



Intermediate Accounting

ELEVENTH EDITION

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University of Memphis

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Cornell University

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Graw
Hill**





Dedicated to:

David's wife Charlene, two daughters Denise and Jessica, and three sons Mike, Michael, and David
 Mark's wife Cathy and daughters Liz and Clara
 Wayne's wife Julee, daughter Olivia, and three sons Jake, Eli, and Luke
 Jennifer's husband Peppy and son Seth

INTERMEDIATE ACCOUNTING, 11e

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About the Authors

DAVID SPICELAND



Courtesy of David Spiceland

David Spiceland is Professor Emeritus in the School of Accountancy where he taught financial accounting at the undergraduate, master's, and doctoral levels for 36 years. He received his BS degree in finance from the University of Tennessee, his MBA from Southern Illinois University, and his PhD in accounting from the University of Arkansas.

David has published articles in a variety of academic and professional journals, including *The Accounting Review*, *Accounting and Business Research*, *Journal of Financial Research*, *Advances in Quantitative Analysis of Finance and Accounting*, and most accounting education journals: *Issues in Accounting Education*, *Journal of Accounting Education*, *Advances in Accounting Education*, *The Accounting Educators' Journal*, *Accounting Education*, *The Journal of Asynchronous Learning Networks*, and *Journal of Business Education*, and he is an author of McGraw Hill's *Financial Accounting* with Wayne Thomas and Don Herrmann. Professor Spiceland has received university and college awards and recognition for his teaching, research, and technological innovations in the classroom.

David enjoys cooking, spoiling his dogs and grandchildren, and strolling on the beach with his wife, Charlene.

MARK NELSON



Courtesy of Jesse Winter LLC

Mark Nelson is the Anne and Elmer Lindseth Dean and Professor of Accounting at Cornell University's Samuel Curtis Johnson Graduate School of Management. He received his BBA degree from Iowa State University and his MA and PhD degrees from The Ohio State University. Professor Nelson has won ten teaching awards, including an inaugural Cook Prize from the American Accounting Association.

Mark's research focuses on decision making in financial accounting and auditing. His research has been published in the *Accounting Review*; the *Journal of Accounting Research*; *Contemporary Accounting Research*; *Accounting, Organizations and Society*; and several other journals. He has received the American Accounting Association's Notable Contribution to Accounting Literature Award, as well as the AAA's Wildman Medal for work judged to make a significant contribution to practice.

Mark served three terms as an area editor of *The Accounting Review* and is a member of the editorial boards of several journals. He also served for four years on the FASB's Financial Accounting Standards Advisory Council.

Mark and his wife Cathy enjoy fitness and kayaking, particularly on Ithaca's Lake Cayuga, and spending time with their daughters Liz and Clara.

WAYNE THOMAS

Wayne Thomas is the Senior Associate Dean for Faculty and Research Innovation and the David C. Steed Chair of Accounting at the University of Oklahoma, where he teaches introductory financial accounting and intermediate accounting. He received his bachelor's degree in accounting from Southwestern Oklahoma State University and his master's and PhD in accounting from Oklahoma State University.

Wayne has won teaching awards at the university, college, and departmental levels and has received the Outstanding Educator Award from the Oklahoma Society of CPAs. He co-authors McGraw Hill's *Financial Accounting* with David Spiceland and Don Herrmann. He also co-authors McGraw Hill's *Financial Accounting for Managers* with Michael Drake, Jake Thornock, and David Spiceland.

His primary research interests include accounting information, capital markets, techniques used by managers to manipulate earnings, the importance of financial disclosures, and financial statement analysis. He previously served as an editor of *The Accounting Review* and has published articles in a variety of journals, including *The Accounting Review*, *Journal of Accounting and Economics*, *Journal of Accounting Research*, *Review of Accounting Studies*, and *Contemporary Accounting Research*. He has won several research awards, including the American Accounting Association's Competitive Manuscript Award and the University of Oklahoma's highest research award, being named a George Lynn Cross Research Professor.

Wayne is married to Julee, and they have four kids, Olivia, Jake, Eli, and Luke. He enjoys sports (basketball, tennis, golf, biking, and ping pong), crossword puzzles, the outdoors, and spending time with his family.



Courtesy of Shevaun Williams & Associates

JENNIFER WINCHEL

Jennifer Winchel is the Carman G. Blough Associate Professor of Accounting at the University of Virginia's McIntire School of Commerce, where she teaches courses at both the undergraduate and graduate levels. She received her BA degree from Illinois Wesleyan University, her MAS from Northern Illinois University, and her PhD from the University of Texas at Austin. Prior to joining UVA, she was a faculty member at the University of South Carolina's Darla Moore School of Business. While at SC, she won the Alfred G. Smith Award for excellence in teaching. She has public accounting experience as an audit manager for PwC.

Jennifer's research focuses on decision making in financial accounting. Her research has been published in scholarly journals, such as *The Accounting Review*; *Contemporary Accounting Research*; and *Accounting, Organizations, and Society*. She has presented her research at a number of universities and scholarly conferences.

In her free time, Jennifer enjoys various activities with her husband and son. She especially loves traveling with her son for soccer.



Courtesy of University of Virginia

Intermediate Accounting Eleventh Edition

Welcome to the new standard in Intermediate Accounting! Instructors recognize the “Spiceland advantage” in preparing their students for success. *Intermediate Accounting* offers an unrivaled experience by incorporating **current** changes in accounting standards and business practices, providing a **comprehensive** approach to instructor resources and assignment materials, applying a **clear** conversational tone in the text and related videos, and using the market-leading technological innovations of **Connect®**. The result—students develop a more complete understanding of Intermediate Accounting topics and are better prepared for their business careers.

