 1, 2015 that pay interest semi-annually on April 1 and September 30. If it has a December 31 year-end, the following entry would be made at that date:

2015

Dec. 31	Bond Interest Expense	2,000	
	Bond Interest Payable		2,000
	<i>To accrue interest on 6% bonds issued October 1 (<math>\\$200,000 \times 6\% \times 2/12 \text{ mos.} = \\$2,000</math>).</i>		

When the semi-annual payment is made on April 1 of the next year, this entry is made:

2016

Apr. 30	Bond Interest Expense	4,000	
	Bond Interest Payable	2,000	
	Cash		6,000
	<i>To record semi-annual interest payment on 6% bonds (<math>\\$200,000 \times 6\% \times 6/12 \text{ mos.} = \\$6,000</math>).</i>		

### 10.3.4 Amortizing Premiums and Discounts on Bonds Sold Between Interest Dates



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If bonds are sold between interest payment dates, it is also necessary to calculate the number of months remaining in the life of the bonds at the date the bonds are sold to record the amortization of premiums or discounts. Recall our original example.

\$100,000 of 12% bonds was sold on January 1, 2015; in one scenario, a bond premium of \$10,485 resulted; in the other scenario, a bond discount of \$9,246 resulted. Now assume the bonds were issued on April 1 instead of January 1. The amortization at June 30 would be calculated as follows:

<i>Amortization of premium:</i>		<i>Amortization of discount:</i>	
Premium is	\$10,485(a)	Discount is	\$9,246(a)
Months left are	33(b)	Months left are	33(b)
Months amortized to date	3(c)	Months amortized to date	3(c)
<i>Calculation of amortization April 1 to June 30:</i>		<i>Calculation of amortization April 1 to June 30:</i>	

$$(a/b) \times c$$

$$(\$10,485/33) \times 3 \text{ mos.} = \$953$$

(rounded)

*Every six months thereafter:*

$$(\$10,485/33) \times 6 \text{ mos.} = \$1,906$$

$$(a/b) \times c$$

$$(\$9,246/33) \times 3 = \$840 \text{ (rounded)}$$

*Every six months thereafter:*

$$(\$9,246/33) \times 6 \text{ mos.} = \$1,681$$

## 10.4 Appendix 1: Present Value Calculations



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LO4 – Describe and calculate the effective interest method of amortization and explain how this differs from the straight-line amortization method.

Interest is the time value of money. If you borrow \$1 today for one year at 10% interest, its future value in one year is \$1.10 (\$1 x 110% = \$1.10). The increase of 10 cents results from the interest on \$1 for the year. Conversely, if you are to pay \$1.10 one year from today, the **present value** is \$1 – the amount you would need to invest today at 10% to receive \$1.10 in one year's time (\$1.10/110% = \$1). The exclusion of applicable interest in calculating present value is referred to as **discounting**.

If the above \$1.10 amount at the end of the first year is invested for an additional year at 10% interest, its future value would be \$1.21 (\$1.10 x 110%). This consists of the original \$1 investment, \$.10 interest earned in the first year, and \$.11 interest earned during the second year. Note that the second year's interest is earned on both the original \$1 and on the 10 cents interest earned during the first year. This increase provides an example of **compound interest** – interest earned on interest.

The following formula can be used to calculate this:

$$F = P \times (1+i)^n$$

where F = future value, P = present value, i = the interest rate, and n = number of periods.

Substituting the values of our example, the calculation would be,  $F = \$1[(1 + .1)^2]$ , or \$1.21.

If the **future value** of today's \$1 at 10% interest compounded annually amounts to \$1.21 at the end of 2 years, the present value of \$1.21 to be paid in 2 years, discounted at 10%, is \$1. The formula to calculate this is just the inverse of the formula shown above, or

$$P = \frac{F}{(1 + .i)^n}$$

Substituting the values of our example,

$$P = \frac{\$1.21}{(1 + .1)^2} = \$1$$

That is, the present value of \$1.21 received two years in the future is \$1. The present value is always less than the future value, since an amount received today can be invested to earn a return (interest) in the intervening period. Calculating the present value of amounts payable or receivable over several time periods is explained more thoroughly below.

### 10.4.1 Future Cash Flows



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The following example illustrates how the prices of \$100,000 of bonds issued by Big Dog Carworks Corp. were derived. Recall the three scenarios:

1. Big Dog Carworks Corp. issues \$100,000 of 3-year, 12% bonds on January 1, 2015 when the market rate of interest is also 12%. Interest is paid semi-annually.
2. BDCC's bonds are issued at a premium (\$110,485) because the market rate of interest is 8% at the date of issue for similar bonds offered in the market.
3. BDCC's bonds are issued at a discount (\$90,574). The market rate of interest is 16%.

There are two steps to calculate the present value of the bonds, because there are two types of future cash amounts that relate to the bond issue. The bond *principal* will be repaid at the end of three years, and *interest* payments will be received every six months for three years. The present value of each of these must be calculated and totalled to arrive at the present value of the bonds at the date of issue.

In the examples below, it will be shown that the resulting amount equals the issue price of the bonds in each scenario described above. First, the present value of the repayment of the bond principal at the end of three years for each of the three scenarios will be calculated.

### 10.4.2 Present Value of Bond Principal to be Repaid at End of Three Years



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The present value of a single future amount — \$100,000 in this case — can be calculated using table A below. Since semi-annual interest payments are made, the 6-month rate is used. This is half the annual rate, or 6% (12% x ½). The “6%” column below is therefore used, rather than the 12% column. Also, because there are 6 interest payment periods over the 3-year life of the bond, the “6 period” row is used

instead of the "3 period" row. The intersection of this row and column is \$.704961 (see amount in blue in the table). This represents the present value of \$1 to be received six periods hence, assuming an interest rate of 6% per period.

**Table A**  
Present Value (P) of \$1

$$P = \frac{1}{1 + i^n}$$

Periods	4%	6%	8%	10%	12%	14%	16%
1	.961538	.943396	.925926	.909091	.892857	.877193	.862069
2	.924556	.889996	.857339	.826446	.797194	.769468	.743163
3	.888996	.839619	.793832	.751315	.711780	.674972	.640658
4	.854804	.792094	.735030	.683013	.635518	.592030	.552291
5	.821927	.747258	.680583	.620921	.567427	.519369	.476113
6	<b>.790315</b>	<b>.704961</b>	<b>.630170</b>	.564474	.506631	.455587	.410442
7	.759918	.665057	.583490	.513158	.452349	.399637	.353830
8	.730690	.627412	.540269	.466507	.403883	.350559	.305025
9	.702587	.591898	.500249	.424098	.360610	.307508	.262953
10	.675564	.558395	.463193	.385543	.321973	.269744	.226684
11	.649581	.526788	.428883	.350494	.287476	.236617	.195417
12	.624597	.496969	.397114	.318631	.256675	.207559	.168463
13	.600574	.468839	.367698	.289664	.229174	.182069	.145227
14	.577475	.442301	.340461	.263331	.204620	.159710	.125195
15	.555265	.417265	.315242	.239392	.182696	.140096	.107927
16	.533908	.393646	.291890	.217629	.163122	.122892	.093041
17	.513373	.371364	.270269	.197845	.145644	.107800	.080207
18	.493628	.350344	.250249	.179859	.130040	.094561	.069144
19	.474642	.330513	.231712	.163508	.116107	.082948	.059607
20	.456387	.311805	.214548	.148644	.103667	.072762	.051385

**Scenario 1: The Bond Contract Interest Rate (12%) Is the Same as the Market Interest Rate (12%)**

The present value of \$100,000 principal to be received three years from now is  
\$100,000 x 0.704961 = \$70,496.

**Scenario 2: The Market Interest Rate Is 8% (per Year)**

Again, since semi-annual interest payments are made, the 6-month rate is half the annual rate. Therefore, the compounding rate this time is 4% (8% x ½); there are 6 periods of interest payments.

According to table A, the present value of \$1 compounded at 4% for 6 periods is 0.790315 (see bolded amount in 4% column). The present value of the principal amount of the bonds is therefore calculated as: \$100,000 x 0.790315 = \$79,032.

**Scenario 3: The Market Interest Rate Is 16% (per Year)**

For these semi-annual interest payments, the 6-month rate is 8% (16% x ½); there are also 6 periods of interest payments.

According to table A, the present value of \$1 compounded at 8% for 6 periods is 0.630170 (see bolded amount in 8% column). The present value of the principal amount of the bonds is therefore calculated as: \$100,000 x 0.630170 = \$63,017.



### 10.4.3 Present Value of Six Interest Payments to be Made Semi-annually for Three years



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The present value of the interest payments can be calculated using table B. This formula is just the sum of the present value of each of the six interest payments made at varying points over the three-year life of the bonds. In this instance, interest of \$6,000 is paid semi-annually for 6 periods on the bonds. Since BDCC's payments are made semiannually, the rate used is half the prevailing market rate of interest.

**Table B**  
Present Value (P) of a Series of Payments of \$1

$$P = \left[ \frac{1 - \frac{1}{1 + i^n}}{i} \right]$$

Periods	4%	6%	8%	10%	12%	14%	16%
1	.961538	.943396	.925926	.909091	.892857	.877193	.862069
2	1.886095	1.833393	1.783265	1.735537	1.690051	1.646661	1.605232
3	2.775091	2.673012	2.577097	2.486852	2.401831	2.321632	2.245890
4	3.629895	3.465106	3.312127	3.169865	3.037349	2.913712	2.798181
5	4.451822	4.212364	3.992710	3.790787	3.604776	3.433081	3.274294
6	<b>5.242137</b>	<b>4.917324</b>	<b>4.622880</b>	4.355261	4.111407	3.888668	3.684736
7	6.002055	5.582381	5.206370	4.868419	4.563757	4.288305	4.038565
8	6.732745	6.209794	5.746639	5.334926	4.967640	4.638864	4.343591
9	7.435332	6.801692	6.246888	5.759024	5.328250	4.946372	4.606544
10	8.110896	7.360087	6.710081	6.144567	5.650223	5.216116	4.833227
11	8.760477	7.886875	7.138964	6.495061	5.937699	5.452733	5.028644
12	9.385074	8.383844	7.536078	6.813692	6.194374	5.660292	5.197107
13	9.985648	8.852683	7.903776	7.103356	6.423548	5.842362	5.342334
14	10.563123	9.294984	8.244237	7.366687	6.628168	6.002072	5.467529
15	11.118387	9.712249	8.559479	7.606080	6.810864	6.142168	5.575456
16	11.652296	10.105895	8.851369	7.823709	6.963986	6.265060	5.668497
17	12.165669	10.477260	9.121638	8.021553	6.119630	6.372859	5.748704
18	12.659297	10.827603	9.371887	8.201812	7.249670	6.467420	5.817848
19	13.133939	11.158116	9.603599	8.364920	7.365777	6.550369	5.877455
20	13.590326	11.469921	9.818147	8.513564	7.469444	6.623131	5.928841

#### **Scenario 1: The Market Interest Rate Is 12% (per Year)**

According to table B, the sum of the present values of six regular payments of \$1 compounded at 6% (12% x ½) for six periods is 4.917324 (see bolded amount in 6% column). The total present value of the six, \$6,000 interest payments made over the three-year life of the BDCC bonds under scenario 1 is therefore \$6,000 x 4.917324 = \$29,504.

#### **Scenario 2: The Market Interest Rate Is 8% (per Year)**

Again using table B, the sum of the present values of six regular interest payments of \$1 compounded at 4% (8% x ½) for 6 periods is 5.242137 (see bolded amount in 4%

column). The total present value of the six, \$6,000 interest payments made over the three-year life of the BDCC bonds under scenario 2 is therefore  $\$6,000 \times 5.242137 = \$31,453$ .

**Scenario 3: The Market Interest Rate Is 16% (per Year)**

The sum of the present values of six regular interest payments of \$1 compounded at 8% ( $16\% \times \frac{1}{2}$ ) for 6 periods is 4.622880 according to table B. The total present value of the six, \$6,000 interest payments made over the three-year life of the BDCC bonds under scenario 3 is therefore  $\$6,000 \times 4.622880 = \$27,737$ .

### 10.4.4 Calculating the Total Present Value of the BDCC bonds



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The total present value of the \$100,000 BDCC bonds issued under each of the three scenarios is the sum of the present value of the principal and interest payments derived above.

**Scenario 1: The Bond Contract Interest Rate (12%) Is the Same as the Market Interest Rate (12%)**

In this case, the bonds are sold at face value. An investor is willing to pay face value because the present value of the future cash payments is \$100,000 – the sum of the present value of the principal and interest payments of the bonds:

- |  |                         |
|--|-------------------------|
| 1. The \$100,000 bond face value is due at the end of six periods. The present value of this cash flow is calculated as $\$100,000 \times 0.704961$ (table A)            | <b>\$70,496</b>         |
| 2. The semi-annual \$6,000 interest is to be received for six periods in total. The present value of this cash flow is calculated as $\$6,000 \times 4.917324$ (table B) | <b><u>29,504</u></b>    |
| Total present value of these bonds is  | <b><u>\$100,000</u></b> |

When the bond contract interest rate is the same as the market interest rate, the present value of all cash flows is the same as the bond's face value. In actual practice, however, the market interest rate may be different from the bond indenture interest rate because of the time that elapses between the creation of the indenture and the time the bonds are actually sold on the bond market. Scenarios 2 and 3 deal with this situation.

**Scenario 2: The Bond Contract Interest Rate (12%) Is Greater than the Market Interest Rate (8%)**



Here the bonds are sold at a premium. An investor is willing to pay more than face value because the present value of the future cash flow amounts to \$110,485, calculated as follows:

- |  |                         |
|--|-------------------------|
| 1. The \$100,000 bond face value is due at the end of six periods. The present value of this cash flow is calculated as $\$100,000 \times 0.790315$ (table A)            | <b>\$79,032</b>         |
| 2. The semi-annual \$6,000 interest is to be received for six periods in total. The present value of this cash flow is calculated as $\$6,000 \times 5.242137$ (table B) | <u><b>31,453</b></u>    |
| Total present value of these bonds is  | <u><b>\$110,485</b></u> |

Therefore, when the bond contract interest rate is greater than the market interest rate, the present value of principal and interest payments is greater than the face value of the bonds, other things being equal. This excess amount of \$10,485 (\$110,485 - 100,000) is the premium that was assumed in the original scenario 2 example.

***Scenario 3: The Bond Contract Interest Rate (12%) Is Less than the Market Interest Rate (16%)***

In this case, the bonds are sold at a discount. An investor will pay less than face value because the present value of future cash flow amounts to only \$90,754.

- |  |                        |
|--|------------------------|
| 1. The \$100,000 bond face value is due at the end of six periods. The present value of this cash flow is calculated as $\$100,000 \times 0.630170$ (table A)            | <b>\$63,017</b>        |
| 2. The semi-annual \$6,000 interest is to be received for six periods in total. The present value of this cash flow is calculated as $\$6,000 \times 4.622880$ (table B) | <u><b>27,737</b></u>   |
| Total present value of these bonds is  | <u><b>\$90,754</b></u> |

Therefore, when the bond contract interest rate is less than the market interest rate, the present value of all cash flows is less than the face value of the bonds. This difference, calculated as \$9,246 (\$100,000 - \$90,754) in this example, is the discount used in the original scenario 3 discussed earlier in the chapter.

## 10.5 Appendix 2: The Effective Interest Method of Amortization



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As also discussed earlier, the bond premium or discount is amortized over the bond life remaining from the date of the bond's issue. The straight-line method allocates an equal amount of amortization to each semi-annual interest period. The simplicity of this method makes it appropriate as an introduction to the bond accounting process.

However, GAAP requires the use of the *effective interest* amortization method. Under this method, the amount of amortization calculated differs from one period to another but produces a more appropriate rate of interest expense when it is recognized in the income statement.

The calculation is facilitated through the preparation of an amortization table. To illustrate, assume that Big Dog Carworks Corp. uses this method of amortization and again issues 8%, three-year bonds with a face value of \$100,000 on January 1, 2015. The issue price is \$110,485.

### Calculating Interest Expense and Premium Amortization

The amortization table shown in Figure 10–5 is prepared:

Issue of \$100,000 Bonds Payable for \$110,485

#### Amortization Table

Using Market Interest Rate of 8%

	A	B	C	D	E	
		Using 8% market rate			(A - D)	
	Six-month period ending	Beginning bond carrying amount	to calculate six-month interest expense [( $\frac{1}{2}$ of 8% = 4%) x A]	Actual cash interest paid	(B - C) Periodic premium amortization	Ending bond carrying amount
Year						
2015	Jun. 30	\$110,485	(4% x \$110,485) = \$4,419	\$6,000	\$1,581	\$108,904
	Dec. 31	108,904	(4% x 108,904) = 4,356	6,000	1,644	107,260
2016	Jun. 30	107,260	(4% x 107,260) = 4,290	6,000	1,710	105,550
	Dec. 31	105,550	(4% x 105,550) = 4,222	6,000	1,778	103,772
2017	Jun. 30	103,772	(4% x 103,772) = 4,151	6,000	1,849	101,923
	Dec. 31	101,923	(4% x 101,923) = 4,077	6,000	1,923	100,000

↑

Note the use of a constant interest rate under this method.

↑

This amount is the interest expense for each 6-month period.

↑

This amount is the amortization for each 6-month period.

Fig. 10.5: Effective Interest Method of Bond Amortization

The calculation begins with the \$110,485 issue amount in period 1 (January 1 to June 30, 2015). The objective of this amortization method is to reduce this carrying amount to the face value of \$100,000 over the life of the bonds; the decrease is shown in column E of the table.

In this case, the market interest rate of 8% is expressed as an annual rate. Because BDCC makes semi-annual interest payments, the six-month rate is 4% (half of the 8% annual rate), which is the rate used in column B for each semi-annual period. (For convenience, all column B calculations are rounded to the nearest dollar.)

The calculation in column D provides the premium amortization amount for each period. In period 1, for example, the difference between the \$4,419 market rate interest expense (column B) and the \$6,000 actual bond contract interest paid (column C) determines the premium amortization of \$1,581 (column B - column C). Columns E and A show the decreasing carrying amount of the bonds during their three-year life.

The advantage of the effective interest method is that it calculates interest expense at a constant 4% each period. Interest expense (column B) decreases each period. From a theoretical point of view, it is preferable to show a financing interest expense that decreases (column B) as the amount of bonds outstanding decreases (column A), as this produces a constant rate of borrowing.

### 10.5.1 Recording Interest Payments and Premium Amortization



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Journal entries to record interest payments and amortization of the premium are made every June 30 and December 31 in the same manner as for straight-line amortization shown in section C. The actual interest paid to bondholders amounts to \$6,000 each semi-annual period; the amount of premium amortization for each period is taken from column D of the amortization table. These are the entries for June 30, 2015.

	<i>Payment of interest:</i>		<i>Amortization of premium:</i>	
Jun. 30	Interest Expense	6,000	Bond Premium	1,581
	Cash	6,000	Interest Expense	1,581
	<i>To record semi-annual bond interest.</i>		<i>To record amortization of bond premium.</i>	

The entries for each remaining period are similar; only the amounts used for premium amortization differ, as shown in column D of the amortization table. After posting the June 30 entries, the following balances result:

Bonds Payable	Premium on Bonds	Bond Int. Expense
100,000	10,485	6,000
↑	1,581	1,581
	8,904	4,419
↑	↑	↑

The bond carrying amount at June 30 is \$108,904 (\$100,000 + 8,904). This is the amount that appeared in column E of the amortization table.

\$4,419 is the balance that was calculated in column B of the amortization table.



Note that the effective interest rate based on the income statement interest expense and the opening bond carrying value shown on the balance sheet is 4% (\$4,419/110,485, rounded).

## 10.5.2 Calculating Interest Expense and Discount Amortization



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The following amortization table is prepared for the BDCC issue of \$100,000 face value bonds at a discount for \$90,754. The calculation begins with the \$90,754 carrying amount in column A. The objective is to increase this carrying amount to the face value of \$100,000 over the three-year life of the bond at a constant interest rate; this increase appears in column E.

The annual market interest rate in this case is 16%. Half this rate — 8% — is used in the column B calculations, since interest payments are made semi-annually. (For convenience, all column B calculations are rounded to the nearest dollar.) The calculation in column D provides the amortization amount. In period 1, for example, the difference between the \$7,260 market rate interest expense (column B) and the \$6,000 actual bond contract interest paid (column C) determines the discount amortization of \$1,260 (column B – column C).

	A	B	C	D	E	
		<i>Using 8% market rate</i>			(A .- D)	
	<i>Six-month period ending</i>	<i>Beginning bond carrying amount</i>	<i>to calculate six-month interest expense</i> ( $[\frac{1}{2} \text{ of } 16\% = 8\%] \times A$ )	<i>Actual cash interest paid</i>	<i>(B - C) Periodic discount amortization</i>	<i>Ending bond carrying amount</i>
2015	Jun. 30	\$90,754	$(8\% \times \$90,754) = \$7,260$	\$6,000	\$1,260	\$ 92,014
	Dec. 31	92,014	$(8\% \times 92,014) = 7,361$	6,000	1,361	93,375
2016	Jun. 30	93,375	$(8\% \times 93,375) = 7,470$	6,000	1,470	94,845
	Dec. 31	94,845	$(8\% \times 94,845) = 7,588$	6,000	1,588	96,433
2017	Jun. 30	96,433	$(8\% \times 96,433) = 7,715$	6,000	1,715	98,148
	Dec. 31	98,148	$(8\% \times 98,148) = 7,852$	6,000	1,852	100,000

Columns E and A show the increasing carrying amount of the bonds during their three-year life. The effective interest method calculates interest expense at a constant 8% of each period's bond carrying amount. To achieve this, interest expense (column B) increases each period as the bond carrying amount increases.

### 10.5.3 Recording Interest Payments and Discount Amortization



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Journal entries to record interest payments and amortization are made each June 30 and December 31 in the same manner as for the straightline method (shown in section C). The actual interest paid to bondholders amounts to \$6,000 each semi-annual period; the amount of discount amortization is taken directly from column D of the amortization table. These are the entries for period 1, January 1 to June 3.

	<i>Payment of interest:</i>		<i>Amortization of discount:</i>	
Jun. 30	Interest Expense	6,000	Interest Expense	1,260
	Cash	6,000	Bond Discount	1,260
	<i>To record semi-annual bond interest.</i>		<i>To record amortization of bond discount.</i>	

The entries for each remaining period are similar; only the amounts used for discount amortization differ, as shown in column D of the amortization table. After the posting of the June 30 entries, the following balances result:

Bonds Payable	Discount on Bonds	Bond Int. Expense
100,000	9,246	6,000
↑	1,260	1,260
	7,986	7,260
	↑	↑

The bond carrying amount at June 30 is \$92,014 (\$100,000 – 7,986). This is the amount that appeared in column E of the amortization table.

\$7,260 is the balance that was calculated in column B of the amortization table.

### 10.5.4 Comparison of the Effective Interest Method with the Straight-Line Method



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A comparison of the two amortization methods can be made using the data applicable to the issue of BDCC's bonds at a discount; \$100,000 face value bonds are issued for \$90,754, resulting in a discount of \$9,246 (\$100,000 - \$90,754). Under the straight-line method, this \$9,246 discount is amortized in equal amounts over the 3-year life of the bonds. The discount is calculated for 6 -month periods, because amortization is recorded at the time that semi-annual interest payments are made. To recap: the straight-line method amortization is calculated as follows:

Discount	\$9,246(a)
Number of 6 -month periods remaining	6(b)

Amortization (a/b)

\$1,541

As explained in section C of this chapter, amortization of a discount increases interest expense. Therefore, the \$1,541 is added to the \$6,000 interest payment to calculate the \$7,541 interest expense applicable to each 6-month period. Under the straight-line method, the effective interest rate varies from period to period.

Under the effective interest method, the amortization of the \$9,246 discount each period varies, but the effective interest rate is a constant 4%. Note that the total interest expense of \$45,246 for the three-year period is the same under both methods.

Year	Effective Interest Method				Straight-Line Method		
	Six-month period ending	Bond carrying amount (A)	Interest expense (B)	(B/A) %	Bond carrying amount (A)	Interest expense (B)	(B/A) %
2015	Jun. 30	\$90,754	\$ 7,260	8	\$90,754	\$ 7,541	8.3
	Dec. 31	92,014	7,361	8	92,295	7,541	8.2
2016	Jun. 30	93,375	7,470	8	93,836	7,541	8.7
	Dec. 31	94,845	7,588	8	95,377	7,541	9.0
2017	Jun. 30	96,433	7,715	8	96,918	7,541	7.8
	Dec. 31	98,148	7,852	8	98,459	7,541	7.7
			<u>\$45,246</u>			<u>\$45,246</u>	

Under this method, the interest percentage is constant.

Under this method, the interest percentage varies.

This comparison involved the issue of bonds at a discount. A similar comparison for bonds issued at a premium would indicate a similar difference in the calculation of a periodic financing charge. Under the straight-line method, however, the percentage of financing charge would increase in the case of a premium, rather than decrease as shown here.

## 10.6 Summary of Chapter 10 Learning Objectives



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### LO1 – Describe the nature of bonds and the rights of bondholders.

A bond is a debt security that necessitates periodic interest payments during its life as well as a future repayment of the borrowed amount. A bond indenture is the contract that binds the corporation to the bondholders; it specifies the terms with which the corporation must comply and may restrict further borrowing by the corporation. A bondholder has the rights to receive the face value of the bond at a specified maturity

date in the future; to receive periodic interest payments at a specified per cent of the bond's face value; and in some cases, to have the corporation pledge assets to protect the bondholder's investment.

**LO2 – Describe how bonds, premiums, and discounts are recorded in the accounting records and disclosed on the balance sheet.**

If the bond contract interest rate is the same as the prevailing market interest rate, the bond will sell "at par". If the bond contract interest rate is higher than the prevailing market interest rate, the bond will sell at a premium. If the bond contract interest rate is lower than the prevailing market interest rate, the bond will sell at a discount. Premiums and discounts are recorded separately from the bonds payable in the accounting records.

**LO3 – Describe and calculate how bond premiums and discounts are amortized.**

Premiums and discounts are amortized over the remaining life of the bonds. Under GAAP, an unamortized premium (discount) is added to (deducted from) the face value of the bond so that the liability is recorded at its carrying amount on the balance sheet.

**LO4 – (Appendices) Describe and calculate the effective interest method of amortization and explain how this differs from the straight-line amortization method.**

Under the straight-line amortization method, any premium or discount is written off in equal amounts over the remaining life of the bond. Under the effective interest method, the price of a bond is determined by combining the present value of the face value to be paid at maturity and interest payments made during the bond's life. Amortization under the effective interest method is calculated by applying the market rate of interest to the carrying amount of the bonds. The difference between this interest and the actual bond contract interest paid is the amortization applicable to the current period. The effective interest method produces a constant interest rate equal to the market rate of interest on the date the bonds were issued.

## 10.7 Assignment Materials

### 10.7.1 Concept Self-check



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1. What is a bond? a bond indenture? Why might a trustee be used to administer a bond indenture?
2. List and explain some bondholder rights.
3. What is the significance of shareholder approval before an issue of bonds?
4. How are different bond issues reported in the financial statements of a corporation?
5. Three main categories of bond terms are identified in this chapter. Identify these categories and list the major terms of each category.



6. What are three reasons why bonds might be redeemed before their maturity date?
7. Why would investors pay a premium for a corporate bond? Why would a corporation issue its bonds at a discount? Explain, using the relationship between the bond contract interest rate and the prevailing market interest rate.
8. How is an unamortized bond premium or discount disclosed in accordance with GAAP?
9. If the bond contract interest rate is greater than that required in the market on the date of issue, what is the effect on the selling price of the bond? Why?
10. What are two different methods used to amortize premiums and discounts? Explain.
11. How is the interest paid to bondholders calculated? How does this practice affect the sale of bonds between interest dates?
12. How is the amortization of bond premium recorded in the accounting records? the amortization of bond discount?
13. (Appendix 1) Distinguish between future value and present value. What is the time value of money? Why is it important?
14. (Appendix 1) How is the actual price of a bond determined? Give an example.
15. (Appendix 2) Explain how the amortization under the effective interest method is calculated. Use an example.
16. (Appendix 2) From a theoretical point of view, why is the effective interest method of amortization more acceptable than the straight-line method? Evaluate the usefulness of the effective interest method from a practical point of view.

## 10.7.2 Comprehension Problems



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*Note:* Answer problems regarding present value calculations and the effective interest method of amortization only if the appendices were studied in your course. Recall as well that “issuing a \$100,000 bond at 105”, for example, means that the bond is sold for  $\$100,000 \times 105\% = \$105,000$ .

### 10.7.2.1 CP 10-1



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*Required:* Complete the following by responding either *premium* or *discount*.

1. If the market rate of interest is 15% and the bond interest rate is 10%, the bonds will sell at a \_\_\_\_\_.
2. If a bond’s interest rate is 10% and the market rate of interest is 8%, the bonds will sell at a \_\_\_\_\_.

3. In computing the carrying amount of a bond, unamortized \_\_\_\_\_ is subtracted from the face value of the bond.
4. In computing the carrying amount of a bond, unamortized \_\_\_\_\_ is added to the face value of the bond.
5. If a bond sells at a \_\_\_\_\_, an amount in excess of the face value of the bond is received on the date of issuance.
6. If a bond sells at a \_\_\_\_\_, an amount less than the face value of the bond is received on the date of issuance.

### 10.7.2.2 CP 10-2



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On January 1, 2015, the date of bond authorization, Nevada Inc. issued a 3-year, 12-per cent bond with a face value of \$100,000 at 94. Semiannual interest is payable on June 30 and December 31.

*Required:*

1. Prepare journal entries to record the following transactions:
  - a. The issuance of the bonds
  - b. The interest payment on June 30, 2015
  - c. The amortization of the discount on June 30, 2015 (use the straight-line method of amortization).
2. Calculate the amount of interest paid in cash during 2015 and the amount of interest expense that will appear in the 2015 income statement.
3. Prepare a partial balance sheet at December 31, 2015 showing how the bonds payable and the discount on the bonds should be shown on the balance sheet.
4. Prepare the journal entry to record the retirement of the bonds on December 31, 2017.
5. Prepare the journal entry on January 1, 2016, assuming the bonds were called at 102.

### 10.7.2.3 CP 10-3



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On January 1, 2017, the date of bond authorization, Sydney Corp. issued 3-year, 12-per cent bonds with a face value of \$200,000 at 112. Semi-annual interest is payable on June 30 and December 31.

*Required:*

1. Prepare the journal entries to record the following transactions:
  - a. The issuance of the bonds
  - b. The interest payment on June 30, 2017
  - c. The amortization of the premium on June 30, 2017 (use the straight-line method of amortization).
2. Calculate the amount of interest paid in cash during 2017 and the amount of interest expense that will appear in the 2017 income statement. Why are these amounts different?
3. Prepare a partial balance sheet at December 31, 2017 showing how the bonds payable and the premium on bonds should be shown on the balance sheet.
4. Prepare the journal entry on January 1, 2020 when the bonds were called at 106.

### 10.7.2.4 CP 10-4



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On January 1, 2018, the date of bond authorization, Paquette Inc. issued 3-year, 12-per cent bonds. Semi-annual interest is payable on June 30 and December 31. Paquette uses the straight-line method of amortization. The following journal entry records the first payment of interest:

2018

June 30	Interest Expense	17,000	
	Cash		16,500
	Discount on Bonds		500

*Required:* Reconstruct the journal entry made to record the issuance of bonds on January 1, 2018.

### 10.7.2.5 CP 10-5



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Gaudette Inc. issued 3-year, 12-per cent bonds on January 1, 2016, the date of bond authorization. Semi-annual interest is payable on June 30 and December 31. Gaudette uses the straight-line method of amortization. The following journal entry records the payment of interest on December 31, 2016:

2016

Dec. 31	Interest Expense	17,900	
	Premium on Bonds	100	
	Cash		18,000

*Required:* Reconstruct the entry made to record the issuance of bonds on January 1, 2016.

### 10.7.2.6 CP 10-6



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Leong Corporation was authorized to issue \$500,000 face value bonds on January 1, 2015. The corporation issued \$100,000 of face value bonds on that date. The bonds will mature on December 31, 2018. Interest is paid semi-annually on June 30 and December 31 each year. The bond interest rate per the terms of the indenture is 12% per year.

*Required:* Answer the questions for each of the following cases.

Case A: The bonds were issued at face value.

Case B: The bonds were issued for \$112,000.

Case C: The bonds were issued for \$88,000.

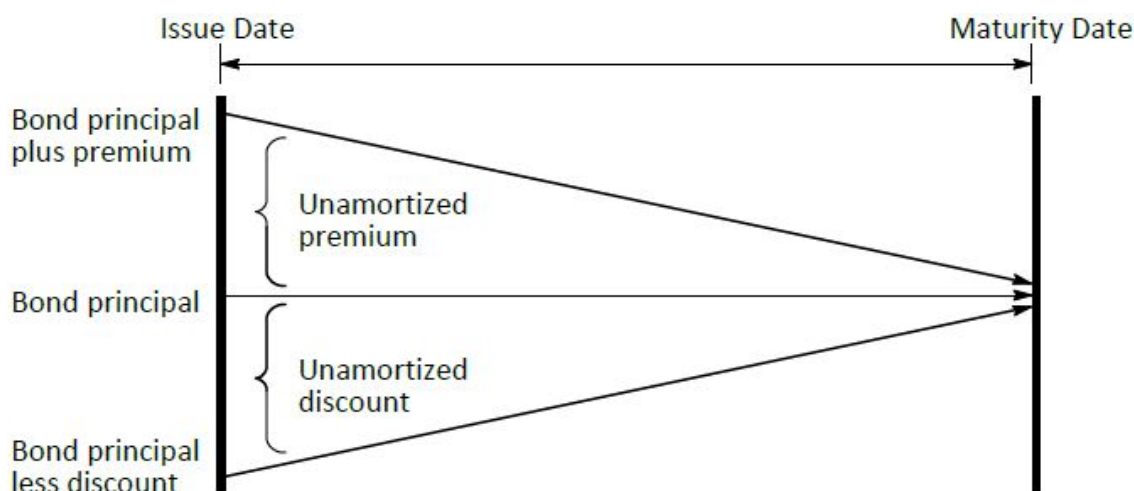
1. How much cash does Leong receive for the bonds?
2. How much annual interest must the corporation pay? On what amount does the corporation pay?
3. Prepare the journal entry to record the sale of the bonds.
4. Record the entries applicable to interest and straight-line amortization for June 30, 2015 and for December 31, 2015.

### 10.7.2.7 CP 10-7



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The following diagram shows how the carrying amount of bonds payable changes over time for bonds issued at a premium, at par, and at a discount.



*Required:*

1. Explain the change in carrying amount of the bonds, in terms of the difference between the periodic interest expense recorded on the corporation's income statement and the cash interest paid to investors.
2. Does the diagram illustrate the straight-line or effective interest method of bond premium and discount amortization? How can you tell?

### 10.7.2.8 CP 10-8 (Appendix)



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Night Owl Distributors Ltd. was authorized to issue \$500,000 of 12% bonds on January 1, 2015. On this date, the corporation issued \$200,000 of bonds for \$210,152. The market rate of interest was 10%. Interest is paid semi-annually on June 30 and December 31.

*Required:*

1. Calculate the amount of interest paid every interest payment date.
2. Complete the amortization table below using the effective interest method of amortization.

Issuance of \$200,000 Bonds Payable for \$210,152  
Amortization Table  
Using Market Interest Rate of 10%

	A	B	C	D	E
		<i>Using 10% market rate</i>			(A - D)
	<i>Beginning bond carrying amount</i>	<i>to calculate six-month interest expense</i>	<i>Cash interest paid</i>	<i>(B - C) Periodic premium amortization</i>	<i>Ending bond carrying amount</i>
<i>Year</i>	<i>Period ending</i>		$([\frac{1}{2} \text{ of } 10\% = 5\%] \times A)$		
2015	Jun. 30	\$210,152	$(5\% \times \$210,152) = \$10,507$		
	Dec. 31		$(5\% \times \quad) =$		
2016	Jun. 30		$(5\% \times \quad) =$		
	Dec. 31		$(5\% \times \quad) =$		
2017	Jun. 30		$(5\% \times \quad) =$		
	Dec. 31		$(5\% \times \quad) =$		

3. Using the following table, calculate the interest percentage under the effective interest method of amortization for each six-month period.

	A	B	
		<i>Using 10% market rate</i>	
	<i>Six-month period ending</i>	<i>Beginning bond carrying amount</i>	<i>to calculate six-month interest expense</i>
<i>Year</i>			$([\frac{1}{2} \text{ of } 10\% = 5\%] \times A)$
2015	Jun. 30	\$210,152	$(5\% \times \$210,152 = ) \$10,507$
	Dec. 31		$(5\% \times \quad = )$
2016	Jun. 30		$(5\% \times \quad = )$
	Dec. 31		$(5\% \times \quad = )$
2017	Jun. 30		$(5\% \times \quad = )$
	Dec. 31		$(5\% \times \quad = )$

4. Comment on the interest percentage that results in each period. Do you think that this should remain constant from period to period? Why or why not?

### 10.7.3 Problems

#### 10.7.3.1 P 10-1



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Round Corporation was authorized to issue \$300,000 of bonds. On January 1, 2015, the corporation issued \$150,000 of bonds for \$147,000. Details of the bond indenture are as follows:

<i>Date of authorization</i>	<i>Term</i>	<i>Interest rate</i>	<i>Interest payment dates</i>
January 1, 2015	3 years	12%	Semi-annually on June 30 and December 31

*Required:*

1. Calculate
  1. The amount of interest paid every interest payment date
  2. The amount of amortization to be recorded at each interest payment date (use the straight-line method of amortization).
2. Calculate actual interest expense for each six-month period.
3. Prepare the journal entries to record the interest and amortization at June 30, 2015.
4. Prepare a partial balance sheet showing the bond liability and discount on December 31, 2015 and 2016 assuming the bonds will be redeemed on December 31, 2017.

### 10.7.3.2 P 10-2



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Consider the following information:

2015

Jun. 1 Zenith Manufacturing Company Limited received authorization to issue \$8,000,000 3-year, 12-per cent bonds. The interest is to be paid semi-annually June 1 and December 1 of each year.

Jun. 1 Issued \$4,000,000 of bonds for \$4,142,800 cash.

2016

Sep. 1 Issued another \$4,000,000 of bonds at 97.76 plus accrued interest.

The year-end of Zenith is December 31.

*Required:* Prepare the journal entries to record:

1. The issue of the bonds on June 1, 2015;
2. The payment of bond interest expense on December 1, 2015;
3. The accrual of bond interest expense and recording of amortization at year-end on December 31, 2015;



4. The payment of bond interest expense on June 1, 2016;
5. The issue of bonds on September 1, 2016; and
6. The final interest payment, premium and discount amortization, and retirement of the bonds at maturity, June 1, 2018.

### 10.7.3.3 P 10-3



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On the date of bond authorization, Esther Corporation issued \$100,000 of callable bonds. Bond indenture information included the following:

<i>Date of authorization</i>	<i>Term</i>	<i>Interest rate</i>	<i>Interest payment dates</i>
January 1, 2015	3 years	12%	Semi-annually on June 30 and December 31

*Required:* Consider these three cases. Case A: the bonds are issued at face value. Case B: the bonds are issued for \$103,000. Case C: the bonds are issued for \$94,000. For each case:

1. Calculate
  1. The amount of interest paid every interest payment date
  2. The amount of amortization to be recorded at each interest payment date as applicable (Use the straight-line method of amortization.)
2. Prepare journal entries to record
  1. The issue of bonds on January 1, 2015
  2. The payment of interest on June 30, 2015
  3. The amortization on June 30, 2015
  4. The payment of interest on December 31, 2015
  5. The amortization on December 31, 2015
  6. The payment of interest on December 31, 2017
  7. The amortization on December 31, 2017
  8. The redemption of the bonds at maturity, January 1, 2018.
3. Calculate the amount of interest expense shown in the income statement at December 31, 2015. Is this amount the same as cash interest paid by Esther? Why or why not?
4. Assume now that on December 31, 2016, the corporation exercised a call feature included in the bond indenture and retired \$50,000 of face value bonds issued January 1, 2015. The bonds were called at 102. Prepare the December 31, 2016 journal entry to record the exercise of the call option. Assume interest has been paid and the discount or premium amortized for the period ended December 31, 2016.

### 10.7.3.4 P 10-4



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Otter Products Inc. was authorized to issue \$1,000,000 of bonds. On January 1, 2015, Otter issued \$300,000 of bonds for \$272,263. Terms of the bond indenture included the following:

<i>Date of authorization</i>	<i>Term</i>	<i>Interest rate</i>	<i>Interest payment dates</i>
January 1, 2015	3 years	12%	Semi-annually on June 30 and December 31

*Required:*

1. Calculate
  - a. The amount of interest paid every interest payment date
  - b. The amount of amortization to be recorded at each interest payment date (use the straight-line method).
2. Prepare an amortization table showing interest expense, and beginning and ending bond carrying amounts at the end of each period over the three years. Use the following format:

#### Issue of \$300,000 Bonds Payable for \$272,263

##### Amortization Table

(straight-line)

		<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>E</u>
		<i>Beginning bond carrying amount</i>	<i>(C + D) Periodic interest expense</i>	<i>Actual cash interest paid</i>	<i>Periodic discount amort.</i>	<i>(A + D) Ending bond carrying amount</i>
Year	<i>Six-month period ending</i>					
2015	Jun. 30 Dec. 31					
2016	Jun. 30 Dec. 31					
2017	Jun. 30 Dec. 31					

3. Calculate the actual interest rate under the straight-line method of amortization for each six-month period. Round all percentage calculations to one decimal place. Use the following format:

Year	Six month period ending	A	B	%
		Bond carrying amount	Six-month interest expense	
2015	Jun. 30			
	Dec. 31			
2016	Jun. 30			
	Dec. 31			
2017	Jun. 30			
	Dec. 31			

4. Comment on the interest rate that results in each period.
5. Prepare a partial balance sheet at December 31, 2015 and 2016 assuming the bonds will be redeemed on December 31, 2017.

### 10.7.3.5 P 10-5



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Selected accounts from three trial balances of the Lake Corporation at December 31 are presented below:

	Adjusted		Unadjusted
	2015	2016	2017
<b>Debits</b>			
Interest Expense	\$22,100	\$44,200	\$43,800
<b>Credits</b>			
9% Bonds Payable	500,000	500,000	500,000
Premium on Bonds	23,600	21,200	20,000

The 9% bonds were authorized on July 1, 2015. Interest is paid semiannually on June 30 and December 31. The bonds were issued on November 1, 2015. Any premium or

discount is amortized on a straight-line basis, and amortization is recorded each time the interest expense is recorded.

*Required:*

1. Compute the following:
  1. original issue price as of November 1, 2015
  2. maturity date.
2. Reconstruct the journal entry to record the issuance of the bonds on November 1, 2015.
3. Prepare any required adjusting entries as of December 31, 2017.
4. Calculate the carrying value of the bonds on December 31, 2017.

### 10.7.3.6 P 10-6



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A 3-year \$1,000,000, 10% bond issue was authorized for Mega Corporation on April 1, 2015. Interest is payable on March 31 and September 30. The year-end of the Corporation is December 31.

*Required:* Consider the following independent cases:

1. The Mega Corporation issued the bonds on April 1, 2015 at 97. Prepare the journal entries required on April 1, 2015, September 30, 2015, and December 31, 2015. Assume straight-line amortization.
2. The bonds are issued at 106 on April 1, 2015. Prepare the journal entries to record the sale of the bonds on April 1, 2015 and entries required on September 30, 2015 and December 31, 2015.
3. The bonds are not issued until December 1, 2016 at 103 plus accrued interest. Prepare the journal entries on December 1, 2016 and December 31, 2016 (year-end). Assume straight-line amortization.

### 10.7.3.7 P 10-7 (Appendices)



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On January 1, 2015, Pete's Planes Inc. was authorized to issue 5-year, \$500,000, 12% bonds. Interest was payable on June 30 and December 31. All the bonds were issued on January 1, 2015.

*Required:* Answer the questions for each of these independent cases.

Case A: the bonds were issued when the market rate of interest was 12%.

Case B: the bonds were issued when the market rate of interest was 16%

Case C: the bonds were issued when the market rate of interest was 8%

1. Calculate
  - a. the amount of each semi-annual cash interest payment on the issued bonds;

- b. the issue price of the bonds, consisting of the present value of the bond face value and the present value of the 10 semi-annual interest payments to be made during the 5-year period (for convenience, round all calculations to the nearest dollar);
  - c. the amount of amortization applicable to each interest payment date up to and including December 31, 2017; and
  - d. the carrying amount of the bonds at December 31, 2017.
2. Prepare journal entries to record the 2017 transactions.

### 10.7.3.8 P 10-8 (Appendix)



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Beacon Products Inc. was authorized to issue \$1,000,000 of bonds as follows:

<i>Date of authorization</i>	<i>Term</i>	<i>Interest rate</i>	<i>Interest payment dates</i>
January 1, 2015	3 years	12%	Semi-annually on June 30 and December 31

On January 1, 2015, Beacon issued \$300,000 of bonds for \$272,263. On this date, the market rate of interest was 16%.

*Required:*

1. Calculate the amount of cash received from the bond issue on January 1, 2015.
2. Prepare an amortization table. Use the effective interest method of amortization.
3. Calculate the effective interest rate for each six-month period.
4. Comment on the results in each period. Do you think the results are appropriate? Why or why not?

## 10.7.4 Alternate Problems

### 10.7.4.1 AP 10-1



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Tron Corp. was authorized to issue \$500,000 of face value bonds, as follows:

<i>Date of authorization</i>	<i>Term</i>	<i>Interest rate</i>	<i>Interest payment dates</i>
January 1, 2018	3 years	12%	Semi-annually on June 30 and December 31

The corporation issued \$250,000 of bonds on January 1, 2018

*Required:* Answer the questions for each of these independent cases.

Case A: the bonds are issued at face value.

Case B: the bonds are issued for \$256,000.

Case C: the bonds are issued for \$242,800.

1. Calculate
  1. the amount of interest paid on the issued bonds every interest payment date;
  2. the amount of amortization, if any, applicable to each interest payment date (use the straight-line method of amortization).
2. Prepare journal entries to record
  1. the issue of the bonds;
  2. the payment of interest and recording of amortization, if any, on June 30, 2018;
  3. the payment of interest and recording of amortization, if any, on December 31, 2018.
3. Calculate the amount of interest expense shown in the income statement at December 31, 2018. Is this amount the same as cash paid by Tron in 2018? Why or why not?
4. On December 31, 2018, the corporation exercised a call feature included in the bond indenture and retired the \$250,000 of face value bonds issued January 1, 2018. The bonds were called at 103. Prepare the December 31 journal entry to record the exercise of the call option. Assume interest and amortization journal entries have been recorded.

#### 10.7.4.2 AP 10-2



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Broker Company arranged to sell \$2,000,000 of its bonds to finance a substantial increase in capacity. The following data are available:

2015

July	2	Broker Company received authorization for an issue of \$2 million, 10-year, 12% bonds. Interest is payable semi-annually: January 2 and July 2. Broker's year-end is December 31.
Aug.	1	Broker issued \$1,000,000 of bonds for \$1,045,700 cash plus accrued interest.

2016

- |      |   |  |
|------|---|--|
| Mar. | 1 | Broker issued the remaining \$1,000,000 face value of the bonds for 97.76 plus accrued interest. |
| July | 2 | Broker recorded the necessary entry related to the bond issue.                                   |

*Required:*

1. Record all necessary entries for the period July 2, 2015 to July 2, 2016 inclusive, including December 31, 2015, the year-end of the company.
2. Calculate the balance of the Bond Premium account in the general ledger at December 31, 2015.
3. Prepare the long-term liability section of Broker's balance sheet for December 31, 2015.
4. If the market interest rate is 18% at December 31, 2015, what would be the effect on the market value of Broker's bonds?
5. How much cash interest was paid to bondholders in 2016? How much interest expense was reported on the income statement for the year ended December 31, 2016? Why the difference? (Show calculations.)

**10.7.4.3 AP 10-3**

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On January 2, 2015, Jamaica Company Ltd. issued \$2,000,000, 3-year, 12% bonds at 97. Interest on the bonds is payable semi-annually on June 30 and December 31. Jamaica's year-end is December 31.