“The textbook is readable and easy to follow since the authors present basic concepts and then cover advanced issues. Conceptually-oriented and dependable as the authors are timely in updating new accounting standards.”

—Hong Pak, California State Polytechnic University, Pomona

The *Intermediate Accounting* learning system is built around four key attributes: current, comprehensive, clear, and Connect.

Current: The Spiceland team is committed to keeping instructors’ courses up to date. The eleventh edition fully integrates the latest updates in accounting standards, business practices, pedagogy, and instructional resources. The content and resources in Spiceland *Intermediate* address the topics outlined in the new **CPA Evolution Model Curriculum**, and at the same time, focus on giving students the tools they need for the ever-changing skills and competencies required of today’s business professionals.

Content Coverage—A core concept of Spiceland *Intermediate* is to structure its content to offer instructors the most flexibility possible in designing their specific courses. Where practicable, each chapter starts with the basic overview of the chapter’s topic (Part A) and then builds incrementally to more advanced topics. For example, revenue recognition in Chapter 6 provides basic coverage of the 5-step revenue recognition principle in Part A and then dives deeper into each of the five steps in Part B. This “basic + expanded” instructional approach is pedagogically effective, but also provides instructors the flexibility to teach the content to their desired depth of coverage.

Student Skills—To help prepare students for today’s business profession, accounting programs are emphasizing (a) the development of students’ skills related to interpreting data visualizations and dashboards, (b) applying critical and logical thinking, (c) using general ledger software, (d) analyzing financial ratios, (e) interpreting accounting disclosures, (f) researching authoritative guidance, and (g) understanding ethical issues. Spiceland *Intermediate* offers THE MOST COMPREHENSIVE set of assignment material on the market to address these needs. Beyond a full set of Brief Exercises, Exercises, and Problems, you’ll find the following specialized assignments in Connect that address these skills:

- **Data Visualizations** – Students will see static images of bar charts, pie charts, line graphs, etc. that demonstrate an accounting concept. Along with the visual, students are given a series of questions that guide them through interpreting the visual in a purposeful way to reinforce an accounting concept.
- **Tableau Dashboard Activities** – Using a live embedded Tableau dashboard, students gather the information they need to answer accounting and business questions. No prior knowledge of Tableau is needed, and no additional software is needed. Students interact with the dashboards to extract the answers needed.
- **Applying Tableau** – For instructors wanting their students to work directly within Tableau, Applying Tableau assignments are available (Tableau software is free to students and instructors). These assignments provide students with an Excel data file and detailed instructions as well as a guided video tutorial that walks through the necessary steps and functions of creating a Tableau dashboard.
- **Integrated Excel** – These assignments provide a seamless integration of Excel within Connect, allowing students to work in live Excel spreadsheets—no additional logins, no need to upload or download files. Instructors can choose to grade by formula or solution value, and students receive instant cell-level feedback via integrated Check My Work functionality.

- **Applying Excel** – Students build their Excel skills by using many of the basic functions and formulas within Excel to perform calculations and analysis. Students are presented with many what-if scenarios to help them see the power of Excel and develop their logical thinking skills. Each assignment is provided with video instruction to help ease the requirement for instructors to teach Excel.
- **Codification Exercises** – Most chapters offer one or more assignment exercises, problems and cases designed to develop students' ability to conduct research using the FASB's Accounting Standards Codification.
- **Star Problems** – Particularly rigorous problems, designated by a ★, require students to combine multiple concepts or require significant use of judgment.
- **Decision Makers' Perspective Cases** – A wide array of cases are available to help your students think more deeply about accounting topics and analyze business situations. Cases include real-world companies, authoritative guidance (codification) research, financial analysis, accounting disclosures, ethics, judgment, and international accounting issues. Students also can follow **Target Corporation** for US GAAP and **Air France-KLM** for IFRS in continuing cases across all chapters. Most Decision Makers' Perspective Cases are now auto-graded in Connect, allowing instructors to conveniently assess students abilities when confronting real-world scenarios.
- **General Ledger Problems** – These accounting software-like assignments allow students to enter transactions in the general journal and see how those measurements flow automatically through the general ledger and trial balance to build the financial statements. Students will see how accounting software allows them to enter transactions and see instantly how financial statements are affected.

Accounting and Reporting Implications of COVID-19

The *Coronavirus Aid, Relief, and Economic Security (CARES) Act*, was designed to provide stimulus relief to businesses affected by COVID-19 in the form of loans, grants, and tax changes. This edition features COVID-19: ACCOUNTING AND REPORTING IMPLICATIONS boxes to explore the effects of the pandemic on businesses.

COVID-19: Accounting and Reporting Implications

Recall from Chapter 1 that political pressures sometimes affect accounting standards. As an example, the *Coronavirus Aid, Relief, and Economic Security (CARES) Act* included a provision that enabled banks and some other financial institutions to avoid applying the provisions of ASU No. 2016-13 between March 27, 2020, and December 31, 2020. That delay would enable banks to avoid recognizing large losses on outstanding receivables that they would have to recognize if applying CECL. In response to this provision, the American Accounting Association issued a resolution indicating that it "opposes direct action by Congress or other regulators outside of the established independent standards-setting framework. Such intervention undermines the authority of independent boards, does not allow for full participation of all stakeholders and is less transparent."¹³

Despite the flexibility provided by the CARES Act, many banks did not delay their planned CECL implementation. As a consequence, this provision of the CARES Act created non-comparability between the financial statements of banks that did and didn't adopt CECL.