*Required:*

1. Prepare all journal entries necessary on the following dates:
  - a. January 2, 2015
  - b. June 30, 2015
  - c. December 31, 2015
  - d. January 2, 2018.
2. Calculate the amount of interest paid in cash in 2015.
3. Calculate the interest expense reported on the 2015 income statement.
4. What is the balance of the Bond Discount account in the general ledger at December 31, 2015?



### 10.7.4.4 AP 10-4



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Providence Inc. was authorized to issue \$500,000 of face value bonds as follows:

<i>Date of authorization</i>	<i>Term</i>	<i>Interest rate</i>	<i>Interest payment dates</i>
January 1, 2015	3 years	12%	Semi-annually on June 30 and December 31

On January 1, 2015, the corporation issued \$200,000 of face value bonds for \$212,000.

*Required:*

- Calculate
  - The amount of interest paid every interest payment date
  - The amount of amortization to be recorded at each interest payment date (use the straight-line method of amortization).
- Prepare a schedule to show the effect of premium amortization on interest expense and bond carrying amount at each interest payment date. Assume amortization is recorded each time interest expense is recorded.
- Prepare the journal entries to record the interest and amortization at June 30, 2015.
- Prepare a partial balance sheet, showing the liability on December 31, 2015 and 2016. Assume the bonds will be redeemed December 31, 2017.

### 10.7.4.5 AP 10-5



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Selected accounts from the trial balances of Mountbatten Corp. at December 31 are presented below:

	<i>Adjusted</i>		<i>Unadjusted</i>
	<i>2015</i>	<i>2016</i>	<i>2017</i>
<b>Debits</b>			
Interest Expense	\$39,750	\$79,500	\$59,625
Discount on Bonds	51,000	39,000	30,000
<b>Credits</b>			
Bond Interest Payable	16,875	16,875	-0-
9% Bonds Payable	750,000	750,000	750,000

The bonds were authorized on April 1, 2015 but not issued until July 1, 2015. Interest is paid semi-annually on April 1 and October 1. Straight-line amortization is used.

*Required:*

1. Compute the following:
  1. original issue price as of July 1, 2015
  2. maturity date.
2. Reconstruct the journal entry to record the issuance of the bonds on July 1, 2015.
3. Prepare any required adjusting entries as of December 31, 2017. Assume that straight-line amortization is recorded at year-end and also each time interest is paid.

**10.7.4.6 AP 10-6**

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Wheaton Wholesalers Ltd. was authorized to issue \$500,000 of face value bonds, as follows:

<i>Date of authorization</i>	<i>Term</i>	<i>Interest rate</i>	<i>Interest payment dates</i>
January 1, 2015	3 years	12%	Semi-annually on June 30 and December 31

On January 1, 2015, the corporation issued \$200,000 of face value bonds for \$210,152.

*Required:*

1. Calculate
  1. The amount of interest paid every interest payment date.
  2. The amount of amortization to be recorded at each interest payment date (use the straight-line method of amortization).
2. Prepare an amortization table showing beginning and ending bond carrying amounts over the three years.
3. Calculate the actual interest rate under the straight-line method of amortization for each six-month period.
4. Comment on the interest rate that results in each period. Do you think that this should vary from period to period? Why or why not?

**10.7.4.7 AP 10-7 (Appendices)**

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Cathy's Copper Products Inc. was authorized to issue \$1,000,000 of face value bonds.

<i>Date of authorization</i>	<i>Term</i>	<i>Interest rate</i>	<i>Interest payment dates</i>
------------------------------	-------------	----------------------	-------------------------------

---

January 1, 2017	3 years	12%	Semi-annually on June 30 and December 31
--------------------	------------	-----	---

The following transactions occurred during 2017.

Jan.	1	Issued \$100,000 of bonds
Jun.	30	Paid the semi-annual interest on the issued bonds and made an entry to record straight-line amortization
Dec.	31	Paid the semi-annual interest on the issued bonds and made an entry to record amortization.

*Required:* Answer the questions for each of these cases.

Case A: the bonds were issued when the market rate of interest was 12%.

Case B: the bonds were issued when the market rate of interest was 16%.

Case C: the bonds were issued when the market rate of interest was 8%.

1. Calculate
  1. the amount of each semi-annual interest payment on the issued bonds;
  2. the present value of the bonds; and
  3. the amount of amortization applicable to each interest payment date (use the effective interest method of amortization).
2. Prepare journal entries to record the 2017 transactions.

# Chapter 11 Equity Financing



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Corporations sometimes finance a large portion of their operations by issuing equity in the form of shares. This chapter discusses in detail the nature of the corporate form of organization, the different types of shares used to obtain funds for business activities, and how these transactions are recorded. It also expands on the concept of dividends.

## Learning Objectives

LO1 – Identify and explain characteristics of the corporate form of organization and classes of shares.

LO2 – Evaluate relative financing effects of bonds, common shares, and preferred shares.

LO3 – Record and disclose preferred and common share transactions including share splits.

LO4 – Record and disclose cash dividends.

LO5 – Calculate and explain the book value per share ratio.

LO6 – (Appendix 1) Record and disclose share dividends.

LO7 – (Appendix 2) Explain and record restrictions on retained earnings.

## 11.1 The Corporate Structure



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LO1 – Identify and explain characteristics of the corporate form of organization and classes of shares.

The accounting equation expresses the relationship between assets owned by a corporation and the claims against those assets by creditors and shareholders. Accounting for equity in a corporation requires a distinction between the two main sources of shareholders' equity: share capital and retained earnings. Their relationship to the accounting equation is shown in [Figure 11.1](#).



Fig. 11.1: Share Capital Versus Retained Earnings

### 11.1.1 Corporate Characteristics



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A unique characteristic of corporations is that they are legally separate from their owners, who are called *shareholders*. Each unit of ownership of a corporation is called a **share**. If a corporation issues 1,000 shares and you own 100 of them, you own 10% of the company. Corporations can be **privately-held** or **publicly-held**. A privately-held corporation's shares are not issued for sale to the general public. A publicly-held corporation offers its shares for sale to the general public, sometimes on a stock market like the Toronto Stock Exchange or the New York Stock Exchange.

A corporation has some of the same rights and obligations as individuals. For instance, it pays income taxes on its earnings, can enter into legal contracts, can own property, and can sue and be sued. A corporation also has distinctive features. It is separately regulated by law, has an indefinite life, its owners have limited liability, and it can usually acquire capital more easily than an individual. These features are discussed below.

### 11.1.2 Creation by law



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A corporation is formed under legislation enacted by a country or a political jurisdiction within it. For instance, in Canada a corporation can be formed under either federal or provincial laws. Although details may vary among jurisdictions, a legal document variously described as *articles of incorporation*, a *memorandum of association*, or *letters patent* is submitted for consideration to the appropriate government by prospective shareholders. The document lists the **classes** or types of shares that will be issued as well as the total number of shares of each class that can be issued, known as the **authorized** number of shares.

When approved, the government issues a *certificate of incorporation*. Investors then purchase shares from the corporation. They meet and elect a *board of directors*. The board formulates corporation policy and broadly directs the affairs of the corporation.

This includes the appointment of a person in charge of day-to-day operations, often called a president, chief executive officer, or similar title. This person in turn has authority over the employees of the corporation.

A shareholder or group of shareholders who control more than 50% of the voting shares of a corporation are able to elect the board of directors and thus direct the affairs of the company. In a large public corporation with many shareholders, minority shareholders with similar ideas about how the company should be run sometimes delegate their votes to one person who will vote on their behalf by signing a proxy statement. This increases their relative voting power, as many other shareholders may not participate in shareholders' meetings.

Shareholders usually meet annually to vote for a board of directors—either to re-elect the current directors or to vote in new directors. The board meets regularly, perhaps monthly or quarterly, to review the operations of the corporation and to set policies for future operations. The board may decide to distribute some assets of the corporation as a dividend to shareholders. It may also decide that some percentage of the assets of the corporation legally available for dividends should be made unavailable; in this case, a *restriction* is created. Accounting for such restrictions is discussed in an appendix of this chapter.

Wherever it is incorporated, a company is generally subject to the following regulations:

1. It must provide timely financial information to investors.
2. It must file required reports with the government.
3. It cannot distribute profits arbitrarily but must treat all shares of the same class alike.
4. It is subject to special taxes and fees.

Despite these requirements, a corporation's advantages usually outweigh its disadvantages when compared to other forms of business such as a proprietorship or partnership. These features of a corporation are described further below. Proprietorships and partnerships are discussed in more detail in a later chapter.

### 11.1.3 Indefinite life



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A corporation has an existence separate from that of its owners. Individual shareholders may die, but the corporate entity continues. The life of a corporation comes to an end only when it is dissolved, becomes bankrupt, or has its charter revoked for failing to follow laws and regulations.

### 11.1.4 Limited liability



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The corporation's owners are liable only for the amount that they have invested in the corporation. If the corporation fails, its assets are used to pay creditors. If insufficient assets exist to pay all debts, there is no further liability on the part of shareholders. This situation is in direct contrast to a proprietorship or a partnership. In these forms of organization, creditors have full recourse to the personal assets of the proprietorship or partners if the business is unable to fulfil its financial obligations. For the protection of creditors, the limited liability of a corporation must be disclosed in its name. The words "Limited," "Incorporated," or "Corporation" (or the abbreviations Ltd., Inc., or Corp.) are often used as the last word of the name of a company to indicate this corporate form.

### 11.1.5 Ease of acquiring capital



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Issuing shares allows many individuals to participate in the financing of a corporation. Both small and large investors are able to participate because of the relatively small cost of a share, and the ease with which ownership can be transferred—shares are simply purchased or sold. Large amounts of capital can be raised by a corporation because the risks and rewards of ownership can be spread among many investors.

A corporation only receives money when shares are first issued. Once a share is issued, it can be bought and sold a number of times by various investors. These subsequent transactions between investors do not affect the corporation's balance sheet.

### 11.1.6 Income Taxes on Earnings



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Because corporations are considered separate legal entities, they pay income taxes on their earnings. To encourage risk-taking and entrepreneurial activity, certain types of corporations may be taxed at rates that are lower than other corporations and individual shareholders' income tax rates. This can encourage research and development activity or small-company start-ups, for instance.



## 11.1.7 Classes of Shares



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There are many types of shares, with differences related to voting rights, dividend rights, liquidation rights, and other preferential features. The rights of each shareholder depend on the class or type of shares held.

Every corporation issues **common shares**. The rights and privileges usually attached to common shares are outlined below.

- The right to participate in the management of the corporation by voting at shareholders' meetings (this participation includes voting to elect a board of directors; each share normally corresponds to one vote).
- The right to receive dividends when they are declared by the corporation's board of directors.
- The right to receive assets upon liquidation of the corporation.
- The right to appoint auditors through the board of directors.

For other classes of shares, some or all of these rights are usually restricted. The articles of incorporation may also grant the shareholders the **pre-emptive** right to maintain their proportionate interests in the corporation if additional shares are issued.

If the company is successful, common shareholders may receive dividend payments. As well, the value of common shares may increase. Common shareholders can submit a proposal to raise any matter at an annual meeting and have this proposal circulated to other shareholders at the corporation's expense. If the corporation intends to make fundamental changes in its business, these shareholders can often require the corporation to buy their shares at their fair value. In addition, shareholders can apply to the courts for an appropriate remedy if they believe their interests have been unfairly disregarded by the corporation.

Some corporations issue different classes of shares in order to appeal to as large a group of investors as possible. This permits different risks to be assumed by different classes of shareholders in the same company. For instance, a corporation may issue common shares but divide these into different classes like class A and class B common shares. When dividends are declared, they might only be paid to holders of class A shares.

Shareholders who hold **preferred shares** are entitled to receive dividends before common shareholders. These shares usually do not have voting privileges. Preferred shareholders typically assume less risk than common shareholders. In return, they receive only a limited (but more predictable) amount of dividends. Issuing preferred shares allows a corporation to raise additional capital without requiring existing shareholders to give up control. Other characteristics of preferred shares and dividend payments are discussed later in this chapter.

The shares of a corporation can have a different status at different points in time. They can be **unissued** or **issued**, issued and **outstanding**, or issued and reacquired

by the corporation (called **treasury shares**). The meaning of these terms is summarized in [Figure 11.2](#):

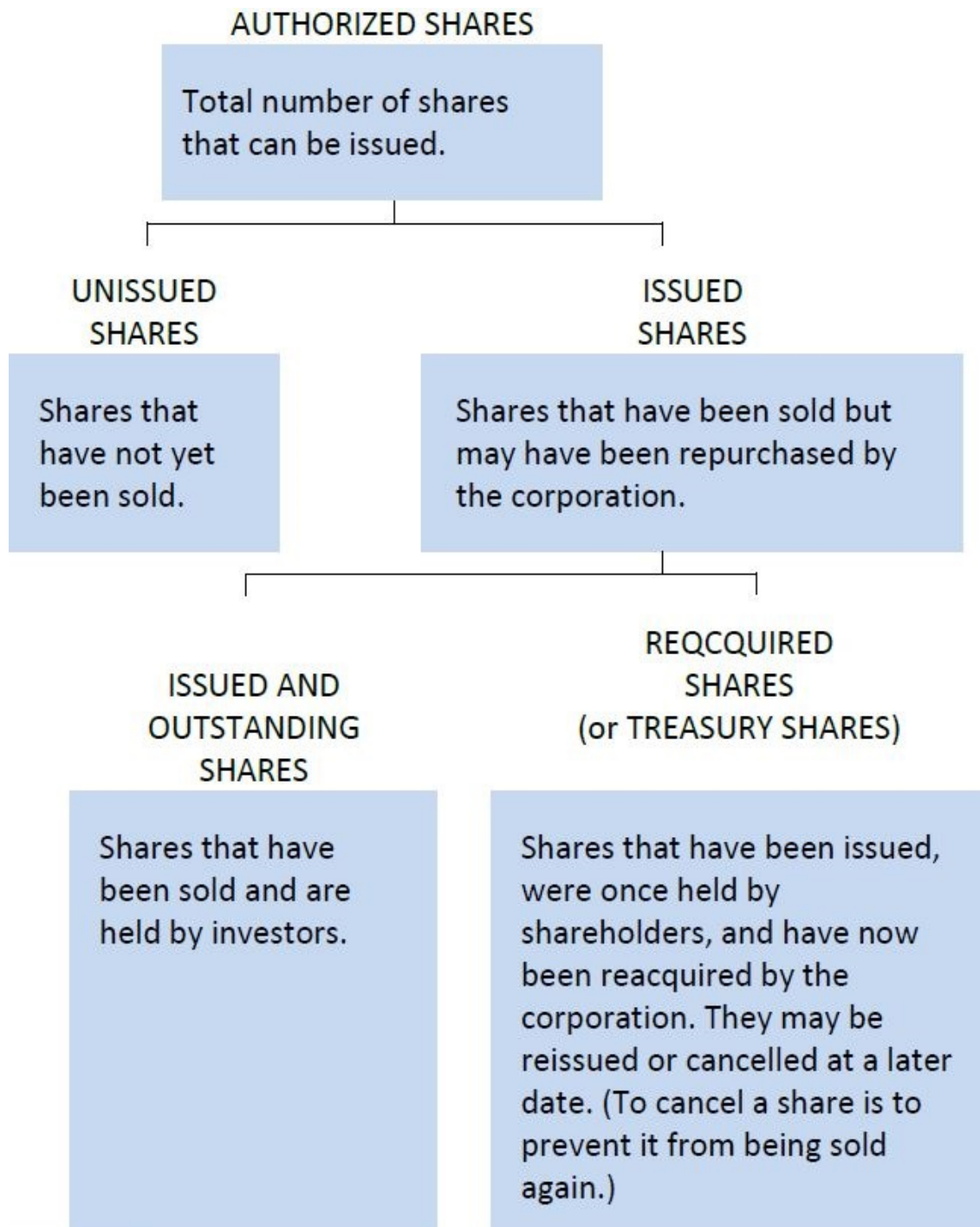


Fig. 11.2: Status of Shares

## 11.2 The Debt Versus Equity Financing Decision



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LO2 – Evaluate relative financing effects of bonds, common shares, and preferred shares.

Many factors influence management in its choice between the issue of debt and the issue of share capital. One of the most important considerations is the potential effect of each of these financing methods on the present shareholders.

Consider the example of Old World Corporation, which has 100,000 common shares outstanding, is a growth company, and is profitable. Assume Old World requires \$30 million in cash to finance a new plant. Management is currently reviewing three financing options:

1. Issue 12% debt, due in three years
2. Issue 300,000 preferred shares (dividend \$8 per share annually)
3. Issue an additional 200,000 common shares at \$30 each.

Management estimates that the new plant should result in income before interest and income taxes of \$6 million. The income tax rate is 50%. Management has prepared the following analysis to compare and evaluate each financing option.

	<i>Plan 1</i>	<i>Plan 2</i> <i>Issue</i> <i>preferred</i> <i>shares</i>	<i>Plan 3</i> <i>Issue common</i> <i>shares</i>
Income before interest and income taxes	\$ 6,000,000	\$ 6,000,000	\$ 6,000,000
Less: Interest expense (\$30M x 12%)	<u>(3,600,000)</u>	-0-	-0-
Income before income taxes	\$ 2,400,000	\$ 6,000,000	\$ 6,000,000
Less: Income taxes ( 50%)	<u>(1,200,000)</u>	<u>(3,000,000)</u>	<u>(3,000,000)</u>
Net income	1,200,000	3,000,000	3,000,000
Less: Preferred dividends (300,000 x \$8 per share)	-0-	<u>(2,400,000)</u>	-0-
Net income available to common shareholders	<u>\$ 1,200,000</u>	<u>\$ 600,000</u>	<u>\$ 3,000,000</u>
Number of common shares outstanding	<u>100,000</u>	<u>100,000</u>	<u>300,000</u>
Earnings per common share	<u>\$ 12</u>	<u>\$ 6</u>	<u>\$ 10</u>

Plan 1, the issue of debt, has several advantages for existing common shareholders.

### **Advantage 1: Earnings per share**

If the additional long-term financing were acquired through the issue of debt, the corporate earnings per share (EPS) on each common share would be \$12. This EPS is greater than the EPS earned through financing with either preferred shares or additional common shares. On this basis alone, the issue of debt is more financially attractive to existing common shareholders.

### **Advantage 2: Control of the corporation**

Creditors have no vote in the affairs of the corporation. If additional common shares were issued, there might be a loss of corporate control by existing shareholders because ownership would be distributed over a larger number of shareholders, or concentrated in the hands of one or a few new owners. In the Old World case, issuing common shares would increase the number threefold from 100,000 to 300,000 shares.

### **Advantage 3: Income taxes expense**

Interest expense paid on debt is deductible from income for income tax purposes. Dividend payments are distributions of retained earnings, which is after-tax income. Thus, dividends are not deductible again for tax purposes. With a 50% income tax rate,

the after-tax interest expense to the corporation is only 6% (12% x 50%). The effective interest rate on preferred shares in this example is much higher, at 40% (\$8/\$20).

### 11.2.1 Debt Financing Disadvantages



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There are also some disadvantages in long-term financing with debt that must be carefully reviewed by management and the board of directors. The most serious disadvantage is the possibility that the corporation might earn less than \$6 million before interest expense and income taxes. The interest expense is a fixed amount. It must be paid to creditors at specified times, unlike dividends. If actual income before interest and income taxes decreased by only \$400,000, net income under plan 1 would fall to \$1,000,000. Earnings per share would then be the same as that of plan 3 (\$10 per common share).

Another disadvantage is the fact that debt must be repaid at maturity, whether or not the corporation is financially able to do so. Shares do not have to be repaid.

### 11.2.2 Recording Share Transactions



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LO3 – Record and disclose preferred and common share transactions including share splits.

Shares have a **stated** or **nominal** value—the amount for which they are issued. Alternatively, but rarely, shares will have a **par-value** which is the amount stated in the corporate charter below which shares cannot be sold upon initial offering. For consistency, we will assume all shares have a stated value.

To demonstrate the issuance and financial statement presentation of shares, assume that New World Corporation is authorized to issue share capital consisting of an unlimited number of voting common shares and 100,000 non-voting preferred shares.

Transaction 1: On January 1, 2015, New World sells 1,000 common shares to its first shareholders for \$10 per share, or \$10,000 cash.

New World would record the following entry:

2015

Jan. 1	Cash	10,000	
	Common Shares		10,000
	<i>To record the issuance of 1,000 common shares at \$10 per share.</i>		

Transaction 2: On February 1, 2015, 2,500 preferred shares are issued to the owner of land and buildings that have a fair value of \$35,000 and \$50,000, respectively. The journal entry to record this transaction is:

2015

Jan. 1	Land	35,000	
	Building	50,000	
	Preferred Shares		85,000
	<i>To record the issuance of 2,500 preferred shares in exchange for land and buildings.</i>		

Usually, one or more individuals decide to form a corporation. Before the corporation is created, they may use their own funds to pay for legal and government fees, travel and promotional costs, and so on. When the corporation is legally formed, it is not unusual for the corporation to issue shares to these organizers for these amounts. These start-up expenditures are referred to as **organization costs** and are usually expensed unless they are a large amount, in which case they are capitalized.

Transaction 3: On March 1, 2015, 500 common shares are issued to the organizers of New World to pay for their services, valued at \$5,000. The journal entry to record this transaction is:

2015

Jan. 1	Organization Expense	5,000	
	Common Shares		5,000
	<i>To record the issuance of 500 common shares in exchange for organization efforts.</i>		

Assuming no further share transactions, and net income of \$480,000 earned during the first year of operations, the shareholders' equity section of the New World Corporation balance sheet would show the following at December 31, 2015:

<i>Shareholders' Equity</i>	
Share capital (Note X)	\$ 100,000
Retained earnings	480,000
Total shareholders' equity	<u><u>\$580,000</u></u>

The relevant note to the financial statements would state:

Note X

The authorized share capital of New World Corporation consists of an unlimited number of no par-value shares and 100,000 no par-value, non-voting preferred shares. Preferred shares take precedence when dividends are declared and upon repayment of capital. Common shares represent one vote each at shareholders' meetings of New World Corporation.

During the year, 1,500 common shares were issued to founding shareholders for a stated value of \$10 per share. This represented 100% of total common shares issued. 2,500 preferred shares were issued for a stated value of \$34 per share in



consideration for land and buildings used in the company's operations. This represented 100% of total preferred shares issued. Information related to number of shares outstanding is as follows:

	<i>Common shares</i>	<i>Preferred shares</i>	<i>Total shares</i>
Shares outstanding at January 1, 2015	-0-	-0-	-0-
Shares issued during 2015	1,500	8,500	10,000
Shares outstanding at December 31, 2015	<u>1,500</u>	<u>8,500</u>	<u>10,000</u>

The statement of changes in equity would show:

	<i>Common shares</i>	<i>Preferred shares</i>	<i>Retained earnings</i>	<i>Total equity</i>
Balance at Jan. 1, 2015	\$ -0-	\$ -0-	\$ -0-	\$ -0-
Shares issued	15,000	85,000		100,000
Net income			480,000	480,000
Balance at Dec. 31, 2015	<u>\$15,000</u>	<u>\$85,000</u>	<u>\$480,000</u>	<u>\$580,000</u>

Transaction 4: Corporate legislation permits a company to reacquire some of its shares, provided that the purchase does not cause insolvency. A company can repurchase and then cancel the repurchased shares. When repurchased shares are cancelled, they are no longer issued and no longer outstanding. A company can also repurchase shares and then hold them in treasury. Treasury shares are issued but not outstanding. A company can use treasury shares for purposes such as giving to employees as an incentive or bonus.

Assume that New World Corporation decides to repurchase 200 common shares on December 1, 2016 and hold them in treasury. Assume that the price of each share is the average issue price of the outstanding common shares, or \$10. The journal entry to record the repurchase is:

2016

Dec. 1	Common shares	2,000	
	Cash		2,000
	<i>To record the repurchase of 200 common shares at \$10 per share to be held in treasury.</i>		

Assuming 2016 net income of \$200,000 and no further transactions, the shareholders' equity section of the New World Corporation balance sheet would show the following at December 31, 2016:

<i>Shareholders' Equity</i>		
	<i>2016</i>	<i>2015</i>
Share capital (Note X)	\$ 98,000	\$100,000
Retained earnings	680,000	480,000
Total shareholders' equity	<u>\$778,000</u>	<u>\$580,000</u>

The relevant note to the financial statements would state:

## Note X

The authorized share capital of New World Corporation consists of an unlimited number of no par-value shares and 100,000 no par-value, non-voting preferred shares. Preferred shares take precedence when dividends are declared and upon repayment of capital. Common shares represent one vote each at shareholders' meetings of New World Corporation.

During the year, 200 common shares with a stated value of \$10 per share were repurchased by the corporation and are held as treasury shares. This represents 13.3% of common shares issued as of December 31, 2016. Information related to number of shares outstanding is as follows (bolded for illustration purposes):

	<i>Common shares</i>	<i>Preferred shares</i>	<i>Total shares</i>
Shares outstanding at January 1, 2015	-0-	-0-	-0-
Shares issued during 2015	1,500	8,500	10,000
Shares outstanding at December 31, 2015	1,500	8,500	10,000
<b>Shares reacquired and held as treasury shares during 2016</b>	<b>(200)</b>	<b>-0-</b>	<b>(200)</b>
Shares outstanding at December 31, 2016	<u>1,300</u>	<u>2,500</u>	<u>3,800</u>

Information is disclosed for the current and prior year when comparative financial statements are prepared.

The statement of changes in equity would show (bolded for illustrative purposes):

	<i>Common shares</i>	<i>Preferred shares</i>	<i>Retained earnings</i>	<i>Total equity</i>
Balance at Jan. 1, 2015	\$ -0-	\$ -0-	\$ -0-	\$ -0-
Shares issued	15,000	85,000		100,000
2015 net income			480,000	480,000
Balance at Dec. 31, 2015	15,000	85,000	480,000	580,000
<b>Shares reacquired and held as treasury shares during 2016</b>	<b>(2,000)</b>			<b>(2,000)</b>
2016 net income			200,000	200,000
Balance at Dec. 31, 2016	<u>\$13,000</u>	<u>\$85,000</u>	<u>\$680,000</u>	<u>\$778,000</u>

Notice that the repurchase of shares caused a decrease in both the total stated capital of the common shares (\$2,000 decrease) and in the number of shares outstanding (decreased by 200 shares).

### 11.2.3 Share Splits



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A corporation may find its shares are selling at a high price on a stock exchange, perhaps putting them beyond the reach of many investors. To increase the marketability of a corporation's shares, management may opt for a **share split**. A share split increases the number of shares issued and outstanding, and lowers the cost of each new share. The originally-issued shares are exchanged for a larger number of new shares

Assume that on December 1, 2017 New World Corporation declares a 3-for-1 common share split. This results in three new common shares replacing each currently-issued



and outstanding common share. The number of issued and outstanding shares has now been tripled. The market price of each share will decrease to about one-third of its former market price. Since there is no change in the dollar amount of common shares, no debit-credit entry is required to record the share split. Instead, a memorandum entry would be recorded in the general ledger indicating the new number of shares issued and outstanding, as follows:

GENERAL LEDGER								
Common Shares					Acct. No. 320			
Date		Description	Folio	Debit	Credit		Balance	
2017								
Jan.	1	Memorandum: Because of a 3-for-1 split, the issued and outstanding common shares increased respectively from 1,500 and 1,300, to 4,500 and 3,900 shares.						

The dollar amount shown on the balance sheet and statement of changes in equity will not change. The only change is an increase in the number of issued and outstanding common shares. After the share split, the shareholders' equity section of the New World Corporation balance sheet and statement of changes in equity would be unchanged.

This would be added to the usual note to the financial statements:

The company holds 600 issued common shares as treasury shares. On December 1, 2017 the company declared a 3:1 share split on common shares. The effect of this was as follows:

	<i>Before share split</i>	<i>After share split</i>
Number of common shares outstanding	1,300	3,900
Stated value per outstanding commons share	\$10	\$3.33
Total stated value of outstanding common shares	\$13,000	\$13,000

↑                      ↑  
The total stated value is not affected by the share split.

## 11.3 Cash Dividends



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LO4 – Record and disclose cash dividends.

Both creditors and shareholders are interested in the amount of assets that can be distributed as dividends. The paid-in share capital is not available for distribution as dividends. This helps protect creditors by preventing shareholders from withdrawing

assets as dividends to the point where remaining assets become insufficient to pay creditors. For example, assume total assets are \$40,000; total liabilities \$39,000; and total shareholders' equity \$1,000, consisting of \$900 in common shares and \$100 of retained earnings. The maximum dividends that could be declared in this situation is \$100, the balance in retained earnings.

### 11.3.1 Dividend Policy



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Sometimes the board of directors may choose not to declare any dividends. There may be financial conditions in the corporation that make the payment impractical.

#### **Consideration 1: There may not be adequate cash**

Corporations regularly reinvest their earnings in assets in order to make more profits. In this way, growth occurs and reliance on creditor financing can be minimized. As a result, there may not be enough cash on hand to declare and pay a cash dividend. The assets of the corporation may be tied up in property, plant, and equipment, for instance.

#### **Consideration 2: A policy of the corporation may preclude dividend payments**

Some corporations pay no dividends. Instead, they reinvest their earnings in the business. Shareholders generally benefit because the market price for the corporation's shares should rise. A statement to this effect can alert investors. This type of dividend policy is often found in growth-oriented corporations.

#### **Consideration 3: No legal requirement that dividends have to be paid**

The board of directors may decide that no dividends should be paid. Legally, there is no requirement to do so. If shareholders are dissatisfied, they can elect a new board of directors or sell their shares.

#### **Consideration 4: Dividends may be issued in shares of the corporation rather than in cash**

*Share dividends* may be issued to conserve cash or to increase the number of shares to be traded on the stock market. Share dividends are discussed in Appendix 1 of this chapter.

### 11.3.2 Dividend Declaration



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Dividends can be paid only if they have been officially declared by the board of directors. The board must pass a formal resolution authorizing the dividend payment. Notices of the dividend are then published. Once a dividend declaration has been made public, the dividend becomes a liability and must be paid. An example of a dividend notice by Nouveau Corporation is shown in [Figure 11.3](#).

## Nouveau Corporation

### Dividend Notice

On May 25, 2016 the board of directors of Nouveau Corporation declared a dividend of \$0.50 per share on common shares outstanding (3,900). The dividend will be paid on June 26, 2016 to shareholders of record on June 7, 2016.

By order of the board

[signed]

Lee Smith

Secretary

May 25, 2016

Fig. 11.3: An Example of a Dividend Notice

There are three dates associated with a dividend. Usually dividends are declared on one date, the **date of declaration** (May 25, 2016 in this case); they are payable to shareholders on a second date, the date of record (June 7, 2016); and the dividend is paid on a third date, the **date of payment** (June 26, 2016).

### 11.3.3 Date of Declaration



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The dividend declaration provides an official notice of the dividend. It specifies the amount of the dividend as well as which shareholders will receive the dividend. The liability for the dividend is recorded in the books of the corporation at its declaration date.

The following entry would be made in the general ledger of Nouveau Corporation on May 25, 2016, the date of declaration:

2016

May 25	Cash Dividends Declared	1,950	
	Dividends Payable		1,950
	<i>To record \$0.50 per common share cash dividend declared; 3,900 shares x \$0.50/share = \$1,950.</i>		

### 11.3.4 Date of Record



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Shareholders who own shares on the date of record will receive the dividend even if they have sold the shares before the dividend is actually paid. No journal entry is made in the accounting records at the date of record.

### 11.3.5 Date of Payment



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When the dividend is paid it is recorded as:

2016			
Jun. 26	Dividends Payable	1,950	
	Cash		1,950
	<i>To record payment of dividend.</i>		

### 11.3.6 Preferred Shareholder Dividends



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Preferred shares are offered to attract investors who have lower tolerance for risk than do common shareholders. Preferred shareholders are content with a smaller but more predictable share of a corporation's profits. For instance, preferred shareholders are entitled to dividends before any dividends are distributed to common shareholders. Also, most preferred shares specifically state what amount of dividends their holders can expect each year. For example, owners of \$8 preferred shares would be paid \$8 per share held each year. These dividends are often paid even if the corporation experiences a net loss in a particular year.

Preferred shares may also have other dividend preferences, depending on what rights have been attached to preferred shares at the date of incorporation. Two additional preferences can be

- the accumulation of undeclared dividends from one year to the next — referred to as *cumulative dividends*.
- the participation of preferred shares with common shares in dividend distributions beyond the usual preferred dividends — referred to as a *participating* feature of preferred shares.

### 11.3.7 Cumulative Dividend Preferences



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**Cumulative preferred shares** require that any unpaid dividends accumulate from one year to the next and are payable from future earnings when a dividend is eventually declared by a corporation. These accumulated dividends must be paid before any dividends are paid on common shares. The unpaid dividends are called *dividends in arrears*. Dividends in arrears are not recorded as a liability on the balance sheet of the company until they have been declared by the board of directors. However, disclosure of dividends in arrears must be made in a note to the financial statements.

If a preferred share is **non-cumulative**, a dividend not declared by the board of directors in any one year is never paid to shareholders.

### 11.3.8 Participating Dividend Preferences

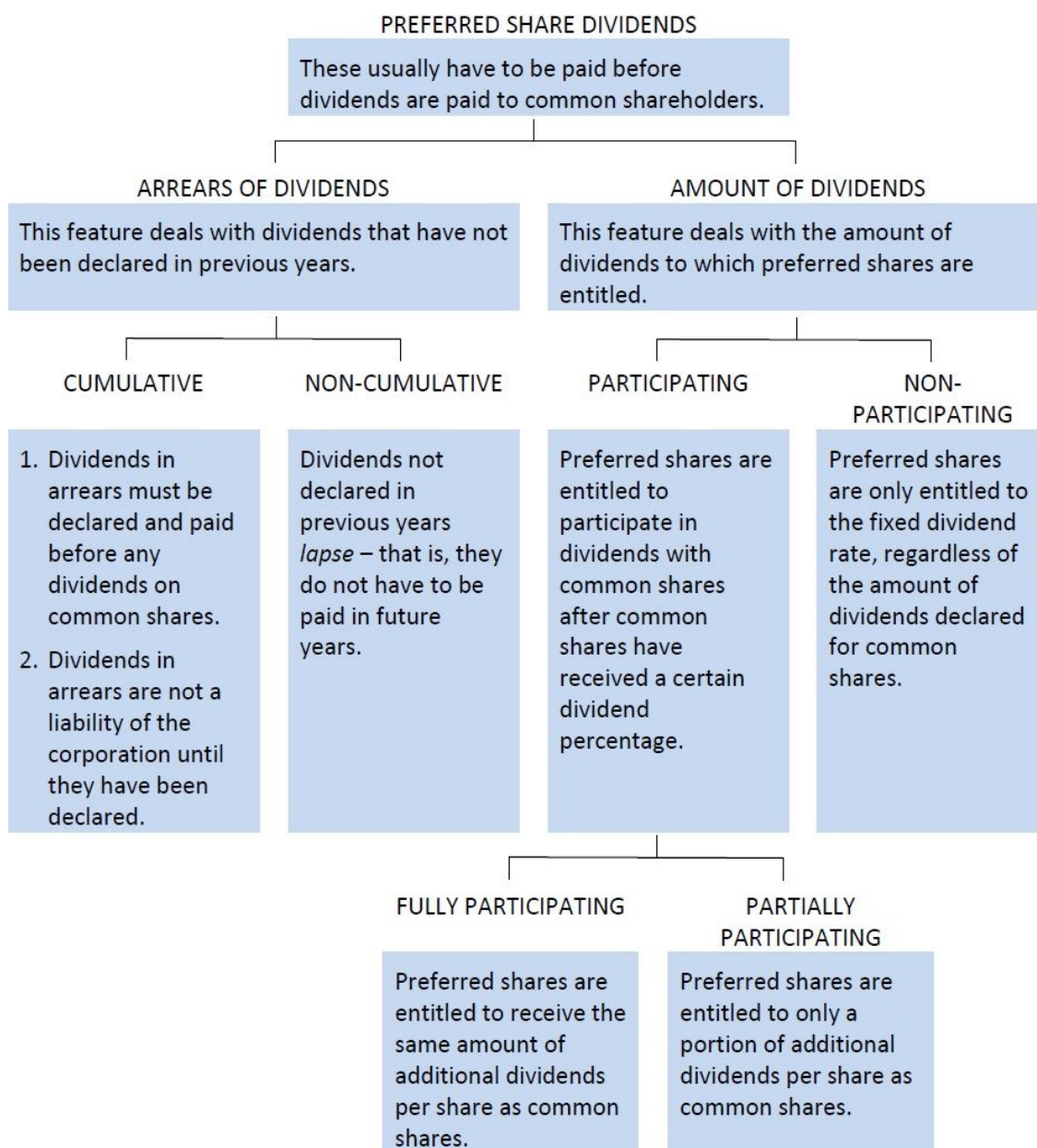


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A **participating** feature is sometimes added to preferred shares to make them more attractive to investors. Under certain circumstances, this feature permits the preferred shares to receive a portion of the earnings of the corporation in excess of a stipulated rate. The extent of this participation can be *limited* (partially participating) or *unlimited* (fully participating). Non-participating preferred shares do not receive a share of additional dividends.

The relationship among these preferred share characteristics is shown in [Figure 11.4](#) below:





**Fig. 11.4: The Relationships Among Dividend Types**

Assume that Bernard Williams Inc. declared dividends totalling \$92,000 when the shareholders' equity section of its balance sheet disclosed the following information:

<i>Shareholders' Equity</i>	
Preferred shares, \$10 nominal value, \$8 dividends, cumulative, non-participating	
Authorized—3,000 shares	
Issued and outstanding—2,000 shares	\$200,000
Common shares, \$1 nominal value	
Authorized—350,000 shares	
Issued and outstanding—300,000 shares	300,000
Total shareholders' equity	<u><u>\$500,000</u></u>

A note to the balance sheet indicates that there are two years of preferred dividends in arrears. If a \$92,000 cash dividend declared, the preferred shares are entitled to \$16,000 dividends per year (2,000 shares x \$8) whenever dividends are declared. Because these shares have a cumulative preference, they are also entitled to dividends in arrears. The dividend distribution would be calculated as:

<i>Shareholder preference to dividends</i>		<i>Dividend distribution</i>		<i>Balance</i>
		<i>To preferred</i>	<i>To common</i>	
	Total dividends declared			\$92,000
1 <sup>st</sup> preference	Arrears (\$16,000 x 2 years)	\$ 32,000	\$ -0-	60,000
2 <sup>nd</sup> preference	Current year – preferred	16,000	-0-	44,000
	Balance to common	-0-	44,000	-0-
	Total	\$ 48,000	\$ 44,000	

The cumulative preference has resulted in the payment to preferred shareholders of dividends unpaid in the previous two years; this amounts to \$32,000. For the current year, preferred shareholders receive another \$16,000 for a total of \$48,000. Because the preferred shares are non-participating, the remainder of the \$92,000 dividend (\$44,000) is paid to common shareholders.

## 11.4 Book Value



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LO5 – Calculate and explain the book value per share ratio.

The **book value** of a share is the amount of net assets represented by one share. When referring to common shares, book value represents the amount of net assets not claimed by creditors and preferred shareholders. When referring to preferred shares, book value represents the amount that preferred shareholders would receive if the corporation were liquidated.

Book value per preferred share =

$$\frac{\text{Paid-in capital for preferred shares plus dividends in arrears}}{\text{Number of preferred shares outstanding}}$$

Book value per common share =

$$\frac{\text{Total equity less (stated capital for preferred shares plus dividends in arrears)}}{\text{Number of common shares outstanding}}$$

### 11.4.1 Calculation of the Book Value of Shares



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The calculation of the book value of preferred and common shares can be illustrated by using the following data:



### *Shareholders' Equity*

<b>Preferred shares</b>	
Authorized—5,000 shares	
Issued and outstanding—1,000 shares	\$ 10,000
<b>Common shares</b>	
Authorized—200,000 shares	
Issued and outstanding—60,000 shares	20,000
Retained earnings	105,000
<b>Total shareholders' equity</b>	<u><u>\$135,000</u></u>

Note: There are \$5,000 dividends in arrears on preferred shares.

Book value is calculated as:

<i>Preferred shares</i>	<i>Common shares</i>
Dividends in arrears	Total shareholders' equity
\$ 5,000	\$135,000
Plus: Stated capital	Less: Preferred claims (a)
10,000	15,000
<u>Balance (a)</u>	<u>Balance</u>
<u>\$15,000</u>	<u>\$120,000</u>
Shares outstanding (b)	Shares outstanding
1,000	60,000
<u>Book value per share (a/b)</u>	<u>Book value per share</u>
<u>\$15</u>	<u>\$2</u>

Comparison of book value with market value provides insight into investors' evaluations of the corporation. For instance, if the book value of one common share of Corporation A is \$20 and its common shares are traded on a public stock exchange for \$40 per share (market value), it is said to be trading for "two times book value." If Corporation B is trading for three times book value, investors are indicating that the future profit prospects for corporation B are higher than those for Corporation A. They are willing to pay proportionately more for shares of Corporation B than Corporation A, relative to the underlying book values.

Some shares regularly sell for less than their book value on various stock exchanges. This does not necessarily mean they are a bargain investment. The market price of a share is related to such factors as general economic outlook and perceived potential of the company to generate earnings.

## 11.5 Appendix 1: Share Dividends



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LO6 – Record and disclose share dividends.

A **share dividend** is a dividend payable to shareholders in shares of a corporation, rather than in cash. In this way, the declaring corporation is able to retain cash in the business and reduce the need to finance its activities through borrowing.

## 11.5.1 Accounting for Share Dividends



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Assume that the Sherbrooke Corporation declares a 10% share dividend to common shareholders. The dividend is declared on July 15, 2016 payable to shareholders of record on July 31, 2016. The share dividends were issued on August 5, 2016. At the time of the dividend declaration, the shareholders' equity of the corporation consisted of the following:

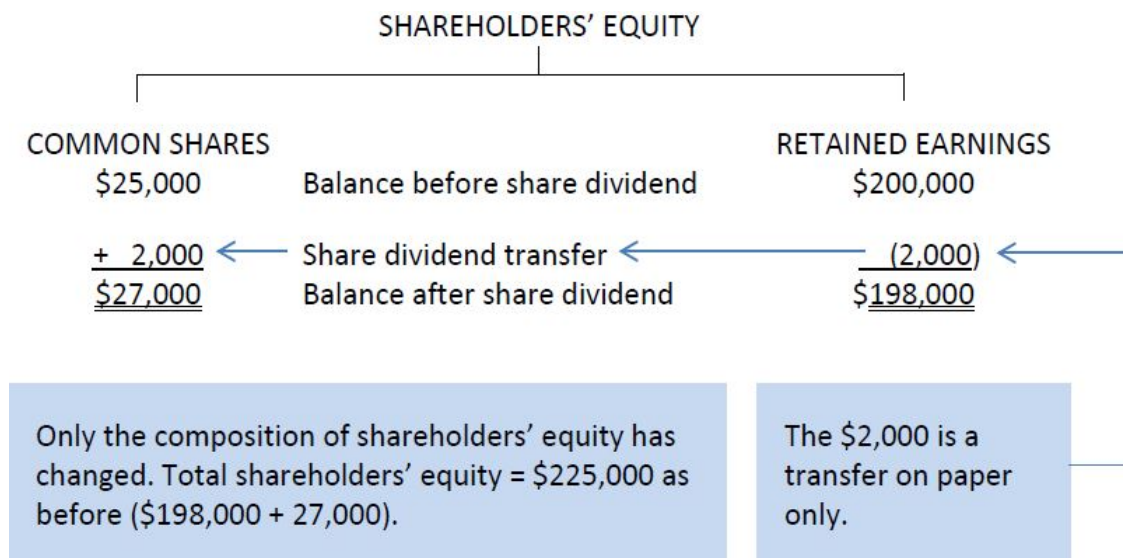
<i>Shareholders' Equity</i>	
<b>Common shares, stated value \$5</b>	
Authorized — 20,000 shares	
Issued and outstanding — 5,000 shares	\$ 25,000
Retained earnings	200,000
<b>Total shareholders' equity</b>	<u><u>\$225,000</u></u>

Assume that at the date of dividend declaration, the common shares of the corporation were trading on the stock exchange at \$4.

In this case, the share dividend is expressed as a percentage of the outstanding common shares. The dividend amounts to 500 shares (5,000 outstanding shares x 10%). This means that an individual investor owning 1,000 shares receives 100 new shares when the dividend is issued.

The market price of the shares is used to record a share dividend. This market price is usually the closing market price per share on the day preceding the declaration of the dividend. Since the shares are recorded at market value, the amount transferred from retained earnings to common shares is \$2,000 (500 shares x \$4 market value).

The \$2,000 transfer to common shares means that this amount becomes a part of stated capital and the assets represented by the \$2,000 are no longer available for the payment of future cash dividends. After the transfer has been recorded, shareholders' equity appears as shown in [Figure 11.5](#) below.



**Fig. 11.5: Shareholders' Equity After Dividend Transfer**

This transfer reduces retained earnings and increases common shares by the same \$2,000 amount. Total shareholders' equity remains unchanged, however. This is different from the distribution of a cash dividend, which reduces both retained earnings and cash and results in a *lower* amount of total shareholders' equity.

Two journal entries at different dates are required to record the share dividend. The original dividend declaration would be recorded as follows:

**2016**

July. 15	Share Dividends Declared	2,000	
	Share Dividends to be Issued		2,000
	<i>To record the declaration of a 10% common share dividend (5,000 x 10% x \$4)</i>		

The effect of this entry is to transfer \$2,000 from retained earnings to share capital. No assets are paid by the corporation when the additional shares are issued as a shares dividend, and therefore *the total shareholders' equity remains unchanged at \$225,000.*

As with cash dividends, there is no effect on the accounting records on July 31 (individual shareholders of record are determined at that date).

When the shares dividend is actually issued, the following entry would be made:

**2016**

Aug. 5	Share Dividends to be Issued	2,000	
	Common Shares		2,000
	<i>To record the issuance of the common share dividend.</i>		

At the December 31 year-end of the corporation, the Share Dividend Declared account would be closed to the Retained Earnings account in the same way a Cash Dividend account is closed. The closing entry for a shares dividend would be:

2016

Dec. 31 Retained Earnings	2,000	
Share Dividends Declared		2,000
<i>To close the Share Dividends Declared account.</i>		

Assume that the retained earnings of \$200,000 include \$20,000 of net income earned in the 2016 year. The statement of changes in equity at December 31, 2016 would show (bolded for illustrative purposes):

	<i>Common shares</i>	<i>Retained earnings</i>	<i>Total equity</i>
Balance at beginning of year	\$25,000	\$180,000	\$205,000
Net income		20,000	20,000
<b>Common share dividend declared</b>	<b>2,000</b>	<b>(2,000)</b>	
Balance at end of year	<u>\$27,000</u>	<u>\$198,000</u>	<u>\$225,000</u>

### 11.5.2 Is There Any Change in the Investor's Percentage of Corporate Ownership?



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Since a share dividend is issued to all shareholders of a particular class, each shareholder has a larger number of shares. However, ownership percentage of the company remains the same for each shareholder, as illustrated in the following example.

Assume that there are five shareholders in Sherbrooke Corporation, each of whom owns 1,000 shares before the share dividend. Each of these shareholders receives a 10 per cent share dividend, that is, 100 new shares. Corporation ownership before and after the share dividends is as follows:

Shareholder	<i>Corporate ownership</i>			
	<i>Before share dividend</i>		<i>After share dividend</i>	
	Shares	Per cent	Shares	Per cent
A	1,000	20%	1,100	20%
B	1,000	20%	1,100	20%
C	1,000	20%	1,100	20%
D	1,000	20%	1,100	20%
E	1,000	20%	1,100	20%
	<u>5,000</u>	<u>100%</u>	<u>5,500</u>	<u>100%</u>

Each shareholder has received 100 new shares but ownership percentage of the company remains at 20 per cent. Since total shareholders' equity does not change, the proportion owned by each is still \$25,000 (\$125,000 total shareholders' equity x 20%).



## 11.6 Appendix 2: Retained Earnings



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LO7 – Explain and record restrictions on retained earnings.

Retained earnings represent the net income earned by a company over its life that has not been distributed as dividends to shareholders.

Retained earnings can be either **restricted** or **unrestricted** with respect to dividend distributions, as follows:

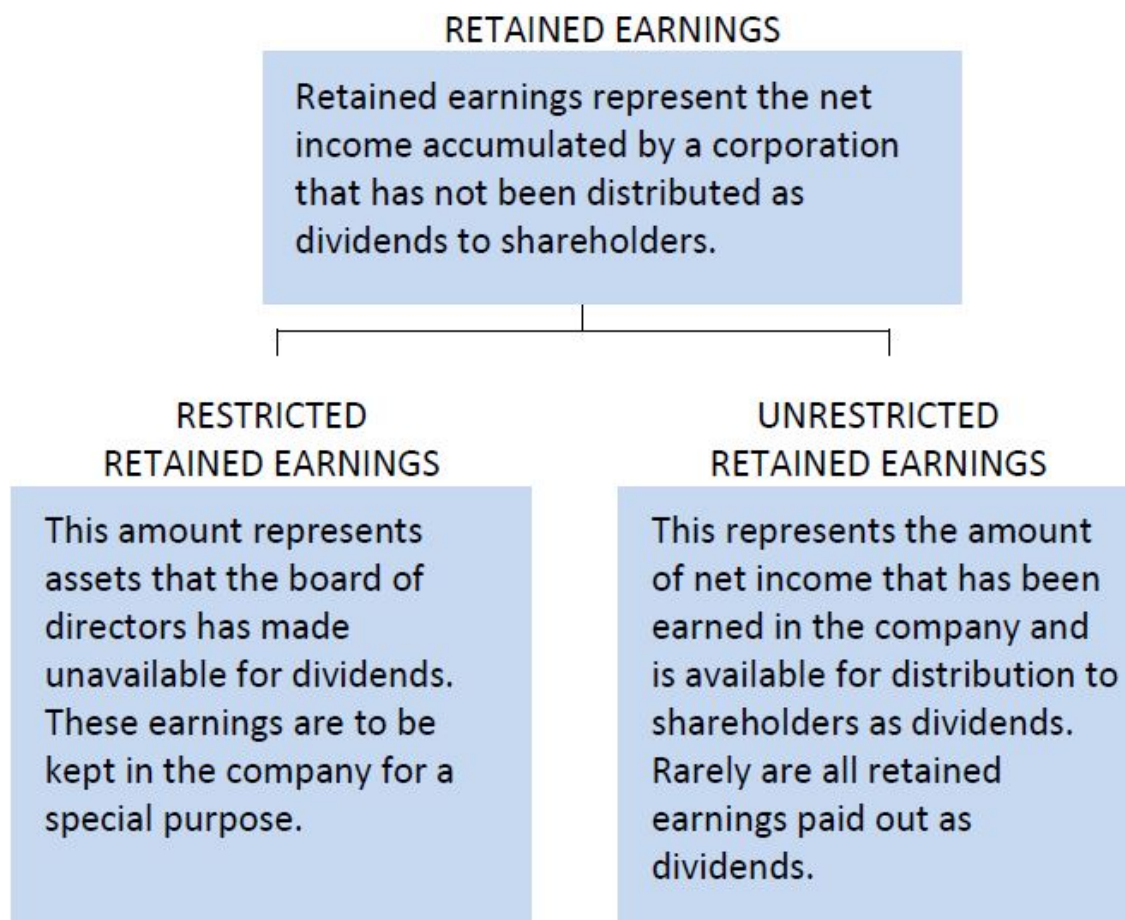


Fig. 11.6: Restricted and Unrestricted Retained Earnings

Assume that New World Corporation has retained earnings of \$800,000 at December 31, 2018. The board of directors passes a resolution at the 2018 year-end to restrict \$70,000 of retained earnings for a plant expansion. The full cycle of the restriction within retained earnings is shown in [Figure 11.7](#).

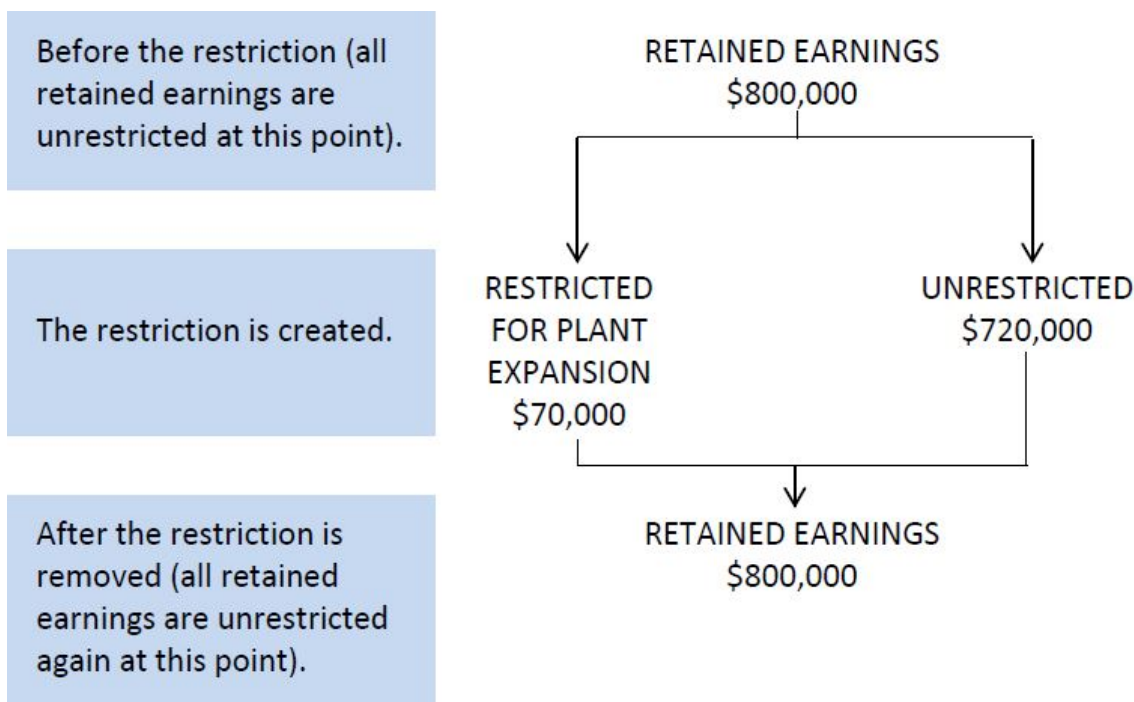


Fig. 11.7: Restriction for Plant Expansion: Creation and Removal

As can be seen, the creation of a restriction on retained earnings divides the \$800,000 amount into a restricted component of \$70,000 and an unrestricted component of \$720,000.

The creation of a restriction on retained earnings indicates management's intention to use assets for a particular purpose. It is reported on the financial statements so that investors and creditors are informed that these assets are unavailable for dividends. These restrictions do not in any way alter the total amount of retained earnings or shareholders' equity.

The journal entry to record the creation of the above \$70,000 restriction for plant expansion would be:

2018

Dec. 31	Retained Earnings	70,000	
	Retained Earnings – Restriction for Plant Expansion		70,000
	<i>To record the restriction on retained earnings.</i>		

This restriction records a portion of these earnings in an account specifically designated to indicate its purpose—plant expansion. The restricted amount is still part of retained earnings. It is classified as retained earnings in the shareholders' equity section of the balance sheet at December 31, 2018 as follows:

<i>Shareholders' Equity</i>		
	2018	2017
Share capital	\$ 98,000	\$ 98,000
Retained earnings (Note Y)	800,000	760,000
Total shareholders' equity	<u>\$898,000</u>	<u>\$858,000</u>

The relevant note to the financial statements would state:

Note Y

On December 31, 2018 the board of directors authorized a \$70,000 restriction on the retained earnings of the company for plant expansion.

The statement of changes in equity would show (bolded for illustrative purposes):

	<i>Common shares</i>	<i>Preferred shares</i>	<i>Retained earnings</i>		<i>Total equity</i>
			<i>Unrestricted</i>	<i>Restricted</i>	
Balance at Jan. 1, 2017	\$ 13,000	\$ 85,000	\$680,000	\$ -0-	\$778,000
2017 net income			80,000		80,000
Balance at Dec. 31, 2017	13,000	85,000	760,000	-0-	858,000
2018 net income			40,000		40,000
<b>Restriction for plant addition (Note Y)</b>			<b>(70,000)</b>	<b>70,000</b>	
Balance at Dec. 31, 2018	<u>\$ 13,000</u>	<u>\$ 85,000</u>	<u>\$730,000</u>	<u>70,000</u>	<u>\$898,000</u>

It is important to understand that recording a restriction for plant expansion does not set up some kind of cash fund for the expansion. It merely ensures that investors are aware that all the retained earnings of the corporation are not eligible to be paid out as dividends while the restriction is in place and that the assets represented by the restriction will be used for another purpose in the meantime.

When the special restriction account has served its purpose and the requirement for which it was set up no longer exists, the amount in the restriction account is returned to the retained earnings account from which it was created. The entry setting up the restriction is reversed. The construction of the plant is recorded in the normal manner.

Assume that the plant expansion costs \$70,000 and is paid in cash on August 31, 2019. The construction and payment is recorded as follows.

2019

Aug. 31	Plant	70,000	
	Cash		70,000
	<i>To record the payment for plant expansion.</i>		

This journal entry records the actual plant expenditure. It also shows that restricted retained earnings are *not* used to pay for the plant. The expenditure is paid with the asset cash. At August 31, 2019, the entry to reverse the original journal entry and eliminate the restricted amount for plant expansion is made:

2019

Aug. 31	Retained Earnings – Restriction for Plant Expansion	70,000	
	Retained Earnings		70,000
	<i>To record expiry of the restriction on retained earnings.</i>		



The restriction account is reversed when the plant has been built because dividends are no longer restricted by the need for a plant expansion.

## 11.7 Summary of Chapter 11 Learning Objectives



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### **LO1 – Identify and explain characteristics of the corporate form of organization and classes of shares.**

A corporation is a legal entity that is separate from its owners, known as shareholders. The board of directors is responsible for corporate policy and broad direction of the corporation, including hiring the person in charge of day-to-day operations. A corporation has an indefinite life, its shareholders have limited liability, it can acquire capital more easily than a sole proprietorship or partnership, and it pays income taxes on its earnings since it is a separate legal entity. A corporation can issue common and preferred shares. Common shares have voting rights while preferred shares do not. Preferred shares are listed before common shares in the shareholders' equity section of the balance sheet. Preferred shareholders are entitled to receive dividends before common shareholders. Authorized shares are the total number of shares that can be issued or sold. Shares that have been issued can be repurchased by the corporation and either held in treasury for subsequent sale/distribution or cancelled. Outstanding shares are those that have been issued and are held by shareholders. Shares repurchased by a corporation are not outstanding shares.

### **LO2 – Evaluate relative financing effects of bonds, common shares, and preferred shares.**

One of the most important considerations between the issue of debt or share capital is the potential effect of each of these financing methods on the present shareholders. These include effects on earnings per share, control of the corporation, and income taxes expense. Differences between projected and actual results can result in wrong decisions.

### **LO3 – Record and disclose preferred and common share transactions including share splits.**

Common and preferred shares can be issued for cash or other assets. Organization costs are expensed when incurred and organizers sometimes accept shares in lieu of cash for their work in organizing the corporation. When more than one type of share has been issued, the shareholders' equity section of the balance sheet must be classified by including a Contributed Capital section. When a corporation's shares are selling at a high price, a share split may be declared to increase the marketability of the shares. There is no journal entry for a share split. Instead, a memorandum entry is entered into the records detailing the split. A share split increases the number of shares but does not change any of the dollar amounts on the financial statements.

### **LO4 – Record and disclose cash dividends.**

Cash dividends are a distribution of earnings to the shareholders and are declared by the board of directors. On the declaration date, cash dividends declared (or retained earnings) is debited and dividends payable is credited. On the date of record, no journal entry is recorded. Shareholders who hold shares on the date of record are eligible to receive the declared dividend. On the date of payment, dividends payable is debited and cash is credited. Preferred shares may have a feature known as cumulative or non-cumulative. Cumulative preferred shares accumulate undeclared dividends from one year to the next. These unpaid dividends are called dividends in arrears. When dividends are subsequently declared, dividends in arrears must be paid before anything is paid to the other shareholders. Non-cumulative preferred shares do not accumulate undeclared dividends.

### **LO5 – Calculate and explain the book value per share ratio.**

The book value of a share is the amount of net assets represented by one share. Book value per common share is the amount of net assets not claimed by creditors and preferred shareholders. Preferred book value per share is the net assets that preferred shareholders would receive if the corporation were liquidated.

### **LO6 – (Appendix 1) Record and disclose share dividends.**

Share dividends distribute additional shares to shareholders and are declared by the board of directors. On the declaration date, share dividends declared (or retained earnings) is debited and common share dividends distributable, a share capital account, is credited. When the share dividend is distributed to shareholders, the Common Share Dividends Distributable account is debited and common shares is credited. Share dividends cause an increase in the number of shares issued and outstanding but do not affect account balances. Share dividends simply transfer an amount from retained earnings to share capital within the shareholders' equity section of the balance sheet.

### **LO7 – (Appendix 2) Explain and record restrictions on retained earnings.**

Retained earnings can be restricted by the board of directors for certain purposes, like a plant expansion. These restricted amounts are unavailable for dividends. Restrictions do not affect the total amount of retained earnings or total shareholders' equity. A restriction does not set aside cash to fund the activity. To set up a restriction, the Retained Earnings account is debited and an account (for example, Retained Earnings – Restriction for Plant Expansion) is credited. When the expansion is complete, the entry is merely reversed.

## **11.8 Assignment Materials**

### **11.8.1 Concept Self-check**



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1. What are some advantages of the corporate form of organization?
2. What is meant by *limited liability* of a corporation?
3. What rights are attached to common shares? Where are these rights indicated?

4. Describe a typical incorporation process.
5. What is a board of directors and whom does it represent? Are the directors involved in the daily management of the entity?
6. Describe:
  - a. two main classes of shares that can be issued by a corporation; and
  - b. the different terms relating to the status of a corporation's shares.
7. In what ways can shares be "preferred"? In which ways are they similar to common shares? Different from common shares?
8. Describe the accounting treatment of reacquired shares.
9. Why do corporations sometimes opt for a share split?
10. Assume a 2-for-1 share split occurs. Explain
  - a. the effect on the total number of issued and outstanding shares; and
  - b. the effect on stated capital.
11. Identify the major components of the shareholders' equity section of a balance sheet. Why are these components distinguished?
12. What are the main issues a board of directors considers when making a dividend declaration decision?
13. Even if a corporation is making a substantial net income each year, why might the board of directors decide to not pay any cash dividends?
14. Distinguish among the date of dividend declaration, the date of record, and the date of payment.
15. Explain the different dividend preferences that may be attached to preferred shares. Why would preferred shares have these preferences over common shares? Does it mean that purchasing preferred shares is better than purchasing common shares?
16. What are dividends in arrears? Are they a liability of the corporation?
17. What does the book value of shares represent? How is it calculated?
18. A corporate entity has both preferred and common classes of shares. How is the book value of common shares calculated in this case? What is meant by the liquidation value of preferred shares?
19. Of what value is the calculation of book value per share?
20. If the market price of a share is less than its book value; is it a bargain? Why or why not?
21. (Appendix 1) What is the difference in accounting between cash dividends and share dividends? Give a sample journal entry for each.
22. (Appendix 1) How does a share dividend differ from a share split?
23. (Appendix 1) Does a share dividend change an investor's percentage of corporate ownership? Explain, using an example.
24. (Appendix 2) What is the difference between restricted and unrestricted retained earnings? Why would some retained earnings be restricted? Prepare the journal entries used to make a restriction.
25. (Appendix 2) How can retained earnings be said to be reinvested in a corporation?

## 11.8.2 Comprehension Problems

### 11.8.2.1 CP 11-1



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The following captions are sub-totals appearing in the shareholders' equity section of the balance sheet for Hudson Day Corporation:

- a. Total share capital
- b. Total retained earnings

Required: For each event listed below, indicate, in the format provided, whether the amount of each subtotal is increased (↑) or decreased (↓). Indicate with an 'x' if there is no change to a particular subtotal. Consider each event to be unrelated to the others.

		<i>Total share capital</i>	<i>Retained earnings</i>
1.	Company is incorporated.	<u>          X          </u>	<u>          X          </u>
2.	Issued shares with a stated value of \$1.	<u>                          </u>	<u>                          </u>
3.	Split the common shares 2 for 1.	<u>                          </u>	<u>                          </u>
4.	Recorded net income for the year.	<u>                          </u>	<u>                          </u>
5.	Reacquired common shares previously outstanding.	<u>                          </u>	<u>                          </u>

6.	Issued a share dividend.	_____	_____
7.	Paid a cash dividend.	_____	_____
8.	(Appendix 1) Declared a share dividend.	_____	_____
9.	(Appendix 2) Created a restriction on retained earnings.	_____	_____

### 11.8.2.2 CP 11-2



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Bagan Corporation, a profitable growth company with 200,000 shares of common shares outstanding, is in need of approximately \$40 million in new funds to finance required expansion. Currently, there are no other securities outstanding. Management has three options open:

- a. Sell \$40 million of 12-per cent bonds at face value.
- b. Sell 10% preferred shares: 400,000 shares at \$100 per share (dividend \$10 per share).
- c. Sell another 200,000 common shares at \$200 per share.

Operating income (before interest and income taxes) on completion of the expansion is expected to average \$12 million per year; the income tax rate is 50%.

*Required:*

1. Complete the schedule below and calculate the earnings per common share.

	<i>12% bonds</i>	<i>Preferred shares</i>	<i>Common shares</i>
Income before interest and income taxes	\$12,000,000	\$12,000,000	\$12,000,000
<i>Less:</i> Interest expense	_____	_____	_____
Income before taxes			
<i>Less:</i> Income taxes at 50%	_____	_____	_____
Net income			
<i>Less:</i> Preferred dividends	_____	_____	_____
Net income available to common shareholders	_____	_____	_____
Number of common shares outstanding	_____	_____	_____
Earnings per common share	_____	_____	_____

2. Which financing option is most advantageous to the common shareholders? Why?

### 11.8.2.3 CP 11-3



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Essential Financial Service Corp. was incorporated on January 1, 2016 to prepare business plans for small enterprises seeking bank financing.

*Required:* Prepare journal entries to record the following transactions on January 2, 2016:

1. Received an incorporation charter authorizing the issuance of an unlimited number of no par-value common shares and 10,000, 4% preferred shares.
2. Issued in exchange for incorporation costs incurred by shareholders 10,000 common shares at \$1.
3. Issued for cash 1,000 preferred shares at \$3 each.

### 11.8.2.4 CP 11-4



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A tract of land valued at \$50,000 has been given to a corporation on July 31, 2016 in exchange for 1,000 preferred shares.

*Required:*

1. Prepare the journal entry to record the transaction.
2. Where would the transaction be classified in the balance sheet?

### 11.8.2.5 CP 11-5



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The shareholders' equity section of Gannon Oilfield Corporation's balance sheet at December 31, 2016 is shown below.



<b>Preferred shares</b>	
Authorized—100 shares	
Issued and outstanding—64 shares	\$3,456
<b>Common shares</b>	
Authorized—2,000 shares	
Issued and outstanding—800 shares	1,680
Retained earnings	600
<b>Total shareholders' equity</b>	<u><u>\$5,736</u></u>

*Required:*

1. What is the average price received for each issued preferred share?
2. What is the average price received for each issued common share?
3. What is the total stated capital of the company?

### 11.8.2.6 CP 11-6



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The general ledger accounts of Human Services Corp. have the following amounts recorded during December 2016:

<b>Cash</b>		<b>Land</b>		<b>Building</b>	
30,000	5,000	10,000	4,000	12,000	
15,000	8,000			8,000	
7,000	6,000				
4,000					
				<b>Incorp. Costs</b>	
				14,000	
<b>Preferred Shares</b>			<b>Common Shares</b>		
6,000	15,000	5,000	30,000		
	14,000		22,000		
			7,000		

*Required:* Reconstruct the transactions that occurred during December and prepare the journal entries to record these transactions, including descriptions. The transactions and related journal entries do not need to be listed in a particular order.

### 11.8.2.7 CP 11-7



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Strada Controls Inc. has 100,000 common shares outstanding on January 1, 2016. On May 25, 2016, the board of directors declared a semi-annual cash dividend of \$1 per share. The dividend will be paid on June 26, 2016 to shareholders of record on June 7, 2016.

*Required:* Prepare journal entries for

1. the declaration of the dividend;
2. the payment of the dividend.

### 11.8.2.8 CP 11-8



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Landers Flynn Inc. has 1,000, \$5 cumulative preferred shares outstanding. Dividends were not paid last year. The corporation also has 5,000 common shares outstanding. Landers Flynn declared a \$14,000 cash dividend to be paid in the current year.

*Required:* Calculate the amount of dividends received by

1. the preferred shareholders;
2. the common shareholders.

### 11.8.2.9 CP 11-9



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The following information is extracted from the shareholders' equity section of the balance sheet of Gibson Clothing Inc. at December 31, 2016:

<b>Preferred shares, stated value \$10, non-cumulative</b>	
Issued and outstanding — 5,000 shares	\$ 20,000
<b>Common shares, stated value \$2</b>	
Issued and outstanding — 20,000 shares	40,000
<b>Retained earnings</b>	150,000
<b>Total shareholders' equity</b>	<u><u>\$210,000</u></u>

Additional information:

- a. There are \$2,000 of dividends in arrears on the preferred shares.
- b. The liquidation value of the preferred shares is \$25,000.

*Required:* Calculate the book value of preferred and common shares.

### 11.8.2.10 CP 11-10



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The shareholders' equity section of Pembina Valley Manufacturing Limited's balance sheet at December 31, 2016 is shown below.

<b>Preferred shares, non-cumulative</b>	
Authorized — 500 shares	
Issued and outstanding — 300 shares	\$ 300
<b>Common shares</b>	
Authorized — 100 shares	
Issued and outstanding — 20 shares	500
<b>Retained Earnings</b>	<u>192</u>
<b>Total shareholders' equity</b>	<u><u>\$992</u></u>

*Note:* There is \$30 of dividends in arrears on the preferred shares. The liquidation value of preferred shares is \$300.

*Required:*

1. Calculate the book value per share of
  1. the preferred shares; and
  2. the common shares.
2. Assume that the common shares were split 2 for 1 on January 2, 2017 and that there was no change in any other account at that time. Calculate the new book value of common shares immediately following the share split.

### 11.8.2.11 CP 11-11



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The following note appeared on the balance sheet of Sabre Rigging Limited:

As of December 31, 2016, dividends on the cumulative preferred shares were in arrears for three years to the extent of \$15 per share or \$15,000 in total.

*Required:*

1. Does the amount of the arrears appear as a liability on the December 31, 2016 balance sheet? Explain your answer.
2. Why might the dividends be in arrears?
3. The comptroller of Sabre Rigging projects net income for the 2017 fiscal year of \$35,000. When the company last paid dividends, the directors allocated 50 per cent of current year's net income for dividends. If dividends on preferred shares are resumed at the end of 2017 and the established policy of 50 per cent is continued, how much will be available for dividends to the common shareholders if the profit projection is realized?

### 11.8.2.12 CP 11–12 (Appendix 1)



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The shareholders' equity section of Lakeview Homes Corporation's balance sheet at December 31, 2016 is reproduced below:

<i>Shareholders' Equity</i>	
Common shares	
Authorized 10,000 shares	
Issued 5,000 shares	\$ 20,000
Retained earnings	100,000
Total shareholders' equity	\$120,000

On January 15, 2016, Lakeview Homes declared a 10 per cent share dividend to holders of common shares. At this date, the common shares of the corporation were trading on the stock exchange at \$10 each. The share dividend was issued February 15, 2016

*Required:* Prepare the journal entries to record the share dividend.

### 11.8.2.13 CP 11–13 (Appendix 1)



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Arrow Streaming Corporation has 10,000 common shares outstanding at January 1, 2016 with a stated value of \$100,000. On April 1, Arrow Streaming declared a 10 per cent share dividend, payable on April 15 to shareholders of record on April 10. The market value of Arrow's shares on April 1 was \$15. On June 1, the company declared a \$2 cash dividend per share to common shareholders of record on June 10, and paid the dividend on June 30. Assume the year-end of the corporation is December 31.

*Required:* Prepare journal entries for the above transactions, including closing entries.

### 11.8.2.14 CP 11–14 (Appendix 1)



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Blitz Power Tongs Inc. received a charter that authorized it to issue an unlimited number of common shares. The following transactions were completed during 2016:

Jan.      5      Issued 10 common shares for a total of \$150 cash.

	12	Exchanged 50 shares of common shares for assets listed at their fair values: machinery – \$100; building – \$100; land – \$50.
Feb.	28	Declared a 10% share dividend. Market value is \$7 per share. Net income to date is \$60.
Mar.	15	Issued the share dividend.
Dec.	31	Closed the 2016 net income of \$200 from the Income Summary account in the general ledger to the Retained Earnings account.
Dec.	31	Declared a \$1 per share cash dividend.

*Required:*

1. Prepare journal entries for the 2016 transactions, including closing entries.
2. Prepare the shareholders' equity section of the balance sheet at
  1. January 31, 2016
  2. February 28, 2016
  3. December 31, 2016.

**11.8.2.15 CP 11–15 (Appendix 2)**

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Acme Corporation has \$100,000 of common shares outstanding and \$200,000 of retained earnings at December 31, 2016. The board of directors passes a resolution at that date to restrict \$80,000 of retained earnings for a plant expansion.

*Required:*

1. Record the restriction in journal entry form.
2. Show the shareholders' equity section of the balance sheet and appropriate note disclosure at December 31, 2016.
3. Record the construction of the building when completed on June 30, 2017 for a cost of \$90,000, paid in cash.
4. Record the journal entry to record the lifting of the restriction on July 31, 2017.

### 11.8.2.16 CP 11–16 (Appendices 1 and 2)



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Stetson Auto Inc. was incorporated on January 1, 2016 and commenced operations at that date. A \$2,000 common share dividend was declared and paid on October 31, 2016. The following information was taken from the shareholders' equity section of the company's balance sheet at December 31, 2016:

#### Common shares

Issued and outstanding – 10,000 shares	\$10,000
Restriction – plant addition	150,000
Revenue (total for 2016)	2,575,000
Expenses (total for 2016)	2,000,000
Cash dividends declared	23,000

*Required:* Prepare the shareholders' equity section of Stetson Auto's balance sheet at December 31, 2016 and the statement of changes in shareholders' equity for the year then ended.

## 11.8.3 Problems

### 11.8.3.1 P 11–1



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The board of directors of Megalopolis Inc. has approved management's recommendation to expand the production facilities. The firm currently manufactures only heavy machinery, but plans are being developed for diversifying the corporation's activities through the production of smaller and more versatile equipment. The directors are considering the following financing methods raise \$2 million of additional capital:

- a. Sell \$2 million of 12% bonds at face value.

- b. Sell \$8 preferred shares: 20,000 shares at \$100 a share (no other preferred shares are outstanding).
- c. Sell another 50,000 shares of common shares at \$40 a share (currently 40,000 common shares are outstanding).

Income before interest and income taxes is expected to average \$1,000,000 per year following the expansion; the income tax rate is 50%.

*Required:*

1. Calculate the earnings per common share for each alternative.
2. As representatives of common shareholders, which financing method most likely meets the board of directors' needs?
3. What other factors should the board of directors consider?

### 11.8.3.2 P 11-2



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Crystal Clear Electronics Inc. was incorporated on January 1, 2016 and was authorized under its charter to issue the following shares — 20,000 non-cumulative, non-voting, 5% preferred shares and an unlimited number of no par-value, voting common shares.

*Required:*

1. Prepare journal entries to record the following 2016 transactions:
  - a. Issued 3,000 preferred shares for \$6 cash each on January 2.
  - b. Issued 2,000 common shares for \$2 cash each on January 2.
  - c. Issued 5,000 preferred shares for \$5 cash each on January 12.
  - d. Issued 1,000 common shares for \$1 cash each on August 1.
  - e. Issued 500 preferred shares for land valued at \$15,000 on December 15.
2. Prepare the shareholders' equity section of the balance sheet at December 31, 2016 and the related note to the financial statements.
3. On December 15, 2017, the common shares were split 2 for 1. Assuming no other transactions occurred during 2017, prepare the statement of changes in equity for the years ended December 31, 2016 and 2017.

### 11.8.3.3 P 11-3



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Following is the shareholders' equity section of Critter Contracting Inc. shown before and after a share split on April 15, 2017.



Before split		After split	
<i>Shareholders' Equity</i>		<i>Shareholders' Equity</i>	
Common shares		Common shares	
Authorized —		Authorized—	
5,000 shares		? shares	
Issued and	\$100,000	Issued and	\$ ?
outstanding—		outstanding	
1,000 shares		— ? shares	

On April 15, the board of directors authorized a 5 for 1 share split.

*Required:*

1. Complete the shareholders' equity section of the balance sheet after the split.
2. Record a memorandum indicating the new number of shares.
3. If the market value per share was \$40 before the split, what would be the approximate market value after the split? Why?

#### 11.8.3.4 P 11-4



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Relevant financial information for Gearing Gravel Limited at January 1, 2016 is as follows:

<b>5% Preferred shares, non-cumulative, non-voting</b>		
Authorized —	1,000 shares	
Issued and outstanding —	10 shares	\$ 50,000
<b>Common shares, voting</b>		
Authorized —	unlimited	
Issued and outstanding —	200 shares	10,000
Retained earnings		100,000
<b>Total shareholders' equity</b>		<u><u>\$160,000</u></u>

During the year, total cash dividends of \$3,000 were declared. Net income for the year amounted to \$20,000. 100 common shares were issued on February 28, 2016 for \$5,000. 20 common shares were reacquired on December 31 for \$1,000 and held as treasury shares.

*Required:* Prepare the statement of changes in equity for the year ended December 31, 2016 and the related note to the financial statements.

### 11.8.3.5 P 11-5



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*Required:* For each event listed below, indicate, in the format provided, whether the amount of each sub-total is increased (↑) or decreased (↓). Indicate with an 'x' if there is no change to a particular subtotal. Consider each event to be unrelated to the others, unless otherwise indicated.

	<i>Assets</i>	<i>Liabilities</i>	<i>Shareholders' Equity</i>
1. Commons shares were issued for cash.	↑	x	↓
2. Declared a cash dividend.	_____	_____	_____
3. Common shares split 3:1.	_____	_____	_____
4. Calculated book value of common shares.	_____	_____	_____
5. Paid cash dividend related to item 2 above.	_____	_____	_____
6. (Appendix 2) Recorded a restriction of retained earnings.	_____	_____	_____

### 11.8.3.6 P 11-6



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The following information relates to River Valley Produce Limited as at December 31, 2016:

<i>Shareholders' Equity</i>		
<b>Share capital</b>		
Preferred shares, \$8, stated value \$100, non-voting		
Authorized — 1,000 shares		
Issued and outstanding — 150 shares	\$15,000	
Common shares, stated value \$5, voting		
Authorized — 10,000 Shares		
Issued and outstanding — 4,800 shares	<u>24,000</u>	
Total share capital		\$ 39,000
Retained earnings		<u>40,000</u>
<b>Total shareholders' equity</b>		<u><u>\$79,000</u></u>

The following transactions occurred during 2017:

- a. Reacquired 400 common shares at \$10 each; held as treasury shares.

- b. Split the common shares 2 for 1.
- c. Issued an additional 200 common shares for \$3 cash each.
- Transferred net income of \$19,500 from the Income
- d. Summary account in the general ledger to the Retained Earnings account.
- e. The board authorized a \$5,000 of retained earnings to be restricted for plant expansion.\*

\*complete only if Appendix 2 is covered

*Required:*

1. Prepare journal entries for the 2017 transactions.
2. Prepare the statement of changes in equity for the year ended December 31, 2017.
3. What amount of is available for distribution to shareholders as of December 31, 2017?

### 11.8.3.7 P 11-7



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The following is the shareholders' equity section of the balance sheet of Tridon Construction Limited at December 31, 2016.

### *Shareholders' Equity*

#### Common Shares, voting

Authorized — 500 shares	
Issued and outstanding — 300 shares	\$3,070
Retained earnings	500
Total shareholders' equity	\$3,570

*Required:*

1. What is the stated value per common share? the book value per common share?
2. On December 31, 2016 the Tridon Construction common shares traded at \$24. Why is the market value different from the book value of commons shares?

### 11.8.3.8 P 11-8 (Appendix 1)



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The shareholders' equity section of the balance sheet of TWR Contracting Inc. at December 31, 2017 showed the following amounts:

<i>Shareholders' Equity</i>	
Preferred shares, \$.60, non-voting, cumulative, non-participating	
Issued and outstanding — 40 shares	\$ 400
Common shares, voting	
Issued and outstanding — 2,000 shares	2,000
Retained earnings	900
<b>Total shareholders' equity</b>	<u><u>\$3,300</u></u>

The following transactions occurred during 2018:

Feb.	15	Declared the regular \$0.30 per share semi-annual cash dividend on its preferred shares and a \$0.05 per share cash dividend on the common shares to holders of record March 5, payable April 1.
Apr.	1	Paid the dividends declared on February 15.
May	1	Declared a 10 per cent share dividend to common shareholders of record May 15 to be issued June 15, 2016. The market value of the common shares at May 1 was \$2 per share.
June	15	Issued the dividends declared on May 1.
Aug.	15	Declared the regular semi-annual cash dividend on preferred shares and a cash dividend of \$0.05 on the common shares to holders of record August 31, payable October 1.
Oct.	1	Paid the dividends declared on August 15.
Dec.	15	Declared a 10 per cent common share dividend to common shareholders of record December 20 to be

issued on January 15, 2019. The market value of the common shares at December 15 was \$3 per share.

Dec. 31 Net income for the year ended December 31, 2018 was \$1,400.

*Required:*

1. Prepare journal entries to record the 2018 transactions, including closing entries. Show calculations. Descriptions are not necessary.
2. Prepare the statement of changes in equity for the year ended December 31, 2018.

### 11.8.3.9 P 11-9 (Appendices 1 and 2)



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At December 31, 2016, the shareholders' equity section of the balance sheet for the Apex Auto Corporation totalled \$2,000,000. Following are the balances of various general ledger accounts at that date.

Preferred shares, \$.40, cumulative	Issued 50,000 shares	\$500,000
Common shares	Issued 50,000 shares	750,000
Retained earnings—unrestricted		750,000

The following transactions occurred during 2017.

Mar. 20 A cash dividend of \$0.20 per preferred share was declared, payable April 1 to shareholders of record on March 25.

Apr. 1 Payment of previously declared dividend on preferred shares was made.

June	15	The regular semi-annual cash dividend on common shares of \$0.40 per share was declared, payable July 10 to shareholders of record on July 1.
July	10	Payment of the previously-declared dividend on common shares was made.
Aug.	1	10,000 common shares were issued for \$200,000 cash.
Nov.	15	The board of directors met and restricted an additional \$75,000 for the plant extension.*
Dec.	15	The regular semi-annual dividend of \$0.40 per common share was declared payable December 31, 2017.
Dec.	31	A cash dividend totalling \$25,000 was paid.

\*complete only if Appendix 2 is covered

*Required:*

1. What amount of cash dividends would be distributed to common shareholders on December 31, 2017?
2. Prepare journal entries for the 2017 transactions. Ignore closing entries. Descriptions are not necessary.
3. Prepare the statement of changes in equity for the year ended December 31, 2017 assuming net income for the year amounted to \$165,000.

## 11.8.4 Alternate Problems

### 11.8.4.1 AP 11-1



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*Required:* For each event listed below, indicate, in the format provided, whether the amount of each subtotal is increased (↑) or decreased (↓). Indicate with an 'x' if there is no change to a particular subtotal. Consider each event to be unrelated to the others, unless otherwise indicated.

	<i>Assets</i>	<i>Liabilities</i>	<i>Shareholders' Equity</i>
1. Declared a cash dividend.	x	↑	↓
2. Paid the cash dividend in item 1.			
3. Split common shares 2:1.			
4. Declared a share dividend.			
5. Redeemed preferred shares for cash.*			
6. Paid a share dividend.*			
7. Recorded a restriction on retained earnings.**			

\*complete only if Appendix 1 covered

\*\*complete only if Appendix 2 covered

### 11.8.4.2 AP 11-2



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The financing structure of Warner Corp. is currently as follows:

Current liabilities	\$200,000
Bond payable	-0-
Preferred shares – \$8 dividend per share	-0-
Common shares – 50,000 shares outstanding	500,000
Retained earnings	300,000

Management is considering a plant expansion costing \$1,000,000. Several different factors have been considered in a selection of a financing method; the effect of alternative financing methods on earnings per common share remains to be analysed.

The following financing methods are being considered:

- a. Sell \$1 million of 12-per cent bonds at face value.
- b. Sell another 10,000 common shares at \$100 per share.



- c. Sell 10,000 shares of preferred shares at \$100.

Warner is a profitable growth company and income before interest and income taxes is expected to average \$200,000 per year; the income tax rate is 40%.

*Required:*

1. Prepare a schedule to compare the effect on earnings per common share of each of the financing options.
2. Based on earnings per common share, which method is financially advantageous to common shareholders?
3. What other factors should be considered before a final decision is made?

### 11.8.4.3 AP 11-3



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Parkland Dental Clinic Corporation was incorporated on May 1, 2016. The following transactions occurred during the month:

May	1	Issued 1,000 preferred shares for \$3 cash each.
	2	Issued 2,000 common shares for \$5 cash each.
	5	Issued 1,500 common shares for \$2 cash each.
	10	Issued 1,000 preferred shares in exchange for land valued at \$1,000.
	15	Issued 3,000 preferred shares for \$2 cash each.
	21	Issued 5,000 common shares for \$3 cash each.
	24	Repurchased 100 preferred shares at \$2 each, held as treasury shares.

Assume that Parkland Dental Clinic was authorized to issue an unlimited number of 6%, non-cumulative, non-voting preferred shares and an unlimited number of common, voting shares.

*Required:*

1. Prepare journal entries to record the May transactions.

2. Prepare the shareholders' equity section of the balance sheet at May 31, 2016 and the related note to the financial statement.
3. Prepare the statement of changes in equity for the one-month period ended May 31, 2016.

#### 11.8.4.4 AP 11-4



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Argo Software Inc. was incorporated on April 1, 2016. The following transactions occurred during April:

Apr.	1	Received a corporate charter authorizing the issue of an unlimited number of voting common shares
	1	Issued 5,000 common shares for \$10,000 cash
	20	Issued 10,000 common shares for land on which a building will be constructed; the market value of the common shares was \$3 each on this date
	25	Issued 1,000 common shares for \$4 cash each
	29	Reacquired 1,000 common shares for \$2,750 to be held as treasury shares
	30	Closed net income of \$5,000 from the Income Summary account in the general ledger to the Retained Earnings account
	30	Declared a cash dividend of \$.10 per common share, payable as of May 15.

*Required:*

1. Prepare journal entries to record the April transactions.
2. Prepare the statement of changes in equity for the one-month period ended April 30, 2016.
3. Assume that on May 25 the common shares were split 2 for 1. How would the share split affect the common shares? Record your answer using the following schedule form.

	<i>Number of shares outstanding</i>	<i>Total value of common shares on balance sheet</i>	<i>Book value per share</i>	<i>Market price per share</i>
Before share split				\$6
After share split				

### 11.8.4.5 AP 11-5



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Relevant financial information for Dawson's General Store Limited at January 1, 2016 is as follows:

<i>Shareholders' Equity</i>	
Preferred shares, unlimited number authorized, non-voting, cumulative, non- participating	
Issued and outstanding — 1,000 shares	\$ 200,000
Common shares, unlimited number authorized, voting	
Issued and outstanding — 400 shares	700,000
Retained earnings	1,000,000
<b>Total shareholders' equity</b>	<b><u>1,900,000</u></b>

During the year, total cash dividends of \$30,000 were declared. \$100,000 preferred dividends were in arrears at January 1, 2016. Net income for the year amounted to \$200,000. 1,000 common shares were issued on September 28, 2016 for \$100,000. 200 preferred shares were reacquired on December 31 for \$1,400 and held as treasury shares.

*Required:* Prepare the statement of changes in equity for the year ended December 31, 2016 and the related note to the financial statements.

### 11.8.4.6 AP 11-6



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On January 1, 2016, the Canwest Corporation began operations. It was authorized to issue 20,000 voting common shares and 10,000 cumulative, non-voting preferred shares. The dividend on each preferred share is \$1 per year. The company issued 4,000 common shares for \$120,000 on January 2, 2016. No preferred shares were issued in 2016. The retained earnings balance on December 31, 2016 was \$145,000. During 2017 the following transactions occurred:

Feb.	15	Issued 1,000 common shares at \$8 each.
Mar.	1	Acquired land with an appraised market value of \$40,000 in exchange for 1,500 preferred shares.
Jun.	1	Declared a \$1 cash dividend on outstanding common shares and the annual cash dividend on outstanding preferred shares payable July 1 to shareholders of record on June 25.
July	1	Paid the June 1 dividend.
Dec.	15	Declared a \$.40 cash dividend on each outstanding common share, payable January 15, 2018.
Dec.	31	Net income for the year was \$98,000.

*Required:*

1. Prepare journal entries to record the 2017 transactions, including closing entries. Descriptions are not necessary.
2. Prepare the shareholders' equity section of the balance sheet at December 31, 2017 and the related note to the financial statements.
3. Prepare the statement of changes in equity for the year ended December 31, 2016.

### 11.8.4.7 AP 11-7



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Pretty Productions Ltd. had the following shareholders' equity at January 1, 2017:

Common shares	
1,000 shares outstanding	\$11,000
Retained earnings	9,000
Total shareholders' equity	<u>\$20,000</u>

**Part A**

The following transactions occurred during the year:

Jun.	1	Declared a cash dividend of \$1 per share to common shareholders of record June 15, payable June 30.
	30	Paid the dividend declared June 1.
Dec.	31	Net income for the year amounted to \$5,000.

*Required:*

1. Compute the book value per share at January 1, 2017.
2. Prepare journal entries to record the 2017 transactions and closing entries. Descriptions are not necessary.
3. Prepare the statement of changes in equity for the year ended December 31, 2017.
4. Compute the stated value and book value per share at December 31, 2017.

**Part B**

The following transactions occurred during 2018:

Feb.	15	Declared a cash dividend of \$1 per share to common shareholders of record March 1, payable March 15.
Mar.	15	Paid the dividend declared February 15.

June	30	Split the common shares 2:1. The new shares are to be issued July 23.
July	23	Issued the new common shares.
Dec.	31	Net income for the year amounted to \$8,000.

*Required:*

- Prepare journal entries to record the 2018 transactions, including closing entries. Descriptions are not necessary.
  - Prepare the statement of changes in equity for the year ended December 31, 2018.
  - Calculate the book value per share at December 31, 2018.
- Assume that the market value of one common share of Pretty Productions Ltd. was \$72 on December 31, 2017 and \$46.50 on December 31, 2018. Prepare ratios comparing market value to book value for each year.

#### 11.8.4.8 AP 11-8



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On December 31, 2016, relevant financial information of the First Financial Company was as follows:

<i>Shareholders' Equity</i>	
\$4 Preferred shares, cumulative, participating, non-voting	
Authorized 5,000 shares	
Issued and outstanding — 200 shares	\$20,000
Common shares	
Authorized — 2,000 shares	
Issued and outstanding — 100 shares	1,000
Retained earnings	5,450
Total shareholders' equity	\$26,450

Preferred shareholders participate equally in cash dividends declared on common shares. During 2017, First Financial engaged in the following transactions:

Mar.	15	Declared the regular semi-annual \$2 per share cash dividend on the preferred shares and a \$0.50 per share cash dividend on the common shares.
Apr.	30	Paid the dividends declared on March 15.
Sept.	15	Declared a \$600 cash dividend.
Oct.	30	Paid the dividends declared on September 15.
Dec.	15	Declared a 10 per cent common share dividend distributable on January 15 to shareholders of record January 10, 2018. The market value of the shares on December 15 was \$18 per share.*
Dec.	31	Transferred net income of \$90,000 from the Income Summary account in the general ledger to the Retained Earnings account.
Dec.	31	The board authorized \$10,000 of retained earnings to be restricted for plant expansion.**

\*complete only if Appendix 1 covered

\*\*complete only if Appendix 2 covered

*Required:*

1. Prepare journal entries to record the 2017 transactions, including closing entries. Descriptions are not necessary. Show calculations when needed.
2. Prepare the statement of changes in equity for the year ended December 31, 2017.

#### 11.8.4.9 AP 11-9 (Appendix 2)



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The partial shareholders' equity section of the Enermax Machine Company Limited balance sheet at December 31, 2016 appears below.



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Retained earnings		
Restricted for plant expansion	\$200	
Unrestricted	<u>900</u>	
Total retained earnings		<u>\$1,100</u>

*Required:*

1. Why do you think the directors established a restriction for plant expansion on retained earnings?
2. Assume that the plant expansion was completed by June 30, 2017. What entry would be made to eliminate the restriction?

# Chapter 12 Proprietorships and Partnerships



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To this point, the corporate form of business organization has been studied. This chapter will discuss the nature of proprietorships and partnerships, and how to account for various types of transactions within these entities.

## Learning Objectives

LO1 – Describe the characteristics of a proprietorship.

LO2 – Describe how the financial statements of a proprietorship are different from those of a corporation.

LO3 – Describe the characteristics of a partnership.

LO4 – Account for a partnership's profits and losses and prepare a statement of partner's capital.

LO5 – Account for the admission or withdrawal of partners from a partnership.

LO6 – Account for the liquidation of a partnership.

## 12.1 Proprietorships



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LO1 – Describe the characteristics of a proprietorship.

A **proprietorship** is a business owned by one person. It is not a separate legal entity like a corporation. This means that the business and the owner are considered to be the same. For example the profits of a proprietorship are taxed as part of the owner's personal income tax return. Also, a corporation has limited liability. Creditors cannot normally access the personal assets of shareholders to satisfy debts. On the other hand, a proprietorship has **unlimited liability**. If the business cannot pay its debts, the owner is responsible for these even if the business' debts are greater than the owner's personal resources. Another difference: a corporation has unlimited life. Shares can be bought or sold, or inherited by others. A proprietorship ceases to exist when the owner dies.

## 12.1.1 Investing in a Proprietorship



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When the shareholders invest in a corporation, shares are issued. A typical journal entry would be:

2015			
Jan. 1	Cash	10,000	
	Common Shares		10,000
	<i>To record the issuance of 1,000 common shares at \$10 per share.</i>		

The shares represent how much of the corporation is owned by each shareholder. In a proprietorship, there is only one owner, and the proprietorship and owner are not considered to be separate legal entities. As a result, there is no need to keep track of share capital and retained earnings in separate accounts as in a corporation. When an owner invests in a proprietorship, a typical journal entry would be:

2015			
Jan. 1	Cash	10,000	
	Proprietor's Capital		10,000
	<i>To record a cash contribution by the owner.</i>		

When a corporation earns net income, it is closed to the Retained Earnings at the end of each fiscal year. When a proprietorship earns net income, the income statement accounts are closed to the same **Proprietor's Capital** account.

## 12.1.2 Distribution of Income in a Proprietorship—Withdrawals



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A corporation distributes a portion of income earned to shareholders in the form of dividends. In a proprietorship, the owner distributes a portion of the business's income in the form of **withdrawals** and these are recorded as debits to the Proprietor's Withdrawals account. At year-end, this account is closed to Proprietor's Capital account. A typical journal entry to record a cash withdrawal would be:

2015			
Jan. 31	Proprietor's Withdrawals	1,000	
	Cash		1,000
	<i>To record a cash withdrawal by the owner.</i>		

### 12.1.3 Closing Entries for a Proprietorship



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In effect, all transactions with the proprietor are recorded in one account – Proprietor’s Capital. Because of this, the four closing entries for a proprietorship are slightly different from those of a corporation:

Figure 12.1 compares the closing entries for a proprietorship and a corporation, assuming revenue of \$10,000, expenses of \$6,000, and withdrawals/dividends of \$1,000 for the year ended December 31, 2016.