Comprehensive: The Spiceland team ensures comprehensive coverage and quality throughout the learning system by building content and assets with a unified methodology that meets rigorous standards. Students are challenged through diverse examples and carefully crafted problem sets which promote in-depth understanding and drive development of critical-thinking skills.

The author team is committed to providing a learning experience that fully prepares students for the future by solidifying core comprehension and enabling confident application of key concepts. Students can feel confident that the conceptual underpinnings and practical skills conveyed in the eleventh edition will prepare them for a wide range of real world scenarios.

Clear: Reviewers, instructors, and students have all hailed *Intermediate Accounting*'s ability to explain both simple and complex topics in language that is coherent and approachable. Difficult topics are structured to provide a solid conceptual foundation and unifying framework that is built upon with thorough coverage of more advanced topics. This structure is paired with the power of Connect offering easy-to-use technology with auto-graded assignments and video resources for students. The author team's highly acclaimed conversational writing style establishes a friendly dialogue—establishing the impression of a conversation with students, as opposed to lecturing at them.

This tone remains consistent throughout the learning system, as authors Spiceland, Nelson, Thomas, and Winchel write not only the primary content but also every major supplement: instructor's resource manual, solutions manual, and test bank. All end-of-chapter material, too, is written by the author team and tested in their classrooms. *Intermediate Accounting* is written to be the most complete, coherent, and student-oriented resource on the market.

Connect: Today's accounting students expect to learn in multiple modalities. As a result, the eleventh edition of Spiceland's learning system offers the following features in Connect: **NEW** Data Analytics activities, SmartBook's adaptive learning and reading experience, **NEW** Concept Review Exercises Videos, Concept Overview Videos, Guided Examples, **NEW** Integrated Excel, and General Ledger problems.

Quality assessment continues to be a focus of Connect, with over **2,500 questions** available for assignment, including more than 1,125 algorithmic questions.

McGraw Hill Education is continually updating and improving our digital resources. To that end, our partnership with UWorld Roger CPA provides multiple-choice practice questions directly within our Connect banks, as well as assignable links to the UWorld Roger CPA site for complementary access to selected simulations. The authors have also created hundreds of practice multiple-choice questions that are available for each chapter.

Spiceland/Thomas Financial Accounting Series

Intermediate Accounting forms a complete learning system when paired with *Financial Accounting* by authors David Spiceland, Wayne Thomas, and Don Herrmann. Now in its sixth edition, *Financial Accounting* uses the same proven approach that has made *Intermediate Accounting* a success—a conversational writing style with real-world focus.

The authors are also proud to introduce a new book in the series, *Financial Accounting for Managers*, for which they are joined by award-winning authors Michael Drake and Jake Thornock. *Financial Accounting for Managers* brings the proven Spiceland/Thomas approach to today's students, either MBAs or undergraduates who aspire to be managers. Featuring modern companies, robust analysis sections, and auto-graded cases, this text focuses on helping students think critically about how accounting information fuels business decisions.

The Spiceland/Thomas Accounting Series is fully integrated with McGraw Hill's Connect, an educational platform that seamlessly joins Spiceland/Thomas superior content with enhanced digital tools to deliver precisely what a student needs, when, and how they need it.



What Keeps SPICELAND Users Coming Back?

In talking with so many intermediate accounting faculty, we heard more than how to improve the book—there was much, much more that both users and nonusers insisted we not change. Here are some of the features that have made Spiceland such a phenomenal success.

Financial Reporting Cases

Each chapter opens with a Financial Reporting Case that places the student in the role of the decision maker, engaging the student in an interesting situation related to the accounting issues to come. Then, the cases pose questions for the student in the role of decision maker. The case questions are answered at the end of the chapter.

Where We're Headed

These boxes describe the potential financial reporting effects of many of the FASB's proposed projects that have not yet been adopted, as well as joint proposed projects with the IASB. Where We're Headed boxes allow instructors to deal with ongoing projects to the extent they desire.

Additional Consideration Boxes

These are "on the spot" considerations of important, but incidental or infrequent, aspects of the primary topics to which they relate.

Decision Makers' Perspective

These sections appear throughout the text to illustrate how accounting information is put to work in today's firms. With the CPA exam placing greater focus on application of skills in realistic work settings, these discussions help your students gain an edge that will remain with them as they enter the workplace. These chapter sections are complemented by a variety of Decision Makers' Perspective Cases available for assignment and designed to further develop students' decision-making abilities.

Financial Reporting Case Solution

1. What are the cash flow aspects of the situation that Mr. Barr may be overlooking in making his case for a wage increase? How can a company's operations generate a healthy profit and yet produce meager or even negative cash flows? Positive net income does not necessarily indicate a healthy cash position. A statement of cash flows provides information about cash flows not seen when looking only at the balance sheet and the income statement. Although cash flows from operating activities result from the same activities reported in the income statement, the income statement reports the activities on an accrual basis. That is, revenues reported are those earned during the reporting period, regardless of when cash is received, and the expenses incurred in generating those revenues, regardless of when cash is paid. Thus, the very same operations can generate a healthy profit and yet produce meager or even negative cash flows.



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Where We're Headed



"Disclosure overload" is a frequent complaint by companies and investors alike. The notes to the financial statements can be very useful, but they are costly for companies to prepare and difficult for many users to sift through and understand. In response to that concern, the FASB has been developing a framework intended to make disclosures more effective and less redundant. In August of 2018, the FASB issued an addition to Concepts Statement No. 8, titled *Chapter 8: Notes to Financial Statements*, which suggests a series of questions that the FASB and its staff should consider when determining what notes should be required by new standards.⁴⁰ A separate part of the project will develop further guidance to help companies apply judgment when meeting disclosure requirements.