	Corporation		Proprietorship	
2016		(1)		(1)
Dec. 31	Revenue	10,000	Revenue	10,000
	Income Summary	10,000	Income Summary	10,000
	To close revenue to the Income Summary.		To close revenue to the Income Summary.	
Dec. 31	Income Summary	6,000	Income Summary	6,000
	Expenses	6,000	Expenses	6,000
	To close expenses to the Income Summary.		To close expenses to the Income Summary.	
Dec. 31	Income Summary	4,000	Income Summary	4,000
	Retained Earnings	4,000	Proprietor’s Capital	4,000
	To close the Income Summary to Retained Earnings.		To close the Income Summary to Proprietor’s Capital.	
Dec. 31	Retained Earnings	1,000	Proprietor’s Capital	1,000
	Dividends	1,000	Prop. Withdrawals	1,000
	To close dividends to Retained Earnings.		To close withdrawals to Proprietor’s Capital.	

**Fig. 12.1: Comparing Closing Entries for a Proprietorship and Corporation**

### 12.1.4 Financial Statements of a Proprietorship



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LO2 – Describe how the financial statements of a proprietorship are different from those of a corporation.

The financial statements for a proprietorship are much the same as those of a corporation. One difference is that the income statement of a proprietorship does not include income taxes expense (since its profits are included in the owner’s personal income tax return). As well, no salaries expense paid the proprietor is recorded on a

proprietorship's income statement, since the proprietor receives all the net income of the business. This is the owner's remuneration.

The effects of these differences are shown in [Figure 12.2](#). Assume a slight variation on the information presented above: revenue of \$10,000, salaries to owner of \$2,000, income taxes expense of \$500, other expenses of \$3,500. The 2016 income statements (bolded for illustrative purposes) would show:

ABC Corporation Income Statement For the Year Ended December 31, 2016			ABC Proprietorship Income Statement For the Year Ended December 31, 2016		
Revenue		\$10,000	Revenue		\$10,000
<b>Salaries</b>	<b>\$2,000</b>				
Other expenses	3,500	5,500	Other expenses		3,500
Income before income taxes		4,500			
<b>Income taxes</b>	<b>500</b>				
Net income		<u>\$ 4,000</u>	Net income		<u>\$ 6,500</u>

**Fig. 12.2: Comparing the Income Statement of a Corporation and a Proprietorship**

Net incomes are different because salaries expense and income taxes expense are included in the corporation's income statement, but excluded from the proprietorship's income statement. Rather, these two expenditures are considered to be proprietor withdrawals, and are included in the statement of proprietor's capital. This is illustrated below.

The statement of changes in equity for each of a proprietorship and corporation includes the same elements: beginning equity, additional investments by the shareholders/owner, net income, distribution of income to the shareholders/owner, and the ending equity. However, the proprietorship statement combines all the equity items in one account, the Proprietor's Capital account. In a corporation, shareholders' equity is divided between share capital and retained earnings. These differences are illustrated in [Figure 12.3](#). Assume the same information as above. In addition, assume that no opening equity balances, shares issued/ proprietor's contributions of \$5,000 for the year, and cash dividends/withdrawals of \$1,000. The statements of changes in equity (bolded for illustrative purposes) would show:

ABC Corporation Statement of Changes in Equity For the Year Ended December 31, 2016				ABC Proprietorship Statement of Proprietor's Capital For the Year Ended December 31, 2016	
	Share capital	Retained earning	Total equity		
Bal. at Jan. 1, 2016	\$ -0-	\$ -0-	\$ -0-	Bal. at Jan. 1, 2016	\$ -0-
Shares issued	5,000		5,000	Contributions	5,000
Net income		4,000	4,000	Net income	6,500
<b>Dividends</b>		<b>(1,000)</b>	<b>(1,000)</b>	<b>Withdrawals</b>	<b>(3,500)</b>
Bal. at Dec. 31, 2016	<u>\$ 5,000</u>	<u>\$ 3,000</u>	<u>\$ 8,000</u>	Bal. at Dec. 31, 2016	<u>\$ 8,000</u>

**Fig. 12.3: Comparing the Statement of Changes in Equity for a Corporation and a Proprietorship**

Although net income differs, ending total equity (\$8,000) is the same in both cases. Salaries and income taxes expenses omitted on the proprietorship income statement are instead added to the proprietor withdrawals. These differences offset each other.

The balance sheet for each of a proprietorship and corporation includes the same elements: assets, liabilities, and equity. Only the equity section of the statement differs. In a proprietorship, all the equity items are combined in one account, the owner's capital account. In a corporation, equity is divided between share capital and retained earnings. These differences are illustrated in [Figure 12.4](#). Asset and liability amounts are all assumed. (Items are bolded for illustrative purposes.)

ABC Corporation Balance Sheet At December 31, 2016		ABC Proprietorship Balance Sheet At December 31, 2016	
<i>Assets</i>		<i>Assets</i>	
<i>Current</i>		<i>Current</i>	
Cash	\$ 9,500	Cash	\$9,500
Accounts receivable	<u>8,500</u>	Accounts receivable	<u>8,500</u>
<b>Total assets</b>	<b><u>\$18,000</u></b>	<b>Total assets</b>	<b><u>\$18,000</u></b>
<i>Liabilities</i>		<i>Liabilities</i>	
<i>Current</i>		<i>Current</i>	
Accounts payable	\$10,000	Accounts payable	\$10,000
<i>Shareholders' Equity</i>		<i>Proprietor's Capital</i>	
Share capital	\$5,000	AB Carr, capital	<u>8,000</u>
Retained earnings	3,000	<b>Total liabilities and</b>	
<b>Total liabilities and shareholders' equity</b>	<b><u>\$18,000</u></b>	<b>proprietor's capital</b>	<b><u>\$18,000</u></b>

Fig. 12.4: Comparing the Balance Sheet of a Corporation and a Proprietorship

## 12.2 Partnerships



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LO3 - Describe the characteristics of a partnership.

A partnership is an unincorporated business owned by more than one person. Partners should have a **partnership agreement** that stipulates such things as each partner's rights and duties, the sharing of net income, limits on withdrawals, and means to terminate the partnership. Like a proprietorship, a partnership is not a separate legal entity. For example, each partner's share of the partnership profits is included as income on the partner's personal income tax return. Also like a proprietorship, partnerships have unlimited liability.<sup>1</sup> Each partner is personally liable for debts that the partnership cannot pay. In the event that a partner is unable to pay a proportionate share of partnership debts, the other partners can be required by creditors to pay these.

Also like a proprietorship, a partnership has a limited life. For example, an existing partnership is dissolved when a new partner is admitted, or an existing partner withdraws or dies. Partner dissolution does not necessarily mean that normal

1. Limited liability partnerships (LLP) are permitted in certain jurisdictions. The details of this type of business organization are beyond the scope of this text.



operations cease. Usually the same business continues under a new partnership agreement. Accounting for partnership capital therefore involves issues related to the formation and dissolution of partnerships and to the allocation of the profits and losses to the individual partners.

Partnerships also have a number of unique characteristics. These include mutual agency, co-ownership of assets, and sharing of profit and losses. As a result, accounting for partners' capital differs from accounting for shareholders' equity and proprietor's capital. These characteristics are described below.

### 12.2.1 Mutual Agency



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Unless otherwise stated in the partnership agreement, each partner is able to make decisions that are legally binding, not only on the partnership, but also on the other partners. This is known as **mutual agency**. The only exception involves activities that fall outside the normal activities of the partnership. For example, a partnership formed to sell used cars would not normally include the buying and selling of footwear; in this case, partners would not be legally bound to footwear contracts signed by only one of the partners.

### 12.2.2 Co-Ownership of Assets



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Unless the partnership agreement specifies otherwise, all assets contributed to the partnership by individual partners are **co-owned** by all partners. Each partner, therefore, has a claim against all partnership assets up to the amount of his/her capital balance. Therefore, partnership assets are often sold on liquidation to facilitate their distribution to partners in the form of cash.

### 12.2.3 Sharing of Profits and Losses



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The partnership agreement usually stipulates the manner in which profits and losses will be shared. If no such provision is specified, then partners share all profits and losses equally. Accounting issues related to the division of profits and losses are discussed below.



## 12.2.4 Advantages of a Partnership



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A partnership has several advantages over other forms of business organizations. It can be easily formed, without the legal process and costs involved in incorporation. A partnership is less subject to government supervision; there are usually fewer government regulations and less paper work regarding partnerships than corporations. Because a partnership is not a legal entity, it is not subject to corporate income tax; individual partners file personal income tax returns, which include their allocation of partnership profits. Since a partnership includes at least two individuals, it has access to more capital and expertise than does a proprietorship.

## 12.2.5 Disadvantages of a Partnership



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Partners have to answer to other partners for their actions and each has mutual agency and unlimited liability. Therefore, individual partners are legally liable for the financial debt arising from actions of other partners. A partnership is dissolved on the death or withdrawal of a partner, although the business may continue with new partners. This arrangement is more cumbersome than the selling of shares in a corporation. Shares can usually be transferred easily among investors. Also, a corporation usually has access to a larger amount of capital, since shares can be issued to a wider range of investors, particularly those who want to be involved with running the business. Corporate tax rates can be more favourable than personal tax rates.

## 12.2.6 Partnership Accounting



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Before considering the differences in record keeping for incorporated and unincorporated businesses, we will examine the differences in the balance sheet reporting for each type of organization. The example below shows the owners' equity section of the balance sheet for three businesses that have identical financial positions. Although the asset and liability presentation is the same, the presentation of the equity section differs in each case, as follows:

a. Corporation

<i>Shareholders' Equity</i>	
Share capital	\$10,000
Retained earnings	5,000
Total shareholders' equity	<u>\$15,000</u>

## b. Proprietorship

<i>Proprietor's Capital</i>	
Jane Jones, capital	\$15,000

## c. Partnership

<i>Partners' Capital</i>	
Jane Jones, capital	\$7,500
Jack Brown, capital	7,500
Total partners' capital	\$15,000

As discussed before, the shareholders' equity section of a corporation's balance sheet is divided into two categories – share capital and retained earnings. The first category represents the owner's investments in shares of the company. The second category is the accumulated earnings of the corporation less any dividends paid to owners from commencement of operations.

For a partnership, and similar to that of a proprietorship, each owners' equity is shown as individual **Partner's Capital** accounts . The capital account reflects each partner's capital contributions to the business, the partner's share of accumulated earnings, and any withdrawals by the particular partner.

Business transactions for a partnership are recorded in the same manner as those for a proprietorship. Distributions are recorded in a **Partner's Withdrawals** account. Individual capital and withdrawal accounts are maintained for each partner in the general ledger. The withdrawals account balance is closed to each partner's capital account at the end of the accounting time period.

### 12.2.7 Partnership Capital Accounts



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Each partner has an individual account that is credited with capital contributions to the partnership. The following entry records a \$5,000 cash contribution by partner A.

Cash	5,000	
A, Capital		5,000
<i>To record investment by A.</i>		

If non-cash assets are contributed, then the appropriate asset account is debited instead of cash.

Partner withdrawals of assets from the partnership are recorded in each partner's withdrawals account. If partner

A withdraws \$1,000 cash, for example, the following entry is recorded:

A, Withdrawals	1,000	
Cash		1,000
<i>To record withdrawals by A.</i>		

At year-end, each partner's withdrawals account is closed to their capital account. The following closing entry would close partner A's withdrawals account, assuming no further withdrawals have been made.

Each withdrawals account is closed directly to the capital account of the applicable partner.	A, Capital	1,000	
	A, Withdrawals		1,000
	<i>To close partner A withdrawals to A's capital account.</i>		

If a partner withdraws any asset, including cash for personal use, the withdrawals account is debited for the cost of the asset and the appropriate asset account is credited for the same amount. For example, if partner A takes a dress from the business with a cost of \$20 and a selling price of \$100, the journal entry will be:

A, Withdrawals	20	
Inventory		20
<i>To record dress taken from inventory by partner A.</i>		

If an owner uses the business's funds to pay personal debts, the withdrawals account is again debited. For example, if partner B writes a cheque drawn on the partnership's bank account for \$35 to pay for his child's swimming lessons, the journal entry will be:

B, Withdrawals	35	
Cash		35
<i>To record personal expenditure by partner B.</i>		

## 12.3 Allocation of Partnership Profits and Losses



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LO4 – Account for a partnership's profits and losses and prepare a statement of partner's capital.

Recall that individual revenue and expense accounts are closed to the Income Summary general ledger account at the end of each fiscal year. In a partnership, and similar to a proprietorship, the Income Summary is then closed directly to each partner's capital account in the general ledger at the fiscal year-end in accordance with an agreed-upon formula. For example, if a partnership earned \$15,000 and the partnership agreement states that profits and losses are to be split evenly between partner A and partner B, the closing entry would be:

Income Summary	15,000	
A, Capital		7,500
B, Capital		7,500

*To close Income Summary to partners' capital accounts.*

Profits and losses are allocated according to a formula. This is usually specified in the partnership agreement. The formula may consider three factors: a return to each partner for the amount of capital invested in the partnership, a payment to each partner for services rendered, and a further division of any remaining profit (or loss) according to a specified profit and loss sharing ratio.

### 12.3.1 Division Using a Fixed Ratio



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The division of profits and losses according to a fixed ratio is appropriate when each partner makes an equal contribution to the business. Ideally, each partner would have an equal amount of capital invested in the partnership and would devote an equal amount of time and effort in the business. However, usually the amount of capital differs, and time and effort devoted to the business is unequal. The initial calculation of a fixed ratio inclusion in the partnership agreement considers these factors. Partners can agree to share profits in any manner – for example, in a fixed ratio, such as 3:2. A ratio of '3:2' means that 60 per cent ( $3/5$ ) of the partnership income is allocated to partner A and 40 per cent ( $2/5$ ) is allocated to Partner B. Assuming that A and B share profits in the ratio of 3:2, a \$15,000 profit would be divided and recorded by the following entry:

Income Summary	15,000	
A, Capital ( $3/5 \times 15,000$ )		9,000
B, Capital ( $2/5 \times 15,000$ )		6,000

*To record division of partnership profits.*

Partnership losses are allocated in the same manner. Assume that partners A and B share profits and losses at a fixed ration of 4:5. In this case, a \$9,000 loss would be divided as follows:

A, Capital ( $4/9 \times 9,000$ )	4,000	
B, Capital ( $5/9 \times 9,000$ )	5,000	
Income Summary		9,000

*To record division of partnership loss.*

## 12.3.2 Division Using Salary and Interest Allocations



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Since the time and effort devoted by individual partners to the business is often unequal and the amount of capital balance varies among partners, other allocation method may be used. Profits and losses can be allocated by *interest on partners' capital balances* and *salaries to partners* to each partner, in accordance with individual contributions. Any remaining profits and losses can be divided through the profit and loss sharing ratio. It is important to understand that the salary and interest allocations are not deducted as expenses on the income statement; *salary* and *interest* used here refer only to individual factors used in dividing profits and losses among partners.

To illustrate: Before beginning their partnership, A and B agreed that 12 per cent interest would be allocated to their capital balances and that A deserved more compensation because of his valuable technical skills. Accordingly, allocation of profit was also to be based on salaries of \$7,000 to A and \$5,000 to B. They also agreed that any remaining profit and loss should be shared in the ratio of 3:2.

Assume A and B have each contributed \$10,000 to the partnership, and that net income for the year is \$15,000. The net income would be allocated as follows:

	A	B	Total
Amount of profit to be allocated to partners			\$15,000
<i>Salary allocation</i>	7,000	5,000	<u>(12,000)</u>
Balance			3,000
<i>Interest allocation:</i>			
A: \$10,000 x 12%	\$ 1,200		
B: \$10,000 x 12%		\$ 1,200	
Balance			<u>(2,400)</u>
			600
<i>Balance allocated in profit and loss sharing ratio:</i>			
A: \$600 x 3/5	360		
B: \$600 x 2/5		240	
Balance			<u>(600)</u>
			<u>-0-</u>
Allocated to partners	<u>\$ 8,560</u>	<u>\$ 6,440</u>	

The following entry records this profit allocation between A and B:



Income Summary	15,000	
A, Capital		8,560
B, Capital		6,440

*To record division of profit per partnership agreement and schedule.*

If the \$15,000 partnership income had been inadequate to cover the salary and interest allocated to A and B, the difference would have been allocated in the profit and loss sharing ratio. Assuming that partnership net income had amounted to \$9,000, the following calculation of amounts allocated to the partners would be made:

	A	B	Total
Amount of loss to be allocated to partners			(\$9,000)
Salary allocation	\$ 7,000	\$ 5,000	(12,000)
Balance			(3,000)
Interest allocation:			
A: \$10,000 x 12%	1,200		} (2,400)
B: \$10,000 x 12%		1,200	
Balance			(5,400)
Balance allocated in profit and loss sharing ratio:			
A: (\$5,400) x 3/5	(3,240)		} 5,400
B: (\$5,400) x 2/5		(2,160)	
Balance			-0-
Allocated to partners	<u>\$ 4,960</u>	<u>\$ 4,040</u>	

The journal entry to allocate the loss would be:

Income Summary	9,000	
A, Capital		4,960
B, Capital		4,040

*To record division of loss per partnership agreement and schedule.*

### 12.3.3 Partnership Financial Statements



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Like a proprietorship, the income statement of a partnership or proprietorship is similar to that of a corporation, except that there is no income taxes expense. Income taxes are paid personally by partners on all sources of income, including their amounts of partnership income allocated each year. A partnership income statement

also does not record any salaries expense paid to partners. "Salaries" consist of the allocation of net income or loss each year to the respective partner, as described above.

Similar to a proprietorship's statement of equity, a **statement of partners' capital** shows each partner's contributions to the business, net income (or loss) allocations, and withdrawals during the year.

Assume that for the year ended December 31, 2016, partners A and B each had opening capital balances of \$10,000. Each contributed \$5,000 to the partnership during the fiscal year. Net income for the year equalled \$15,000, allocated as A: \$8,560; B: 6,400. Partner A withdrew \$10,000 during the year; partner B withdrew \$15,000. The statement of partners' capital for A and B Partnership would appear as follows:

**A and B Partnership**  
**Statement of Partners' Capital**  
**For the Year Ended December 31, 2016**

	<i>A</i>	<i>B</i>	<i>Total</i>
Bal. at Jan. 1, 2016	\$ 5,000	\$ 5,000	\$10,000
Contributions	5,000	5,000	10,000
Net income	8,560	6,440	15,000
Withdrawals	<u>(10,000)</u>	<u>(15,000)</u>	<u>(25,000)</u>
Bal. at Dec. 31, 2016	<u>\$ 8,560</u>	<u>\$ 1,440</u>	<u>\$10,000</u>

The balance sheet of a partnership can show the equity of each partner if there are only a few. For instance, the partners' capital section of A and B Partnership could appear as follows on the balance sheet:

<i>Partners' Capital</i>	
A, capital	\$ 8,560
B, capital	<u>1,440</u>
Total partners' capital	<u><u>\$10,000</u></u>

If there are many partners, only a total capital amount could be shown (\$10,000 in this case), with details of each partner's capital account disclosed in the statement of partners' capital.



## 12.4 Admission and Withdrawal of Partners



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L05 – Account for the admission or withdrawal of partners from a partnership.

The admission of a new partner results in the creation of a new partnership. Although the business of the former partnership can continue, the former partnership ceases to exist. Since the liability, agency, and profit sharing arrangements may be altered, a new partnership agreement is required.

Assume the following balance sheet information.

<b>A and B Partnership</b>			
<b>Balance Sheet</b>			
<b>At December 31, 2016</b>			
<i>Assets</i>		<i>Liabilities</i>	
Cash	\$ 5,000	Accounts payable	\$ 7,000
Other assets	22,000		
		<i>Partners' Capital</i>	
		A, capital	\$10,000
		B, capital	10,000
	<u>\$27,000</u>		<u>20,000</u>
			<u>\$27,000</u>

New partner C wants to enter the A and B partnership. C can be admitted either by purchasing an existing partner's interest or by contributing assets to the partnership.

### 12.4.1 Purchase of an Existing Partner's Interest



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Assume C is going to purchase B's interest in A and B Partnership, and B will leave. The purchase of an existing partner's interest in a partnership is a private transaction between the new partner and the applicable existing partner. The new partner C makes a payment to the existing partner B, who in turn transfers the partnership interest. This type of purchase does not affect the assets of the partnership. Only an entry recording the change in ownership is made in the partnership books. The following entry illustrates the recording of C's purchase of B's interest.

B, Capital	10,000
C, Capital	10,000
<i>To record transfer of B's partnership interest to C.</i>	

The balance sheet of the partnership would show the following:

<i>A and C Partnership</i>			
<i>Balance Sheet</i>			
<i>At December 31, 2016</i>			
<i>Assets</i>		<i>Liabilities</i>	
Cash	\$ 5,000	Accounts payable	\$ 7,000
Other assets	22,000		
		<i>Partners' capital</i>	
		A, capital	\$10,000
		C, capital	10,000
	<u>\$27,000</u>		<u>20,000</u>
			<u>\$27,000</u>

The amount paid by C to B is not reflected in the partnership records. Assume now that C purchased only ½ of B's interest. In this case, only half of B's interest would be transferred to C by the following entry:

<i>B, Capital</i>	5,000
<i>C, Capital</i>	5,000
<i>To record transfer of half B's partnership interest to C.</i>	

The balance sheet of the partnership would show the following:

<i>Assets</i>		<i>Liabilities</i>	
Cash	\$ 5,000	Accounts payable	\$ 7,000
Other assets	22,000		
		<i>Partners' Capital</i>	
		A, capital	\$10,000
		B, capital	5,000
		C, capital	5,000
	<u>\$27,000</u>		<u>20,000</u>
			<u>\$27,000</u>

## 12.5 Investment in the Partnership



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Rather than purchase an existing partner's interest, the new partner could contribute cash or other assets in return for a partnership interest. This method differs from the purchase of an existing partner's interest; in this case, both the assets and equity of the partnership are increased. Assume that C contributes assets at their fair value of \$10,000 (referred to as *other assets* for illustrative purposes) to the partnership for a one-third interest in the partnership capital after his contribution. This investment is recorded as follows:

Other Assets	10,000	
C, Capital		10,000
<i>To record C's investment in the partnership.</i>		

Following the investment, the balance sheet would appear as follows:

<i>Assets</i>		<i>Liabilities</i>	
Cash	\$ 5,000	Accounts payable	\$ 7,000
Other assets (\$22,000 + 10,000)	32,000		
		<i>Partners' Capital</i>	
		A, capital	\$10,000
		B, capital	10,000
		C, capital	10,000
	<u>\$37,000</u>		<u>30,000</u>
			<u>\$37,000</u>

In some cases, C may receive more or less than a \$10,000 capital balance because a **bonus** may be given either to the new partner or to the existing partners.

The partnership may want to add a new partner who can bring certain technical skills, management abilities, or some other desirable business strengths. To entice a desirable individual, a bonus may be offered in excess of the amount invested by the new partner. In this case, the existing partners allocate a portion of their capital to C.

### 12.5.1 Bonus to the New Partner



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Assume instead that C invests assets at their fair value of \$4,000 into the partnership for a one-third ownership interest. The new total capital amounts to \$24,000 (\$10,000 + 10,000 + 4,000); of this amount, \$8,000 (\$24,000 × 1/3) belongs to C. In this case, an equal amount of capital must be contributed by A and B to C to make up the difference between what C contributes and C's capital balance. A bonus is used to accomplish this. Assuming that A and B share profits equally, the new partner's entry is recorded as follows:

Other Assets	4,000	
A, Capital	2,000	
B, Capital	2,000	
C, Capital		8,000
<i>To record payment of bonus to partner C on admission.</i>		

The partnership balance sheet following the recording of C's investment would appear as follows:

<i>Assets</i>		<i>Liabilities</i>	
Cash	\$ 5,000	Accounts payable	\$ 7,000
Other assets (\$22,000 + 4,000)	26,000		
		<i>Partners' Capital</i>	
		A, capital	\$8,000
		B, capital	8,000
		C, capital	8,000
	<u>\$31,000</u>		<u>24,000</u>
			<u>\$31,000</u>

## 12.5.2 Bonus to Existing Partners



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If the partnership business is particularly successful and profitable, the existing partners may require the new partner to pay them a bonus as an admission requirement. Assume that C invests assets at their fair value of \$13,000 in the partnership for a one-third ownership interest. The new total capital amounts to \$33,000 (\$10,000 + 10,000 + 13,000); of this amount, \$11,000 ( $\$33,000 \times 1/3$ ) belongs to C.

The bonus to existing partners is recorded as follows:

<b>Other Assets</b>	<b>13,000</b>	
A, Capital		1,000
B, Capital		1,000
C, Capital		11,000

*To record admission of partner C and payment of bonus to existing partners.*

The \$13,000 invested by C results in only an \$11,000 capital balance for C. A and B receive a \$1,000 increase in each of their capital balances as a result of C's \$13,000 investment in the partnership.

The partnership balance sheet, following the recording of C's investment, would appear as follows:

<i>Assets</i>		<i>Liabilities</i>	
Cash	\$ 5,000	Accounts payable	\$ 7,000
Other assets (\$22,000 + 13,000)	35,000		
		<i>Partners' Capital</i>	
		A, capital	\$11,000
		B, capital	11,000
		C, capital	11,000
	<u>\$40,000</u>		<u>33,000</u>
			<u>\$40,000</u>

### 12.5.3 Withdrawal of an Existing Partner



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It is common for an existing partner to withdraw from a partnership. Settlement of the exiting partner's ownership interest is made in accordance with provisions of the partnership agreement.

The withdrawal of a partner can be accounted for as a sale to a new partner, as a sale to one or more of the existing partners, or through a payment of partnership assets to the withdrawing partner. The following balance sheet of A, B, and C Partnership will be used to illustrate the concepts in this section:

#### A, B, and C Partnership Balance Sheet At December 31, 2016

<i>Assets</i>		<i>Liabilities</i>	
Cash	\$ 5,000	Accounts payable	\$ 7,000
Other assets	32,000		
		<i>Partners' Capital</i>	
		A, capital	\$10,000
		B, capital	10,000
		C, capital	10,000
	\$37,000		30,000
			\$37,000

### 12.5.4 Sale to a New Partner



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This method is similar to the purchase of an existing partner's interest. Assume C sells a partnership interest to D. Payment for the ownership interest is a private transaction, though the existing partners must approve the new arrangement. There is no change in either the assets or the capital of the partnership as a result of this transaction. However, the following journal entry would be made:

C, Capital	10,000	
D, Capital		10,000
<i>To record transfer of C's partnership interest to D.</i>		

The balance sheet would show the following:



*A, B, and D Partnership  
Balance Sheet  
At December 31, 2016*

<i>Assets</i>		<i>Liabilities</i>	
Cash	\$ 5,000	Accounts payable	\$ 7,000
Other assets	32,000		
		<i>Partners' Capital</i>	
		A, capital	\$10,000
		B, capital	10,000
		D, capital	10,000
	\$37,000		30,000
			\$37,000

### 12.5.5 Sale to the Remaining Partners



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An alternate method is for the withdrawing partner to the ownership interest to the remaining partner(s). This transaction is also private. The assets and the total equity of the partnership are not altered. An entry is made to record the change in the partnership books. If C wants to withdraw, and A and B both purchase C's interest, the following entry would be recorded:

<i>C, Capital</i>	<i>10,000</i>
<i>A, Capital</i>	<i>5,000</i>
<i>B, Capital</i>	<i>5,000</i>

*To record transfer of C's partnership interest to A and B.*

Although more or less than \$10,000 may have been paid personally by A and B to C, the entry to transfer C's ownership is based on the capital balance of the partnership.

The balance sheet would show the following:

<i>Assets</i>		<i>Liabilities</i>	
Cash	\$ 5,000	Accounts payable	\$ 7,000
Other assets	32,000		
		<i>Partners' Capital</i>	
		A, capital	\$15,000
		B, capital	15,000
	\$37,000		30,000
			\$37,000

## 12.5.6 Payment from Partnership Assets



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A third method involves a payment to the withdrawing partner for the amount of her capital balance. Assuming the payment is made in cash, the following entry would be prepared:

	C, Capital	10,000	
	Cash		10,000
	<i>To record C's withdrawal from the partnership.</i>		

The balance sheet would now show:

<i>Assets</i>		<i>Liabilities</i>	
Other assets	\$ 32,000	Bank overdraft	\$5,000
		Accounts payable	7,000
			\$ 12,000
		<i>Partners' Capital</i>	
		A, capital	\$10,000
		B, capital	10,000
	\$32,000		20,000
			\$32,000

Note that this transaction results in a \$5,000 bank overdraft. The remaining partners will have to contribute more cash, or the partnership will have to sell of its assets for cash, or obtain a bank loan to cover the cash deficiency.

Often, the withdrawing partner may receive either more or less than the recorded capital balance. The difference can result from undervalued or overvalued partnership assets, anticipated future profitable operations in excess of normal returns to which the exiting partner is entitled, or to settle inter-personal conflicts among partners. As a result, the partners calculate an agreed amount that is due to C; the difference is treated as a bonus to either the withdrawing partner or the remaining partners. For instance, if C is paid \$12,000, or \$2,000 more than her capital balance, the capital balances of both A and B would each be reduced by \$1,000.

	C, Capital	10,000	
	A, Capital	1,000	
	B, Capital	1,000	
	Cash		12,000
	<i>To record C's withdrawal from the partnership.</i>		

In this case, the two remaining partners are assumed to share the difference equally. C, therefore, receives a total of \$12,000, represented by the \$10,000 capital balance and a bonus of \$2,000, which is paid equally by A and B.



If C is paid \$3,000 less than his capital balance, the capital balances of both A and B would be increased by \$1,500.

C, Capital	10,000	
A, Capital	1,000	
B, Capital	1,000	
Cash		12,000

*To record C's withdrawal from the partnership.*

C receives \$7,000 in cash; the \$3,000 difference, shared equally by A and B, increases their capital balances.

## 12.6 Liquidation of a Partnership



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LO6 – Account for the liquidation of a partnership.

The **liquidation** of a partnership results in a termination of the partnership business. Its assets are sold, debts are paid, and any remaining cash or unsold assets are distributed to the partners in settlement of their capital balances. The amount of cash available to partners depends on the amount of proceeds from the sale of partnership assets after liabilities have been paid. The following partnership post-closing balance sheet at December 31, 2016 will be used to illustrate the accounting for the liquidation of A, B, and C Partnership.

### A, B, and C Partnership Balance Sheet At December 31, 2016

<i>Assets</i>		<i>Liabilities</i>	
Cash	\$ 5,000	Accounts payable	\$ 7,000
Other assets	32,000		
		<i>Partners' Capital</i>	
		A, capital	\$10,000
		B, capital	10,000
		C, capital	10,000
	<u>\$37,000</u>		<u>30,000</u>
			<u>\$37,000</u>

For purposes of this section, profits and losses are assumed to be shared in a ratio of 5:3:2 (A: 50%; B: 30%; 20%). All the following transactions take place on January 1, 2017.

## 12.6.1 Gain on Sale of Assets



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Each partner's share of gains realized on the sale of assets is recorded as an increase in his/her capital account. If the other assets are sold for \$42,000, the following entry is prepared to record the gain.

Cash	42,000	
Gain on Sale of Assets		10,000
Other Assets		32,000

*To record the gain on sale of other assets.*

The \$10,000 gain is then divided among the partners in their 5:3:2 profit and loss sharing ratio:

Gain on Sale of Assets	10,000	
A, Capital		5,000
B, Capital		3,000
C, Capital		2,000

*To record the division of the gain from sale of other assets.*

The liabilities are then paid; the journal entry to record the payment follows.

Accounts Payable	7,000	
Cash		7,000

*To record payment of liabilities.*

At this point, the balance sheet would show:

<i>Assets</i>		<i>Partners' Capital</i>	
Cash	\$40,000	A, capital	\$15,000
		B, capital	13,000
		C, capital	12,000
	<u>\$40,000</u>		<u>\$40,000</u>

The following entry is prepared to record payment of the three capital account balances and complete the liquidation of the partnership:

A, Capital	15,000	
B, Capital	13,000	
C, Capital	12,000	
Cash		40,000

*To record payment of capital accounts.*

Note that all capital account balances are zero following the distribution of cash.

### 12.6.2 Loss on Sale of Assets



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In the case of a loss on sale of assets, losses resulting from the conversion of assets to cash are also allocated to partners in their profit and loss sharing ratio. The discussion that follows assumes the partners' capital balances are sufficient to absorb the applicable share of the loss.

### 12.6.3 Adequate Amount of Capital Balances



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Assume that the sale of the \$32,000 of other assets in the example given earlier realizes only \$22,000. The following entry records the sale:

Cash	22,000	
Loss on Sale of Assets	10,000	
Other Assets		32,000
<i>To record loss on sale of assets.</i>		

The \$10,000 loss is then allocated to each partner in accordance with the 5:3:2 profit and loss sharing ratio.

A, Capital	5,000	
B, Capital	3,000	
C, Capital	2,000	
Loss on Sale of Assets		10,000
<i>To record the division of loss from sale of assets.</i>		

The payment of liabilities is then recorded.

Accounts Payable	7,000	
Cash		7,000
<i>To record payment of accounts payable.</i>		

The partnership balance sheet would show:

<i>Assets</i>		<i>Partners' Capital</i>	
Cash	\$20,000	A, capital	\$ 5,000
		B, capital	7,000
		C, capital	8,000
	<u>\$20,000</u>		<u>\$20,000</u>

The following entry records the final distribution of cash to the partners:

A, Capital	5,000	
B, Capital	7,000	
C, Capital	8,000	
Cash		20,000
<i>To record payment of capital accounts.</i>		

Note that the balance in each capital account is again zero following the distribution of cash, and the liquidation is complete.

### 12.6.4 Inadequate Amount of Capital Balances



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The sale of partnership assets may result in a debit balance in one partner's capital account following allocation of the loss. Assume that sale of the previous \$32,000-worth of other assets realizes only \$8,000.

The following entry records the sale:

Cash	8,000	
Loss on Sale of Assets	24,000	
Other Assets		32,000
<i>To record loss on sale of assets.</i>		

This \$24,000 loss is next allocated to each partner in accordance with the 5:3:2 profit and loss sharing ratio.

A, Capital	12,000	
B, Capital	7,200	
C, Capital	4,800	
Loss on Sale of Assets		24,000
<i>To record the division of loss from sale of assets.</i>		

The payment of liabilities is then recorded.

Accounts Payable	7,000	
Cash		7,000
<i>To record payment of accounts payable.</i>		

The partnership balance sheet now appears as follows:

<i>Assets</i>		<i>Partners' Capital (Deficiency)</i>	
Cash	\$ 6,000	A, deficiency	\$(2,000)
		B, capital	2,800
		C, capital	5,200
	<u>\$ 6,000</u>		<u>\$ 6,000</u>

Partner A has a deficiency (debit balance) in his capital account. A would be expected to contribute \$2,000 cash to the partnership to make up this debit balance. If A does not contribute this amount, then this \$2,000 debit balance is allocated to the remaining partners in their agreed profit and loss sharing ratio, in this case 3:2. The following entry illustrates the allocation of A's debit balance to B and C.

B, Capital	1,200	
C, Capital	800	
A, Capital		2,000

*To record allocation of A's debit balance.*

At this point, the partnership balance sheet shows:

<i>Assets</i>		<i>Partners' Capital</i>	
Cash	\$ 6,000	B, capital	\$ 1,600
		C, capital	4,400
	<u>\$ 6,000</u>		<u>\$ 6,000</u>

The distribution of cash to B and C would be recorded by the following entry, and the liquidation would be complete:

B, Capital	1,600	
C, Capital	4,400	
Cash		6,000

*To record payment of capital accounts.*

### 12.6.5 Statement of Partnership Liquidation



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A *statement of partnership liquidation* can be prepared to show the progress of the liquidation over a period of time. The prior information involving the sale of \$32,000 of other assets for \$8,000, allocation of loss to the partners, payment of liabilities, allocation of A's debit balance to B and C, and final distribution of cash, are summarized in the following statement.



A, B, and C Statement of Partnership Liquidation For the Day Ending January 1, 2017						
	Cash	Other assets	Accounts payable	Partners' capital		
				A	B	C
Opening balance	\$5,000	\$32,000	\$7,000	\$10,000	\$10,000	\$10,000
Sale of other assets	8,000	(32,000)				
Allocation of loss (\$24,000)				(12,000)	(7,200)	(4,800)
Balances	13,000	\$ -0-	7,000	(2,000)	2,800	5,200
Payment of liabilities	(7,000)		(7,000)			
Balances	6,000		\$ -0-			
Allocation of A's debit balance				2,000		
B: $3/5 \times \$2,000$					(1,200)	
C: $2/5 \times \$2,000$						(800)
Balances				\$ -0-	1,600	4,400
Distribution of cash	(6,000)				(1,600)	(4,400)
Balances	\$ -0-				\$ -0-	\$ -0-

## 12.7 Summary of Chapter 12 Learning Objectives



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### LO1 – Describe the characteristics of a proprietorship.

A proprietorship is a business owned by one person. It is not a separate legal entity, which means that the business and the owner are considered to be the same. The profits of a proprietorship are reported on the owner's personal income tax return. A proprietorship has unlimited liability. If the business cannot pay its debts, the owner would be responsible even if the business's debts were greater than the owner's personal resources. A proprietorship has limited life. It ceases to exist upon the proprietor's death, for instance.

### LO2 – Describe how the financial statements of a proprietorship are different from those of a corporation.

A proprietorship's income statement does not show items like salaries paid to the proprietor or income taxes expense, since the business and owner are the same legal entity. A proprietorship's statement of equity and balance sheet do not distinguish between share capital and retained earnings. All contributions, withdrawals, and net income or losses are recorded in the Proprietor's Capital account.

### LO3 – Describe the characteristics of a partnership.

A partnership is a business owned by more than one person. Like a proprietorship, a partnership is not a separate legal entity. It also has unlimited liability and a limited life. The partnership ceases when a partner joins or leaves the firm, or upon the death of a partner. Unlike a proprietorship, partners are subject to mutual agency. Each partner is an authorized agent of the partnership. A partner can commit the partnership to a contract. The closing entries for a partnership are the same as those for a proprietorship except there is more than one capital account and more than one withdrawals account. The closing of the income summary to each partner's capital account is based on the allocation of net income, which should be detailed in the partnership agreement.

#### **LO4 – Account for a partnership’s profits and losses and prepare a statement of partner’s capital.**

Profits and losses are allocated according to a formula. This is usually specified in the partnership agreement. The formula may consider three factors: a return to each partner for the amount of capital invested in the partnership, a payment to each partner for services rendered, and a further division of any remaining profit (or loss) according to a specified profit and loss sharing ratio. Individual revenue and expense accounts are closed to the Income Summary general ledger account at the end of each fiscal year. The Income Summary is then closed directly to each partner’s capital account in the general ledger at the fiscal year-end.

#### **LO5 – Account for the admission or withdrawal or partners from a partnership.**

The admission of a new partner results in the creation of a new partnership. New partners can be admitted either by purchasing an existing partner’s interest or by contributing assets to the partnership. A bonus may be paid to the new partner, or by the new partner to existing partners. The withdrawal of a partner can be accounted for as a sale to a new partner, as a sale to one or more of the existing partners, or through a payment of partnership assets to the withdrawing partner.

#### **LO6 – Account for the liquidation of a partnership.**

The liquidation of a partnership results in a termination of the partnership business. Its assets are sold, debts are paid, and any remaining cash or unsold assets are distributed to the partners in settlement of their capital balances.

## **12.8 Assignment Materials**

### **12.8.1 Concept Self-Check**



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1. What are some of the characteristics of a proprietorship that are different from those of a corporation?
2. What is the journal entry to record the investment of cash by the owner into a proprietorship?
3. How are the closing entries for a proprietorship different than those recorded for a corporation?
4. Why is there only one equity account on a sole proprietorship’s balance sheet and multiple accounts in the equity section of a corporate balance sheet?
5. Define a partnership and briefly explain five characteristics.
6. What are the advantages and disadvantages of partnerships?
7. How does accounting for a partnership differ from that for a corporation?
8. How can partnership profits and losses be divided among partners?
9. Why are salary and interest bases used as a means to allocate profits and losses in a partnership?
10. How are partners’ capital balances disclosed in the balance sheet?



11. What is a partnership bonus? How is it calculated when a new partner is admitted?
12. Distinguish between the sale of a withdrawing partner's interest to a new partner and sale of an interest to his/her existing partner(s).
13. Explain how a deficiency (debit balance) in one partner's capital account is handled if that partner is unable to contribute additional assets to cover it.

## 12.8.2 Comprehension Problems

### 12.8.2.1 CP 12-1



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You are given the following data for the proprietorship of R. Black.

**R. Black Proprietorship  
Trial Balance  
December 31, 2016**

	<i>Debit</i>	<i>Credit</i>
Cash	\$ 10,000	
Accounts receivable	20,000	
Merchandise inventory	30,000	
Accounts payable		\$ 25,000
R. Black, capital		5,000
R. Black, withdrawals	7,000	
Sales		166,000
Cost of goods sold	100,000	
Rent expense	24,000	
Income taxes expense	5,000	
<b>Totals</b>	<b>\$196,000</b>	<b>\$196,000</b>

Black contributed \$5,000 capital during the year.

*Required:*

1. Prepare an income statement for the year.
2. Prepare a statement of proprietor's capital for the year in the following format:

**R. Black Proprietorship  
Statement of Proprietor's Capital  
For the Year Ended December 31, 2016**

Balance at Jan. 1, 2016	\$
Contributions	
Net income	
Withdrawals	
Balance at Dec. 31, 2016	\$

3. Prepare a balance sheet at December 31, 2016.
4. Prepare closing entries at year-end.

### 12.8.2.2 CP 12-2



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Refer to CP 12-1. Assume that the proprietorship is instead a corporation named R. Black Ltd., with 1,000 common shares issued on January 1, 2016 for a stated value of \$5 per share. Assume there are no opening retained earnings and consider withdrawals to be dividends. Assume income taxes expense applies to corporate earnings.

*Required:*

1. Prepare an income statement for the year ended December 31, 2016.
2. Prepare a statement of changes in equity.
3. Prepare a balance sheet at December 31, 2016.
4. Prepare closing entries at year-end.

### 12.8.2.3 CP 12-3



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Assume the following information just prior to the admission of new partner I:

<i>Assets</i>		<i>Liabilities</i>	
Cash	\$ 5,000	Accounts payable	\$ 8,000
Accounts receivable	43,000		
		<i>Partners' Capital</i>	
		G, Capital	\$30,000
		H, Capital	10,000
			40,000
	<u>\$48,000</u>		<u>\$48,000</u>

*Required:* Prepare journal entries to record the following unrelated scenarios:

1. New partner I purchases partners G's partnership interest for \$40,000.
2. New partner I receives a cash bonus of \$2,000 and a one-tenth ownership share, allocated equally from the partnership interests of G and H.
3. New partner I contributes land with a fair value of \$100,000. Relative ownership interests after this transaction are:

<i>Partner</i>	<i>Ownership interest</i>
G	20%
H	5%
I	75%
	<u>100%</u>

#### 12.8.2.4 CP 12-4



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Assume the following information just prior to the withdrawal of Partner X:

<i>Assets</i>		<i>Liabilities</i>	
Cash	\$20,000	Accounts payable	\$ 5,000
Inventory	50,000		
		<i>Partners' Capital</i>	
		X, Capital	\$10,000
		Y, Capital	20,000
		Z, Capital	35,000
			65,000
	<u>\$70,000</u>		<u>\$70,000</u>

*Required:* Prepare journal entries to record the following unrelated scenarios:

1. Partner X sells his interest to new partner T for \$25,000.
2. Partner X sells his interest to partner Y for \$30,000.
3. Partner X sells his interest and is paid a share of partnership net assets as follows

Cash	\$ 5,000
Inventory	5,000
Accounts payable	(2,000)
	<u>\$ 8,000</u>

Partner Y receives a 60% share of the partnership interest of X.

Partner Z receives 40%.

### 12.8.2.5 CP 12-5



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The following balance sheet is for the partnership of Able, Brown, and Crown at November 1, 2016.

<i>Assets</i>		<i>Liabilities</i>	
Cash	\$ 20,000	Accounts payable	\$ 50,000
Other assets	180,000		
		<i>Partners' Capital</i>	
		Able, capital	\$37,000
		Brown, capital	65,000
		Crown, capital	48,000
	<u>\$200,000</u>		<u>150,000</u>
			<u>\$200,000</u>

The profit and loss sharing ratio is Able 40%; Brown: 40%, and Crown: 20%. The partnership is dissolved and liquidated during November by selling the other assets for \$100,000 and paying off the creditors.

*Required:*

1. Prepare a schedule of partnership liquidation for the month ending November 30, 2016. Assume any capital deficiency is absorbed by the other partners.
2. Prepare the journal entries to record the dissolution.

### 12.8.3 Problems

#### 12.8.3.1 P 12-1



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You are given the following data for the partnership of B. White and C. Green.

**B. White and C. Green Partnership**  
**Trial Balance**  
**December 31, 2016**

	<i>Debit</i>	<i>Credit</i>
Cash	\$ 41,000	
Accounts receivable	68,400	
Merchandise inventory	27,000	
Accounts payable		\$ 45,800
B. White, capital		30,000
B. White, withdrawals	7,000	
C. Green, capital		20,000
C. Green, withdrawals	5,000	
Sales		322,000
Cost of goods sold	160,500	
Rent expense	36,000	
Advertising expense	27,200	
Delivery expense	9,600	
Office expense	12,800	
Utilities expense	23,300	
<b>Totals</b>	<b><u>\$417,800</u></b>	<b><u>\$417,800</u></b>

Each partner contributed \$10,000 capital during the year; the opening credit balance in each capital account was White \$20,000 and Green \$10,000. The partners share profits and losses equally.

*Required:*

1. Prepare an income statement for the year.
2. Prepare a statement of partners' capital for the year in the following format:

**Statement of Partners' Capital**  
For the Year Ended December 31, 2016

	<i>White</i>	<i>Green</i>	<i>Total</i>
Balance at Jan. 1, 2016	\$	\$	\$
Contributions			
Net income			
Withdrawals			
Balance at Dec. 31, 2016	\$	\$	\$

3. Prepare a balance sheet at December 31, 2016.
4. Prepare closing entries at year-end.

### 12.8.3.2 P 12-2



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Refer to P 12-1.

*Required:* Prepare the equivalent statement of partners' capital at December 31, 2016 assuming that the partnership is instead:

1. A proprietorship owned by B. White. (Combine C. Green balances and transactions with those of B. White.)
2. A corporation named BW and CG Ltd. with 100 common shares issued to each of B. White and C. Green for a stated value of \$1 per share. Assume opening retained earnings equal \$29,800 and that 20,000 common shares were issued during 2016 for a stated value of \$1 per share.

### 12.8.3.3 P 12-3



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Refer to P 12-1.

*Required:* Prepare the journal entry to allocate net income to each of the partners assuming the following unrelated scenarios:

1. Net income is allocated in a fixed ratio of 5:3 (White: Green).
2. Net income is allocated by first paying each partner 10% interest on opening capital balances, then allocating salaries of \$30,000 for White and \$10,000 for Green, then splitting the remaining unallocated net income in a fixed ratio of 3:2 (White:Green).



### 12.8.3.4 P 12-4



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On January 1, 2016, Bog, Cog, and Fog had capital balances of \$60,000, \$100,000, and \$20,000 respectively in their partnership. In 2016 the partnership reported net income of \$40,000. None of the partners withdrew any assets in 2016. The partnership agreed to share profits and losses as follows:

- a. A *monthly* salary allowance of \$2,000, \$2,500, and \$4,000 to Bog, Cog and Fog respectively.
- b. An annual interest allowance of 10 per cent to each partner based on her capital balance at the beginning of the year.
- c. Any remaining balance to be shared in a 5:3:2 ratio (Bog:Cog:Fog).

*Required:*

1. Prepare a schedule to allocate the 2016 net income to partners.
2. Assume all the income statement accounts for 2016 have been closed to the income summary account. Prepare the entry to record the division of the 2016 net income.

### 12.8.3.5 P 12-5



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Bo and Diddley have decided to establish a partnership. Bo contributes \$50,000 in cash; Diddley contributes \$100,000 cash. They are evaluating two plans for a profit and loss sharing agreement:

- |           |  |
|-----------|--|
| Plan<br>A | Bo to receive a salary of \$15,000 per year, the balance to be divided between Bo and Diddley according to their opening capital balance ratios.   |
| Plan<br>B | Bo to receive a salary of \$12,000 per year; Bo and Diddley to receive 8 per cent interest per year each on their opening capital balances, and the balance of profit or loss to be split equally. |



Required:

Calculate the division under each plan in the following schedule, assuming: (a) a profit of \$60,000 per year, and (b) a loss of \$30,000 per year.

	<i>Profit and loss sharing plan</i>		<i>Division with profit of \$60,000</i>		<i>Division with loss of \$30,000</i>	
			Bo	Diddley	Bo	Diddley
<b>Plan A:</b>						
	Salary					
1.	Balance					
	Total					
<b>Plan B:</b>						
	Salary					
	Interest					
	Balance					
	Total					
2.	Comment on the advantages and disadvantages of each plan.					

### 12.8.3.6 P 12-6



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Good, Hood, and Food are partners, sharing profits equally. They decide to admit Mood for an equal partnership (25%). The balances of the partners' capital accounts are:

Good, capital	\$30,000
Hood, capital	26,000
Food, capital	19,000
	<u>\$75,000</u>

Required: Prepare journal entries to record admission of Mood, using the bonus method:

1. assuming the bonus is paid to the new partner; Mood invests \$15,000 cash;
2. assuming the bonus is paid to existing partners; Mood invests \$45,000 cash; the remaining partners benefit equally from the bonus.

### 12.8.3.7 P 12-7



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The balance sheet of A, B, and C Partnership is shown below. The partnership has decided to liquidate. The general ledger shows the following balances on March 1, 2016:

Cash	\$ 10,000
Other assets	125,000
Accounts payable	10,000
A, capital	25,000
B, capital	37,500
C, capital	62,500

Proceeds from the sale of non-cash assets during March were \$42,500.

*Required:*

1. Prepare a statement of partnership liquidation for the month ending March 31, 2016. Assume profits and losses are shared equally and that any capital deficiency is absorbed by the other partners.
2. Prepare the journal entries to record the dissolution. Dates are not required.

## 12.8.4 Alternate Problems

### 12.8.4.1 AP 12-1



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You are given the following data for the partnership of J. Smith and S. Jones.

J. Smith and S. Jones Partnership  
Trial Balance  
December 31, 2016

	<i>Debit</i>	<i>Credit</i>
Cash	\$ 5,000	
Accounts receivable	25,000	
Merchandise inventory	10,000	
Accounts payable		\$ 4,000
J. Smith, capital		5,000
J. Smith, withdrawals	5,000	
S. Jones, capital		60,000
S. Jones, withdrawals	5,000	
Sales		259,000
Cost of goods sold	202,000	
Rent expense	36,000	
Advertising expense	8,000	
Salaries expense – Smith	18,000	
Office expense	4,000	
Income taxes expense – Smith	10,000	
<b>Totals</b>	<b>\$328,000</b>	<b>\$328,000</b>

Smith is involved in the day-to-day operations of the business. Jones provides most of the cash contributions when needed. Smith pays himself \$1,500 per month as a “salary” though the partners have agreed to share profits and losses equally. Jones contributed \$20,000 capital during the year. The opening credit balance in the capital accounts was Smith \$5,000 and Jones \$40,000.

*Required:*

1. Prepare an income statement for the year.
  
2. Prepare a statement of partners’ capital for the year in the following format and comment on the results:

**Statement of Partners' Capital**  
For the Year Ended December 31, 2016

	<i>Smith</i>	<i>Jones</i>	<i>Total</i>
Balance at Jan. 1, 2016	\$	\$	\$
Contributions			
Net income			
Withdrawals			
Balance at Dec. 31, 2016	\$	\$	\$

3. Prepare a balance sheet at December 31, 2016.
4. Prepare closing entries at year-end.

### 12.8.4.2 AP 12-2



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Refer to AP 12-1.

*Required:* Prepare the equivalent income statement and statement of changes in equity for the year ended December 31, 2016 and a balance sheet at December 31 assuming that the partnership is instead:

1. A proprietorship owned by J. Smith. (Combine S. Jones' balances and transactions with those of J. Smith.)
2. A corporation named JS and SJ Ltd. with 1,000 common shares issued to each of Smith and Jones for a stated value of \$1 per share as of December 31, 2015. Assume opening retained earnings equal \$44,000 and that 20,000 common shares were issued during 2016 for a stated value of \$1 per share. Consider withdrawals to be dividends, and income taxes expense to be that of the corporation, not Smith personally.

### 12.8.4.3 AP 12-3



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Partners A and B are subject to the following agreement for the sharing of profits/losses:

- a. Annual salary allocations are allowed as follows: \$12,000 to A, \$14,000 to B.

- b. Interest at 10 per cent is paid each year on original capital contributions of \$100,000 from A, and \$70,000 from B.
- c. Any remainder is to be split in the ratio of 3:2 (A:B).

*Required:* How much net income must be earned by the partnership in the fiscal year for A to be allocated a total of \$47,000? (Hint: use a schedule of profit allocation.)

#### 12.8.4.4 AP 12-4



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Madge and Ryan have decided to open a business partnership. Madge is familiar with the business and is expected to spend a good deal of time running it. Ryan, on the other hand, will handle the financial duties of the partnership. The following plans for sharing profits and losses are being considered:

- |           |  |
|-----------|--|
| Plan<br>A | Salary, with balance of net income or net loss divided equally. Madge's salary: \$10,000 per year; Ryan's salary: zero.  |
| Plan<br>B | Salary, interest on investment and balance of net income or net loss split equally: Madge's salary: \$10,000 per year, Ryan's salary: zero; both to receive 10 per cent per year interest on beginning investments. Beginning investments: Madge: \$50,000, Ryan: \$200,000. |

*Required:*

1. Calculate the division under each plan in the schedule below assuming (a) a profit for the year of \$150,000, and (b) a loss of \$25,000.

<i>Profit and loss sharing plan</i>	<i>Division with profit of \$150,000</i>		<i>Division with loss of \$25,000</i>	
	<i>Madge</i>	<i>Ryan</i>	<i>Madge</i>	<i>Ryan</i>
<i>Plan A:</i>				
Salary				
Balance				
Totals				
<i>Plan B:</i>				
Salary				
Interest				
Balance				
Totals				

2. Assume you are Ryan's financial advisor? What plan would you recommend?

#### 12.8.4.5 AP 12-5



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Cogsworth and Darwin are partners sharing profits and losses 60 per cent and 40 per cent, respectively. On July 1, their capital balances are as follows: Cogsworth \$23,000, Darwin \$18,600. Howard is admitted as a partner and invests \$16,000.

*Required:* Record the investment by Howard in journal entry form, assuming:

1. The new partner is given credit for the actual investment made.
2. The new partner is given a 1/3 interest, a bonus being given to Howard according to the profit allocation formula.
3. The new partner is given a 1/4 interest, a bonus being given to the existing partners according to the profit allocation formula.

#### 12.8.4.6 AP 12-6



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A, B, C, and D share profits 40 per cent, 30 per cent, 20 per cent, and 10 per cent, respectively. Assume all partners are unable to contribute any amount to the partnership. The balance sheet at January 1, 2016 shows:

<i>Assets</i>		<i>Liabilities</i>	
Cash	\$ 4,000	Accounts payable	\$ 20,000
Non-current assets	54,000		
		<i>Partners' Capital</i>	
		A, capital	4,000
		B, capital	9,600
		C, capital	18,400
		D, capital	6,000
	<u>\$58,000</u>		<u>38,000</u>
			<u>\$58,000</u>

The partnership is liquidated during the month of January 2016; the non-current assets are sold for \$26,000.

*Required:* Prepare a statement of partnership liquidation for the month ending January 31, 2016. Assume any capital deficiency is paid by the other partners in proportion to the allocation formula.

## 12.8.5 Decision Problems

### 12.8.5.1 DP 12-1



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Killibrew, Santos, and Terry were partners in KST Sports. Under the partnership agreement, each partner receives an interest allowance of 9 per cent of her opening capital balance and a salary allowance as follows: Killibrew - \$20,000; Santos - \$18,000; and Terry - \$10,000. Terry, who manages the stores in the off season, receives a bonus of 20 per cent of the income in excess of \$18,000 after partners' interest and salary allowances. The balance of net income or net loss is divided equally. The capital balances at the beginning of the year were: Killibrew - \$120,000, Santos - \$110,000, and Terry - \$170,000.

*Required:*

1. Prepare the journal entry to divide net income of \$144,000.
2. Prepare the journal entry to divide net loss of \$6,000.

### 12.8.5.2 DP 12-2



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Jones, Smith, and Scott is a partnership. The partners allocate net income and net losses in a 5:3:2 ratio (Jones: Smith: Scott). The post-closing trial balance for the partnership at June 30, 2016 shows the following:

*Book value*



Cash	\$10,800
Accounts receivable	19,400
Merchandise inventory	23,800
Equipment	35,200
Accumulated depreciation – equipment	8,200
Accounts payable	21,600
Income summary	20,000
Jones, capital	13,760
Smith, capital	12,000
Scott, capital	13,640

On July 1, 2016, JSS Corporation was established. It was authorized to issue an unlimited number of no par-value common shares and 500,000, 6%, cumulative preferred shares. On July 3, the partnership was dissolved. JSS Corporation acquired the cash, accounts receivable, and accounts payable from the partnership at their June 30 book values. Merchandise inventory was transferred for its fair value of \$20,000. Equipment was transferred for its fair value of \$50,000.

On July 1, JSS Corporation issued 100 common shares to each of Jones, Smith and Scott for a stated value of \$1 per share, which they paid in cash. On July 3, it issued notes payable to each of the three shareholders according to their proportion of the net assets of the partnership at book value on June 30, and no par-value, 6% cumulative preferred shares with a stated value of \$10 per share to each of the three shareholders according to their proportions of the differences between fair values and book values of the partnership's net assets at that date.

*Required:*

1. Prepare a statement of partnership liquidation and journal entries to record the dissolution of the partnership at July 3, 2016.

2. Prepare journal entries to record the issue of common shares on July 1 and the acquisition of assets and liabilities in the records of JSS Corporation at July 3, 2016.

3. Record on the books of the new corporation the following transactions for the fiscal period ended June 30, 2017:

Jul.	3	2016	Jones and Smith each invested \$500,000 additional cash in the corporation and were issued 10,000 common shares each.
Jul.	5	2016	An additional 5,000 common shares were issued to numerous individuals for \$1,000,000 cash.
June	30	2017	JSS Corporation earned \$400,000 income before income taxes, all in cash. The corporate income tax rate is 20%.
June	30	2017	JSS Corporation declared a \$1 dividend per common share.

4. Prepare the statement of changes in equity for JSS Corporation at its first period ended June 30, 2017. Assume there are no other transactions.

# Chapter 13 Financial Statement Analysis



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Financial statements can be used by shareholders, creditors, and other interested parties to analyze a corporation's liquidity, profitability, and financial structure compared to prior years and other similar companies. As part of this analysis, financial evaluation tools are used. Some of these tools are discussed in this chapter.

## Learning Objectives

LO1 – Describe ratio analysis, and explain how liquidity, profitability, leverage, and market ratios are used to analyze and compare financial statements.

LO2 – Describe horizontal and vertical trend analysis, and explain how they are used to analyze financial statements.

LO3 – (Appendix) Describe the Scott formula and explain how it is used to analyze financial statements.

## 13.1 Introduction to Ratio Analysis



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LO1 – Describe ratio analysis, and explain how liquidity, profitability, leverage, and market ratios are used to analyze and compare financial statements.

A common way to evaluate financial statements is through **ratio analysis**. A *ratio* is a relationship between two numbers of the same kind. For example, if there are two apples and three oranges, the ratio of the number of oranges to the number of apples is 2:3 (read as “two to three”). A **financial ratio** is a measure of the relative magnitude of two selected numerical values taken from a company's financial statements. For instance, the gross profit percentage studied in an earlier chapter and also known as the gross profit ratio, expresses the numerical relationship between gross profit and sales. If a company has a gross profit ratio of 0.25:1, this means that for every \$1 of sales, the company earns, on average, \$0.25 to cover expenses other than cost of goods sold. Another way of stating this is to say that the gross profit ratio is 25%.<sup>1</sup>

1. Any ratio in the form X:1 can be expressed as a percentage by multiplying both the numerator and denominator by 100. For example, a 0.25:1 ratio would equal 25%  $[(0.25 \times 100)/(1 \times 100) = 25/100 = 25\%]$

Financial ratios are effective tools for measuring the financial performance of a company because they provide a common basis for evaluation—for instance, the amount of gross profit generated by each dollar of sales for different companies. Numbers that appear on financial statements need to be evaluated in context. It is their relationship to other numbers and the relative changes of these numbers that provide some insight into the financial health of a business. One of the main purposes of ratio analysis is to highlight areas that require further analysis and investigation. Ratio analysis alone will not provide a definitive financial evaluation. It is used as one analytic tool, which, when combined with informed judgment, offers insight into the financial performance of a business.

For example, one business may have a completely different product mix than another company even though both operate in the same broad industry. To determine how well one company is doing relative to others, or to identify whether key indicators are changing, ratios are often compared to *industry averages*. To determine trends in one company's performance, ratios are often compared to past years' ratios of the same company.

To perform a comprehensive analysis, qualitative information about the company as well as ratios should be considered. For example, although a business may have sold hundreds of refrigerators last year and all of the key financial indicators suggest growth, qualitative information from trade publications and consumer reports may indicate that the trend will be towards refrigerators using significantly different technologies in the next few years. If the company does not have the capacity or necessary equipment to produce these new appliances, the present positive financial indicators may not accurately reflect the likely future financial performance of the company.

An examination of qualitative factors provides valuable insights and contributes to the comprehensive analysis of a company. An important source of qualitative information is also found in the notes to the financial statements, which are an integral part of the company's financial statements.

In this chapter, financial ratios will be used to provide insights into the financial performance of Big Dog Carworks Corp. (BDCC). The ratios will focus on financial information contained within the income statement, statement of changes in equity, and balance sheet of BDCC for the three years 2019, 2020, and 2021. This information is shown below. Note that figures in these statements are reported in thousands of dollars (000s).

Big Dog Carworks Corp.  
Balance Sheet  
At December 31  
(\$000s)

<i>Assets</i>			
	<i>2021</i>	<i>2020</i>	<i>2019</i>
<i>Current</i>			
Cash	\$ 20	\$ 30	\$ 50
Short-term investments	36	31	37
Accounts receivable	544	420	257
Inventories	833	503	361
	<u>1,433</u>	<u>984</u>	<u>705</u>
<i>Property, plant, and equipment, net</i>	<u>1,053</u>	<u>1,128</u>	<u>712</u>
<b>Total assets</b>	<u><u>\$2,486</u></u>	<u><u>\$2,112</u></u>	<u><u>\$1,417</u></u>
 <i>Liabilities</i>			
<i>Current</i>			
Borrowings	\$ 825	\$ 570	\$ 100
Accounts payable	382	295	219
Income taxes payable	48	52	50
	<u>1,255</u>	<u>917</u>	<u>369</u>
 <i>Shareholders' Equity</i>			
Share capital	1,063	1,063	963
Retained earnings	168	132	85
	<u>1,231</u>	<u>1,195</u>	<u>1,048</u>
<b>Total liabilities and shareholders' equity</b>	<u><u>\$2,486</u></u>	<u><u>\$2,112</u></u>	<u><u>\$1,417</u></u>

Fig. 13.1: BDCC Financial Statements

Big Dog Carworks Corp.  
Income Statement  
For the Year Ended December 31  
(\$000s)

	2021	2020	2019
Sales (net)	\$3,200	\$2,800	\$2,340
Cost of goods sold	2,500	2,150	1,800
Gross profit	<u>700</u>	<u>650</u>	<u>540</u>
<i>Operating expenses</i>			
Selling, general, and administration	212	183	154
Employee benefits	113	109	119
Depreciation	75	84	63
	<u>400</u>	<u>376</u>	<u>336</u>
Income from operations	300	274	204
<i>Financing costs</i>			
Interest	89	61	-0-
Income before income taxes	211	213	204
Income taxes	95	96	92
Net income	<u>\$ 116</u>	<u>\$ 117</u>	<u>\$ 112</u>

Big Dog Carworks Corp.  
Statement of Changes in Equity  
For the Year Ended December 31  
(\$000s)

	2021			2020	2019
	<i>Share capital</i>	<i>Retained earnings</i>	<i>Total equity</i>	<i>Total equity</i>	<i>Total equity</i>
Balance at start of year	\$1,063	\$132	\$1,195	\$1,148	\$ 143
Common shares issued					953
Net income		116	116	117	112
Dividends declared		(80)	(80)	(70)	(60)
Balance at end of year	<u>\$1,063</u>	<u>\$168</u>	<u>\$1,231</u>	<u>\$1,195</u>	<u>\$1,148</u>

**Fig. 13.2: BDCC Financial Statements (continued)**

Assume that 100,000 common shares are outstanding at the end of 2019, 2020, and 2021.

There are four major types of financial ratios: a) *liquidity ratios* that measure the ability of a corporation to satisfy demands for cash as they arise in the near-term (such as payment of current liabilities); b) *profitability ratios* that measure various levels of return on sales, total assets employed, and shareholder investment; c) *leverage ratios* that measure the financial structure of a corporation, its amount of relative debt, and its ability to cover interest expense; and d) *market ratios* that measure financial returns to shareholders, and perceptions of the stock market about the corporation's value.

## 13.2 Liquidity Ratios: Analyzing Short-term Cash Needs



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**Liquidity** is the ability of a corporation to satisfy demands for cash as they arise in the near-term (such as payment of current liabilities). Initial insights into the financial performance of BDCC can be derived from an analysis of relative amounts of current and non-current debt. This analysis is addressed in this section.

### 13.2.1 Current (Short-term) versus Non-current (Long-term) Debt



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Short-term and long-term financing strategies both have their advantages. The advantage of some short-term debt (repayable within one year of the balance sheet date) is that it often does not require interest payments to creditors. For example, accounts payable may not require payment of interest if they are paid within the first 30 days they are outstanding. Short-term debt also has its disadvantages; payment is required within at least one year, and often sooner. Interest rates on short-term debt are often higher than on long-term debt. An increase in the proportion of short-term debt is more risky because it must be renewed and therefore renegotiated more frequently.

The advantages of long-term debt are that payment may be made over an extended period of time. Risk may be somewhat reduced through the use of a formal contractual agreement that is often lacking with short-term debt. The disadvantages of long-term debt are that interest payments must be made at specified times and the amounts owing may be secured by assets of the company.

### 13.2.2 Analyzing Financial Structure



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As a general rule, long-term financing should be used to finance long-term assets.

Note that in BDCC's case, property, plant, and equipment assets amount to \$1,053,000 at December 31, 2021 yet the firm has no long-term liabilities. This is unusual. An analysis of the company's balance sheet reveals the following:

	(\$000s)		
	2021	2020	2019
Current liabilities	\$1,255	\$917	\$369
Non-current liabilities	-0-	-0-	-0-



2021 information indicates that BDCC's management relies solely on short-term creditor financing, part of which is \$382,000 of accounts payable that may bear no interest and \$825,000 of borrowings that also need to be repaid within one year. The risk is that management will likely need to replace current liabilities with new liabilities. If creditors become unwilling to do this, the ability of BDCC to pay its short-term creditors may be compromised. As a result, the company may experience a **liquidity crisis**—the inability to pay its current liabilities as they come due.

Even though a company may be earning net income each year (as in BDCC's case), it may still be unable to pay its current liabilities as needed because of a shortage of cash:

#### *Current liabilities*

- Creditors can refuse to provide any further goods or services on account.
- Creditors can sue for payment.
- Creditors can put the company into receivership or bankruptcy.

#### *Non-current liabilities*

- Long-term creditors can refuse to lend additional cash.
- Creditors can demand repayment of their long-term debts, under some circumstances.

#### *Shareholders' equity*

- Shareholders may be unwilling to invest in additional share capital of the company.
- Shareholders risk the loss of their investments if the company declares bankruptcy.

There are several ratios that can be used to analyze the liquidity of a company.

### 13.2.3 Working Capital



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**Working capital** is the difference between a company's current assets and current liabilities at a point in time. BDCC's working capital calculation is as follows:

	(000s)		
	2021	2020	2019
<i>Current assets</i>			
Cash	\$ 20	\$ 30	\$ 50
Short-term investments	36	31	37
Accounts receivable	544	420	257
Inventories	833	503	361
<b>Total current assets (a)</b>	<b>1,433</b>	<b>984</b>	<b>705</b>
<i>Current liabilities</i>			
Borrowings	825	570	100
Accounts payable	382	295	219
Income taxes payable	48	52	50
<b>Total current liabilities (b)</b>	<b>1,255</b>	<b>917</b>	<b>369</b>
<b>Net working capital (a-b)</b>	<b>\$ 178</b>	<b>\$ 67</b>	<b>\$336</b>

In the schedule above, working capital amounts to \$178,000 at December 31, 2021. Between 2019 and 2021, working capital decreased by \$158,000 (\$336,000 – 178,000). BDCC is less liquid in 2021 than in 2019, though its liquidity position has improved since 2020 when it was only \$67,000.

In addition to calculating an absolute amount of working capital, ratio analysis can also be used. The advantage of a ratio is that it is usually easier to interpret.

### 13.2.4 Current Ratio



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Is BDCC able to repay short-term creditors? The **current ratio** can help answer this question. It expresses working capital as a proportion of current assets to current liabilities and is calculated as:

$$\frac{\text{Current assets}}{\text{Current liabilities}}$$

The relevant BDCC financial data required to calculate this ratio is taken from the balance sheet, as follows:

		(000s)		
		2021	2020	2019
<b>Current assets</b>	<b>(a)</b>	<b>\$1,433</b>	<b>\$ 984</b>	<b>\$ 705</b>
<b>Current liabilities</b>	<b>(b)</b>	<b>1,255</b>	<b>917</b>	<b>369</b>
<b>Current ratio</b>	<b>(a/b)</b>	<b>1.14:1</b>	<b>1.07:1</b>	<b>1.91:1</b>

This ratio indicates how many current asset dollars are available to pay current liabilities at a point in time. The expression “1.14:1” is read, “1.14 to 1.” In this case it means that at December 31, 2021, \$1.14 of current assets exist to pay each \$1 of

current liabilities. This ratio is difficult to interpret in isolation. There are two types of additional information that could help. First, what is the trend within BDCC over the last three years? The ratio declined between 2019 and 2020 (from 1.91 to 1.07), then recovered slightly between the end of 2020 and 2021 (from 1.07 to 1.14). The overall decline may be a cause for concern, as it indicates that in 2021 BDCC had fewer current assets to satisfy current liabilities as they became due.

A second interpretation aid would be to compare BDCC's current ratio to a similar company or that of BDCC's industry as a whole. Information is available from various trade publications and business analysts' websites that assemble financial ratio information for a wide range of industries.

Some analysts consider that a corporation should maintain a 2:1 current ratio, depending on the industry in which the firm operates. The reasoning is that, if there were \$2 of current assets to pay each \$1 of current liabilities, the company should still be able to pay its current liabilities as they become due, even in the event of a business downturn. However, it is recognized that no one current ratio is applicable to all entities; other factors—such as the composition of current assets—must also be considered to arrive at an acceptable ratio. This is illustrated below.

### 13.2.5 Composition of Specific Items in Current Assets



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In the following example, both Corporation A and Corporation B have a 2:1 current ratio. Are the companies equally able to repay their short-term creditors?

	<i>Corp. A</i>	<i>Corp. B</i>
<i>Current assets</i>		
Cash	\$ 1,000	\$10,000
Accounts receivable	2,000	20,000
Inventories	37,000	10,000
Total current assets	<u>\$40,000</u>	<u>\$40,000</u>
<i>Current liabilities</i>	<u>\$20,000</u>	<u>\$20,000</u>
<b>Current ratio</b>	<b>2:1</b>	<b>2:1</b>

The companies have the same dollar amounts of current assets and current liabilities. However, they have different short-term debt paying abilities because Corporation B has more liquid current assets than does Corporation A. Corporation B has less inventory (\$10,000 vs. \$37,000) and more in cash and accounts receivable. If Corporation A needed more cash to pay short-term creditors quickly, it would have to sell inventory, likely at a lower-than-normal gross profit. So, Corporation B is in a better position to repay short-term creditors.

Since the current ratio doesn't consider the components of current assets, it is only a rough indicator of a company's ability to pay its debts as they become due. This weakness of the current ratio is partly remedied by the acid-test ratio discussed below.

### 13.2.6 Acid-Test Ratio



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A more rigid test of liquidity is provided by the **acid-test ratio**; also called the *quick ratio*. To calculate this ratio, current assets are separated into *quick* current assets and *non-quick* current assets.

<i>Quick Current Assets</i>		
Cash	}	These current assets are considered to be readily convertible into cash.
Short-term investments		
Accounts receivable		
<i>Non-quick current assets</i>		
Inventories	}	Cash cannot be obtained either at all or easily from these current assets.
Prepaid expenses		

Inventory and prepaid expenses cannot be converted into cash in a short period of time, if at all. Therefore, they are excluded in the calculation of this ratio. The acid-test ratio is calculated as:

$$\frac{\text{Quick current assets}}{\text{Current liabilities}}$$

The BDC information required to calculate this ratio is:

		(000s)		
		2021	2020	2019
Cash		\$ 20	\$ 30	\$ 50
Short-term investments		36	31	37
Accounts receivable		544	420	257
Quick current assets	(a)	<u>\$ 600</u>	<u>\$481</u>	<u>\$344</u>
Current liabilities	(b)	<u>\$1,255</u>	<u>\$917</u>	<u>\$369</u>
Acid-test ratio	(a/b)	<u>0.48:1</u>	<u>0.52:1</u>	<u>0.93:1</u>

This ratio indicates how many quick asset dollars exist to pay each dollar of current liabilities. What is an adequate acid-test ratio? It is generally considered that a 1:1 acid test ratio is adequate to ensure that a firm will be able to pay its current obligations. However, this is a fairly arbitrary guideline and is not appropriate in all situations. A

lower ratio than 1:1 can often be found in successful companies. However, BDCC's acid-test ratio trend is worrisome.

There was \$0.48 of quick assets available to pay each \$1 of current liabilities in 2021. This amount appears inadequate. In 2020, the acid-test ratio of \$0.52 also seems to be too low. The 2019 ratio of \$0.93 is less than 1:1 but may be reasonable. Of particular concern to financial analysts would be BDCC's declining trend of the acid-test ratio over the three years.

Additional analysis can also be performed to determine the source of liquidity issues. These are discussed next.

### 13.2.7 Accounts Receivable Collection Period



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Liquidity is affected by management decisions related to trade accounts receivable. Slow collection of receivables can result in a shortage of cash to pay current obligations. The effectiveness of management decisions relating to receivables can be analyzed by calculating the *accounts receivable collection period*.

The calculation of the **accounts receivable collection period** establishes the average number of days needed to collect an amount due to the company. It indicates the efficiency of collection procedures when the collection period is compared with the firm's sales terms (in BDCC's case, the sales terms are *net 30* meaning that amounts are due within 30 days of the invoice date).

The accounts receivable collection period is calculated as:

$$\frac{\text{Average accounts receivable}^2}{\text{Net credit sales}} \times 365 \text{ days}$$

<sup>2</sup> Average balance sheet amounts are used when income statement amounts are compared to balance sheet amounts in a ratio. This is because the income statement item is realized over a fiscal year, while balance sheet amounts are recorded at points in time at the end of each fiscal year. Averaging opening and ending balance sheet amounts is an attempt to match numerators and denominators to an approximate midpoint in the fiscal year.

The BDCC financial information required to make the calculation is shown below (the 2019 calculation cannot be made because the 2018 Accounts Receivable amount is not available). Assume all of BDCC's sales are on credit.



		(000s)	
		2021	2020
Net credit sales	(a)	\$3,200	\$2,800
Average accounts receivable [(Opening balance + closing balance)/2]	(b)	\$ 482 <sup>1</sup>	\$ 338 <sup>2</sup>
Average collection period [(b/a) x 365 days]		55 days	44 days

$$^1 (\$420 + 544)/2 = \$482$$

$$^2 (\$257 + 420)/2 = \$338 \text{ (rounded)}$$

When Big Dog's 30-day sales terms are compared to the 55-day collection period, it can be seen that an average 25 days of sales (55 days – 30 days) have gone uncollected beyond the regular credit period in 2021. The collection period in 2021 is increasing compared to 2020. Therefore, some over-extension of credit and possibly ineffective collection procedures are indicated by this ratio. Quicker collection would improve BDCC's cash position. It may be that older or uncollectible amounts are buried in the total amount of receivables; this would have to be investigated.

Whether the increase in collection period is good or bad depends on several factors. For instance, more liberal credit terms may generate more sales (and therefore profits). The root causes of the change in the ratio need to be investigated. However, the calculation does provide an indication of the change in effectiveness of credit and collection procedures between 2020 and 2021.

### 13.2.8 Number of Days of Sales in Inventory



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The effectiveness of management decisions relating to inventory can be analyzed by calculating the number of days of sales that can be serviced by existing inventory levels.

The **number of days of sales in inventory** is calculated by dividing average inventory by the cost of goods sold and multiplying the result by 365 days.

$$\frac{\text{Average merchandize}}{\text{Cost of goods sold}} \times 365 \text{ days}$$

The BDCC financial data for 2020 and 2021 required to calculate this ratio are shown below.

		(000s)	
		2021	2020
Cost of goods sold		\$2,500	\$2,150
Average inventory			
[(opening balance + closing balance)/2]	(a)	\$ 668 <sup>1</sup>	\$432 <sup>2</sup>
Cost of goods sold	(b)	365	365
Number of days sales in inventory			
[(b/a) x 365 days]		98 days	73 days

$$^1 (\$503 + 833)/2 = \$668$$

$$^2 (\$361 + 503)/2 = \$432$$

The calculation indicates that BDCC is investing more in inventory in 2021 than in 2020 because there are 98 days of sales in inventory in 2021 versus 73 days in 2020. BDCC has approximately 3 months of sales with its existing inventory (98 days represents about 3 months). The increase from 2020 to 2021 may warrant investigation into its causes.

A declining number of days of sales in inventory is usually a sign of good inventory management because it indicates that the average amount of assets tied up in inventory is lessening. With lower inventory levels, inventory-related expenses such as rent and insurance are lower because less storage space is often required. However, lower inventory levels can have negative consequences since items that customers want to purchase may not be in inventory resulting in lost sales.

Increasing days of sales in inventory is usually a sign of poor inventory management because an excessive investment in inventory ties up cash that could be used for other purposes. Increasing levels may indicate that inventory is becoming obsolete (consider clothing) or deteriorating (consider perishable groceries). Obsolete and/or deteriorating inventories may be unsalable. However, the possible positive aspect of more days of sales in inventory is that there can be shorter delivery time to customers if more items are in stock.

Whether Big Dog's increasing days of sales in inventory is positive or negative depends on management's objectives. Is management increasing inventory to provide for increased sales in the next year, or is inventory being poorly managed? Remember that ratio analyses identify areas that require investigation. The resulting investigation will guide any required action.

### 13.2.9 The Revenue Portion of the Operating Cycle



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As discussed in an earlier chapter, the sale of inventory and resulting collection of receivables are part of a business's operating cycle as shown in [Figure 13.3](#).



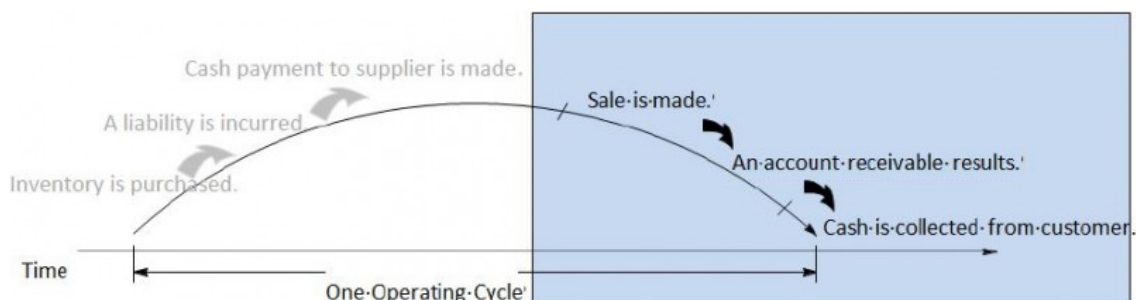


Fig. 13.3: The Sales and Collection Portion of the Operating Cycle

A business's **revenue operating cycle** is a subset of the operating cycle and includes the purchase of inventory, the sale of inventory and creation of an account receivable, and the generation of cash when the receivable is collected. The length of time it takes BDCC to complete one revenue operating cycle is an important measure of liquidity and can be calculated by adding the number of days of sales in inventory plus the number of days it takes to collect receivables. The BDCC financial data required for this calculation follows.

	2021	2020
Average number of days of sales in inventory	98 days	73 days
Average number of days to collect receivables	55 days	44 days
Number of days to complete the revenue cycle	<u>153 days</u>	<u>117 days</u>

In 2021, 153 days were required to complete the revenue cycle, compared to 117 days in 2020. So, if accounts payable terms require payment within 60 days, BDCC may not be able to pay them because the number of days to complete the revenue cycle for both 2020 (117 days) and 2021 (153 days) are significantly greater than 60 days.

### 13.2.10 Analysis of BDCC's Liquidity



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Reflecting on the results of all the liquidity ratios, it appears that Big Dog Carworks Corp. is growing less liquid. Current assets, especially quick assets, are declining relative to current liabilities. The revenue operating cycle is increasing.

## 13.3 Profitability Ratios: Analyzing Operating Activities



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**Profitability ratios** compare various expenses to revenues, and measure how well the assets of a corporation have been used to generate revenue.

### 13.3.1 Gross Profit Ratio



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The **gross profit ratio** indicates the percentage of sales revenue that is left to pay operating expenses, creditor interest, and income taxes after deducting cost of goods sold. The ratio is calculated as:

$$\frac{\text{Gross profit}}{\text{Net sales}}$$

BDCC's gross profit ratios for the three years are:

		(000s)		
		2021	2020	2019
Gross profit	(a)	\$ 700	\$ 650	\$ 540
Net sales	(b)	\$3,200	\$2,800	\$2,340
Gross profit ratio	(a/b)	0.22:1	0.23:1	0.23:1

In other words, for each dollar of sales BDCC has \$0.22 of gross profit left to cover operating, interest, and income tax expenses (\$0.23 in each of 2020 and 2019). The ratio has not changed significantly from year to year. However, even a small decline in this percentage can affect net income significantly because the gross profit is such a large component of the income statement. Changes in the gross profit ratio should be investigated, as it will impact future financial performance.

### 13.3.2 Operating Profit Ratio



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The **operating profit ratio** is one measure of relative change in these other expenses. This ratio indicates the percentage of sales revenue left to cover interest and income taxes expenses after deducting cost of goods sold and operating expenses. In other words:

$$\frac{\text{Income from operations}}{\text{Net sales}}$$

BDCC's operating profit ratio for the 2019, 2020, and 2021 fiscal years is calculated as follows:

		(000s)		
		2021	2020	2019
Income from operations	(a)	\$ 300	\$ 274	\$ 204
Net sales	(b)	\$3,200	\$2,800	\$2,340
Operating profit ratio	(a/b)	0.09:1	0.10:1	0.09:1

For each dollar of sales revenue in 2021, the company had \$0.09 left to cover interest and income tax expenses after deducting cost of goods sold and operating expenses. A review of the company's operating expenses (selling, general, and administrative expenses; employee benefits, and depreciation) show that they have all increased. As a result, and despite increasing sales revenue and gross profit, operating income has remained relatively flat. Although it seems reasonable that an increase in operating expenses would follow an increase in sales, the reasons for the operating expense increases should be investigated.

### 13.3.3 Net Profit Ratio



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The **net profit ratio** is the percentage of sales revenue retained by the company after payment of operating expenses, interest expenses, and income taxes. It is an index of performance that can be used to compare the company to others in the same industry.

This ratio is calculated by the following formula:

$$\frac{\text{Net income}}{\text{Net sales}}$$

BDCC's net profit ratios for the three years are calculated as follows:

		(000s)		
		2021	2020	2019
Net income	(a)	\$ 116	\$ 117	\$ 112
Net sales	(b)	\$3,200	\$2,800	\$2,340
Net profit ratio	(a/b)	0.04:1	0.04:1	0.05:1

For each \$1 of sales in 2021, BDCC earned \$0.04 of net income. The net profit ratio has been relatively stable but needs to be compared with industry or competitors' averages for a better perspective.

Recall that revenues are generated from a business's asset holdings. The financial strength and success of a corporation depends on the efficient use of these assets. An analysis of asset investment decisions can be made by calculating several ratios, and is discussed next.

### 13.3.4 Sales to Total Assets Ratio



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Are BDCC's sales adequate in relation to its assets? The calculation of the **sales to total assets ratio** helps to answer this question by establishing the number of sales dollars earned for each dollar invested in assets. The ratio is calculated as:

$$\frac{\text{Net sales}}{\text{Average total assets}}$$

BDCC's ratios are calculated as follows:

		(000s)	
		2021	2020
Net sales	(a)	\$3,200	\$ 2,800
Average total assets	(b)	\$2,299 <sup>1</sup>	\$1,765.5 <sup>2</sup>
Sales to total assets ratio	(a/b)	1.39:1	1.59:1

$$^1 (\$2,112 + 2,486)/2 = \$2,299$$

$$^2 (\$1,417 + 2,112)/2 = \$1,764.5$$

The ratio has decreased from 2020 to 2021. Each \$1 of investment in assets in 2020 generated sales of \$1.59. In 2021, each \$1 of investment in assets generated only \$1.39 in sales. Over the same period, BDCC's investment in assets increased. The ratios indicate that the additional assets are not producing revenue as effectively as in the past. It may be too soon to tell whether the increase in assets in 2020 will eventually create greater sales but an investigation is required.

As noted earlier, comparison with industry averages would be useful. A low ratio in relation to other companies in the same industry may indicate an over-investment in or inefficient use of assets by BDCC. On the other hand, a higher ratio in comparison to other companies would be a positive indicator.

### 13.3.5 Return on Total Assets Ratio (ROA)



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The **return on total assets ratio (ROA)** is designed to measure the efficiency with which all of a company's assets are used to produce income from operations. The ratio is calculated as:

$$\frac{\text{Income from operations}}{\text{Average total assets}}$$

Note that expenses need to finance the company operations are excluded from the calculation, specifically interest and income taxes. This is because all the assets of the company are considered in the ratio's denominator, whether financed by investors or creditors. Average Total Assets are used in the calculation because the amount of assets used likely varies during the year. The use of averages tends to smooth out such fluctuations.

BDCC's returns on total assets for 2020 and 2021 are calculated as follows:

		(000s)	
		2021	2020
Income from operations	(a)	\$ 300	\$ 274
Average total assets	(b)	\$2,299 <sup>1</sup>	\$1,765.5 <sup>2</sup>
Return on total assets ratio	(a/b)	0.13:1	0.16:1

$$^1 (\$2,112 + 2,486)/2 = \$2,299$$

$$^2 (\$1,417 + 2,112)/2 = \$1,764.5$$

The ratios indicate that Big Dog earned \$0.13 of income from operations for every \$1 of average total assets in 2021, a decrease from \$0.16 per \$1 in 2020. This downward trend indicates that assets are being used less efficiently. However, it may be that the increased investment in assets has not yet begun to pay off. On the other hand, although sales are increasing, it is possible that future sales volume will not be sufficient to justify the increase in assets. More information about the company's plans and projections would be useful. Recall that ratio analysis promotes the asking of directed questions for the purpose of more informed decision making.

### 13.3.6 Return on Shareholders' Equity Ratio (ROSE)



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The **return on shareholders' equity ratio (ROSE)** measures how much net income was earned for the amount shareholders have invested in a business. It is calculated as:

$$\frac{\text{Net income}}{\text{Average shareholders' equity}}$$

The 2020 and 2021 returns on shareholders' equity ratios for BDCC are calculated as follows (note that the 2019 ratio is excluded; average shareholders' equity cannot be calculated since 2018 ending balances are not provided):

		(000s)	
		2021	2020
Net income	(a)	\$ 116	\$ 117
Average shareholders' equity	(b)	\$1,213 <sup>1</sup>	\$1,121.5 <sup>2</sup>
Return on shareholders' equity ratio	(a/b)	0.10:1	0.10:1

$$^1 (\$1,195 + 1,231)/2 = \$1,213$$

$$^2 (\$1,048 + 1,195)/2 = \$1,121.5$$

In both years, shareholders earned, on average, \$0.10 for every \$1 invested in BDCC, or 10%. Industry averages could help with this analysis. For instance, if the industry as a whole earned only a 5% return on shareholders' equity in 2021, it could be concluded that BDCC performed better than the industry average in terms of return on shareholders' equity.



## 13.4 Leverage Ratios: Analyzing Financial Structure



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The accounting equation expresses a relationship between assets owned by an entity and the claims against those assets. Although shareholders own a corporation, they alone do not finance the corporation; creditors also finance some of its activities. Together, creditor and shareholder capital are said to form the **financial structure** of a corporation.

At December 31, 2021, the balance sheet of BDCC shows the following financial structure:

<b>ASSETS</b>	=	<b>LIABILITIES</b>	+	<b>SHAREHOLDERS' EQUITY</b>
\$2,486	=	\$1,255	+	\$1,231

### 13.4.1 Debt to Shareholders' Equity Ratio



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The proportion of creditor to shareholders' claims is called the **debt to shareholders' equity ratio**, and is calculated by dividing total liabilities by shareholders' equity. In BDCC's case, these amounts are:

		(000s)		
		2021	2020	2019
Total liabilities	(a)	\$1,255	\$ 917	\$ 369
Shareholders' equity	(b)	\$1,231	\$1,195	\$1,048
Debt to shareholders' equity ratio	(a/b)	1.02:1	0.77:1	0.35:1

In other words, BDCC has \$1.02 of liabilities for each dollar of shareholders' equity at the end of its current fiscal year, 2021. The proportion of debt financing has been increasing since 2019. In 2019 there was only \$0.35 of debt for each \$1 of shareholders' equity. In 2021, creditors are financing a greater proportion of BDCC than are shareholders. This may be a cause for concern.

On the one hand, management's reliance on creditor financing is good. Issuing additional shares might require existing shareholders to give up some of their control of BDCC. Creditor financing may also be more financially attractive to existing shareholders if it enables BDCC to earn more with the borrowed funds than the interest paid on the debt.

On the other hand, management's increasing reliance on creditor financing increases risk because interest and principal have to be paid on this debt. Before deciding to extend credit, creditors often look at the total debt load of a company, and therefore the company's ability to meet interest and principal payments in the future. Total earnings of BDCC could be reduced if high interest payments have to be made, especially if interest rates rise. Creditors are interested in a secure investment and

may evaluate shareholder commitment by measuring relative amounts of capital invested. From the creditors' perspective, the more capital invested by owners of the company, the greater the relative risk assumed by shareholders thus decreasing risk to creditors.

Although there is no single most appropriate debt to shareholders' equity ratio, there are techniques for estimating the optimum balance. These are beyond the scope of introductory financial accounting. For now, it is sufficient to note that for BDCC the debt to shareholders' equity ratio has increased considerably over the three-year period which is generally unfavourable because of the risk associated with debt financing.

### 13.4.2 Times Interest Earned Ratio



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Creditors are interested in evaluating a company's financial performance, in order to project whether the firm will be able to pay interest on borrowed funds and repay the debt when it comes due. Creditors are therefore interested in measures such as the **times interest earned ratio**. This ratio indicates the amount by which income from operations could decline before a default on interest may result. The ratio is calculated by the following formula:

$$\frac{\text{Income from operations}}{\text{Interest expense}}$$

Note that income from operations is used, so that income before deduction of creditor payments in the form of income taxes and interest is incorporated into the calculation. BDCC's 2020 and 2021 ratios are calculated as follows:

		(000s)		
		2021	2020	2019
Income from operations	(a)	\$300	\$274	\$204
Interest expense	(b)	\$ 89	\$ 61	-0-
Times interest earned ratio	(a/b)	3.4:1	4.5:1	n/a

The larger the ratio, the better creditors are protected. BDCC's interest coverage has decreased from 2020 to 2021 (3.37 times vs. 4.49 times), but income would still need to decrease significantly for the company to be unable to pay its obligations to creditors. The analysis does indicate, though, that over the past two years interest charges have increased compared to income from operations. Creditors need to assess company plans and projections, particularly those affecting income from operations, to determine whether their loans to the company are at risk. As discussed above, it may be that significant investments in assets have not yet generated related increases in sales and income from operations.



## 13.5 Market Ratios: Analysis of Financial Returns to Investors



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Investors frequently consider whether to invest or divest in shares of a corporation. There are various ratios that help them make this decision. These are called market ratios, because the stock market plays an important role in allocating financial resources to corporations that offer their shares to the public.

### 13.5.1 Earnings-per-Share (EPS)



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Measures of efficiency can focus on shareholder returns on a per-share basis. That is, the amount of net income earned in a year can be divided by the number of common shares outstanding to establish how much return has been earned for each outstanding share. This **earnings-per-share (EPS)** value is calculated as:

$$\frac{\text{Net income}}{\text{Number of common shares outstanding}}$$

EPS is quoted in financial markets and is disclosed on the income statement of publicly-traded companies. If there are preferred shareholders, they have first rights to distribution of dividends. Therefore, when calculating EPS, preferred shareholders' claims on net income are deducted from net income to calculate the amount available for common shareholders:

$$\frac{\text{Net income} - \text{preferred share dividends}}{\text{Number of common shares outstanding}}$$

BDCC has no preferred shares and thus no preferred share dividends. Recall that 100,000 common shares are outstanding at the end of 2019, 2020, and 2021.

For BDCC, EPS calculations for the three years are:

		(000s)		
		2021	2020	2019
Net income	(a)	\$116	\$117	\$112
Number of common shares outstanding	(b)	100	100	100
Earnings per share	(a/b)	\$1.16	\$1.17	\$1.12

Big Dog's EPS has remained relatively constant over the three-year period because both net income and number of outstanding shares have remained fairly stable. Increasing sales levels and the resulting positive effects on net income, combined with unchanged common shares issued, has generally accounted for the slight increase from 2019 to 2020.

## 13.5.2 Price-earnings (P/E) Ratio



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A price at which a common share trades on a stock market is perhaps the most important measure of a company's financial performance. The market price of one share reflects the opinions of investors about a company's future value compared to alternative investments.

The earnings performance of common shares is often expressed as a **price-earnings (P/E) ratio**. It is calculated as:

$$\frac{\text{Market price per share}}{\text{Earnings per share}}$$

This ratio is used as an indicator of the market's expectation of a company's future performance. Assume Company A has a current market value of \$15 per share and an EPS of \$1 per share. It will have a P/E ratio of 15. If Company B has a market value of \$4 per share and an EPS of \$0.50 per share, it will have a P/E ratio of 8. This means that the stock market expects Company A to earn relatively more in the future than Company B. For every \$1 of net income generated by Company A, investors are willing to invest \$15. In comparison, for every \$1 of net income generated by Company B, investors are willing to pay only \$8. Investors perceive shares of Company A as more valuable because the company is expected to earn greater returns in the future than is Company B.

Assume that BDCC's average market price per common share was \$4 in 2019, \$5 in 2020, and \$6 in 2021. Its P/E ratio would be calculated as:

		(000s)		
		2021	2020	2019
Market price per common share	(a)	\$6.00	\$5.00	\$4.00
Earnings per share ratio (see above)	(b)	\$1.16	\$1.17	\$1.12
Price-earnings ratio	(a/b)	5.17	4.27	3.57

BDCC's P/E ratio has increased each year. Although industry and competitor's P/E ratio comparisons would be important to compare, BDCC's increasingly positive ratio also indicates that investors are "bullish" on BDCC. That is, the stock market indicates that it expects BDCC to be increasingly profitable in the coming years. Despite a relatively constant EPS ratio from 2019 to 2021, investors are willing to pay more and more for the company's common shares. This must be because future financial prospects are anticipated to be better than in the past three years.