Additional Consideration

In Illustration 5–5, if Sporting Goods Inc. had prepaid The Shoe Company for delivery of the shoes in two years, rather than buying now and paying later, Sporting Goods Inc. would be viewed as providing a two-year loan to The Shoe Company. Assuming that Sporting Goods Inc. pays The Shoe Company \$41,323, the present value of \$50,000 for two periods at 10%, The Shoe Company would record interest expense and Sporting Goods Inc. would record interest revenue of \$8,677 (\$50,000 – \$41,323) over the two-year period. When delivery occurs in two years, The Shoe Company records sales revenue of \$50,000 and Sporting Goods Inc. values the inventory acquired at \$50,000.

Decision Makers' Perspective

LO7–9

Management must evaluate the costs and benefits of any change in credit and collection policies.

RECEIVABLES MANAGEMENT A company's investment in receivables is influenced by several variables, including the level of sales, the nature of the product or service sold, and credit and collection policies. These variables are, of course, related. For example, a change in credit policies could affect sales. In fact, more liberal credit policies—allowing customers a longer time to pay or offering cash discounts for early payment—often are initiated with the specific objective of increasing sales volume.

Management's choice of credit and collection policies often involves trade-offs. For example, offering cash discounts may increase sales volume, accelerate customer payment, and reduce bad debts. These benefits are not without cost. The cash discounts reduce the amount of cash collected from customers who take advantage of the discounts. Extending payment terms also may increase sales volume. However, this creates an increase in the required investment in receivables and may increase bad debts.

The ability to use _____ as a method of financing offers management alternative

Proven Text Features

Ethical Dilemma



The Raintree Cosmetic Company has several loans outstanding with a local bank. The debt agreements all contain a covenant stipulating that Raintree must maintain a current ratio of at least 0.9. Jackson Phillips, company controller, estimates that the 2024 year-end current assets and current liabilities will be \$2,100,000 and \$2,400,000, respectively. These estimates provide a current ratio of only 0.875. Violation of the debt agreement will increase Raintree's borrowing costs as the loans are renegotiated at higher rates.

Jackson proposes to the company president that Raintree purchase inventory of \$600,000 on credit before year-end. This will cause both current assets and current liabilities to increase by the same amount, but the current ratio will increase to 0.9. The extra \$600,000 in inventory will be used over the later part of 2025. However, the purchase will cause warehousing costs and financing costs to increase.

Jackson is concerned about the ethics of his proposal. What do you think?

Ethical Dilemmas

Because ethical ramifications of business decisions impact so many individuals as well as the core of our economy, Ethical Dilemmas are incorporated within the context of accounting issues as they are discussed. These features lend themselves very well to impromptu class discussions and debates, and are complemented by Ethics Cases found in the Decision Makers' Perspective Case section at the end of each chapter.

(\$ in millions)

Current assets:

	May 31, 2020	May 31, 2019
Cash and equivalents	\$ 8,348	\$ 4,466
Short-term investments	439	197
Accounts receivable (net)	2,749	4,272
Inventory	7,367	5,622
Prepaid expenses and other current assets	1,653	1,968
Total current assets	<u>\$20,556</u>	<u>\$16,525</u>

Source: Nike, Inc.

Illustration 3-3

Current Assets—Nike, Inc.

Real World Financials

Real-World Examples

Chapter discussion is enhanced by bountiful real company examples and excerpts from actual financial statements to add realism and garner student engagement with the topics being presented.

Revenue Recognition and Accounts Receivable (in part): Returns

Sales revenue and cost of sales reported in the statement of operations are reduced to reflect estimated returns. We record an estimated right of return liability for returns at the time of sale based on historical trends, current pricing and volume information, other market-specific information, and input from sales, marketing, and other key management personnel. The liability accrued reflects the variable consideration not expected to be received. The estimated value of the return to the customer's inventory is recorded as an asset. These procedures require the exercise of significant judgments. We believe these procedures enable us to make reliable estimates of future returns. Our actual results have historically approximated our estimates. When the product is returned and verified, the customer is given credit against their accounts receivable.

Source: AVX Corporation

Illustration 7-5

Disclosure of Sales Returns Policy—AVX Corporation

Real World Financials

Disclosure Note Illustrations

Frequent illustrations of actual companies' disclosure notes to demonstrate how so much accounting information is reported outside the financial statements.

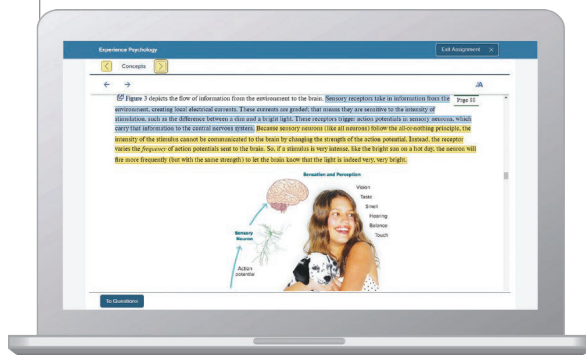


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Less Time
Grading



Laptop: McGraw Hill; Woman/dog: George Doyle/Getty Images

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"I really liked this app—it made it easy to study when you don't have your textbook in front of you."

- Jordan Cunningham,
Eastern Washington University



Calendar: owattaphotos/Getty Images

Everything you need in one place

Your Connect course has everything you need—whether reading on your digital eBook or completing assignments for class, Connect makes it easy to get your work done.