### 13.5.3 Dividend Yield



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Some investors' primary objective is to maximize dividend revenue from share investments, rather than realize an increasing market price of the shares. This type of investor is interested in information about the earnings available for distribution to shareholders and the actual amount of cash paid out as dividends rather than the market price of the shares.

The **dividend yield ratio** is a means to determine this. It is calculated as:

$$\frac{\text{Dividends per share}}{\text{Market price per share}}$$

This ratio indicates how large a return in the form of dividends can be expected from an investment in a company's shares. The relevant information for BDCC over the last three years is shown in the financial statements, as follows:

		<i>(000s—except per share values)</i>		
		<i>2021</i>	<i>2020</i>	<i>2019</i>
Dividends declared	(a)	\$ 80	\$ 70	\$ 60
Outstanding common shares	(b)	100	100	100
Dividends per share	(a/b)	\$0.80	\$0.70	\$0.60

The dividend yield ratio is therefore:

		<i>2021</i>	<i>2020</i>	<i>2019</i>
Dividends per share (see above)	(a)	\$0.80	\$0.70	\$0.60
Market price per share (given)	(b)	\$6.00	\$5.00	\$4.00
Dividend yield ratio	(a/b)	0.13:1	0.14:1	0.15:1

The company's dividend yield ratio decreased from 2019 to 2021. In 2019, investors received \$0.15 for every \$1 invested in shares. By 2021, this had decreased to \$0.13 for every \$1 invested. Though the decline is slight, the trend may concern investors who seek steady cash returns. Also notice that total dividends declared increased from 2019 to 2021 even though net income did not substantially increase, and despite the company's poor liquidity position noted earlier. Investors might ask why such high levels of dividends are being paid given this situation.

## 13.6 Overall Analysis of Big Dog's Financial Statements



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Results of ratio analysis are always more useful if accompanied by other information such as overall industry performance, the general economy, financial ratios of prior years, and qualitative factors such as analysts' opinions and management's plans.

However, there are some interpretations that can be made about BDCC from the foregoing ratio analyses even without other information. Although BDCC is experiencing growth in sales, net income has not substantially increased over the three-year period 2019 to 2021. The gross profit ratio is relatively constant. Their increasing operating expenses appear to be an issue. The sales to total assets and return on assets ratios have decreased due to a recent investment in property, plant and equipment assets and growth in current assets. Income from operations has not increased with the growth in the asset base. However, it may be premature to make conclusions regarding the timing of outlays for property, plant, and equipment.

The most immediate problem facing BDCC is the shortage of working capital and its poor liquidity. BDCC expanded its property, plant, and equipment in 2020 and experienced increases in revenue that did not correspond to increases in accounts receivable and inventories. The company should therefore review its credit policies and monitor its investment in inventory to ensure that these expand in proportion to sales.

The plant expansion produced an increase in current liabilities (mainly borrowings). The company's ability to meet its debt obligations appears to be deteriorating. The ability of income from operations to cover interest expense has declined. The company's liquidity position is deteriorating, even though it continues to produce net income each year. BDCC should investigate alternatives to short-term borrowings, such as converting some of this to long-term debt and/or issuing additional share capital to retire some of its short-term debt obligations.

Despite these challenges, the stock market indicates that it expects BDCC to be increasingly profitable in the future. Perhaps it views the negative indicators noted above as only temporary or easily rectified by management.

The next section provides further insights into BDCC's operations through trend analysis of the company's financial statements.

## 13.7 Horizontal and Vertical Trend Analysis



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LO2 – Describe horizontal and vertical trend analysis, and explain how they are used to analyze financial statements.



Trend analysis is the evaluation of financial performance based on a restatement of financial statement dollar amounts to percentages. Horizontal analysis and vertical analysis are two types of trend analyses.

**Horizontal analysis** involves the calculation of percentage changes from one or more years over the base year dollar amount. The base year is typically the oldest year and is always stated as 100%.

**Vertical analysis** requires numbers in a financial statement to be restated as percentages of a base dollar amount. For income statement analysis, the base amount used is sales. For balance sheet analysis, total assets, or total liabilities and shareholders' equity, are used as the base amounts. When financial statements are converted to percentages, they are called **common-size financial statements**.

Horizontal and vertical analyses of the balance sheets of Big Dog Carworks Corp. are as follows:

<i>Horizontal Analysis: Balance Sheet</i>					<i>Vertical Analysis (Common-size): Balance Sheet</i>			
	2021	2020	Change				2021	2020
			Difference	%				
Current assets	\$1,433 (a)	\$ 984(b)	+\$449 (a-b)	+45.6	[(a-b)/b]	Current assets	57.6	46.6 (b/c)
PPE assets	1,053	1,128	-75	-6.6		PPE assets	42.4	53.4
Total	<u>\$2,486</u>	<u>\$2,112(c)</u>	<u>+\$374</u>	<u>+17.7</u>		Total	<u>100.0</u>	<u>100.0</u>
Current liabilities	\$1,255	\$917	+\$338	+36.9		Current liabilities	50.5	43.4
S/H equity	1,231	1,195	+36	+3.0		S/H equity	49.5	56.6
Total	<u>\$2,486</u>	<u>\$2,112</u>	<u>+\$374</u>	<u>+17.7</u>		Total	<u>100.0</u>	<u>100.0</u>

Notice the two columns introduced here. Analysis of the changes indicates a large increase in current assets (45.6%) together with a large increase in current liabilities (36.9%). There was a small decline in PPE assets (6.6%) and a small increase in shareholders' equity (3%). The percentage change must always be interpreted together with the absolute dollar amount of change to avoid incorrect conclusions; percentages can sometimes be misleading.

The common-size balance sheet reveals that the composition of the assets has shifted more to current assets in 2021 (46.6% to 57.6%). Also, an increase in the percentage of current liabilities has occurred (43.4% to 50.5%), resulting in an overall shift from shareholders' equity financing to debt financing between 2020 and 2021.

The same analysis of BDCC's income statement is as follows:

<i>Horizontal Analysis: Income Statements</i>					<i>Vertical Analysis (Common-Size): Income Statements</i>			
	2021	2020	Change				2021	2020
			Amount	Per Cent				
Sales	\$3,200(a)	\$2,800(b)	+\$400 (a-b)	+14	(((a-b)/b)	Sales	100	100 (b/c)
Cost of goods sold	2,500	2,150	+350	+16		Cost of goods sold	78	77
Gross profit	700	650 (c)	+\$ 50	+8		Gross profit	22	23
Expenses	584	533	+\$ 51	+10		Expenses	18	19
Net income	<u>\$ 116</u>	<u>\$ 117</u>	<u>-\$ 1</u>	<u>-1</u>		Net income	<u>4</u>	<u>4</u>

Although sales and gross profit increased in dollar amounts, net income decreased slightly from 2020 to 2021 (1%). This net decrease resulted because cost of goods sold increased at a faster rate than sales (16% vs. 14%).

Notice the relative change in the components. For example, cost of goods sold increased in 2021 relative to sales (77% to 78%), while expenses in 2021 relative to sales decreased (19% to 18%). The overall changes were almost offsetting, as net income remained fairly stable.

The percentages calculated become more informative when compared to earlier years. Further analysis is usually undertaken in order to establish answers to the following questions:

**Horizontal Analysis:**  
What caused this change? Is the change favourable or unfavourable?

**Vertical Analysis:**  
How do the percentages of this company compare with other companies in the same industry? In other industries?

These and similar questions call attention to areas that require further study. One item of note becomes more apparent as a result of the trend analysis above. Initially, it was stated that operating expenses were increasing between 2019 and 2021. Based on trend analysis, however, these expenses are actually declining as a percentage of sales. As a result, their fluctuations may not be as significant as first inferred. Conversely, the increases each year in cost of goods sold may be worrisome. Initial gross profit ratio calculations seemed to indicate little variation, and thus little effect on income from operations. However, given the increase in cost of goods sold (77% to 78%) may warrant further investigation.

## 13.8 Summary of Financial Ratios



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The ratios covered in this chapter are summarized in [Figure 13.4](#).

Analysis of liquidity:	Calculation of ratio:	Indicates:
1. Working capital	Current assets – current liabilities	The excess of current assets available after covering current liabilities (expressed as a dollar amount).
2. Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$	The amount of current assets available to pay current liabilities.
3. Acid-test ratio	$\frac{\text{Quick current assets}}{\text{Current liabilities}}$	Whether the company is able to meet the immediate demands of creditors. (This is a more severe measure of liquidity.)
4. Accounts receivable collection period	$\frac{\text{Average accounts receivable}}{\text{Net credit sales}} \times 365$	The average time needed to collect receivables.
5. Number of days of sales in inventory	$\frac{\text{Average inventory}}{\text{Cost of goods sold}} \times 365$	How many days of sales can be made with existing inventory.
6. Revenue operating cycle	Average number of days to collect receivables + average number of days of sales inventory	Length of time between the purchase of inventory and the subsequent collection of cash.

Analysis of	Calculation of ratio:	Indicates:
<b>profitability:</b>		
1. Gross profit ratio	$\frac{\text{Gross profit}}{\text{Net sales}}$	The percentage of sales revenue that is left to pay operating expenses, interest, and income taxes after deducting cost of goods sold.
2. Operating profit ratio	$\frac{\text{Income from operations}}{\text{Net sales}}$	The percentage of sales revenue that is left to pay interest and income taxes expenses after deducting cost of goods sold and operating expenses.
3. Net profit ratio	$\frac{\text{Net income}}{\text{Net sales}}$	The percentage of sales left after payment of all expenses.
4. Sales to total assets ratio	$\frac{\text{Net sales}}{\text{Average total assets}}$	The adequacy of sales in relation to the investment in assets.
5. Return on total assets (ROA)	$\frac{\text{Income from operations}}{\text{Average total assets}}$	How efficiently a company uses its assets as resources to earn net income.
6. Return on shareholders' equity (ROSE)	$\frac{\text{Net income}}{\text{Average S/H equity}}$	The adequacy of earnings as a return on owners' investment.
<b>Leverage ratios:</b>	<b>Calculation of ratio:</b>	<b>Indicates:</b>
1. Debt to shareholders' equity ratio	$\frac{\text{Total liabilities}}{\text{Shareholders' equity}}$	The proportion of creditor financing to shareholder financing.
2. Times interest earned ratio	$\frac{\text{Income from operations}}{\text{Interest expense}}$	The ability of a company to pay interest to long-term creditors.
<b>Market ratios:</b>	<b>Calculation of ratio:</b>	<b>Indicates:</b>
1. Earnings per share	$\frac{\text{Net income} - \text{preferred share dividends}}{\text{Average number of common shares outstanding}}$	The amount of net income that has been earned on each common share after deducting dividends to preferred shareholders.
2. Price-earnings ratio	$\frac{\text{Market price per share}}{\text{Earnings per share}}$	Market expectations of future profitability.
3. Dividend yield ratio	$\frac{\text{Dividends per share}}{\text{Market price per share}}$	The short-term cash return that can be expected from an investment in a company's shares.

**Fig. 13.4: Summary of Financial Statement Analysis Ratios**

Schematically, the various analytical tools can be illustrated as shown in [Figure 13.5](#).



Liquidity		Profitability		Financial Structure	Market Measures	Trend Analysis
<i>Short-term cash needs</i>	<i>Current asset performance</i>	<i>Returns on sales</i>	<i>Returns on balance sheet items</i>			
Current ratio	A/R collection period	Gross profit ratio	Sales to total assets ratio	Debt to S/H equity ratio	Earnings per share	Horizontal
Acid-test ratio	Number of days of sales in inventory	Operating income ratio	Return on total assets	Times interest earned ratio	Price-earnings ratio	Vertical
	Revenue operating cycle	Net profit ratio	Return on shareholders' equity		Dividend yield ratio	

Fig. 13.5: Categorization of Financial Statement Analytical Tools

## 13.9 Appendix: The Scott Formula



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LO3 – Describe the Scott formula and explain how it is used to analyze financial statements.

The **Scott formula** was developed by WR Scott, a Canadian accounting academic. The formula links return on total assets (ROA) to return on shareholders' equity (ROSE), and also integrates a number of related financial ratios to provide a more informed analysis of ROSE. The formula breaks down return on shareholders' equity into two major components – *return on operating capital*, similar to return on total assets, and *return on leveraging* – that is, the return to a corporation through its ability to borrow money at a given interest rate, purchase assets with the loan proceeds, and earn a return on these assets that is greater than the interest rate paid on the loan. This excess return accrues to shareholders since creditors already have been paid for the use of borrowed funds via interest payments.

### 13.9.1 An Example of Leverage



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To illustrate the concept of **leverage**, consider the following example:

	<i>Company A</i>	<i>Company B</i>
Total assets	\$400,000	\$400,000
Bonds (12%)	–0–	200,000

Shareholders' equity	400,000	200,000
----------------------	---------	---------

Although both A and B have the same amount of assets – \$400,000. However, company A has no long-term liabilities. Company B has \$200,000 of 12% bonds. If both companies earn income from operations of \$100,000, do they have a similar return on total assets and shareholders' equity? First, net income needs to be determined, as follows:

	<i>Company A</i>	<i>Company B</i>
Income from operations	\$100,000	\$100,000
<i>Less: Interest</i> (\$200,000 x 12%)	-0-	(24,000)
Income before income taxes	100,000	76,000
<i>Less: Income taxes</i> (50%)	(50,000)	(38,000)
Net income	<u>\$ 50,000</u>	<u>\$ 38,000</u>

Fig. 13.6: Partial Income Statement of Companies A and B

The use of long-term financing results in a lower net income figure for company B because of interest expense (\$24,000). This is mitigated somewhat by the lower income taxes expense that results for company B (\$38,000 vs. \$50,000). The difference occurs because the interest expense incurred by B is a deductible expense for income tax purposes. As a result, B's net interest expense is only \$12,000, and its *after-tax* cost of borrowing is 6% (12% x 50%). When an interest expense is recorded separately and an income taxes expense is allocated between income from operations and interest expense, this becomes more apparent:

	<i>Company A</i>	<i>Company B</i>
Income from operations	\$100,000	\$100,000
<i>Less: Income taxes</i> (50%)	(50,000)	(50,000)
Income from operations, after-tax	50,000	50,000
<i>Financing costs</i>	-0-	(24,000)
Interest expense (\$200,000 x 12%)		
<i>Less: Income tax savings</i> (50%)	-0-	12,000
Net interest expense	-0-	12,000
Net income	<u>\$ 50,000</u>	<u>\$ 38,000</u>

Fig. 13.7: Partial Income Statement of Companies A and B Showing Allocation of Income Taxes Expense (Savings)

Now consider the implications of this higher debt load on the calculation of after-tax return on total assets and return on shareholders' equity:

		Company A	Company B
Income from operations, after-tax	(a)	\$50,000	\$50,000
Net income for the year	(b)	50,000	38,000
Total assets	(c)	400,000	400,000
Shareholders' equity	(d)	400,000	200,000
Return on total assets	(a/c)	12.5%	12.5%
Return on shareholders' equity	(b/d)	12.5%	19%

Fig. 13.8: Effects of Leverage on Return on Shareholders' Equity

The return on total assets is 12.5% for both companies; however the return on shareholders' equity is considerably greater for company B (19% vs. 12.5% = 6.5%). This is because company B borrowed funds at an after-tax cost of 6% to earn a 12.5% return on the assets it purchased. This 6.5 cent gain for every \$1 borrowed (12.5% – 6%) accrues to shareholders of company B and therefore increases or *leverages* return on shareholders' equity.

However, there is risk involved in leveraging. While return on shareholders' equity is increased when the return on related assets exceeds the cost of borrowing the funds, the opposite occurs. In this case, return on shareholders' equity is decreased. As a result, and in general, companies with stable earnings can carry more debt in their financial structures than companies with fluctuating earnings because there is less risk that the cost of borrowing will exceed the return on assets that the borrowed funds generate.

### 13.9.2 The Specifics of the Scott Formula



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To add analytic power to the Scott formula analysis, the traditional balance sheet format is rearranged somewhat:

1. Liabilities like accounts payable and income taxes payable that arise from normal operating activities are deducted from related assets like accounts receivable and inventory. This is called "**working capital from operations**".
2. Cash and short-term investments normally reported as current assets are deducted from borrowings to give a more representative picture of amounts actually owing to creditors (since these could be used to pay off debt if desired). The new amount is called "**net financial debt**".
3. With these changes, total assets are now called "**operating capital**". The total of net financial debt and shareholders' equity is now called "**financial capital**". Operating capital always equals financial capital, just as total assets always equals total liabilities plus shareholders' equity on a standard balance sheet.

Recall the Big Dog Carworks Corp. balance sheet presented in [Figure 13.2](#) above. For Scott formula analysis, this would be re-cast as follows:

		Big Dog Carworks Corp. Balance Sheet At December 31 (\$000s)		
		Operating Capital		
		2021	2020	2019
Operating liabilities are deducted from operating assets to arrive at working capital from operations.	<i>Working capital from operations</i>			
	Accounts receivable	544	420	257
	Inventories	833	503	361
	<i>Less: Accounts payable</i>	(382)	(295)	(219)
	Income taxes payable	(48)	(52)	(50)
		947	576	349
	<i>Property, plant, and equipment, at carrying amount</i>	1,053	1,128	712
	<b>Operating capital</b>	<b>\$2,000</b>	<b>\$1,704</b>	<b>\$1,061</b>
Cash and short-term investments are deducted from borrowings to arrive at net financial debt.	<i>Net Financial Debt</i>			
	Borrowings	\$ 825	\$ 570	\$ 100
	<i>Less: Cash</i>	(20)	(30)	(50)
	Short-term investments	(36)	(31)	(37)
		769	509	13
Operating capital equals financial capital.	<i>Shareholders' Equity</i>			
	Share capital	1,063	1,063	963
	Retained earnings	168	132	85
		1,231	1,195	1,048
	<b>Financial capital</b>	<b>\$2,000</b>	<b>\$1,704</b>	<b>\$1,061</b>

Fig. 13.9: BDCC Balance Sheet Restated in Terms of Operating and Financial Capital.

Some changes are also made to the presentation of income taxes expense on the BDCC income statement, using the same concept as illustrated in Figure 13.7 above.

First, the average income tax rate needs to be calculated. This is 45% for all three years, derived from Figure 13.2 as follows:

		2021	2020	2019
1.	Income before income taxes (a)	211	213	204
	Less: Income taxes (b)	95	96	92
	Net income	\$ 116	\$ 117	\$ 112
	Income tax rate (b/a)	45%	45%	45%

2. Based on this rate, income taxes expense is allocated between income from operations and interest expense, as shown below:



Big Dog Carworks Corp. Income Statement For the Year Ended December 31 (\$000s)			
	2021	2020	2019
Sales (net)	\$3,200	\$2,800	\$2,340
Cost of goods sold	<u>2,500</u>	<u>2,150</u>	<u>1,800</u>
Gross profit	700	650	540
<i>Operating expenses</i>			
Selling, general, and administration	212	183	154
Employee benefits	113	100	119
Depreciation	<u>75</u>	<u>84</u>	<u>63</u>
	400	376	336
Income from operations	300	274	204
<i>Less: Income taxes (45%)</i>	<i>(135)</i>	<i>(123)</i>	<i>(92)</i>
Income from operations, after-tax	<u>165</u>	<u>151</u>	<u>112</u>
<i>Financing costs</i>			
Interest	89	61	-0-
<i>Less: Income taxes saved (45%)</i>	<i>(40)</i>	<i>(27)</i>	<i>-0-</i>
Net interest expense	<u>49</u>	<u>34</u>	<u>-0-</u>
Net income	<u>\$ 116</u>	<u>\$ 117</u>	<u>\$ 112</u>

Fig. 13.10: BDCC Income Statement Restated to Allocate Income Taxes Expense (Savings).

Allocating income taxes expense in this manner lowers income from operations as previously stated (for example in 2021 from \$300 to \$165), and decreases interest expense by 45% (for example in 2021: from \$89 to \$49).

The Scott formula can now be used to calculate how much of BDCC's return on shareholders' equity is derived from operations (return on assets) and how much is derived from leverage. It is calculated as:

RETURN ON CAPITAL + RETURN ON LEVERAGING = RETURN ON SHAREHOLDERS' EQUITY

Return on capital and return on leveraging will be examined more closely below.

### 13.9.3 Return on Operating Capital



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Under the Scott Formula, **return on operating capital** is calculated as:

$$\frac{\text{Income from operations (after-tax)}}{\text{Operating capital}}$$

Based on the altered balance sheet and income statement of BDCC as shown in [Figure 13.9](#) and [Figure 13.10](#) above, the calculations of return on operating capital (ROC) for the three years are:

2021	2020	2019
------	------	------

Income from operations (after-tax)	(a)	\$165	\$151	\$112
Operating capital	(b)	\$2,000	\$1,704	\$1,061
Return on operating capital	(a/ b)	8.3%	8.9%	10.6%

Return on operating capital is significantly lower than the somewhat equivalent return on assets originally calculated earlier in this chapter (for example in 2021: 8.3% vs. 13%). This is primarily because income tax effects on income from operations are now considered, but also because the denominator is somewhat lower. Accounts payable and income taxes payable are now deducted from current assets to arrive at operating capital; cash and short-term investments are omitted.

Return on operating capital is analyzed further within the Scott formula. Two related ratios are calculated: the **after-tax operating profit ratio**, and the **sales to operating capital ratio**. These are somewhat similar to two ratios studied earlier in the chapter – the operating profit ratio and sales to total assets ratio, respectively. However, they are altered to incorporate changes to the balance sheet and income statement noted above. One other change is also made to simplify calculations: *ending balance sheet amounts rather than average are used*.

The after-tax operating profit ratio for BDCC can be calculated as:

$$(1) \frac{\text{Income from operations (after-tax)}}{\text{Net sales}}$$

The sales to operating capital ratio is calculated as:

$$(2) \frac{\text{Net sales}}{\text{Operating capital}}$$

Notice that the product of these two ratios equals the return on operating capital ratio:

$$\begin{array}{rclcl}
 (1) & & (2) & & (3) \\
 \text{After-tax operating} & \times & \text{Sales to operating} & = & \text{Return on operating} \\
 \text{profit ratio} & & \text{capital ratio} & & \text{capital} \\
 & & & & \\
 \frac{\text{Income from}}{\text{operations (after-tax)}} & \times & \frac{\text{Net sales}}{\text{Operating capital}} & = & \frac{\text{Income from}}{\text{operations (after-tax)}} \\
 \text{Net sales} & & & & \text{Operating capital}
 \end{array}$$

This relationship is used to provide further insights into the return on operating capital ratio. Using BDCC's financial statement from [Figure 13.9](#) and [Figure 13.10](#), the ratios are calculated as:

	(1)		(2)		(3)
2021	$\frac{\$ 165}{3,200}$	x	$\frac{\$ 3,200}{2,000}$	=	$\frac{\$ 165}{2,000}$
	OR 5.1%	x	1.6	=	8.3%
2020	$\frac{\$ 151}{2,800}$	x	$\frac{\$ 2,800}{1,704}$	=	$\frac{\$ 151}{1,704}$
	OR 5.4%	x	1.6	=	8.9%
2019	$\frac{\$ 112}{2,340}$	x	$\frac{\$ 2,340}{1,061}$	=	$\frac{\$ 112}{1,061}$
	OR 4.8%	x	2.2	=	10.6%

The return on operating capital (column 3) has declined from 10.6% in 2019 to 8.3% in 2021. The after-tax operating profit ratio (column 1) has fluctuated somewhat over the same period. No trend is apparent. Therefore, the largest effect on ROC has been the decline in the sales to operating capital ratio (column 2) from 2.2 times in 2019 to 1.6 times in 2020 and 2021. This indicates that the increase in operating capital (chiefly assets like accounts receivable, inventory, and PPE) has not been matched with a proportionate increase in sales. This is similar to the conclusion reached earlier in the chapter. However, using the Scott formula, its direct effect on can now be calculated.

### 13.9.4 Return on Leveraging



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As noted above, the other useful feature of the Scott formula is its analysis of **return on leveraging (ROL)**, and the resultant effects on return on shareholders' equity. Recall that leverage is the return generated by assets in excess of the cost of borrowing money to finance these assets (after-tax interest expense). An example of leveraging was illustrated in [Figure 13.8](#). A further refinement of leverage is the effect of financial structure. This is indicated by the debt to shareholders' equity ratio. In [Figure 13.8](#), the debt to shareholders' equity ratio is 1:1 for company B (\$200,000/200,000). (We can ignore analysis of leverage for company A, as it has no liabilities.) Now assume the same information for company B, and additional information for company C, as follows:

<i>Company</i>	<i>Company</i>
<i>B</i>	<i>C</i>



Total assets (same as operating capital)	\$400,000	\$400,000
Bonds (12%) (same as net financial debt)	200,000	300,000
Shareholders' equity	200,000	100,000

The only difference in financial structure is that company C has \$300,000 of bonds and only \$100,000 of shareholders' equity. Its debt to shareholders' equity ratio is 3:1 (\$300,000/100,000) compared to company B's debt to shareholders' equity ratio of 1:1 (\$200,000/200,000). Assume the same income from operations and income tax rate as our prior example in [Figure 13.8](#). The partial income statements of each company would show:

	<i>Company B</i>	<i>Company C</i>
Income from operations	\$100,000	\$100,000
Less: Income taxes (50%)	(50,000)	(50,000)
Income from operations, after-tax	<u>50,000</u>	<u>50,000</u>
<i>Financing costs</i>	(24,000)	-0-
Interest expense (B) (\$200,000 x 12%)		
Interest expense (C) (\$300,000 x 12%)		(36,000)
Less: Income tax savings (50%)	<u>12,000</u>	<u>18,000</u>
Net interest expense	<u>12,000</u>	<u>18,000</u>
Net income	<u><u>\$ 38,000</u></u>	<u><u>\$ 32,000</u></u>

Return on capital and return on shareholders' equity would be calculated for each company as follows using the Scott formula:

		<i>Company B</i>	<i>Company C</i>
Income from operations, after-tax	(a)	\$50,000	\$50,000
Net income for the year	(b)	38,000	32,000
Total operating capital	(c)	400,000	400,000
Shareholders' equity	(d)	200,000	100,000
Return on operating capital	(a/c)	12.5%	12.5%
Return on shareholders' equity	(b/d)	19%	32%

**Fig. 13.11: Effects of Leverage and Financial Structure: Return on Shareholders' Equity**

In each case, the companies have realized leverage on borrowed money. Bonds were issued at an after-tax interest rate of 6% and earned returns on operating capital of

12.5% for both companies, a difference of 6.5%. Why is company C's return on shareholders' equity 32%, and company B's only 19%? The answer lies in the relative financial structure of the companies. In company B's case, the debt to shareholders' equity ratio is 1:1. Therefore each 6.5 cents earned on one dollar of financed assets (12.5 - 6%) is transferred to shareholders in proportion to the debt to shareholders' equity ratio (1:1). In other words, company B's return on shareholders' equity is composed of a 12.5% return on assets plus a 6.5% return on leveraging, for a total return on shareholder's equity of 19%.

However, in company C's case each 6.5 cents earned on one dollar of financed assets is increased because there are three dollars of debt for each dollar of shareholders' equity. Therefore, the return on borrowed money *to shareholders* is magnified by this amount, or 6.5% x 3 = 19.5%. Company C's return on shareholders' equity is composed of a 12.5% return on assets plus a 19.5% return on leveraging, for a total return on shareholder's equity of 32%.

Return on leveraging (ROL) is therefore determined as follows using the Scott formula:

$$[\text{ROC} - \text{Interest rate (after-tax)}^*] \times \frac{\text{Net financial debt}}{\text{Shareholders' equity}}$$

$$*\text{calculated as: } \frac{\text{Interest expense (after-tax)}}{\text{Net financial debt}}$$

For company C, return on leveraging for 2021 is calculated as:

$$\left[ \frac{\$500,000}{400,000} - \frac{18,000}{300,000} \right] \times \frac{\$300,000}{100,000}$$

$$= (12.5\% - 6\%) \times 3$$

$$= 19.5\%$$

### 13.9.5 Combining Return on Operating Capital and Return on Leveraging



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Recall that under the Scott formula, return on shareholders' equity is the sum of return on operating capital and return on leverage; in other words, ROC + ROL = ROSE. Combining the constituent ratios for ROC and ROL, the Scott formula suggests that return on shareholders' equity will equal:

$$\begin{array}{r}
 \text{Return on operating capital} \\
 \left[ \frac{(1) \text{ Income from operations (after tax)}}{\text{Net sales}} \times \frac{(2) \text{ Net sales}}{\text{Operating capital}} \right] + \left[ \frac{(3) \text{ (ROC - Interest rate)}}{\text{Shareholders' equity}} \times \frac{(4) \text{ Net financial debt}}{\text{Shareholders' equity}} \right] = \frac{\text{Return on shareholders' equity}}{(5) \text{ Net income}} \\
 \text{Shareholders' equity}
 \end{array}$$

This can be illustrated in the case of BDCC. The Scott formula ratios for the 2019, 2020 and 2021 years are calculated as follows:

	Return on operating capital		+	Return on leveraging		=	Return on shareholders' equity
	(1)	(2)		(3)	(4)	=	(5)
2021	$\frac{\$165}{3,200}$	$\times \frac{\$3,200}{2,000}$	+	$\left[ \frac{\$165}{2,000} - \frac{\$49}{769} \right]$	$\times \frac{\$769}{1,231}$	=	$\frac{\$116}{1,231}$
	= $5.1\%$	$\times 1.6$	+	$1.9\%$	$\times .62$	=	$9.4\%$
	= <b>8.3%</b>		+		<b>1.1%</b>	=	<b>9.4%</b>
2020	$\frac{\$151}{2,800}$	$\times \frac{\$2,800}{1,704}$	+	$\left[ \frac{\$151}{1,704} - \frac{\$34}{509} \right]$	$\times \frac{\$509}{1,195}$	=	$\frac{\$117}{1,195}$
	= $5.4\%$	$\times 1.6$	+	$2.2\%$	$\times .43$	=	$9.8\%$
	= <b>8.9%</b>		+		<b>.9%</b>	=	<b>9.8%</b>
2019	$\frac{\$112}{2,340}$	$\times \frac{\$2,340}{1,061}$	+	$\left[ \frac{\$112}{1,061} - \frac{\$0}{13} \right]$	$\times \frac{\$13}{1,048}$	=	$\frac{\$112}{1,048}$
	= $4.8\%$	$\times 2.2$	+	$10.6\%$	$\times .01$	=	$10.7\%$
	= <b>10.6%</b>		+		<b>.1%</b>	=	<b>10.7%</b>

### 13.9.6 Analysing BDCC's Performance using the Scott formula



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Maintaining an acceptable return on shareholders' equity is an important objective for investors, and senior managers are hired to maximize these returns. The Scott formula highlights a number of interconnected ratios and demonstrates how these influence return on shareholders' equity. Because of this, it can provide a valuable analytic tool for investors and managers.

In BDCC's case, the formula results indicate that return on shareholders' equity has declined from 10.7% to 9.4% over the three years (column 5), in spite of increasing returns from leveraging of .1% in 2019 to 1.9% in 2021 (columns 3 and 4). Return on operating capital has declined more precipitously than ROSE, from 10.6% in 2019 to 8.3% in 2021 (columns 1 and 2). With respect to return on operating capital, and as noted earlier, the after-tax operating profit ratio displays no trend (column 1). However, the sales to operating capital ratio has declined from 2.2 times in 2019 to 1.6 times in 2020 and 2021, indicating that the additions to operating assets as yet have

not been matched with a proportionate increase in sales. With respect to return on leverage, the relatively small difference between return on capital and the after-tax cost of borrowing funds in 2020 and 2021 (column 3) suggests that return from leveraging will most likely be improved by increasing the difference between return on capital and the after-tax cost of borrowing funds. This further emphasizes the importance of increasing the sales to operating capital ratio, as it most significantly affects the return on operating capital ratio. The relatively low debt to shareholders' equity ratio (column 4), suggests that BDCC should consider borrowing more funds when required, rather than issuing additional shares and increasing the amount of shareholders' equity. This can magnify return on leveraging. However, the difference between return on operating capital and the cost of borrowed funds should be improved before more borrowing takes place, to minimize risk to shareholders and maximize effects on return on shareholders' equity.

## 13.10 Summary of Chapter 13 Learning Objectives



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### **LO1 – Describe ratio analysis, and explain how the liquidity, profitability, leverage, and market ratios are used to analyze and compare financial statements.**

Ratio analysis measures the relative magnitude of two selected numerical values taken from a company's financial statements and compares the result to prior years and other similar companies. Financial ratios are an effective tool for measuring: (a) liquidity (current ratio, acid-test ratio, accounts receivable collection period, and number of days of sales in inventory); (b) profitability (gross profit ratio, operating profit ratio, net profit ratio, sales to total assets ratio, return on total assets, and return on shareholders' equity); (c) leverage (debt ratio, shareholders' equity ratio, debt to shareholders' equity ratio, and times interest earned ratio); and (d) market ratios (earnings per share, price-earnings ratio, and dividend yield ratio). Ratios help identify the areas that require further investigation.

### **LO2 – Describe horizontal and vertical trend analysis, and explain how they are used to analyze financial statements.**

Horizontal analysis involves the calculation of percentage changes from one or more years over the base year dollar amount. The base year is typically the oldest year and is always 100%. Vertical analysis requires that numbers in a financial statement be restated as percentages of a base dollar amount. For income statement analysis, the base amount used is sales. For balance sheet analysis, total assets, or total liabilities and shareholders' equity, are used as the base amounts. When financial statements are converted to percentages, they are called common-size financial statements.

### **LO3 – (Appendix) Describe the Scott formula and explain how it is used to analyze financial statements.**

The Scott formula separates return on shareholders' equity into two components: return on operating capital (ROC) and return on leveraging (ROL). ROC can be further

analysed as the product of the after-tax return on operating income x sales to operating capital ratio. ROL can be further analysed as  $(\text{ROC} - \text{after-tax interest rate}) \times \text{debt to shareholders' equity ratio}$ . The after-tax interest rate is calculated as  $[\text{interest expense} \times (1 - \text{income tax rate})] / \text{net financial debt}$ .

## 13.11 Assignment Materials

### 13.11.1 Concept Self-check



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1. Ratios need to be evaluated against some base. What types of information can be used?
2. Explain what *liquidity* means. When a corporation is becoming less liquid, what are the implications for shareholders? For creditors?
3. How is it possible that a corporation earning net income each year is becoming less liquid?
4. What ratios can be calculated to evaluate liquidity? Explain what each one indicates.
5.
  - a. Define working capital. Distinguish between the current ratio and the acid-test ratio.
  - b. “The current ratio is, by itself, inadequate to measure liquidity.” Discuss this statement.
6. Two firms have the same amount of working capital. Explain how it is possible that one is able to pay off short-term creditors, while the other firm cannot.
7. Management decisions relating to accounts receivable and inventory can affect liquidity. Explain.
8. What is one means to evaluate the management of accounts receivable? inventory?
9. Discuss the advantages and disadvantages of decreasing number of days of sales in inventory.

10. What is the revenue operating cycle? How is its calculation useful in evaluating liquidity?
11. Identify and explain six ratios (and any associated calculations) that evaluate a corporation's profitability. What does each ratio indicate?
12. Why are analysts and investors concerned with the financial structure of a corporation?
13. Is the reliance on creditor financing good or bad? Explain its impact on net income.
14. Discuss the advantages and disadvantages of short-term debt financing compared to long-term debt financing.
15. Identify and explain ratios that evaluate financial returns for investors.
16. Distinguish between horizontal and vertical analysis of financial statements.
17. (Appendix) Describe the components of the Scott formula.

## 13.11.2 Discussion Cases

### 13.11.2.1 DC 13-1



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The following are condensed comparative financial statements of Stockwell Inc. for the three years ended December 31, 2017.



Balance Sheet  
At December 31

<i>Assets</i>		<i>2017</i>	<i>2016</i>	<i>2015</i>
<i>Current</i>				
Cash		\$21	\$8	\$17
Accounts receivable		38	30	20
Merchandise inventory		60	40	30
Prepaid expenses		<u>1</u>	<u>2</u>	<u>3</u>
Total current assets		<u>120</u>	<u>80</u>	<u>70</u>
<i>Capital assets, at carrying amount</i>		<u>260</u>	<u>150</u>	<u>76</u>
<b>Total assets</b>		<b><u>\$380</u></b>	<b><u>\$230</u></b>	<b><u>\$146</u></b>
<i>Liabilities</i>				
<i>Current</i>				
Accounts payable		\$100	\$80	\$50
<i>Non-current</i>				
Borrowings, 4%		<u>50</u>	<u>50</u>	<u>-0-</u>
		<u>150</u>	<u>130</u>	<u>50</u>
<i>Shareholders' Equity</i>				
Common shares		200	80	80
Retained earnings		<u>30</u>	<u>20</u>	<u>16</u>
		<u>230</u>	<u>100</u>	<u>96</u>
<b>Total liabilities and shareholders' equity</b>		<b><u>\$380</u></b>	<b><u>\$230</u></b>	<b><u>\$146</u></b>

Income Statement  
For the Years Ended December 31

	<i>2017</i>	<i>2016</i>	<i>2015</i>
Sales	\$210	\$120	\$100
Cost of goods sold	<u>158</u>	<u>80</u>	<u>55</u>
Gross profit	52	40	45
Operating expenses	<u>35</u>	<u>32</u>	<u>33</u>
Income from operations	17	8	12
Interest expense	<u>2</u>	<u>2</u>	<u>-0-</u>
Income before income taxes	15	6	12
Income taxes	<u>5</u>	<u>2</u>	<u>4</u>
<b>Net Income</b>	<b><u>\$ 10</u></b>	<b><u>\$ 4</u></b>	<b><u>\$ 8</u></b>

Additional information:

- a. The company's accounts receivable at December 31, 2014 totalled \$20.



- b. The company's merchandize inventory at December 31, 2014 totalled \$20.
- c. The company's capital assets at December 31, 2014 totalled \$70.
- d. Credit terms are net 60 days from date of invoice.
- e. Number of common shares outstanding: 2015—80, 2016—80, 2017—400.

*For discussion:*

1. Calculate liquidity ratios and discuss.
2. What is your evaluation of
  1. The financial structure of the corporation?
  2. The proportion of shareholder and creditor claims to its assets?
  3. The structure of its short-term and long-term credit financing?
3. What are some other observations you can make about the financial performance of Stockwell?
4. (Appendix) Restate the financial statements to facilitate Scott formula analysis. Then calculate this formula for 2016 and 2017, and analyze your results. Does this analysis change any or your observations in part 3?

### 13.11.2.2 DC 13-2



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The following are comparative financial statements of Hi Inc. and Low Corp. for the last four years:

Balance Sheets  
At December 31  
(000s)

	<i>Hi Inc.</i>				<i>Low Corp.</i>			
	2018	2017	2016	2015	2018	2017	2016	2015
<i>Assets</i>								
Current assets	\$185	\$165	\$155	\$140	\$ 480	\$ 450	\$410	\$381
Capital assets, at carrying amount	535	397	392	378	599	603	572	601
	<u>\$720</u>	<u>\$562</u>	<u>\$547</u>	<u>\$518</u>	<u>\$1,079</u>	<u>\$1,053</u>	<u>\$982</u>	<u>\$982</u>
<i>Liabilities</i>								
Current liabilities	\$160	\$135	\$130	\$110	\$ 272	\$ 251	\$170	\$180
Bonds payable								
12% due in 10 Years	120	-0-	-0-	-0-				
15% due in 7 Years					400	400	400	400
Total liabilities	<u>280</u>	<u>135</u>	<u>130</u>	<u>110</u>	<u>672</u>	<u>651</u>	<u>570</u>	<u>580</u>
<i>Shareholders' Equity</i>								
Share capital								
Preferred								
(Issued: 200,000 shares)	200	200	200	200	200	200	200	200
Common								
(Issued: Hi 100,000 shares; Low 50,000 shares)	100	100	100	100	50	50	50	50
Retained earnings	140	127	117	108	157	152	162	152
Total shareholders' equity	<u>440</u>	<u>427</u>	<u>417</u>	<u>408</u>	<u>407</u>	<u>402</u>	<u>412</u>	<u>402</u>
	<u>\$720</u>	<u>\$562</u>	<u>\$547</u>	<u>\$518</u>	<u>\$1,079</u>	<u>\$1,053</u>	<u>\$982</u>	<u>\$982</u>

Income Statements  
For the Year Ended December 31  
(000s)

	<i>Hi Inc.</i>				<i>Low Corp.</i>			
	2018	2017	2016	2015	2018	2017	2016	2015
Sales	\$600	\$540	\$528	\$516	\$330	\$330	\$320	\$270
Cost of goods sold	460	430	420	410	105	75	100	90
Gross profit	140	110	108	106	225	145	220	180
Operating expenses	56	50	50	50	85	105	100	96
Income from operations	84	60	58	56	140	40	120	84
Interest expense	14	-0-	-0-	-0-	60	60	60	60
Income (loss) before income taxes	70	60	58	56	80	(20)	60	24
Income taxes (recovered)	35	30	29	28	40	(10)	30	12
Net income (loss)	<u>\$ 35</u>	<u>\$ 30</u>	<u>\$ 29</u>	<u>\$ 28</u>	<u>\$ 40</u>	<u>\$(10)</u>	<u>\$ 30</u>	<u>\$ 12</u>
Dividends declared								
Preferred	\$10	\$10	\$10	\$10	\$20	\$-0-	\$10	\$10
Common	\$12	\$10	\$10	\$10	\$15	\$-0-	\$10	\$10
Market price per common share	\$1.25	\$1.00	\$0.95	\$0.90	\$0.80	\$0.20	\$1.20	\$0.10

*For discussion:*

1. a. Calculate the following ratios for each corporation for 2016, 2017, and 2018.

Current

Sales to total assets

Return on total assets

Return on shareholders' equity

Gross profit

Net profit

Debt to shareholders' equity

Earnings per share

Price-earnings

- b. Evaluate each company's trends for sales, gross profit, and net income as disclosed on the income statements.

2. What is your evaluation of

- a. The liquidity of each corporation?
- b. Profitability?
- c. The financial structure of each corporation?
- d. The stock market's perceptions of these companies?

3. Which corporation do you think would be a better investment if you were planning to purchase common shares?

### 13.11.3 Comprehension Problems

#### 13.11.3.1 CP 13-1



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*Required:* Match the following ratios with the appropriate formula.

<i>Ratio or Rate</i>	<i>Formula</i>
_____ Acid-test	a. $\frac{\text{Income from operations}}{\text{Interest expense}}$
_____ Current	b. $\frac{\text{Total liabilities}}{\text{Shareholders' equity}}$
_____ Return on shareholders' equity	c. $\frac{\text{Net income} - \text{preferred share dividends}}{\text{Number of common shares outstanding}}$
_____ Times interest earned	d. $\frac{\text{Net sales}}{\text{Average total assets}}$
_____ Earnings per share	e. $\frac{\text{Market price per share}}{\text{Earnings per share}}$
_____ Accounts receivable collection period	f. $\frac{\text{Current assets}}{\text{Current liabilities}}$
_____ Sales to total assets	g. $\frac{\text{Average inventory} \times 365 \text{ days}}{\text{Cost of goods sold}}$
_____ Dividend yield	h. $\frac{\text{Net income}}{\text{Net sales}}$
_____ Price-earnings ratio	i. $\frac{\text{Income from operations}}{\text{Average total assets}}$
_____ Number of days of sales in Inventory	j. $\frac{\text{Dividends per share}}{\text{Market price per share}}$
_____ Debt to shareholders' equity ratio	k. $\frac{\text{Net income}}{\text{Average shareholders' equity}}$
_____ Net profit ratio	l. $\frac{\text{Quick current assets}}{\text{Current liabilities}}$
_____ Accounts receivable collection period	m. $\frac{\text{Average accounts receivable} \times 365 \text{ days}}{\text{Net credit sales}}$
_____ Return on total assets	n. $\frac{\text{Average accounts receivable} \times 365 \text{ days}}{\text{Net credit sales}}$

### 13.11.3.2 CP 13-2



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The following information is taken from the partial balance sheet of Quail Productions Corp.

	2016	2015
<i>Current assets</i>		
Cash	\$ 10	\$ 15
Short-term investment	35	35
Accounts receivable	200	150
Inventory	600	400
<i>Current liabilities</i>		
Accounts payable	500	400
Borrowings	245	180

*Required:*

1. Describe the purpose of and calculate the current ratio for each year.
2. Describe the purpose of and calculate the acid-test ratio for both years.
3. What observations can you make from a comparison of the two types of ratios?
4. (Appendix) Restate the balance sheet to facilitate Scott formula analysis.

### 13.11.3.3 CP 13-3



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The following information is taken from the records of Black Spruce Co. Ltd.:

	2017	2016	2015
Sales	\$252	\$141	\$120

Gross profit	63	48	54
Net income	12	5	15

*Required:* Analyze the gross profit and net profit ratios using the above data. Comment on trends you observe.

### 13.11.3.4 CP 13-4



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The following information relates to three companies in the same industry:

<i>Company</i>	<i>Latest market price</i>	<i>Earnings per share</i>	<i>Dividends per share</i>
A	\$35	\$11	\$-0-
B	40	5	4
C	90	10	6

*Required:* Explain and calculate the price-earnings and dividend yield ratios. On the basis of only the foregoing information, which company represents the most attractive investment opportunity to you? Explain.

### 13.11.3.5 CP 13-5



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The following data are taken from the records of Cronkite Corp.:

	<i>2016</i>	<i>2015</i>
Sales	\$2,520	\$1,440
Cost of goods sold	<u>1,890</u>	<u>960</u>
Gross profit	630	480
Other expenses	<u>510</u>	<u>430</u>
Net income	<u><u>\$ 120</u></u>	<u><u>\$ 50</u></u>

*Required:* Perform horizontal analysis on the above date and interpret your results.

### 13.11.3.6 CP 13–6



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In the left-hand column, a series of independent transactions is listed; in the right-hand column, a series of ratios is listed.

<i>Transaction</i>	<i>Ratio</i>	<i>Effect on ratio</i>		
		<i>Increase</i>	<i>Decrease</i>	<i>No change</i>
Declared a cash dividend	Current ratio			
Wrote-off an uncollectible account receivable	Accounts receivable collection period			
Purchased inventory on account	Acid-test ratio			
Issued 10-year bonds to acquire capital assets	Return on total assets			
Issued additional shares for cash	Debt to shareholders' equity ratio			
Declared a share dividend on common shares	Earnings per share			
Restricted part of retained earnings*	Return on shareholders' equity			
Purchased supplies on account	Current ratio			
Paid a short-term creditor in full	Acid-test ratio			
Paid an account payable, taking the cash discount	Number of days of sales in inventory			

\*include only if this topic was covered in a prior chapter.

*Required:* For each transaction indicate whether the ratio will increase, decrease, or remain unchanged. Assume all ratios are greater than 1:1 before each transaction where applicable.

### 13.11.3.7 CP 13–7



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Consider the following financial statement data:



*Balance Sheet*

Cash	\$20	Accounts payable	\$20
Accounts receivable	20	Non-current borrowings	60
Merchandise inventory	40	Common shares (8 shares issued)	80
Plant, at carrying amount	140	Retained earnings	60
	<u>\$220</u>		<u>\$220</u>

*Income Statement*

Sales	\$100
Cost of goods sold	50
Gross profit	50
Operating expenses	14
Income from operations	36
Less: Interest	6
Income before income taxes	30
Less: Income taxes	10
Net income	<u>\$20</u>

Assume that the average of all balance sheet items is equal to the yearend figure and that all sales are on credit.

*Required:*

- Calculate the following ratios:
  - Return on total assets (assume interest has been paid)
  - Return on shareholders' equity
  - Times interest earned ratio
  - Earnings per share
  - Number of days of sales in inventory
  - Accounts receivable collection period
  - Sales to total assets ratio
  - Current ratio
  - Acid-test ratio
  - Debt to shareholders' equity ratio.
- Which of these ratios are measures of liquidity?
- (Appendix) Restate the financial statements to facilitate Scott formula analysis.
- (Appendix) Calculate the Scott formula.

**13.11.3.8 CP 13-8**

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Consider the following information:

Salinas Limited  
Balance Sheet  
At December 31, 2017

<i>Assets</i>		<i>Liabilities and Shareholders' Equity</i>	
Cash	\$ 72	Accounts payable	\$ 60
Accounts receivable	88	Bank loan, non-current	150
Merchandise inventory	100		
Prepaid expenses	40	Preferred shares (10%)	60
Property, plant, and equipment, at carrying amount	320	Common shares	250
Total assets	\$620	Retained earnings	100
		Total liabilities and shareholders' equity	\$620

**Salinas Limited**  
**Income Statement**  
For the Year Ended December 31, 2017

Sales			\$240
Cost of goods sold			144
Gross profit			96
<i>Operating expenses</i>			
Salaries	\$44		
Depreciation	6		50
Income from operations			46
<i>Less: Interest</i>			8
Income before income taxes			38
<i>Less: Income taxes</i>			18
Net income			\$ 20

Assume that 80% of sales are on credit, that the average of all balance sheet items is equal to the year-end figure, that all preferred share dividends have been paid, and that the number of common shares outstanding is 10.

*Required:* Calculate the following ratios and percentages

1. Current ratio
2. Return on total assets
3. Sales to total assets
4. Acid-test ratio
5. Times interest earned
6. Earnings per common share
7. Accounts receivable collection period
8. Return on shareholders' equity
9. (Appendix) Scott formula.

### 13.11.3.9 CP 13-9



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Assume a company has the following financial information:

Cash and short-term investment	\$ 6
Prepaid expenses	-0-
Capital assets	90
Total liabilities	40
Shareholders' equity	140
Sales	420
Credit sales	300
Current ratio	2.5:1
Acid-test ratio	1:1
Gross profit ratio	30%

Assume current assets consist of cash, short-term investments, accounts receivable, inventory, and prepaid expenses, and that ending balances are the same as average balances for the year.

*Required:* Calculate

1. Current liabilities
2. Inventory
3. Accounts receivable collection period
4. Number of days of sales in inventory.
5. (Appendix) Net financial debt. Assume current liabilities consist of a bank loan.

### 13.11.3.10 CP 13-10



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A company began the month of May with \$200,000 of current assets, a 2.5 to 1 current ratio, and a 1.25 to 1 acid-test ratio. During the month, it completed the following transactions:

<i>Transaction</i>	<i>Effect on current ratio</i>		
	<i>Increase</i>	<i>Decrease</i>	<i>No change</i>
a. Bought \$20,000 of merchandize on account (the company uses a perpetual inventory system)			
b. Sold for \$10,000 cash, merchandize that cost \$5,000			
c. Collected a \$2,500 account receivable			
d. Paid a \$10,000 account payable			
e. Wrote off a \$1,500 bad debt against the allowance for doubtful accounts			
f. Declared a \$1 per-share cash dividend on the 10,000 outstanding common shares			
g. Paid the dividend declared above			
h. Borrowed \$10,000 from a bank by assuming a 60-day, 10-per cent loan			
i. Borrowed \$25,000 from a bank by placing a 10-year mortgage on the plant			
j. Used the \$25,000 proceeds of the mortgage to buy additional machinery.			

*Required:*

1. Indicate the effect on current ratio assuming each transaction is independent of the others.
2. At the end of May, and taking all the above transactions into account, what was
  1. The current ratio?
  2. The acid-test ratio?

Use the following format:

		May 1										May	
		Bal.	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)	31 Bal.
Current assets	x	_____											
Current liabilities	y	_____											
Current ratio	x/y	_____											

### 13.11.4 Problems

#### 13.11.4.1 P 13-1



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Consider the following information:

Assets		Liabilities	
<i>Current</i>		<i>Current</i>	
Cash	\$ 100	Accounts payable	\$ 300
Accounts receivable	200	Wages payable	50
Merchandise inventory	500	Dividends payable	50
Prepaid expenses	50		<u>400</u>
	<u>850</u>		
<i>Capital assets, at carrying amount</i>	1,000	Non-current borrowings	800
			<u>1,200</u>
		<i>Shareholders' Equity</i>	
		Common shares	500
		Retained earnings	150
			<u>650</u>
Total assets	<u>\$1,850</u>	Total liabilities and shareholders' equity	<u>\$1,850</u>

Required:

- Based on this information, calculate the
  - Current ratio
  - Acid-test ratio
  - Debt to shareholders' equity ratio.
- What do these ratios tell you about Mammoth Corporation?
- What other information would help with the financial analysis of Mammoth Corporation?

#### 13.11.4.2 P 13-2



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The following information for 2016 was gathered from the financial statements of Epicentre Corporation.

<i>Balance Sheet</i>		<i>Income Statement</i>	
<i>At December 31, 2016</i>		<i>For the Year Ended December 31, 2016</i>	
<i>Assets</i>			
<i>Current</i>		Net sales (all on credit)	\$800
Cash	\$ 60	Cost of goods sold	<u>600</u>
Accounts receivable	140	Gross profit	200
Merchandise inventory	250	Selling and administrative expenses	<u>100</u>
Prepaid expenses	<u>10</u>	Income from operations	100
	460	Interest expense	<u>20</u>
<i>Capital assets, at carrying amount</i>	<u>330</u>	Income before income taxes	80
	<u>\$790</u>	Income taxes	<u>30</u>
		Net income	<u>\$ 50</u>
<i>Liabilities</i>			
<i>Current</i>			
Accounts payable	\$100		
Current portion of borrowings	20		
Notes payable, due in 6 months	<u>60</u>		
	180		
<i>Non-current</i>			
borrowings, net of current portion	<u>140</u>		
	<u>320</u>		
<i>Shareholders' Equity</i>			
Preferred shares, 10% (8 shares outstanding)	120		
Common shares (50 shares outstanding)	250		
Retained earnings	<u>100</u>		
	<u>470</u>		
	<u>\$790</u>		

Additional information from the December 31, 2015 balance sheet:

Accounts receivable	\$180
Merchandise inventory	200
Capital assets, at carrying amount	250
Retained earnings	80
Preferred shares	120
Common shares	250

*Required:*

1. Compute the following ratios for 2016:
  1. Current ratio
  2. Acid-test ratio
  3. Accounts receivable collection period
  4. Number of days of sales in inventory
  5. Debt to shareholders' equity ratio
  6. Return on shareholders' equity
  7. Earnings per share (assume all preferred share dividends are paid)



2. Compute dividends paid on common shares for 2016.
3. What do these ratios tell you about Epicentre Corporation?
4. (Appendix) Restate the financial statements to facilitate Scott formula analysis.
5. (Appendix) Calculate the Scott formula and analyze the results.

### 13.11.4.3 P 13-3



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Belafonte Corporation's books were destroyed in a fire on April 20, 2016. The comptroller of the corporation can only remember a few odd pieces of information:

- a. The current ratio was 3.75 to 1.
- b. Sales for the year were \$73,000.
- c. Inventories were \$20,000 and were equal to property, plant and equipment at carrying amount, and also equal to bonds payable.
- d. The accounts receivable collection period was 40 days.
- e. The bonds payable amount was 10 times cash.
- f. Total current assets were twice as much as common shares.

*Required:* Using this information, prepare Belafonte Corporation's balance sheet at April 30, 2016. Assume balances at April 30, 2016 are the same as average balances for the year then ended, and besides retained earnings, there are no additional accounts.

### 13.11.4.4 P 13-4



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Assume you are an accountant analysing Escalade Corporation. Escalade has expanded its production facilities by 200% since 2015. Its income statements for the last three years are as follows:



**Escalade Corporation**  
**Income Statements**  
**For the Years Ending December 31**

	2018	2017	2016
Sales	\$250	\$150	\$120
Cost of goods sold	190	100	60
Gross profit	60	50	60
Other expenses	35	34	35
Net income	\$ 25	\$ 16	\$ 25

*Required:*

1. Prepare a vertical analysis of Escalade Corporation's income statement for the three years.
2. What conclusions can be drawn from this analysis?

**13.11.4.5 P 13-5**



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The incomplete balance sheet of Hook Limited is given below.

Hook Limited  
Balance Sheet  
At December 31, 2016  
*Assets*

<i>Current</i>		
Cash	\$ 30,000	
Accounts receivable	?	
Merchandise inventory	?	
		\$ ?
<i>Capital assets</i>		
	?	
Less: Accumulated depreciation	100,000	
		?
<b>Total assets</b>		<b>\$ ?</b>

*Liabilities*

<i>Current</i>		
Accounts payable	\$ 50,000	
Estimated liabilities	?	
		\$120,000
<i>Non-current</i>		
8% bonds payable		?
		?
<i>Shareholders' Equity</i>		
Common shares		?
Retained earnings		?
		?
<b>Total liabilities and shareholders' equity</b>		<b>\$ ?</b>

Additional information for 2016 year-end:

- a. The amount of working capital is \$150,000.
- b. The issued value of the shares is \$10 per share.
- c. Market price per share is \$15.
- d. Price-earnings ratio is 3.
- e. Income before payment of interest and income tax is \$80,000.
- f. The ratio of shareholder's equity to total assets is 0.60 to 1.

- g. Income tax expense equals \$30,000.
- h. The acid-test ratio is 1.5 to 1.
- i. The times interest earned ratio is 8 to 1.

*Required:* Complete Hook Limited's balance sheet.

## 13.11.5 Alternate Problems

### 13.11.5.1 AP 13-1



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The Regina Corporation reported the following information for the year ended December 31, 2018:

Net income	\$61,200
Interest expense	5,000
Income taxes	20,000

The company's balance sheet at December 31, 2018 disclosed the following information: preferred shares (\$0.12 per share cumulative dividends, 10,000 shares issued and outstanding at \$20 per share); and common shares (15,000 shares issued and outstanding at \$25 per share). During 2018, \$5 per-share cash dividends were declared and paid to the common shareholders, in addition to the preferred share dividends. Dividend yield on common shares was 27.5%.

*Required:* Determine Regina's:

1. Earnings per share
2. Price-earnings ratio.

### 13.11.5.2 AP 13-2



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The financial statements of Crockett Corporation are as follows:

Crockett Corporation  
Balance Sheet  
At December 31, 2016

	<i>Assets</i>		<i>Liabilities</i>
<i>Current</i>		<i>Current</i>	
Cash	\$ 20	Accounts payable	\$ 30
Accounts receivable	60	Wages payable	10
Merchandise inventory	90		40
	170	<i>Non-current borrowings (8%)</i>	100
<i>Capital assets, at carrying amount</i>	110	Total liabilities	140
		<i>Shareholders' Equity</i>	
		Common shares	100
		Retained earnings	40
			140
		Total liabilities and	
Total assets	\$280	shareholders' equity	\$280

## Crockett Corporation Income Statement

For the Year Ended December 31, 2016

Sales	\$300
Cost of sales	180
Gross profit	120
Other expenses	80
Net income	\$ 40

The following additional information is available:

- a. The income tax rate is 50%; income taxes expense is included in other expenses.
- b. Interest expense is included in other expenses. Borrowings were outstanding for the entire year.
- c. Beginning balances of balance sheet accounts were the same as ending balances as applicable.

- d. All sales are on credit.

*Required:* Descriptions of certain ratios are given below. Give the name of the corresponding ratio and calculate the ratios for the Crockett Corporation.

1. Primary test for liquidity
2. A more severe test of liquidity
3. Test of efficiency of account receivable collection
4. Indication of liquidity of inventory
5. Reflection of financial strength and cushion for creditors
6. Indication of the net productivity of each sales dollar
7. Indication of management's ability to efficiently use resources provided.
8. (Appendix) Restate the financial statements to facilitate Scott formula analysis. Calculate the Scott formula.

### 13.11.5.3 AP 13-3



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The following financial information is available for Maxim Enterprises Limited for the year ended December 31, 2018:

- a. The acid-test ratio is 1.5 to 1.  
  
Accounts receivable is \$3,000, which is one-half of the quick assets, one-third of the current assets, and twice the amount of property, plant, and equipment at carrying amount.
- b.
- c. Notes payable is a long-term liability; it is four times the dollar amount of the short-term investments.
- d. Total shareholders' equity is equal to the working capital, and common shares are 150% of the dollar amount of the retained earnings.

*Required:* Using this information, prepare the company's balance sheet at December 31, 2018. Assume that other than retained earnings, there are no additional accounts.

**13.11.5.4 AP 13-4**

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The following information is taken from the records of Erie Corp. for the year ended December 31:

	2017	2016
Sales	\$1,397	\$1,112
Cost of goods sold	935	814
Selling expenses	154	121
General expenses	88	77
Other revenue	4	7
Interest expense	2	9
Income taxes	134	66

*Required:*

1. Prepare a vertical analysis of the income statement, showing the above items as well as gross profit, income from operations (excludes other revenue), income before interest and income taxes, income before income taxes, and net income.
2. Describe the favourable and unfavourable changes.

**13.11.5.5 AP 13-5**

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The following ratios and other data are taken from the financial statements of Dene Company for the year ended December 31, 2016.

Current ratio	1.8 to 1
Acid-test ratio	1.3 to 1

Net working capital	\$40,000
Number of days of sales in inventory	73 days
Gross profit as a percentage of sales	50%
Earnings per share	\$0.25
Accounts receivable collection period	73 days
Common shares outstanding	50,000 shares
Current liabilities to shareholders' equity	31.25%
Issued value of each common share	\$2.25
Income tax rate	20%

Assume beginning balance sheet amounts equal ending balance sheet amounts when calculating averages.

*Required:*

1. Using the information given, prepare the balance sheet. Assume only accounts indicated by the ratios above appear on the balance sheet, other than retained earnings. Show all calculations.
2. Prepare an income statement listing sales, cost of goods sold, gross profit, operating expenses, income before income taxes, income taxes, and net income. Show all calculations.
3. (Appendix) Restate the financial statements to facilitate Scott formula analysis. Assume 50% of current liabilities are borrowings and the rest relate to operations. Assume interest expense (before taxes) is \$1,000 and is included in operating expenses. Calculate the Scott formula.

## 13.11.6 Supplementary Problems

### 13.11.6.1 SP 13-1



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The balance sheet of the Blanchet Corporation is as follows:



**Blanchet Corporation**  
**Balance Sheet**  
**At December 31**

<i>Assets</i>		
	2017	2016
<i>Current</i>		
Cash	\$60	\$10
Short-term investments	10	20
Accounts receivable	60	40
Merchandise inventories	108	120
Prepaid expenses	12	10
	250	200
<i>Property, plant, and equipment at carrying amount</i>	170	180
<b>Total assets</b>	<b>\$420</b>	<b>\$380</b>
 <i>Liabilities</i>		
<i>Current</i>		
Accounts payable	\$100	\$80
Accrued liabilities	20	10
	120	90
<i>Non-current borrowings</i>	50	30
	170	120
 <i>Shareholders' Equity</i>		
Common shares (10 shares outstanding)	150	150
Retained earnings	100	110
	250	260
<b>Total liabilities and shareholders' equity</b>	<b>\$420</b>	<b>\$380</b>

*Required:*

1. Prepare a horizontal analysis of Blanchet Corporation's balance sheet for 2017.
2. What are some observations you can make?

### 13.11.6.2 SP 13-2



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#### **Part A**

The balance sheet and income statement of Post Inc. are shown below.

**Balance Sheet**  
At December 31, 2018

<i>Assets</i>		<i>Liabilities</i>	
<i>Current</i>		<i>Current liabilities</i>	
Cash	\$ 5	Accounts payable	\$ 26
Accounts receivable	175	Notes payable	66
Merchandise inventory	240	Estimated liabilities	<u>10</u>
Prepaid insurance	6		<u>102</u>
<i>Property, plant, and equipment, at carrying amount</i>		<i>Shareholders' Equity</i>	
	360	Common shares	300
		Retained earnings	<u>384</u>
			<u>684</u>
Total assets	<u>\$786</u>	Total liabilities and shareholders' equity	<u>\$786</u>

**Income Statement**  
For the Year Ended December 31, 2018

Sales	\$1,000
Cost of goods sold	<u>730</u>
Gross profit	270
Operating expenses	<u>120</u>
Income before income taxes	150
Income taxes	<u>60</u>
Net income	<u><u>\$ 90</u></u>

Additional Information: No shares were issued and no dividends were paid during the year. There were 30 common shares outstanding throughout the year. Assume ending balance sheet amounts are the same as averages where applicable.

*Required:*

1. Calculate
  1. current ratio
  2. number of days of sales in inventory
  3. earnings per share
  4. return on shareholders' equity ratio.
2. Comment on the results.

3. (Appendix) Restate the financial statements to facilitate Scott formula analysis. Assume interest expense (before tax) is \$10 and is included in operating expenses.
4. (Appendix) Calculate the Scott formula and comment on the results. Does this change any of your observations from part 2?

### Part B

Assume that the following unrelated transactions occurred in Post Inc. in 2019.

*Required:* Indicate the effect of each transaction below on the current ratio.

<i>Transaction</i>	<i>Effect on current ratio</i>		
	<i>Increase</i>	<i>Decrease</i>	<i>No change</i>
Additional common shares were sold for cash			
Paid \$20,000 of accounts payable			
Purchased \$15,000 of inventory on account			
Wrote off \$2,000 of accounts receivable as uncollectible.			

### 13.11.6.3 SP 13-3



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The following are condensed comparative financial statements of Nero Corporation for the three years ended December 31, 2016, 2017, and 2018.

Nero Corporation  
Balance Sheet  
At December 31

<i>Assets</i>				
	<i>2018</i>	<i>2017</i>	<i>2016</i>	
<i>Current</i>				
Cash	\$ 24	\$ -0-	\$ -0-	
Accounts receivable	45	45	44	
Inventory	72	48	36	
Prepaid expenses	3	3	4	
	<u>144</u>	<u>96</u>	<u>84</u>	
Property, plant, and equipment, at carrying amount	<u>312</u>	<u>180</u>	<u>91</u>	
Total assets	<u>\$456</u>	<u>\$276</u>	<u>\$175</u>	

*Liabilities and Shareholders' Equity*

<i>Current</i>				
Accounts payable	\$ 54	\$ 72	\$ 40	
Estimated liabilities	30	24	20	
Non-current bonds payable, 4%	96	60	-0-	
	<u>180</u>	<u>156</u>	<u>60</u>	
Common shares	240	96	96	
Retained earnings	36	24	19	
Total liabilities and shareholders' equity	<u>\$456</u>	<u>\$276</u>	<u>\$175</u>	

Nero Corporation  
Income Statement  
For the Years Ended

	<i>2018</i>	<i>2017</i>	<i>2016</i>
Sales	\$252	\$144	\$120
Cost of goods sold	<u>189</u>	<u>96</u>	<u>66</u>
Gross profit	63	48	54
Selling and administrative	<u>37</u>	<u>34</u>	<u>30</u>
Income from operations	26	14	24
Interest expense	<u>6</u>	<u>6</u>	<u>-0-</u>
Income before income taxes	20	8	24
Income taxes	<u>8</u>	<u>3</u>	<u>9</u>
Net income	<u>\$ 12</u>	<u>\$ 5</u>	<u>\$ 15</u>

The following additional information is available:

- a. All sales are on credit; credit terms are net 60 days after invoice date.
- b. Twenty common shares were outstanding in years 2016 and 2017. On April 1, 2018, an additional 30 common shares were issued for \$144 cash in total.
- c. The accounts receivable balance at January 1, 2016 was \$19.
- d. The inventory balance at January 1, 2016 was \$24.
- e. The net capital assets balance at January 1, 2016 was \$91.
- f. The total assets balance at January 1, 2016 was \$165.
- g. The total shareholders' equity balance at January 1, 2016 was \$101.
- h. Dividends of \$8 were declared in 2016. No dividends were declared in 2017 and 2018.
- i. Interest has been paid on the bonds each year and is included in interest expense.

*Required:*

1. From the above information, calculate the following for each of the three years:
  - a. Liquidity
    - Current ratio
    - Acid-test ratio
    - Accounts receivable collection period
    - Number of days of sales in inventory
    - Revenue operating cycle.

b. Profitability

Gross profit ratio

Net profit ratio

Return on total assets

Return on shareholders' equity

c. Leverage

Debt to shareholders' equity ratio

Times interest earned

d. Market measures

Earnings per share

2. What conclusions can be drawn?

3. (Appendix) Restate the financial statements for all three years to facilitate Scott formula analysis.

4. (Appendix) Calculate the Scott formula for the three years and comment on the results.

## 13.11.7 Decision Problems

### 13.11.7.1 DP 13-1



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The selected financial information presented below has been derived from the financial statements of four companies. Each of the companies belongs to one of the following industries: (1) public accounting, (2) vehicle manufacturing, (3) airline, and (4) retail grocery sales.



	<i>Firm A</i>	<i>Firm B</i>	<i>Firm C</i>	<i>Firm D</i>
Percentage of total assets in:				
Cash and short-term investments	5%	5%	7%	3%
Accounts receivable	2	10	40	1
Inventories	2	30	42	70
Total current assets	9	45	89	74
Property, plant, and equipment (net )	91	55	13	26
Total assets	100%	100%	100%	100%
Percentage relative to total sales:				
Net income	10%	12%	12%	9%
Gross profit	–	45	–	10
Depreciation	35	20	1	5

*Required:*

1. Which of the companies would be expected to have relatively large investments in receivables? in inventories? in property, plant, and equipment?
2. Which company would have high gross profit? a high rate of depreciation?
3. Identify the industry to which each company belongs.

### 13.11.7.2 DP 13-2



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Assume you are the bank manager of Third National Bank. Two companies, A and B, are seeking bank loans. You are given the following financial statements.

Balance Sheets  
At December 31, 2016

	<i>Assets</i>		<i>Liabilities and Shareholders' Equity</i>		
	<i>Company A</i>	<i>Company B</i>	<i>Company A</i>	<i>Company B</i>	
Cash	\$ 80	\$165	Current liabilities	\$ 240	\$ 300
Accounts receivable	125	235	Non-current liabilities	600	500
Merchandise Inventory	480	660	Common Shares	250	640
	685	1,060	Retained Earnings	100	160
Capital assets, at carrying amount	505	540			
	<u>\$1,190</u>	<u>\$1,600</u>		<u>\$1,190</u>	<u>\$1,600</u>



Income Statements  
For the Year Ended December 31, 2016

	<i>Company A</i>	<i>Company B</i>
Sales (all on credit)	\$1,500	\$ 900
Cost of goods sold	1,050	540
Gross profit	450	360
Selling and administrative expenses	90	170
Income from operations	360	190
Interest expense	60	50
Income before income taxes	300	140
Income taxes	60	30
Net income	\$ 240	\$ 110

*Required:*

1. From this information, calculate for each company

Current ratio

Acid-test ratio

Accounts receivable collection period

Number of days of sales in inventory

Revenue operating cycle

Return on total assets

Return on shareholders' equity

Debt to shareholders' equity ratio

Times interest earned

Sales to total assets ratio

Gross profit ratio

Net profit ratio

Assume averages equal ending balances where necessary.

2. Choose one company to which you would grant a 6-month, 6% loan of \$150. Give reasons for your choice.

- (Appendix) Restate the financial statements to facilitate Scott formula analysis and calculate the formula. Assume
- current liabilities all relate to operations. Does this additional information change your decision in (2) above? Explain.

### 13.11.7.3 DP 13-3



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As chief financial officer of Jumbo Corporation, you have calculated the following ratios and percentages of the company's financial information to enable you to answer questions the board of directors may ask at their next meeting.

	2018	2017	2016
Current ratio	3.1:1	2.6:1	2.0:1
Acid-test ratio	0.8:1	1.2:1	1.5:1
Accounts receivable collection period	93 days	76 days	64 days
Number of days of sales in inventory	88 days	72 days	68 days
Return on shareholders' equity	12.0%	13.3%	14.1%
Return on total assets	12.6%	12.8%	13.3%
Percentage sales increase over prior year	123%	118%	100%
Selling expenses to net sales ratio	13.9%	13.9%	14.2%

*Required:*

Using these ratios, answer each question with a brief explanation to support each answer.

1. Is it becoming easier than in previous years for the company to take advantage of cash discounts offered by suppliers?
2. Is the company collecting its accounts receivable more rapidly than before?
3. Is the company's investment in accounts receivable decreasing?
4. Is the company's investment in inventory increasing?
5. Is the shareholders' return on investment increasing?
6. Did the dollar amount of selling expenses decrease during the three-year period?

### 13.11.7.4 DP 13-4



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When a vehicle is built, it contains parts purchased or produced by the original equipment manufacturer (OEM). When these parts need to be replaced, consumers often purchase after-market parts instead of OEM replacement parts because they may be cheaper or of better quality, and may enhance the performance or appearance of the vehicle. Acme Auto Parts Ltd. is an after-market automotive parts manufacturer established in 2010. It went public in 2014. The company's headquarters are located in Oakville, Ontario. It has manufacturing plants in Oakville and four other Canadian and US locations. Each location is organized as a separate division. The company manufactures electrical components and provides parts to US and Canadian national retail chains that specialize in providing both sound advice and reliable parts to clients with higher-than-average disposable incomes, like car and truck hobbyists, as well as heavy truck fleet owners. It has several regional warehouses and divisional offices across Canada and the US. It has a reputation for producing high quality parts that are innovative, reliable, and efficient, and backing what it sells through a generous warranty and refund policy.

Acme has weathered a recent economic downturn well enough. Demand for its type of electrical auto parts has remained relatively strong. The company has two main competitors, both headquartered in the Far East. Though still ranked as the number one after-market electronic parts supplier in Canada in terms of total sales dollars and number four in the US, its competitors are slowly gaining ground. Acme is considered well-managed and is respected for the high quality of its electrical components. It does not compete by supplying a full range of after-market automotive products, but by identifying new niche markets for electrical components and leveraging its product line by continually searching for innovations in design and performance.

Acme has maintained very good relations with its suppliers and retail chains. These chains actively promote the brand as good value for money, and provide valuable feedback to Acme about retail customer purchasing trends and requests for new products. Unlike its competitors, the Acme sales force is well-trained to not only sell existing products, but to glean new ideas from customers and communicate these back to Acme management for consideration.

The company recognizes that long-term success largely depends on continued promotion of Acme products by these retail chains, which means that the chains must be able to continue to earn high gross profit on sales of these same products. However, increased competition from lower-priced electrical components produced

by Acme's Far East competitors has begun to cut into Acme's sales and profit margins. In the past, Acme has relied on research and development and the North American patent process to maintain its market share. A few extremely successful product innovations were responsible for most of the past sales levels and profit margins. However, increased complexity of component design has created longer timelines to move new products from conception to production. Also, at least one of its competitor's activities border on patent infringement, but legal remedies are costly, time-consuming, and often unsatisfactory.

Acme's manufacturing facilities and processes are state-of-the-art. Once products have been successfully designed and tested, they are able to be manufactured very quickly and inexpensively, and in small batches. Acme's distribution costs are lower than competitors because its manufacturing plants are closer to customers. In recent years, the threat of shortages of rare, very expensive metals used in the manufacture of many of its products has required the company to increase its raw materials inventories. Rapidly developing economies, particularly China, are demanding increasing amounts of these precious metals, and have begun to lock up supplies from African producers.

Financial statements for the three years ended December 31, 2019 are shown at the end of this problem, as well as financial ratios for the 2017 and 2018 fiscal years. Additional information gathered from the auditor's report, management discussion and analysis, and notes to the financial statements indicated that:

1. All sales are on credit.
  
2. In 2017, vacant land was sold for \$11,000,000. No capital assets were sold in 2018 or 2019.
  
3. Issued shares are composed entirely of common shares. Average number of shares outstanding was as follows:  
  
2017: 700,000 shares  
2018: 1,100,000 shares  
2019: 1,200,000 shares
  
4. Average market price per share was as follows:  
  
2017: \$32.52  
2018: \$55.50  
2019: \$73.40
  
5. Electronic fuel injectors are a significant portion of the company's product line. Starting in mid-2018 until the

problem was rectified near the end of 2019, a number of defective injectors were produced. As a result, warranty claims increased significantly during this period.

6. Unlike the rest of the industry, the company depreciates tools, dies, and moulds over a two year period using an accelerated method. The rest of the industry generally depreciates these assets over a four-year period on a straight line basis. Acme's investment in tools, dies, and moulds was significant during the period 2017-2019.
7. Research and development has remained important to the company. On average, the industry spends about 2% of sales on R&D.
8. There are no outstanding litigation issues, nor is management aware of any impending litigation.
9. There are no operating leases for rented premises in place after 2019.
10. The company's auditor has issued unqualified audit reports each year.

*Required:* Assume you are a loans officer with a large investment bank. Complete the 2019 financial ratio calculations below based on the financial statements at the end of this question, then analyze the results. Make a recommendation regarding Acme's recent request for an additional \$10 million long-term loan from your bank.

Acme Auto Parts Ltd.

Selected Financial Ratios

	2019	2018	2017	2019 industry average
a. Current ratio		1.3	1.5	1.8
b. Acid-test ratio		.48	.62	1.1

---

c.	Accounts receivable collection period	35	30	35
d.	Number of days of sales in inventory	140	135	122
e.	Return on total assets	14.9%	(7.0%)	18.0%
f.	Return on shareholders' equity	23.2%	15.2%	20.0%
g.	Times interest earned ratio	3.9X	(2.9)X	5X
h.	Sales to total assets ratio	2.7	2.6	1.5
i.	Debt to shareholders' equity ratio	2.4	2.6	1.5
j.	Gross profit ratio	59.1%	60.7%	52.4%
k.	Net profit ratio	2.5%	1.7%	2.1%
l.	Earnings per share	\$3.00	\$2.14	\$4.00
m.	Price-earnings ratio	18.5X	15.2X	21X

Acme Auto Parts Ltd.  
Balance Sheet  
At December 31, 2019  
(\$000,000s)

	2019	2018	2017
<i>Assets</i>			
<i>Current</i>			
Cash	\$ 1.6	\$ 2.2	\$ 3.2
Accounts receivable	17.3	12.5	7.2
Inventory	37.1	25.7	15.2
	56.0	40.4	25.6
<i>Property, plant, and equipment, at carrying value</i>	28.4	23.0	10.4
Total assets	\$84.4	\$63.4	\$36.0
<i>Liabilities</i>			
<i>Current</i>			
Borrowings	\$43.8	\$18.5	\$8.3
Accounts payable	10.5	7.7	3.3
Estimated warranty liability	1.2	4.4	5.2
	55.5	30.6	16.8
<i>Non-current borrowings</i>	7.8	14.4	9.1
Total liabilities	63.3	45.0	25.9
<i>Shareholders' Equity</i>			
Share capital	11.6	11.2	5.2
Retained earnings	9.5	7.2	4.9
	21.1	18.4	10.1
Total liabilities and shareholders' equity	\$84.4	\$63.4	\$36.0



Acme Auto Parts Ltd.  
Income Statement  
For the Year Ended December 31, 2019  
(000,000s)

	<i>2019</i>	<i>2018</i>	<i>2017</i>
Sales	\$142.0	\$132.0	\$89.0
Cost of goods sold	63.0	54.0	35.0
Gross profit	<u>79.0</u>	<u>78.0</u>	<u>54.0</u>
<i>Operating expenses</i>			
<i>Selling expenses</i>			
Commissions	14.0	15.5	12.3
Rent	1.2	2.2	3.2
Marketing	.5	4.9	6.6
	<u>15.7</u>	<u>22.6</u>	<u>22.1</u>
<i>General and administrative expenses</i>			
Warranty	2.6	2.5	2.4
Employee benefits	41.0	36.5	26.3
Research and development	7.2	6.2	4.4
Depreciation	2.8	2.8	1.4
Total general and administrative expenses	<u>53.6</u>	<u>48.0</u>	<u>34.5</u>
Total operating expenses	<u>69.3</u>	<u>70.6</u>	<u>56.6</u>
Income (loss) from operations	9.7	7.4	(2.6)
<i>Other revenue</i>			
Gain on sale of capital assets	-0-	-0-	6.0
Income before interest expense	<u>9.7</u>	<u>7.4</u>	<u>3.4</u>
Interest expense	2.6	1.9	.9
Income before income taxes	<u>7.1</u>	<u>5.5</u>	<u>2.5</u>
Income taxes	2.7	2.2	1.0
Net income	<u>\$ 4.4</u>	<u>\$ 3.3</u>	<u>\$ 1.5</u>

Acme Auto Parts Ltd.  
Statement of Changes in Equity  
For the Year Ended December 31, 2019  
(\$000,000s)

	<i>2019</i>			<i>2018</i>	<i>2017</i>
	<i>Share capital</i>	<i>Retained earnings</i>	<i>Total equity</i>	<i>Total equity</i>	<i>Total equity</i>
Balance at Jan. 1	\$11.2	\$7.2	\$18.4	\$10.1	\$ 9.1
Common shares issued	.4		.4	6.0	
Net income		4.4	4.4	3.3	1.5
Dividends declared		(2.1)	(2.1)	(1.0)	(.5)
Balance at Dec. 31	<u>\$11.6</u>	<u>\$9.5</u>	<u>\$21.1</u>	<u>\$18.4</u>	<u>\$10.1</u>

# Chapter 14 The Statement of Cash Flows



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Details about the amount of cash received and paid out during an accounting period are not shown on the balance sheet, income statement, or statement of changes in equity. This information is disclosed on the **statement of cash flows (SCF)**. This chapter discusses the purpose of the statement of cash flows, the steps in preparing the SCF, as well as how to interpret various sections of the statement of cash flows.

## Learning Objectives

LO1 – Explain the purpose of the statement of cash flows.

LO2 – Prepare a statement of cash flows.

LO3 – Interpret a statement of cash flows.

## 14.1 Financial Statement Reporting



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LO1 – Explain the purpose of the statement of cash flows.

Cash flow is an important factor in determining the success or failure of a corporation. It is quite possible for a profitable business to be short of cash. A company can have liquidity issues because of large amounts of cash tied up in inventory and accounts receivable, for instance. Conversely, an unprofitable business might have sufficient cash to pay its bills if it has access to enough bank financing or if it can issue additional shares.

The financial activities of a corporation are reported through four financial statements: a balance sheet, an income statement, a statement of changes in equity, and a statement of cash flows. This chapter discusses the statement of cash flows in detail.

The statement of cash flows provides a detailed summary of where cash came from during the accounting period and how cash was used. The SCF explains why cash on hand at the end of the accounting period is different from the cash on hand at the beginning of the period by describing the enterprise's *operating*, *financing* and *investing* activities on a company's cash resources.

Cash flow information is useful to management when making decisions such as purchasing equipment, plant expansion, paying down long-term debt, or declaring dividends. The SCF is useful to external users when evaluating a corporation's financial performance.

Provision of information useful for assessing the timing, amount, and uncertainty of future cash flows is a primary objective of financial reporting. Using the SCF, analysts examine the relationship among the various sources and uses of cash during the period to help predict future cash flows.

The SCF, together with the income statement, provides a somewhat limited means of assessing future cash flows because these statements are based on historical, not prospective data. Nevertheless, the ability to generate cash from past operations is often an important indication of whether the enterprise will have difficulty meeting obligations as they fall due, paying dividends, paying for recurring operating costs, or surviving adverse economic conditions.

"Cash" consists of anything a bank will accept for deposit. However, for SCF purposes, cash can also include **cash equivalents**—assets that can be quickly converted into a known amount of cash, such as short-term investments that are not subject to significant risk of changes in value.

*For our purposes, an investment will be considered a cash equivalent when it has a maturity of three months or less from the date of acquisition.*

Conversely, there are examples of "negative" cash, like bank overdrafts. An overdraft occurs when a corporation is allowed to pay out more cash from its bank account than it has on deposit, with the understanding that the overdraft situation is temporary and limited to a predetermined amount. Another example is a demand bank loan. This is a short-term "demand" loan that provides cash to a company when needed. However, the bank can require that the loan be repaid at any time.

Because of differences in the nature of each entity and industry, management judgement is required to determine what assets constitute cash and cash equivalents for a particular firm. This decision needs to be disclosed on the SCF or in a note to the financial statements. For instance, the following note disclosure could be made:

*Note X*

Cash and cash equivalents consist of cash on deposit and short-term investments held for the purposes of meeting cash commitments within three months from their date of acquisition, net of demand bank loans. Cash and cash equivalents reported on the statement of cash flows are comprised of the following:

	(\$000s)	
	2018	2017
Cash on deposit	\$20	\$30
Short-term investments	37	33
Less: Demand bank loan	(1)	(2)
	\$56	\$61

Cash flows result from a wide variety of a corporation's activities as cash is received and disbursed over a period of time. Because the income statement is based on accrual accounting that matches expenses with revenues, net income usually is not the same as cash receipts and disbursements occurring during the same time period. As we will see, the statement of cash flows converts accrual-based net income into cash flow from operating activities.

## 14.2 Preparing the Statement of Cash Flows



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LO2 – Prepare a statement of cash flows.

The statement of cash flows is classified into three sections: operating activities, financing activities, and investing activities. A simplified example is shown in [Figure 14.1](#) below:

Sample Corporation Statement of Cash Flows For the Year Ended December 31, 2017	
The SCF covers a period of time, like the income statement.	<div style="margin-left: 20px;">→ <i>Operating activities</i></div> <div style="margin-left: 40px;">Net income <span style="float: right;">\$100</span></div> <div style="margin-left: 40px;">Plus: Changes in working capital <span style="float: right; border-bottom: 1px solid black;">8</span></div> <div style="margin-left: 40px;">Cash flow from operating activities <span style="float: right;">108</span></div>
The SCF is divided into three areas.	<div style="margin-left: 20px;">→ <i>Investing activities</i></div> <div style="margin-left: 40px;">Purchase of equipment <span style="float: right;">(150)</span></div>
These amounts agree to cash reported on the balance sheet.	<div style="margin-left: 20px;">→ <i>Financing activities</i></div> <div style="margin-left: 40px;">Common shares issued <span style="float: right; border-bottom: 1px solid black;">50</span></div> <div style="margin-left: 40px;">Net increase in cash <span style="float: right;">8</span></div> <div style="margin-left: 40px;">Cash at beginning of year <span style="float: right; border-bottom: 1px solid black;">10</span></div> <div style="margin-left: 40px;">Cash at end of year <span style="float: right; border-bottom: 3px double black;">\$ 18</span></div>

Fig. 14.1: Sample Corporation Statement of Cash Flows

Cash flow from operations is generated from the principal activities that produce revenue for a corporation, such as selling products, and most of the expenses reported on the income statement, which are necessary to carry out these activities. Changes to non-cash working capital accounts like accounts receivable also affect cash generated by operating activities, as will be explained below.

Cash flows from investing activities involve increases and decreases in long-term asset accounts. These include outlays for the acquisition of property, plant, and equipment, as well as cash proceeds from their disposal.

Cash flows from financing activities occur when there are changes to debt or shareholders' equity accounts, like when long-term debt is repaid or shares are issued. Dividend payments are also considered financing activities, since these represent a return on the original capital invested by shareholders.

The analysis of cash inflows and outflows focuses any transactions that involve a cash and cash equivalents account and any other balance sheet account. The following balance sheet format can be used to visualize this. The bold black line separates the cash and cash equivalent accounts from all other accounts.

	Assets	<i>Liabilities and Shareholders' Equity</i>
These are cash and cash equivalent accounts.	<div style="margin-left: 20px;">→ <b>Cash and s/t investments</b></div>	<div style="margin-left: 20px;"><b>Overdrafts and demand loans</b></div>
Changes to these accounts are classified as operating, investing, or financing activities.	<div style="margin-left: 20px;">Non-cash current assets</div> <div style="margin-left: 20px;">Non-current assets</div>	<div style="margin-left: 20px;">Other current liabilities</div> <div style="margin-left: 20px;">Non-current liabilities</div> <div style="margin-left: 20px;">Share capital</div> <div style="margin-left: 20px;">Retained earnings</div> <div style="margin-left: 40px;">+ Revenue</div> <div style="margin-left: 40px;">- Expenses</div>



Any transaction that affects one account above and one account below the black line results in either a cash inflow or a cash outflow. Such transactions cause changes to cash and cash equivalents.

Consider the balance sheet, income statement and statement of changes in equity of Example Corporation:

<b>Example Corporation</b>		
<b>Balance Sheet</b>		
<b>At December 31</b>		
(\$000s)		
	<i>2018</i>	<i>2017</i>
<i>Assets</i>		
<i>Current</i>		
Cash	\$ 27	\$ 150
Accounts receivable	375	450
Merchandise inventory	900	450
Prepaid expenses	20	10
	<u>1,322</u>	<u>1,060</u>
Property, plant, and equipment		
Land	210	290
Buildings	1,200	400
Machinery	990	700
Less: Accumulated depreciation	(540)	(300)
	<u>1,860</u>	<u>1,090</u>
Total assets	<u>\$3,182</u>	<u>\$2,150</u>
<i>Liabilities</i>		
<i>Current</i>		
Accounts payable	\$ 235	\$ 145
Dividends payable	25	30
Income taxes payable	40	25
	<u>300</u>	<u>200</u>
Non-current borrowings	<u>1,000</u>	<u>500</u>
	<u>1,300</u>	<u>700</u>
<i>Shareholders' Equity</i>		
Share capital	1,210	800
Retained earnings	672	650
	<u>1,882</u>	<u>1,450</u>
Total liabilities and shareholders' equity	<u>\$3,182</u>	<u>\$2,150</u>

Example Corporation  
Income Statement  
For the Year Ended December 31, 2018  
(\$000s)

Sales		\$1,200
Cost of goods sold		<u>674</u>
Gross profit		<u>526</u>
<i>Operating expenses</i>		
Selling, general, and administration	\$115	
Depreciation	<u>260</u>	<u>375</u>
Income from operations		151
<i>Other items</i>		
Gain on disposal of land	24	
Loss on disposal of machinery	<u>(10)</u>	<u>14</u>
Income before interest expense		165
Interest		<u>50</u>
Income before income taxes		115
Income taxes		<u>35</u>
Net income		<u><u>\$ 80</u></u>

Example Corporation  
Statement of Changes in Equity  
For the Year Ended December 31, 2018  
(\$000s)

	<i>Share capital</i>	<i>Retained earnings</i>	<i>Total equity</i>
Balance at Jan. 1, 2018	\$ 800	\$650	\$1,450
Common shares issued	410	-	410
Net income	-	80	80
Dividends declared	-	<u>(58)</u>	<u>(58)</u>
Balance at Dec. 31, 2018	<u><u>\$1,210</u></u>	<u><u>\$672</u></u>	<u><u>\$1,882</u></u>

The SCF can be prepared from an analysis of transactions recorded in the Cash account. Accountants summarize and classify these cash flows on the SCF for the three major activities noted above – operating, investing, and financing. To aid our analysis, the following summarized transactions from the records of Example Corporation will be used.



<i>Transaction</i>	<i>Description (\$000s)</i>
1	Land costing \$80 was sold for \$104.
2	A building was purchased for \$800 cash.
3	Machinery was purchased for \$350 cash.
4	Machinery costing \$60 with accumulated depreciation of \$20 was sold for \$30 cash.
5	Depreciation expense of \$260 was recorded during the year.
6	Example Company received \$500 cash from a long-term bank loan.
7	Shares were issued for \$410 cash.
8	\$58 of dividends were declared and paid during the year.

## 14.2.1 Analysis of Cash Flows



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The steps used to prepare a statement of cash flows are as follows:

Step 1 Set up a **cash flow table**.

Step 2 Calculate the changes in each balance sheet account.

Step 3 Analyze changes in non-cash balance sheet accounts.

Step 4 Prepare the cash flow from operating activities section of the SCF.

Step 5 Prepare a statement of cash flows.

### Step 1 Set up a cash flow table

Set up a table as shown below with a row for each account shown on the balance sheet. Enter amounts for each account for 2017 and 2018. Show credit balances in parentheses. Total both columns and ensure they equal zero. The table should appear as follows after this step has been completed:

<i>Account</i>	<i>Balance</i>	
	<i>(\$000s)</i>	
	<i>2018</i>	<i>2017</i>
	<i>Dr. (Cr.)</i>	<i>Dr. (Cr.)</i>
Cash	27	150
Accounts receivable	375	450
Merchandise inventory	900	450
Prepaid expenses	20	10
Land	210	290
Buildings	1,200	400
Machinery	990	700
Accumulated depreciation	(540)	(300)
Accounts payable	(235)	(145)
Dividends payable	(25)	(30)
Income taxes payable	(40)	(25)
Borrowings	(1,000)	(500)
Share capital	(1,210)	(800)
Retained earnings	(672)	(650)
<b>Total</b>	<b>-0-</b>	<b>-0-</b>

**Step 2 Calculate the changes in each balance sheet account**

Add two columns to the cash flow table. Calculate the net debit or net credit changes for every account on the balance sheet and insert these changes in the appropriate column. This step is shown below.

Account	Step 1		Step 2		
	Balance		Change		
	(\$000s)				
	2018	2017	Dr.	Cr.	
	Dr. (Cr.)	Dr. (Cr.)			
Cash	27	150		123	Cash has decreased by \$123,000.
Accounts receivable	375	450		75	
Merchandise Inventory	900	450	450		
Prepaid expenses	20	10	10		
Land	210	290		80	
Buildings	1,200	400	800		
Machinery	990	700	290		
Accumulated depreciation	(540)	(300)		240	
Accounts payable	(235)	(145)		90	
Dividends payable	(25)	(30)	5		
Income taxes payable	(40)	(25)		15	
Borrowings	(1,000)	(500)		500	Total debit changes equal total credit changes.
Share capital	(1,210)	(800)		410	
Retained earnings	(672)	(650)		22	
Total	-0-	-0-	1,555	1,555	

### Step 3 Analyze changes in non-cash balance sheet accounts

Recall from earlier chapters that a cash inflow is recorded as a debit to cash. For instance, a cash sale of \$100 is recorded as:

Dr.	Cash	100	
Cr.	Sales		100

Similarly, a cash outflow is recorded as a credit to cash. Purchase of \$50 of inventory for cash is recorded as:

Dr.	Merchandise Inventory	100	
Cr.	Cash		100

This same principle is used to record cash inflows and outflows from operating, investing, and financing activities when the cash flow table method is used to prepare the SCF. A debit to cash represents a cash inflow; a credit to cash represents a cash outflow. Each type of activity represents a cash flow effect, in or out.

The next step is to set up three columns to the right of the "Change" columns shown in the table above. These columns should be titled "Cash Effect—Inflow," "Cash Effect—Outflow," and "Activity." Record the changes in each account listed in Step 2 as a *cash inflow effect* if the account's change is a credit (because the opposing debit represents an increase in cash, and therefore a cash inflow). It is a *cash outflow effect* if the change is a debit (because the opposing credit represents a decrease in cash, a cash outflow). The cash flow table should appear as follows:

Account	Step 1		Step 2		Step 3		Activity
	Balance (\$000s)		Change		Cash effect		
	2018 Dr. (Cr.)	2017 Dr. (Cr.)	Dr.	Cr.	Inflow Dr.	Outflow Cr.	
Cash	27	150		123			To be explained by SCF
Accounts receivable	375	450		75	75		<div style="border: 1px solid black; padding: 5px; background-color: #e0f0ff;">           These represent all the operating, investing, and financing effects that will be shown on the SCF.         </div>
Merchandise inventory	900	450	450			450	
Prepaid expenses	20	10	10			10	
Land	210	290		80	80		
Buildings	1,200	400	800			800	
Machinery	990	700	290			290	
Acc. depreciation	(540)	(300)		240	240		
Accounts payable	(235)	(145)		90	90		
Dividends payable	(25)	(30)	5			5	
Income taxes payable	(40)	(25)		15	15		
Borrowings	(1,000)	(500)		500	500		
Share capital	(1,210)	(800)		410	410		
Retained earnings	(672)	(650)		22	22		
Total	-0-	-0-	1,555	1,555	1,432	1,555	

\$123 net cash outflow (\$1,432 – 1,555)

The \$123 net outflow in all non-cash balance sheet accounts (\$1,432 – 1,555) equals the \$123 decrease in cash (\$150 – 27). An analysis of these non-cash accounts below the thick black line will explain the net outflow of cash. Each account shown in the table above will be examined to determine whether the observed changes result from operating, investing, or financing activities.