Learning for everyone

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POWERFUL ONLINE TOOLS & ASSESSMENTS

Online Assignments

Connect helps students learn more efficiently by providing feedback and practice material when they need it, where they need it. Connect grades homework automatically and gives immediate feedback on any questions students may have missed. The extensive assignable, gradable end-of-chapter content includes a general journal application that looks and feels like what one would find in a general ledger software package.

End-of-chapter questions in Connect include:

- Brief Exercises
- Exercises
- Problems
- *Star Problems
- Decision Makers' Perspective Cases
- Target and Air France Continuing Cases
- Data Analytics Cases
- Excel assignments
- General Ledger assignments
- Practice quizzes
- Test banks

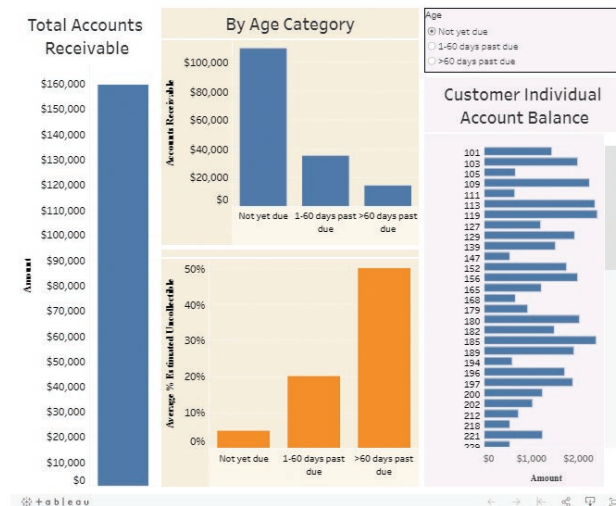
NEW! Data Analytics

Data analytics is an enormously in-demand skill among employers. Students who can interpret data and effectively communicate their findings to help businesses make better-informed decisions are in high-demand. Instructors can visit Connect to find a variety of auto-graded Data Analytics activities to introduce students to seeing data presented in the types of visual formats they'll see in today's business environments. These exercises have been thoughtfully developed and scaffolded to build data analytics exposure and skills.

Assignable, auto-gradable materials include:

- Data Visualizations—Familiarize students with data visualizations. Students interpret data in a static visual to answer accounting questions.
- Tableau Dashboard Activities—Easily introduce students to Tableau. Students learn to gather the information they need from a live embedded Tableau dashboard—no prior knowledge of Tableau is needed.
- Applying Tableau cases—Build student's data analytics skills. Students download an Excel file and build a Tableau dashboard with video tutorial guidance. Once they've completed their dashboard, they'll use it to answer auto-graded questions in Connect.

Review the Tableau visualization, and then answer the questions that follow.



Required:

Complete this question by entering your answers in the tabs below.

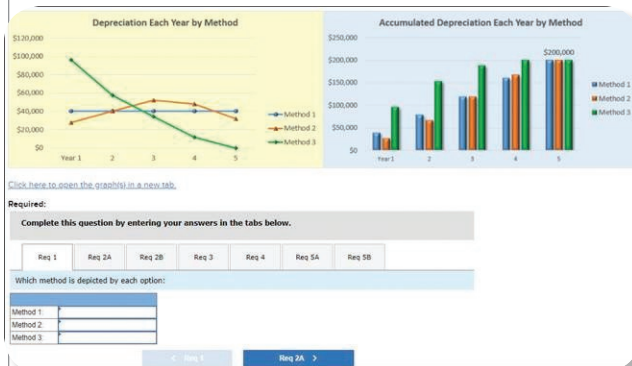
Required 1 Required 2 Required 3 Required 4 Required 5

Estimate the amount of uncollectible receivables. (Round your answers to 1 decimal place.)

Age group	
Not yet due	
1 to 60 days past due	
> 60 days past due	

Required 1

Required 2



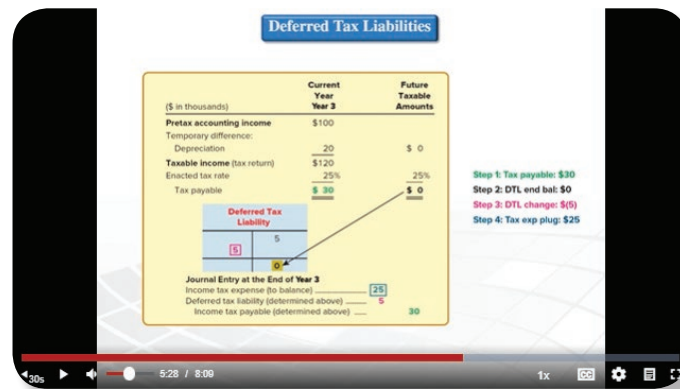
Back Journal entry is posted automatically to the general ledger. Use the drop-down button to view the unadjusted, adjusted, or post-closing balances.

Post-closing

General Ledger Account				Accounts Receivable			
Date	Debit	Credit	Balance	Date	Debit	Credit	Balance
Jan 01, 2015				Jan 01, 2015			
Jan 01, 2015	12		12	Jan 01, 2015			
Jan 02, 2015		5	7	Jan 02, 2015			
Jan 03, 2015	23		30	Jan 03, 2015			
Jan 04, 2015		12	18	Jan 04, 2015			
Jan 05, 2015		13	5	Jan 05, 2015			
Jan 06, 2015				Jan 06, 2015			
Jan 07, 2015				Jan 07, 2015			
Jan 08, 2015				Jan 08, 2015			
Jan 09, 2015				Jan 09, 2015			
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Concept Overview Videos

Concept Overview Videos provide engaging narratives of key topics in an assignable and interactive online format. These videos follow the structure of the text and are available with all learning objectives within each chapter of *Intermediate Accounting*. The Concept Overview Videos provide additional explanation of material in the text, allowing students to learn at their own pace—and test their knowledge with assignable questions.



2. On August 31, year 1, the company borrowed \$88,000 from a local bank. The note requires principal and interest at 9% to be paid on August 31, year 2.

AZMIE WHOLESALE FOOD COMPANY General Journal			
Date	Account Title and Explanation	Debit	Credit
June 30	Interest expense	1,980	
	Interest payable		1,980

$$\text{Principal} \times \text{Interest rate} \times \text{Time} = \$88,000 \times 9\% \times \frac{3}{12} = \$1,980$$

Guided Example/Hint Videos

The **Guided Examples** in Connect provide a narrated, animated, step-by-step walk-through of select exercises similar to those assigned. These short videos are presented to students as hints and provide reinforcement when students need it most. Instructors have the option of turning them on or off.

New Concept Review Exercise Videos

The **Concept Review Exercise videos** relate to select Concept Review sections in the text, showing students how to solve certain exercises. In walking students through a particular scenario or question, these videos model how students can approach problem solving.

The Wyndham Wholesale Company began operations on August 1. The following transactions occur during the month of August.

- The company receives \$50,000 cash from owners and issues 5,000 shares of common stock.
- Equipment is purchased for \$20,000 cash.
- On the first day of August, \$6,000 rent on office space is paid for the months of August, September, and October (\$2,000 month).
- Inventory costing \$38,000 is purchased on account. The company uses the perpetual inventory system.
- \$30,000 is borrowed from a local bank, and a note payable is signed.
- Credit sales for the month are \$40,000. The cost of inventory sold is \$22,000.
- \$15,000 is collected on account from customers.
- \$20,000 is paid on account to suppliers of inventory.
- Cash of \$2,000 was received from a customer for consulting services to be provided later in August and completed in early September.
- Salaries of \$7,000 are paid to employees for August.
- A bill for \$2,000 is received from the local utility company for the month of August.
- \$20,000 cash is loaned to another company, evidenced by a note receivable.
- The company pays its shareholders a cash dividend of \$1,000.



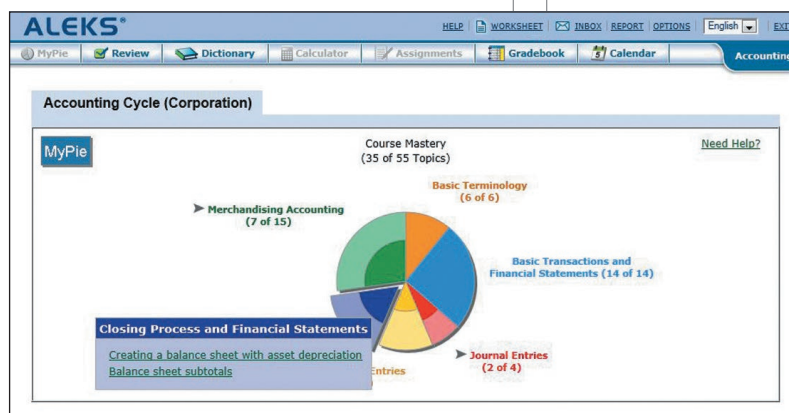
CPA SIMULATIONS

McGraw Hill Education has partnered with UWorld Roger CPA Review, a global leader in CPA Exam preparation, to provide students a smooth transition from the accounting classroom to successful completion of the CPA Exam. While many aspiring accountants wait until they have completed their academic studies to begin preparing for the CPA Exam, research shows that those who become familiar with exam content earlier in the process have a stronger chance of successfully passing the CPA Exam. Accordingly, students using these McGraw Hill materials will have access to sample CPA Exam Multiple-Choice questions and Task-Based Simulations from UWorld Roger CPA Review, with expert-written explanations and solutions. All questions are either directly from the AICPA or are modeled on AICPA questions that appear in the exam. Task-Based Simulations are delivered via the UWorld Roger CPA Review platform, which mirrors the look, feel, and functionality of the actual exam. McGraw Hill Education and UWorld Roger CPA Review are dedicated to supporting every accounting student along their journey, ultimately helping them achieve career success in the accounting profession. For more information about the full UWorld Roger CPA Review program, exam requirements, and exam content, visit <https://accounting.uworld.com/cpa-review/>.

ALEKS®

ALEKS ACCOUNTING CYCLE

ALEKS Accounting Cycle is a web-based program that provides targeted coverage of prerequisite and introductory material necessary for student success in Intermediate Accounting. ALEKS uses artificial intelligence and adaptive questioning to assess precisely a student's preparedness and deliver personalized instruction on the exact topics the student is **most ready to learn**. Through comprehensive explanations, practice, and immediate feedback, ALEKS enables students to quickly fill individual knowledge gaps in order to build a strong foundation of critical accounting skills. Better prepared students save you valuable time at the beginning of your course!



Use ALEKS Accounting Cycle as a pre-course assignment or during the first weeks of the term to see improved student confidence and performance, as well as fewer drops.

ALEKS Accounting Cycle Features:

- **Artificial Intelligence:** Targets Gaps in Prerequisite Knowledge
- **Individualized Learning and Assessment:** Ensure Student Preparedness
- **Open-Response Environment:** Avoids Multiple-Choice and Ensures Mastery
- **Dynamic, Automated Reports:** Easily Identify Struggling Students

For more information, please visit: www.aleks.com/highered/business.