### Procedure 1: Calculating cash flow from operating activities

Calculating cash flow from operating activities is the first step in preparing a statement of cash flows. Net income of \$80,000 is used as the starting point. Let's assume for the moment that this net income represents a net inflow of cash from operating activities of the same amount. The summary journal entry would be

Dr. Cash	80,000	
Cr. Retained Earnings		80,000

Therefore, the first cash flow table effect we record is to the Retained Earnings account. The effect on the SCF would be a \$80,000 cash inflow, shown as follows:

Account	Balance (\$000s)		Change		Cash effect		Activity
	2018 Dr. (Cr.)	2017 Dr. (Cr.)	Dr.	Cr.	Inflow Dr.	Outflow Cr.	
	Retained earnings	(672)	(650)		80*	80	

(\*The actual change is a \$22 credit. This \$58 discrepancy will be explained in Procedure 3a)

The net income is recorded as an operating activity in the cash flow table. However, this amount includes three categories of items that must be adjusted to derive cash flow from operating activities: (a) net debit and credit changes in working capital that do not affect the income statement; (b) losses and gains not due to normal operations of the entity; and (c) expenses and revenues not involving cash. These are explained below.

#### a. Analysis of working capital accounts that do not affect the incomestatement

The first category of adjustments involves working capital accounts that are used in accrual accounting. For Example Corporation, these consist of:

<i>Current assets</i>	<i>Current liabilities</i>
Accounts receivable	Accounts payable
Merchandise inventory	Income taxes payable
Prepaid expenses	

The criteria for inclusion are whether adjustments through these accounts at some point affect items on the income statement. As a result, changes to the related Dividends Payable account are not considered operating activities. (Payment of dividends directly affects the Retained Earnings account, not a net income account.) The Dividends Payable account is therefore not analyzed at this point.

The remaining non-cash current asset and current liability accounts are relevant to the calculation of cash flow from operating activities because they affect expense and revenue items in the income statement. Examples of related items are sales on account that are recorded as accounts receivable, and merchandise purchases that eventually are reflected as cost of goods sold. The effects of changes in these accounts on net income must be considered when calculating cash flow from operating activities.

First, consider the change of \$75 credit in the Accounts Receivable balance from the end of 2017 to 2018. If the relative levels of accounts receivable have decreased by \$75 from 2017 to 2018 (a credit), a \$75 cash inflow (a debit) has also occurred, as shown in the related cash effect column below.

<i>Account</i>	<i>Balance</i>		<i>Change</i>		<i>Cash effect</i>		<i>Activity</i>
	<i>(\$000s)</i>				<i>Inflow</i>	<i>Outflow</i>	
	<i>2018</i>	<i>2017</i>	<i>Dr.</i>	<i>Cr.</i>	<i>Dr.</i>	<i>Cr.</i>	
Accounts receivable	375	450		75	75		Operating

In effect, Example Corporation has produced cash inflow during 2018 by speeding up cash collections of its accounts receivable from customers. This overall effect is not reflected in net income. This cash inflow must be added to the net income figure when calculating cash flow from operating activities in the statement of cash flows.

Next, consider the working capital account Merchandise Inventory. The balance in this account has increased by \$450 from 2017 to 2018. If the relative levels of merchandise inventory have increased by \$450 (a debit), cash of \$450 has been used to accomplish this. This activity has not been included in net income. Hence the \$450 credit (a cash outflow) shown in the cash effect column below needs to be deducted from the net income figure used as the starting point in determining cash flow from operating activities on the SCF. Similarly, the Prepaid Expenses balance has increased by \$10 (a



debit) from 2017 to 2018. To accomplish this, a \$10 cash outflow (a credit) must have occurred, also as shown in the related cash effect column below. This amount also needs to be deducted from net income on the SCF to arrive at cash flow from operating activities.

Account	Balance (\$000s)		Change		Cash effect		Activity
	2018	2017	Dr.	Cr.	Inflow	Outflow	
	Dr. (Cr.)	Dr. (Cr.)			Dr.	Cr.	
Merchandise inventory	900	450	450			450	Operating
Prepaid expenses	20	10	10			10	Operating

The next applicable working capital account to be analyzed is Accounts Payable, a liability. Refer to the table below. The balance in this account has increased by \$90 from 2017 to 2018. In effect, Example Corporation has delayed cash payments to its short-term creditors during 2018, causing this liability account to increase. An increase in a liability is indicated by a credit. The consequent effect on cash is the opposite – a debit, denoting a cash inflow effect. Example Corporation has provided more cash for itself by delaying payments to trade creditors. Similarly, the Income Taxes Payable liability account has increased by \$15 from 2017 to 2018 (a credit). The consequent cash effect is a \$15 inflow (a debit), as shown in the table. By increasing the amount that Example Corporation owes to the government, the company has created a \$15 cash inflow effect compared to the prior year. These effects are shown as cash inflows from operating activities on the SCF. They are added to net income to arrive at cash flow from operating activities.

Account	Balance (\$000s)		Change		Cash effect		Activity
	2018	2017	Dr.	Cr.	Inflow	Outflow	
	Dr. (Cr.)	Dr. (Cr.)			Dr.	Cr.	
Accounts payable	(235)	(145)		90	90		Operating
Income taxes payable	(40)	(25)		15	15		Operating

### b. Losses and gains not due to normal operating activities

Losses and gains on disposal of capital assets are not part of normal operations and therefore do not affect cash flow from operating activities. Since a loss is deducted when calculating net income, it is added back when calculating cash flow from operating activities on the SCF. Conversely, a gain on sale is included in net income reported on the income statement. It is deducted from the net income starting point when calculating cash flow from operating activities on the SCF.

The first example of this effect arises when analyzing the changes to the Land account. As noted previously (Transaction 1), land originally costing \$80 was sold for \$104. The journal entry to record the sale of the land would have been:

Dr.	Cash		104,000	
Cr.	Land			80,000
Cr.	Gain on Disposal of Land			24,000

The sale of the land thus has two effects on the SCF, as shown in the cash effects columns in the table below. First, the gain of \$24 is shown as a credit. It was initially included in net income, but does not relate to day-to-day operations. Therefore, the gain is *deducted* from net income on the SCF to negate the original effect and arrive at

cash flow from operating activities. This is done by recording it as a cash outflow. Second, in the above journal entry, the \$104 sale proceeds are shown as a cash inflow (debit). *This represents a cash inflow from an investing activity, since it involves a non-current asset account.* The cash effects are shown below.

Account	Balance (\$000s)		Change		Cash Effect		Activity
	2018 Dr. (Cr.)	2017 Dr. (Cr.)	Dr.	Cr.	Inflow Dr.	Outflow Cr.	
Land	210	290		80	104		Investing
						24	Operating

### c. Expenses and revenue not involving cash

These consist of non-cash amounts that were included in the calculation of net income – depreciation expense in this case. Depreciation for 2018 amounted to \$260 as shown on the Example Corporation income statement. The entry to record the amount must have been

Dr.	Depreciation Expense	260,000	
Cr.	Acc. Dep'n – PPE		260,000

Note that this entry does not involve cash flow. As a result, it is *added back* to net income on the SCF to reverse its effect and arrive at cash flow from operating activities. Hence it is shown as a \$260 debit in the cash effect column of the table, as shown below:

Account	Balance		Change		Cash effect		Activity
	2018 Dr. (Cr.)	2017 Dr. (Cr.)	Dr.	Cr.	Inflow Dr.	Outflow Cr.	
Acc. Dep'n	(540)	(300)		260*	260		Operating

\* The actual change is \$240. This discrepancy will be explained in Procedure 2c.

In addition to adjustments described above needed to translate net income reported on the income statement into cash flow from operating activities, the remaining cash flow table accounts need to be analyzed to complete the SCF. This process is described below.

### Procedure 2: Calculating Cash Flow from Investing Activities

To calculate cash flow from investing activities, non-current asset accounts are analyzed, as follows:

#### a. Analysis of Buildings account

As noted earlier, a building was purchased for \$800,000 cash. The journal entry would have been:

Dr.	Buildings	800,000	
Cr.	Cash		800,000

The effect on cash is obvious – a cash outflow of \$800,000 (a credit) is recorded in the applicable cash effect column in the table as shown below. Since this transaction



affects a non-current asset account, it is recorded in the investing section of the SCF. (Depreciation on the building is assumed to be zero to simplify the illustration.)

Account	Balance (\$000s)		Change		Cash Effect		Activity
	2018	2017	Dr.	Cr.	Inflow	Outflow	
	Dr. (Cr.)	Dr. (Cr.)			Dr.	Cr.	
Buildings	1,200	400	800			800	Investing

### b. Analysis of Machinery account - purchases

The next accounts to be analyzed are the Machinery and Accumulated Depreciation accounts. Recall that machinery costing \$350,000 was purchased for cash. The journal entry to record this would be:

Dr. Machinery	350,000	
Cr. Cash		350,000

The cash effect should be a \$350,000 outflow (a credit). Since this transaction affects a non-current asset account, it is recorded in the Investing section of the SCF.

Account	Balance (\$000s)		Change		Cash effect		Activity
	2018	2017	Dr.	Cr.	Inflow	Outflow	
	Dr. (Cr.)	Dr. (Cr.)			Dr.	Cr.	
Machinery	990	700	350*			350	Investing

\* The actual change is \$290. This discrepancy will be explained in Procedure 2c.

### c. Analysis of Machinery account - disposals

The transactions recorded to this point do not fully account for the change in the Machinery account balances from 2017 to 2018 (\$990 – 700 = \$290 debit) nor the Accumulated Depreciation balances (\$540 – 300 = \$240 credit). An additional transaction needs to be considered. As noted earlier, machinery costing \$60,000 and having accumulated depreciation of \$20,000 was sold for \$30,000 cash.

The journal entry to record the sale would be:

Dr. Cash	30,000 (a)	
Dr. Acc. Dep'n. – Mach.	20,000 (b)	
Dr. Loss on Sale of Machinery	10,000 (c)	
Cr. Machinery		60,000 (d)

There are two types of cash effects that need to be recorded in the SCF. The \$10 loss on sale (c) originally has been deducted to arrive at net income on the income statement. Since the transaction does not relate to an operating activity, it is recorded as a debit (cash inflow) in the applicable cash effect column and *added back* to net income on the SCF to arrive at cash flow from operating activities.

Second, the \$30 cash proceeds (a) from the sale need to be recorded as a cash inflow (debit) in the cash effects column, and shown as an investing activity on the SCF. The cash flow table would show these effects as follows:

Account	Balance (\$000s)		Change		Cash effect		Activity
	2018 Dr. (Cr.)	2017 Dr. (Cr.)	Dr.	Cr.	Inflow Dr.	Outflow Cr.	
Machinery	990	700	350			350	Investing
				(d) 60	(a) 30		Investing
Acc. Dep.	(540)	(300)	(b) 20		(c) 10		Operating
				260	260		Operating

After these adjustments, all the changes in the Machinery and Accumulated Depreciation accounts have been recorded.

### Procedure 3: Calculating cash flow from financing activities

The last accounts to be analyzed are the non-current liability and shareholders' equity accounts. These comprise financing activities reported on the SCF.

#### a. Analysis of dividends

Changes in the Dividends Payable account from 2017 to 2018 are analyzed in conjunction with any dividends declared during 2018. Transaction 8 above noted that these amounted to \$58,000. This is also disclosed on the statement of changes in equity. As well, dividends payable have decreased by \$5 from 2017 to 2018 (\$25 - 30 = \$5 debit). This means that an additional \$5 credit (cash outflow) must have occurred that need to be recorded in the cash flow table and the SCF. Together, the effect on the SCF is recorded as a \$63,000 cash outflow from financing activities (\$58,000 + \$5,000), as shown in the cash effects column below.

Account	Balance (\$000s)		Change		Cash effect		Activity
	2018 Dr. (Cr.)	2017 Dr. (Cr.)	Dr.	Cr.	Inflow Dr.	Outflow Cr.	
Dividends payable	(25)	(30)	5			5	Financing
Retained earnings	(672)	(650)	58*			58	Financing
						<u>63</u>	

\*The actual net change is a \$22 credit. The balancing amount is the \$80 net income credit, explained in Procedure 1 above.

#### b. Analysis of borrowings

Transaction 6 shown above stated that Example Corporation received \$500,000 cash from a long-term bank loan. This is reflected in the change in the Borrowings account from 2017 to 2018. The journal entry to record this transaction would have been:

Dr. Cash	500,000	
Cr. Borrowings		500,000

As shown in the journal entry above, the cash effect is a \$500,000 inflow (debit). This is shown in the applicable cash effects column below. This is recorded as a financing activity on the SCF because it relates to a noncurrent liability account.

Account	Balance (\$000s)		Change		Cash effect		Activity
	2018 Dr. (Cr.)	2017 Dr. (Cr.)	Dr.	Cr.	Inflow Dr.	Outflow Cr.	
Borrowings	(1,000)	(500)		500	500		Financing

### A note about offsetting cash flows

Certain transactions may involve offsetting cash inflows and outflows. For instance, if a \$200,000 building is acquired entirely by borrowing money from a bank, the journal entry would be:

Dr.	Buildings	200,000	
Cr.	Borrowings		200,000

Based on this entry, there is no cash effect. However, for SCF purposes, two transactions are considered to have occurred. First, the receipt of the bank loan proceeds:

Dr.	Cash	200,000	
Cr.	Borrowings		200,000

This would be shown as a cash inflow in the financing section of the SCF. Second, the purchase of the building:

Dr.	Buildings	200,000	
Cr.	Cash		200,000

This would be shown as a cash outflow in the investing section of the SCF. These effects are automatically considered using the cash flow table method, since each balance sheet account is considered separately.

### c. Analysis of share capital

As noted in transaction 7 above, share capital of \$410,000 was issued during 2018. This accounts for the entire change in this account. The entry to record this transaction would have been:

Dr.	Cash	410,000	
Cr.	Share Capital		410,000

The cash effect is a \$410,000 inflow (debit), as shown by the journal entry and in the cash effects column below. This is recorded as a financing activity inflow on the SCF because it relates to a shareholders' equity account.

Account	Balance (\$000s)		Change		Cash effect		Activity
	2018 Dr. (Cr.)	2017 Dr. (Cr.)	Dr.	Cr.	Inflow Dr.	Outflow Cr.	
Share capital	(1,210)	(800)		410	410		Financing

All accounts have now been analyzed. Based on this, the revised cash flow table is as follows:

Account	Step 1		Step 2		Step 3		Activity
	Balance (\$000s)		Change		Cash Effect		
	2018 Dr. (Cr.)	2017 Dr. (Cr.)	Dr.	Cr.	Inflow Dr.	Outflow Cr.	
Cash	27	150		123	To be explained		Cash and Cash Equiv.
Accounts receivable	375	450		75	75		Operating (Procedure 1a)
Merchandise inventory	900	450	450			450	Operating (Procedure 1a)
Prepaid expenses	20	10	10			10	Operating (Procedure 1a)
Land	210	290		80	<del>80</del> 104	24	Operating (Procedure 1b) Investing (Procedure 1b)
Buildings	1,200	400	800			800	Investing (Procedure 2a)
Machinery	990	700	<del>290</del> 350		<del>290</del>		Investing (Procedure 2b)
				(d) 60	(a) 30		Investing (Procedure 2c)
Acc. dep'n. – mach.	(540)	(300)	(b) 20		(c) 10		Investing (Procedure 2c)
				260	260		Operating (Procedure 1c)
				<del>240</del> 90	<del>240</del> 90		Operating (Procedure 1a)
Accounts payable	(235)	(145)		90	90		Operating (Procedure 1a)
Dividends payable	(25)	(30)	5			5	Financing (Procedure 3a)
Income taxes payable	(40)	(25)		15	15		Operating (Procedure 1a)
Borrowings	(1,000)	(500)		500	500		Financing (Procedure 3b)
Share capital	(1,210)	(800)		410	410		Financing (Procedure 3c)
Retained earnings	(672)	(650)		22	<del>22</del> 80		Operating (Procedure 1)
						58	Financing (Procedure 3a)
<b>Total</b>	<b>-0-</b>	<b>-0-</b>	<b>1,635</b>	<b>1,635</b>	<b>1,574</b>	<b>1,697</b>	

From this, the statement of cash flows can be prepared, classified into operating, investing, and financing activities.

#### Step 4 Prepare the cash flow from operating activities section of the SCF

The following cash flow from operating activities section of the SCF can now be prepared from the information in the cash effects columns in the cash flow table (amounts in 000s). Each activity labelled "Operating" in the completed cash flow table is used:

Net income		\$ 80
Add (deduct) changes in non-cash working capital accounts		
Increase in accounts receivable	\$ 75	
Increase in inventory	(450)	
Increase in prepaid expenses	(10)	
Increase in accounts payable	90	
Increase in income taxes payable	15	(280)
Items not affecting cash flow		
Depreciation expense	260	
Loss on disposal of machinery	10	
Gain on disposal of land	(24)	246
Cash flow from operating activities		<u>\$ 46</u>

To start the SCF preparation process, we originally assumed that net income of \$80,000 was the same amount of cash inflow from operating activities. After adjusting net income for the three categories of items that do not affect cash flow, we see that cash flow from operating activities is actually only \$46,000. The major effects



accounting for this difference are the add-back of depreciation expense (\$260,000) and the large cash expenditures to build up inventory during 2018 (\$450,000).

There are still some slight changes needed to the cash flow from operating activities section of the SCF to conform to generally accepted accounting standards.

- Income taxes paid need to be disclosed separately. To accomplish this, income before income taxes is used as the starting point instead of net income. The income taxes expense of \$35 as shown on the income statement is considered a separate cash outflow. This is combined with
- a. the change in the income taxes payable account between 2017 and 2018. The change in the income taxes payable account is a \$15 credit (\$40 - 25). The cash effect of this change is a \$15 debit, or a cash inflow. The net effect on the SCF is that income taxes have created a \$20 cash outflow during the year (\$35 outflow - \$15 inflow).

- For presentation brevity, often the changes in non-cash working capital accounts are combined and shown as one amount. Gains and losses on disposal are also combined into one amount. If desired, details of these changes can be disclosed in a note to the financial statements.
- b.

The revised cash flow from operating activities section of the SCF would show:

Income before income taxes	\$ 115
Income taxes paid	(20)
Items not affecting cash flow	
Net changes in non-cash working capital accounts <sup>1</sup>	(295)
Depreciation expense	260
Net gains on disposal <sup>2</sup>	(14)
Cash flow from operating activities	<u>\$ 46</u>
<sup>1</sup> (\$75 - 450 - 10 + 90) = \$295	
<sup>2</sup> (\$40 - 24) = \$14	

Note that cash flow from operating activities (\$46) has not changed.

### **Step 5 Prepare a statement of cash flows**

When analysis is complete, the cash effects columns of the cash flow table contain all the information needed to prepare the statement of cash flows:

Example Corporation  
Statement of Cash Flows  
For the Year Ended December 31, 2018  
(\$000s)

<i>Operating activities</i>	
Income before income taxes	\$ 115
Income taxes paid	(20)
Items not affecting cash flow	
Net changes in non-cash working capital	(295)
Depreciation expense	260
Net gains on disposal	(14)
Cash flow from operating activities	46
<i>Investing activities</i>	
Proceeds from sale of land	\$ 104
Proceeds from sale of machinery	30
Purchase of building	(800)
Purchase of machinery	(350)
Cash flow used by investing activities	(1,016)
<i>Financing activities</i>	
Loan proceeds	500
Issuance of shares	410
Payment of dividends	(63)
Cash flow from financing activities	847
Net decrease in cash	(123)
Cash at beginning of year	150
Cash at end of year	\$ 27

This agrees to the cash flow table.

These amounts agree to Cash reported on the balance sheet.

## 14.3 Interpreting the Statement of Cash Flows



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LO3 – Interpret a statement of cash flows.

Readers of financial statements need to know how cash has been used by the enterprise. The SCF provides external decision makers such as creditors and investors with this information. The statement of cash flows provides information about an enterprise's financial management policies and practices. It also may aid in predicting future cash flows, which is an important piece of information for investors and creditors.

The *quality* of earnings as reported on the income statement can also be assessed with the information provided by the SCF. The measurement of net income depends on a number of accruals and allocations that may not provide clear information about the cash-generating power of a company. Users will be more confident in a company with a high correlation between cash provided by operations and net income measured under the accrual basis. Recall, for instance, that although Example Corporation has net income of \$80,000 during 2018, its net cash inflow from operations is only \$46,000 – chiefly due to the large increase in inventory levels. Although net cash flow from operations is still positive, this discrepancy between net income and cash flow from operations may indicate looming cash flow problems, particularly if the trend continues over time.

Example Corporation's SCF also reveals that significant net additions to plant and equipment occurred during the year (\$1,016,000), financed somewhat by cash flow from operating activities but primarily by financing activities that included the assumption of loans and issue of shares that amounted to \$857,000, net of dividend payments.

It appears that a significant plant expansion may be underway, which may affect future financial performance positively. However, the magnitude of this expansion coupled with the payment of the dividends to shareholders has more than offset cash inflows from operating and financing activities, resulting in a net overall decrease in cash of \$123,000. Though the current cash expenditure on plant and equipment may be a prudent business decision, it has resulted in (hopefully temporary) adverse effects on overall cash flow.

The SCF is not a substitute for an income statement prepared on the accrual basis. Both statements should be used to evaluate a company's financial performance. Together, the SCF and income statement provide a better basis for determining the enterprise's ability to generate funds from operations and thereby meet current obligations when they fall due (liquidity), pay dividends, meet recurring operating costs, survive adverse economic conditions, or expand operations with internally-generated cash.

The SCF highlights the amount of cash available to a corporation, which is important. Excess cash on hand is unproductive. Conversely, inadequate cash decreases liquidity. Cash is the most liquid asset, and its efficient use is one of the most important tasks of management. Cash flow information, interpreted in conjunction with other financial statement analyses, is useful in assessing the effectiveness of the enterprise's cash management policies.

Readers who wish to evaluate the financial position and results of operations of an enterprise also require information on cash flows produced by investing and financing activities. The SCF is the only statement that explicitly provides this information. By examining the relationship among the various sources and uses of cash during the year, readers can also focus on the effectiveness of management's investing and financing decisions and how these may affect future financial performance.



## 14.4 Summary of Chapter 14 Learning Objectives



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### LO1 – Explain the purpose of the statement of cash flows.

The statement of cash flows is one of the four financial statements. It highlights the net increase or decrease in the cash and cash equivalents balance during the accounting period, and details the sources and uses of cash that caused that change.

### LO2 – Prepare a statement of cash flows.

The operating activities section of the statement of cash flows begins with net income calculated on the accrual basis and, by adjusting for changes in current assets, current liabilities, adding back depreciation expense, and adjusting for losses or gains on disposal of capital assets, arrives at cash flow from operating activities. The investing activities section analyzes cash inflows and outflows resulting from the sale and purchase of capital assets. The finance activities section discloses the cash inflows and outflows resulting from the assumption or payment of loans, issue or repurchase of shares, and payment of dividends.

### LO3 – Interpret a statement of cash flows.

A statement of cash flows contributes to the decision-making process by explaining the sources and uses of cash. The operating activities section can signal potential areas of concern by focusing on differences between accrual net income and cash flow from operating activities. The investing activities section can highlight if cash is being used to acquire assets for generating revenue, while the financing activities section can identify where the cash to purchase those assets might be coming from. Those who use financial statements can focus on the effectiveness of management's investing and financing decisions and how these may affect future financial performance.

## 14.5 Assignment Materials

### 14.5.1 Concept Self-check



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1. Using an example, explain in your own words the function of a statement of cash flows. Why is it prepared? What does it communicate to the reader of financial statements? What is its advantage over a balance sheet? over an income statement?
2. Why are financing and investing activities of a corporation important to financial statement readers?
3. How does an increase in accounts receivable during the year affect the cash flow from operating activities?

4. Is a statement of cash flows really only a summary of cash receipts and disbursements recorded in the corporation's Cash account?
5. What effect does the declaration of a cash dividend have on cash flow? the payment of a dividend declared and paid during the current year? the payment of a dividend declared in the preceding year?
6. Why may a change in the short-term investments account not affect the amount of cash provided by operations?
7. Why is it possible that cash may have decreased during the year, even though there has been a substantial net income during the same period?
8. Describe common transactions affecting balance sheet accounts that use cash. Explain how these items are analysed to identify cash flows that have occurred during the year.
9. How is the cash flow table method used to prepare a SCF?
10. What is the basic format of a SCF? Prepare a model format.

## 14.5.2 Comprehension Problems

### 14.5.2.1 CP 14-1



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The following transactions were carried out by Crozier Manufacturing Limited.

*Required:*

Indicate into which category each transaction or adjustment is placed in the statement of cash flows: operating (O), financing (F), or investing (I) activities.

\_\_\_\_\_ A payment of \$5,000 was made on a non-current bank loan.

\_\_\_\_\_ Depreciation expense for equipment was \$1,000.

\_\_\_\_\_ \$10,000 of share capital was issued for cash.

\_\_\_\_\_ Cash dividends of \$2,500 were declared and paid to shareholders.

\_\_\_\_\_ A non-current bank loan was assumed in exchange for equipment costing \$7,000.

\_\_\_\_\_ Land was purchased for \$25,000 cash.

- \_\_\_\_\_ \$750 of accrued salaries was paid.
- \_\_\_\_\_ A \$5,000 short-term demand loan was obtained.
- \_\_\_\_\_ \$10,000 of accounts receivable was collected.
- \_\_\_\_\_ A building was purchased for \$80,000: \$30,000 was paid in cash and the rest was borrowed.
- \_\_\_\_\_ Land was sold for \$50,000 cash.
- \_\_\_\_\_ Equipment was sold for \$6,000. The original cost was \$10,000. The related accumulation depreciation was \$3,000.
- \_\_\_\_\_ \$1,200 was paid for a 12-month insurance policy to take effect next year.
- \_\_\_\_\_ A patent was amortized for \$500.
- \_\_\_\_\_ Shares were redeemed for \$50,000 cash, their original purchase price.

### 14.5.2.2 CP 14-2



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The following table includes transactions carried out by Ram Horn Corporation, as well as columns for each of the three categories found in the statement of cash flows: operating, financing, and investing activities.

*Required:* For each event shown, indicate whether there is an inflow or outflow of cash in each of the categories, and indicate the amount. If the transaction would not appear on the statement of cash flows, explain why.

Example	<i>Operating activities In (out)</i>	<i>Financing activities In (out)</i>	<i>Investing activities In (out)</i>
1. Retired \$100 of non-	_____	_____ (100)	_____

---

	current debt with cash.			
2.	Purchased a building for \$90; \$60 was borrowed and the rest was paid in cash.	_____	_____	_____
3.	Declared and paid cash dividends of \$12 during the year.	_____	_____	_____
4.	Purchased equipment by issuing \$20 of common shares.	_____	_____	_____
5.	Paid \$50 in cash to pay off a bank loan.	_____	_____	_____
6.	Sold land for \$30 cash.	_____	_____	_____
7.	Earned net income of \$75.	_____	_____	_____
8.	Purchased equipment costing \$15; of this, \$5 was paid in cash and the	_____	_____	_____

---

	rest with a 90-day note payable.			
9.	Amortized a patent by \$2.	_____	_____	_____
10.	Assumed \$100 of non-current debt and repurchased common shares with the proceeds.	_____	_____	_____
11.	Purchased short-term investments for \$5 cash.	_____	_____	_____
12.	Sold a machine that cost \$20 for \$7 cash; the accumulated depreciation on it was \$10.	_____	_____	_____
13.	Depreciation expense for building and equipment amounted to \$8	_____	_____	_____
14.	Paid in cash the note payable in	_____	_____	_____

	transaction 8 above			
15.	Issued \$20 of preferred shares for cash	_____	_____	_____
16.	Purchased a patent for \$25 cash	_____	_____	_____
17.	Prepaid \$20 for the next two months of advertising	_____	_____	_____
18.	Purchased land for \$60 cash.	_____	_____	_____

### 14.5.2.3 CP 14-3



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*Required:* For each of the following items indicate whether it increases, decreases, or has no effect (N/E) on cash flow:

<u>Cash flow</u>				
Inc.	Dec.	N/E		
_____	_____	_____	1.	Earning net income for the year
_____	_____	_____	2.	Redemption of preferred shares at face value.
_____	_____	_____	3.	Purchase of inventory

_____	_____	_____	4.	Issuing common shares for equipment
_____	_____	_____	5.	Assuming non-current debt.
_____	_____	_____	6.	Declaring a cash dividend
_____	_____	_____	7.	Collection of an account receivable
_____	_____	_____	8.	Payment of an account payable
_____	_____	_____	9.	Purchase of land for cash
_____	_____	_____	10.	Issuing common shares for cash
_____	_____	_____	11.	Reclassifying non-current liabilities as current liabilities for the amount to be paid in cash next year
_____	_____	_____	12.	Payment of a cash dividend declared last year
_____	_____	_____	13.	Decrease in market value of short-term investments
_____	_____	_____	14.	Calculated amount owing for income taxes.

#### 14.5.2.4 CP 14-4



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Assume the following balance sheet information:



	2018	2017
<i>Assets</i>		
Cash	\$ -0-	\$100
Short-term investments	100	-0-
	\$100	\$100
<i>Shareholders' Equity</i>		
Share capital	\$100	\$100

*Required:* Calculate the change in cash and cash equivalents during 2018.

#### 14.5.2.5 CP 14-5



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	2018	2017
<i>Assets</i>		
Cash	\$100	\$50
<i>Liabilities</i>		
Current bank loan, due on demand	\$100	\$50

*Required:* Calculate the change in cash and cash equivalents during the year, and the ending balance.

#### 14.5.2.6 CP 14-6



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Assume the following income statement and balance sheet information for the year ended December 31, 2017:

Sales	\$200
Cost of goods sold	120
Gross profit	80
Operating expenses	
Rent	30
Net income	\$50

	2017	2016
	Dr. (Cr.)	Dr. (Cr.)
Cash	\$100	\$86
Accounts receivable	60	40
Inventory	36	30
Prepaid rent	10	-0-
Retained earnings	(206)	(156)

*Required:* Calculate cash flow from operating activities.

### 14.5.2.7 CP 14-7



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Assume the following income statement for the year ended December 31, 2017 and balance sheet at year-end:

Revenue	\$ -0-
Gain on sale of equipment	500
Net income	<u>\$500</u>

	2017	2016
Equipment	\$ -0-	\$1,000
Accumulated depreciation – equipment	-0-	(600)

No equipment was purchased during the year. Equipment was sold for cash during the year.

*Required:*

1. Calculate the amount of cash for which the equipment was sold.
2. Prepare the journal entry to record the sale of the equipment.
3. Calculate the cash flow from operating activities and investing activities.

### 14.5.2.8 CP 14-8



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Assume the following income statement and balance sheet information:

Service revenue (all cash)	\$175
Operating expenses	
Salaries (all cash)	85
Net income	<u>\$90</u>

	2017	2016
	Dr. (Cr.)	Dr. (Cr.)
Cash	\$1,250	\$1,600
Short-term investments	100	200
Borrowings	(600)	(1,000)
Common shares	(200)	(300)
Retained earnings	(550)	(500)

Other information: All dividends were paid in cash. The short-term investments will be converted to cash in 60 days. No gain or loss occurred when common shares were repurchased.

*Required:*

1. Calculate cash flow from operating activities.
2. Calculate the amount of dividends paid during the year.
3. Calculate cash flow used by financing activities.

### 14.5.2.9 CP 14-9



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The comparative balance sheets of Glacier Corporation showed the following at December 31.

	<i>2017</i>	<i>2016</i>
<i>Debits</i>		
Cash	\$ 10	\$ 8
Accounts receivable	18	10
Merchandise inventory	24	20
Land	10	24
Plant and equipment	94	60
	<u>\$156</u>	<u>\$122</u>
<i>Credits</i>		
Accumulated depreciation	\$ 14	\$ 10
Accounts payable	16	12
Non-current borrowings	40	32
Common shares	60	50
Retained earnings	26	18
	<u>\$156</u>	<u>\$122</u>

The income statement for 2017 was as follows:

Glacier Corporation  
income statement  
For the Year Ended December 31, 2017

Sales		\$300
Cost of sales		<u>200</u>
Gross profit		100
Operating expenses		
Rent	\$77	
Depreciation	<u>6</u>	<u>83</u>
Income from operations		17
Other gains (losses)		
Gain on sale of equipment	1	
Loss on sale of land	<u>(4)</u>	<u>(3)</u>
Net income		<u><u>\$ 14</u></u>

Additional information:

- a. Cash dividends paid during the year amounted to \$6.
- b. Land was sold during the year for \$10. It was originally purchased for \$14.
- c. Equipment was sold during the year that originally cost \$7. Carrying amount was \$5.
- d. Equipment was purchased for \$41.

*Required:*

1. Prepare a cash flow table.
2. Prepare a statement of cash flows for the year ended December 31, 2017.
3. Comment on the operating, financing, and investing activities of Glacier Corporation for the year ended December 31, 2017.

## 14.5.3 Problems

### 14.5.3.1 P 14-1



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Assume the following income statement information:

Sales (all cash)	\$35
Operating expenses	
Depreciation	10
Income before other item	<u>25</u>
Other item	
Gain on sale of equipment	8
Net income	<u><u>\$33</u></u>

Required:

1. Assume the equipment originally cost \$20, had a carrying amount of \$4 at the date of disposal and was sold for \$12. Prepare the journal entry to record the disposal. What is the cash effect of this entry?
2. Calculate cash flow from operating activities.

### 14.5.3.2 P 14-2



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Assume the following income statement and balance sheet information:

Service revenue (all cash)	\$300
Operating expenses	
Supplies	200
Income before income taxes	<u>100</u>
Income taxes	20
Net income	<u><u>\$ 80</u></u>

	2017	2016
	Dr. (Cr.)	Dr. (Cr.)
Cash	\$135	\$38
Accounts payable	(15)	(6)



Income taxes payable	(20)	(12)
Retained earnings	(100)	(20)

*Required:* Prepare the cash flow from operating activities section of the SCF.

### 14.5.3.3 P 14-3



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Assume the following income statement and balance sheet information:

Revenue		\$ -0-
Depreciation expense		<u>(100)</u>
Net loss		<u><u>\$(100)</u></u>
	2017	2016
	Dr. (Cr.)	Dr. (Cr.)
Cash	\$350	\$650
Machinery	500	200
Accumulated depreciation – machinery	(250)	(150)
Retained earnings	(600)	(700)

No machinery was disposed during the year. All machinery purchases were paid in cash.

*Required:*

1. Prepare a journal entry to record the depreciation expense for the year. Determine the cash effect.
2. Prepare a journal entry to account for the change in the Machinery balance sheet account. What is the cash effect of this entry?
3. Prepare a statement of cash flows for the year ended December 31, 2017.

**14.5.3.4 P 14-4**

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The following transactions occurred in the Hubris Corporation during the year ended December 31, 2017.

a.	Net income	\$800
b.	Depreciation expense	120
c.	Increase in wages payable	20
d.	Increase in accounts receivable	40
e.	Decrease in merchandize inventory	50
f.	Amortization of patents	5
g.	Payment of non- current borrowings	250
h.	Issuance of common shares for cash	500
i..	Payment of cash dividends	30

Other information: Cash at December 31, 2017 was \$1,200.

*Required:*

1. Prepare a cash flow table. The first two columns are not necessary. Enter amounts above in the "Change" columns. (Hint: the change to cash is the balancing figure in the "Change" columns - \$1,175.)
2. Prepare a statement of cash flows.

**14.5.3.5 P 14-5**

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During the year ended December 31, 2017, Wheaton Co. Ltd. Reported \$20,000 of net income, consisting of \$95,000 of revenues, \$70,000 of operating expenses, and \$5,000 of income taxes expense. Following is a list of transactions that occurred during the year:

- a. Depreciation expense, \$3,000 (included with operating expenses)
- b. Increase in wages payable, \$500
- c. Increase in accounts receivable, \$900
- d. Decrease in merchandise inventory, \$1,200
- e. Amortization of patent, \$100
- f. Non-current borrowings paid in cash, \$5,000
- g. Issuance of common shares for cash, \$12,500
- h. Equipment, cost \$10,000, acquired by issuing common shares
- i. At the end of the fiscal year, a \$5,000 cash dividend was declared, payable one month later
- j. Old machinery sold for \$6,000 cash; it originally cost \$15,000 (one-half depreciated). Loss reported on income statement as ordinary item and included in the \$70,000 of operating expenses.
- k. Decrease in accounts payable, \$1,000.
- l. Cash at January 1, 2017 was \$1,000; change in cash during the year, \$37,900
- m. There was no change in income taxes owing.

*Required:*

1. Prepare a cash flow table. The first two columns are not necessary. Enter amounts above in the "Change" columns. (Hint: the change to cash is the balancing figure in the "Change" columns - \$37,900.)
2. Prepare a statement of cash flows.
3. Explain what this statement tells you about Wheaton Co. Ltd.

### 14.5.3.6 P 14-6



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The following trial balance has been prepared from the ledger of Obelisk Corporation at December 31, 2017, following its first year of operations.

	<i>Debits</i>	<i>Credits</i>
Cash	\$ 45	
Accounts receivable	100	
Merchandise inventory, ending	60	
Prepaid rent	10	
Equipment	160	
Accumulated depreciation—equipment		\$ 44
Land	-0-	
Accounts payable		50
Dividends payable		5
Income taxes payable		8
Borrowings—due 2019		80
Common shares		140
Retained earnings		-0-
Dividends declared	15	
Sales		225
Depreciation	44	
Cost of goods sold	92	
Selling and administrative expenses	39	
Income taxes expense	7	
Gain on sale of land		20
	\$572	\$572

Additional information:

- a. Obelisk assumed \$100 of long-term debt during the year.
- b. Obelisk issued common shares for equipment, \$40. Other equipment was purchased for \$120 cash. No equipment was sold during the year.

- c. Land costing \$30 was purchased, then sold during the year for \$50.
- d. Some borrowings were repaid during the year for \$20 cash.
- e. The company declared dividends of \$15 during the year.

*Required:*

1. Calculate retained earnings at December 31, 2017.
2. Prepare a statement of cash flows.
3. Explain what the statement of cash flows tells you about Obelisk Corporation at December 31, 2017.

**14.5.3.7 P 14-7**



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The balance sheet information of Cormier Limited at December 31 appears below.

	2017	2016
<i>Debits</i>		
Cash	\$ 40	\$ 30
Accounts receivable	38	28
Merchandise inventory	102	106
Prepaid expenses	8	6
Land	-0-	20
Buildings	240	180
Machinery	134	80
Patents, at carrying amount	8	10
	<u>\$570</u>	<u>\$460</u>
<i>Credits</i>		
Accounts payable	\$ 40	\$ 44
Income taxes payable	8	6
Accumulated depreciation	76	80
Non-current borrowings	70	60
Common shares	310	240
Retained earnings	66	30
	<u>\$570</u>	<u>\$460</u>

The following additional information is available:

- a. Net income for the year was \$56,000; income taxes expense was \$20,000.
- b. Depreciation recorded on building and machinery was \$14,000.
- c. Amortization of patents amounted to \$2,000.
- d. Machinery costing \$30,000 was purchased; one-third was paid in cash and a 5-year loan assumed for the balance.
- e. Machinery costing \$60,000 was purchased, and was paid for by issuing 6,000 common shares.
- f. Machinery was sold for \$16,000 that originally cost \$36,000 (one-half depreciated); loss or gain reported in the income statement.
- g. Addition to building was made for \$60,000; paid cash.
- h. Land costing \$20,000 was sold for \$24,000 cash during the year. The related gain was reported in the income statement.
- i. Cash dividends of \$20,000 were paid.
- j. No shares were reacquired.

*Required:*

1. Prepare a cash flow table.
2. Prepare a statement of cash flows at December 31, 2017.
3. What observations about Cormier can you make from this statement?

## 14.5.4 Alternate Problems

### 14.5.4.1 AP 14-1



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Assume the following income statement information:



Service revenue (all cash)		\$235
Operating expenses		
Rent		
Amortization of patents	\$ 50	
Salaries	20	
	<u>100</u>	<u>170</u>
Income from operations		65
Other item		
Loss on sale of land		<u>18</u>
Net income		<u><u>\$ 47</u></u>

Assume that rent and salaries expenses are all paid in cash.

*Required:*

1. Prepare the journal entry to record the amortization of leasehold improvements. What is the cash effect of this entry?
2. Assume that the land was recorded at its original cost of \$32 on the balance sheet at the disposal date and was sold for \$14. Prepare the journal entry to record the disposal. What is the cash effect of this entry?
3. Calculate the cash flow from operating activities.

#### 14.5.4.2 AP 14-2



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Assume the following income statement for the year ended December 31, 2018 and balance sheet information at year-end:

Sales		\$400
Cost of goods sold		<u>180</u>
Gross profit		220
<i>Operating expenses</i>		
Insurance		<u>50</u>
Net income		<u><u>\$170</u></u>

	2018	2017
Accounts receivable	\$35	\$42
Inventory	56	65

Prepaid insurance	8	12
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*Required:* Calculate the cash flow from operating activities.

### 14.5.4.3 AP 14-3



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Assume the following income statement information at December 31, 2017 and balance sheet at year-end:

Service revenue (all cash)	\$500
Operating expenses	
Supplies	260
Income before income taxes	<u>240</u>
Income taxes	<u>100</u>
Net income	<u><u>\$140</u></u>

	2017	2016
Accounts payable	\$26	\$32
Income taxes payable	8	17

*Required:* Prepare the cash flow from operating activities section of the SCF.

### 14.5.4.4 AP 14-4



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Assume the following balance sheet information at December 31, 2018:

	2018	2017
Mortgage payable	\$2,000	\$1,600
Preferred shares	1,300	800

Common shares	200	150
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There were no income statement transactions during the year.

*Required:* Calculate the cash provided by financing activities.

#### 14.5.4.5 AP 14-5



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The comparative balance sheets of Sovereign Corporation showed the following information at December 31.

	2017	2016
<i>Debits</i>		
Cash	\$ 22	\$ 20
Short-term investments	30	38
Merchandise inventory	110	104
Prepaid expenses	16	6
Land	-0-	20
Buildings	240	180
Machinery	124	80
Patents, at carrying amount	8	10
	<u>\$550</u>	<u>\$458</u>
<i>Credits</i>		
Accounts payable	\$ 16	\$ 24
Dividends payable	26	18
Income taxes payable	4	6
Accumulated depreciation	78	80
Non-current borrowings	70	60
Common shares	300	240
Retained earnings	56	30
	<u>\$550</u>	<u>\$458</u>

Additional data for 2017:

- a. Net income for the year amounted to \$48, including income taxes expense of \$12.

- b. Amortization of patents amounted to \$2.
- c. Purchased machinery for \$30, paying \$10 in cash, and obtained a 5-year loan for the balance.
- d. Purchased \$50 of machinery by issuing common shares.
- e. Paid \$60 cash for an addition to the building.
- f. Sold land for \$24 (gain or loss is included in the income statement).
- g. Declared cash dividends of \$22.
- h. Depreciation expense for the year amounted to \$16.
- i. Sold machinery for \$14 that had originally cost \$36; it was one-half depreciated at the time of sale (gain or loss is included in the income statement).
- j. The short-term investments will be sold in 60 days for a known amount of cash.

*Required:*

1. Explain the appropriate treatment of items c. and d. above.
2. Prepare a cash flow table.
3. Prepare a statement of cash flows.
4. Explain what the statement of cash flows tells you about Sovereign Corporation.

#### 14.5.4.6 AP 14-6



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The records of Cambria Corporation showed the following information in the balance sheet accounts at December 31, 2017 and 2016.

	<i>2017</i>	<i>2016</i>
<i>Debits</i>		
Cash	\$ 11	\$ 10
Short-term investments	24	19
Merchandise inventory	53	52
Prepaid expenses	1	3
Land	-0-	10
Equipment, net	147	95
	<u>\$236</u>	<u>\$189</u>
<i>Credits</i>		
Accounts payable	\$ 8	\$ 12
Demand bank loan	2	3
Non-current debt	48	39
Common shares	150	120
Retained earnings	28	15
	<u>\$236</u>	<u>\$189</u>

Additional information for 2017:

- a. Net income was \$24; there were no income taxes.
- b. Cash dividends of \$11 were paid.
- c. Depreciation expense was \$3.
- d. Common shares were given in exchange for equipment costing \$30.
- e. A building was purchased for \$25; \$16 was paid in cash and a noncurrent loan was assumed for the difference.
- f. Land purchased for \$10 was sold for a \$6 gain. The gain is included in net income.
- g. Short-term investments will be sold in 30 days for a known amount.

Required:

1. Explain the appropriate treatment for items d. and e. above.
2. Prepare a cash flow table.
3. Prepare a statement of cash flows.
4. Explain what the statement of cash flows tells you about the Cambria Corporation.

#### 14.5.4.7 AP 14-7



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The comparative balance sheets for Sors Limited at December 31 are as follows:

<b>Sors Limited</b>			
<b>Balance Sheets</b>			
<b>At December 31</b>			
	<i>Assets</i>	<i>2017</i>	<i>2016</i>
Cash		\$ 6,000	\$ 7,000
Accounts receivable		3,000	4,500
Merchandise inventory		12,000	11,000
Land		23,000	10,000
Equipment		40,000	30,000
Accumulated depreciation		(9,000)	(8,000)
		<u>\$ 75,000</u>	<u>\$54,500</u>
<i>Liabilities and Shareholders' Equity</i>			
Accounts payable		\$ 6,000	\$ 7,000
Non-current borrowings, due in one year		6,000	6,000
Non-current borrowings		10,000	16,000
Common shares		8,000	3,000
Retained earnings		45,000	22,500
		<u>\$ 75,000</u>	<u>\$54,500</u>

Additional information for 2017:

- a. Net income for the year was \$27,500. There were no income taxes.
- b. No land was sold.



- c. Equipment was purchased for \$20,000 in exchange for common shares valued at \$5,000, plus \$15,000 cash.
- d. Equipment costing \$10,000 was sold for \$12,000 cash; a \$4,000 gain was reported in net income.
- e. Cash dividends of \$5,000 were declared and paid.
- f. Depreciation expense of \$3,000 was included in the net income amount.

*Required:*

1. Prepare a cash flow table for the year ended December 31, 2017.
2. Prepare a statement of cash flows.
3. What observations about Sors Limited can you make from the SCF?

## 14.5.5 Decision Problems

### 14.5.5.1 DP 14-1



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The balance sheet, income statement, and statement of changes in equity of Big Dog Carworks Corp. for the years ended December 31, 2019 through 2021 were presented in [Figure 13.1](#) of chapter 13. Refer to these.

Additional information:

1. Short-term investments are held to meet on-going cash requirements and are liquidated 120 days after acquisition.

Accounts receivable consist of the following (\$000s):

	2021	2020	2019
Trade accounts receivable	\$600	\$406	\$302
Allowance for doubtful accounts	(56)	(36)	(45)
2. Net trade receivables	<u>544</u>	<u>370</u>	<u>257</u>
Insurance proceeds from warehouse fire (see Note 4 below)	-0-	50	-0-
Total	<u>\$544</u>	<u>\$420</u>	<u>\$257</u>



3. Inventory at December 31, 2021 was reduced by \$200,000 due to obsolescence of some items.

During 2020, a warehouse building costing \$100,000 and with a carrying amount of \$47,000 was destroyed by fire. Insurance proceeds of \$50,000 were received in 2009 and recorded as part of accounts receivable at December 31, 2020 (see note 2 above).

4. The gain on disposal was recorded as part of selling, general, and administrative expenses on the 2020 income statement. There were no other disposals of property, plant, and equipment in 2020 and 2021.

Borrowings consist of the following (\$000s):

	2021	2020	2019
Demand bank loan	\$600	\$570	\$ -0-
5. Amount due to shareholder	225	-0-	-0-
<b>Total</b>	<u>\$825</u>	<u>\$570</u>	<u>\$ -0-</u>

The shareholder loan is subordinated to the demand bank loan. That is, it may not be repaid before the bank loan.

6. Accounts payable at December 31, 2021 include \$80,000 of dividends payable (2020 and 2019: \$-0-).

*Required:*

1. Prepare cash flow tables for 2020 and 2021. State any assumptions you make.
2. Prepare a comparative statement of cash flows for the years ended December 31, 2020 and 2021.
3. Interpret the SCF results.

### 14.5.5.2 DP 14-2



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Refer to DP 13-4 in Chapter 13 (Acme Auto Parts Ltd.).

*Required:*

1. Prepare cash flow tables for 2018 and 2019. State any assumptions you make.
2. Prepare a comparative statement of cash flows for the years ended December 31, 2018 and 2019.
3. Interpret the SCF results. Does this affect your decision as the loans officer to grant Acme's request for a \$10M loan?