Read ALEKS Success Stories: www.aleks.com/highered/business/success_stories.

Flexible & Effective Teaching Resources

INSTRUCTOR LIBRARY

The **Connect** Instructor Library is a repository of additional resources to improve student engagement in and out of class. You can select and use any asset that enhances your lecture. The Connect Instructor Library includes:

In-Class Presentation Tools

PowerPoints

Three types of PowerPoint decks are available, each responding to a different instructional need:

- **Lecture PowerPoints with Concept Checks:** Allow instructors to intersperse short exercises that students can solve individually or do in groups before an answer is “revealed.”
- **Lecture PowerPoints without Concept Checks:** No questions included, mirror presentation from book with key illustrations and notes.
- **Accessible PowerPoints:** Allow slide content to be read by a screen reader and provide alternative text descriptions for any image files. Accessible PowerPoints are also designed with high-contrast color palettes and use texture instead of color whenever possible to denote different aspects of imagery.

Digital Image Library

High-resolution images of all illustrations from the text.

Instruction Resources

Instructor's Manual

Specific to each chapter, contains *Authors' Perspectives* sections that offer insights from the authors on how they view the chapter's key topics and teach them to their students. There are also suggestions for in-class activities including real world scenarios, group research activities, IFRS activities, and professional skills development activities. Assignment charts are provided with topics and estimated completion times.

Solutions Manual

Created by the authors, includes solutions to end-of-chapter content.

Updates

Stop here for all the most recent updates from FASB. Our authors work tirelessly to keep you current—for instance, within a month of the CARES Act, our authors had posted an updated PowerPoint deck, video walkthrough, and teaching tip material on how to address the new updates. We have your back!

Test Bank

Connect Test Bank

Multiple-choice, true/false, and worksheet questions are all available to help assess students throughout all levels from understanding to evaluation.

Available within Connect, Test Builder is a cloud-based tool that enables instructors to format tests that can be printed or administered within a LMS. Test Builder offers a modern, streamlined interface for easy content configuration that matches course needs without requiring a download.


Test Builder allows you to:

- Access all test bank content from a particular title.
- Easily pinpoint the most relevant content through robust filtering options.
- Manipulate the order of questions or scramble questions and/or answers.
- Pin questions to a specific location within a test.
- Determine your preferred treatment of algorithmic questions.
- Choose the layout and spacing.
- Add instructions and configure default settings.

Test Builder provides a secure interface for better protection of content and allows for just-in-time updates to flow directly into assessments.

Remote Proctoring & Browser-Locking Capabilities



connect +  **proctorio**

New remote proctoring and browser-locking capabilities, hosted by Proctorio within Connect, provide control of the assessment environment by enabling security options and verifying the identity of the student.

Seamlessly integrated within Connect, these services allow instructors to control students' assessment experience by restricting browser activity, recording students' activity, and verifying students are doing their own work.

Instant and detailed reporting gives instructors an at-a-glance view of potential academic integrity concerns, thereby avoiding personal bias and supporting evidence-based claims.

MCGRAW HILL EDUCATION CUSTOMER EXPERIENCE GROUP CONTACT INFORMATION

At McGraw Hill Education, we understand that getting the most from new technology can be challenging. That's why our services don't stop after you purchase our products. You can contact our Product Specialists 24 hours a day to get product training online. Or you can search the knowledge bank of Frequently Asked Questions on our support website. For Customer Support, call **800-331-5094**, or visit www.mhhe.com/support. One of our Technical Support Analysts will be able to assist you in a timely fashion.

What's New in the Eleventh Edition?

Spiceland is the new global standard for providing students the most accessible, comprehensive, and current Intermediate Accounting learning system. We take seriously the confidence the marketplace has accorded our text. Each revision carefully considers how the print and digital content work together to coordinate improvements in content and industry-leading technology to provide the most robust learning solution. The Spiceland team implements only those changes that constitute real improvements as identified through extensive research with users. The result is a learning system that enhances our reputation for providing the best preparation for passing the CPA exam and successful accounting careers.

Improvements to this edition include the following:

- Updated and revised **real-world** illustrations, assignments, and discussions.
- Revised Continuing Cases featuring **Target Corporation** financial statements prepared using U.S. GAAP, *auto-gradable in Connect*. A comprehensive version of the case is available in Appendix B.
- Revised Continuing Cases featuring **Air France–KLM** financial statements prepared using IFRS, *auto-gradable in Connect*. A comprehensive version of the case is available in Appendix C.
- Incorporated the latest technology, including:
 - **NEW! Data Analytics** activities provide students the opportunity to experience the power and efficacy of data analytics in the context of each chapter's topics, using Tableau as a tool, that are *auto-gradable in Connect*. Materials include **Data Visualizations**, **Tableau Dashboard Activities**, and **Applying Tableau Cases**.
 - **NEW! Integrated Excel assignments** that allow students to practice their Excel skills within the context of accounting (*auto-gradable in Connect*).
 - **NEW! Concept Review Exercise Videos** show students how to solve select review exercises.
 - **NEW! Most Decision Makers' Perspective** cases are now *auto-gradable in Connect*.
 - **General Ledger Problems** that auto-post from journal entries to T-accounts to trial balances (*auto-gradable in Connect*).
 - **Concept Overview Videos** that provide engaging narratives of key topics in an assignable and interactive online format (*assignable in Connect*).
 - **Guided Example/Hint Videos** in Connect that provide a narrated, animated, step-by-step walk-through of select exercises that provide reinforcement when students need it most (can be turned on or off by instructors).

Chapter 1

ENVIRONMENT AND THEORETICAL STRUCTURE OF FINANCIAL ACCOUNTING

- Revised the discussion of Sarbanes-Oxley to focus on the most important attributes.
- Revised the discussion of financial reporting reforms to include critical audit matters.
- Revised the discussion of measurement attributes included in the conceptual framework.
- Added an IFRS box covering changes in the IFRS conceptual framework.
- Revised the Where We're Headed box covering possible changes in the FASB's conceptual framework.
- Added a Research Case focused on the Accounting Standards Codification.

- Revised multiple Decision Makers' Perspective cases to make them auto-gradable.
- Revised **Target** and **Air France–KLM** cases and made them auto-gradable.

- Converted for auto-grading Decision Makers' Perspective.
- **Target** and **Air France–KLM** continuing cases are now auto-gradable.

Chapter 2

REVIEW OF THE ACCOUNTING PROCESS

- Added a new unnumbered illustration of the basic accounting equation in LO2–1.
- Revised Illustrations 2–1 and 2–3.
- Revised and shortened discussion of account relationships in LO2–1.
- Modified each Concept Review Exercise to include deferred revenue transaction.
- Revised the discussion of adjusting entries in LO2–5.

Chapter 3

THE BALANCE SHEET AND FINANCIAL DISCLOSURES

- Updated all real-world illustrations to the most recent information.
- Added a discussion of new disclosures of operating leases to long-term assets.
- Added a discussion of new disclosures of operating leases to current and long-term liabilities.
- Revised Illustration 3–10 to include **Nike**.
- Revised Illustration 3–11 to **Hyatt Hotels**.

- Added an example of impact of COVID-19 on MD&A disclosure for **Darden Restaurants** in Illustration 3–12 and for going concern opinion for **RTW Retailwinds** for Illustration 3–16.
- Added a new section on Sustainability Disclosures, along with new Brief Exercise.
- Converted for auto-grading Decision Makers' Perspective cases.
- **Air France–KLM** continuing case is now auto-gradable.

Chapter 4

THE INCOME STATEMENT, COMPREHENSIVE INCOME, AND THE STATEMENT OF CASH FLOWS

- Updated all real-world illustrations to the most recent information.
- Changed the feature story to **Campbell Soup Company**.
- Changed Illustration 4–5 to **Estée Lauder Companies**.
- Revised the discussion of non-GAAP earnings and included an example of **Nvidia**.
- Revised the opening example of discontinued operations.
- Revised substantially the entire section on comprehensive income.
- Revised the discussion on statement of cash flows by including an example with successive balance sheets.
- Decision Makers' Perspective cases are now auto-gradable.
- **Air France–KLM** continuing case is now auto-gradable.

Chapter 5

TIME VALUE OF MONEY CONCEPTS

- Updated all real-world illustrations to the most recent information.
- Included Excel functions in the margins for many time value calculations.
- Revised the unnumbered illustration in L05–2 on future value.
- Revised the unnumbered illustration in L05–3 on present value.
- Clarified the discussion of ordinary annuity versus annuity due, as well as corresponding unnumbered illustrations.

- Added a new Illustration 5–13 for present value of annuity due.
- Revised the discussion of deferred annuity to improve clarity.
- Added a new Summary section with Excel.
- Added an Excel icon and functions in several places.
- Decision Makers' Perspective cases are now auto-gradable.
- Revised **Target** continuing case to include operating leases.

Chapter 6

REVENUE RECOGNITION

- Revised the introduction to reduce coverage of revenue-recognition standards in place prior to ASC 606.
- Added a discussion of **Peloton Interactive, Inc.**, as offering contracts with multiple performance obligations.
- Revised Illustration 6–16 to show **Emcor Group, Inc.**'s disclosure of variable consideration.
- Revised Illustration 6–18 to show **Amazon**'s disclosure of its roles as a principal and agent.
- Revised Illustration 6–22 to show the **Walt Disney Company**'s disclosure of revenue recognition with respect to licenses.
- Added a COVID-19 box discussing accounting for revenue associated with vaccines.
- Added a Real World Case concerning determining progress toward completion for **Verizon, Lockheed Martin, and TriNet**.
- Added a Research Case regarding codification.
- Added a Real World Case concerning revenue recognition and time value of money for **Deere & Company**.
- Added a Real World Case concerning estimating stand-alone selling prices for **eBay, Oracle, Lockheed Martin, and EMCOR**.
- Added two Trueblood Cases dealing with identifying performance obligations and principal v. agent considerations.
- Revised multiple Decision Makers' Perspective cases to make them auto-gradable.
- Revised **Target** and **Air France–KLM** cases and made them auto-gradable.

Chapter 7

CASH AND RECEIVABLES

- Added a COVID-19 box discussing delayed CECL implementation under the CARES Act.

- Revised the discussion of sales of accounts receivable (with and without recourse) to enhance clarity.
- Revised the discussion of accounts receivable turnover, and comparison between **NortonLifeLock, Inc.** and **Broadcom, Inc.**
- Added a COVID-19 box discussing suspension of accounting for troubled debt restructurings.
- Added questions with respect to COVID-19 boxes.
- Added a new problem regarding **Dell Technologies**' accounting for bad debts.
- Added a Real World Case regarding accounting for sales returns and receivables by **Toughbuilt Industries, Inc.**
- Added a Trueblood case regarding financing with receivables.
- Revised multiple Decision Makers' Perspective cases to make them auto-gradable.
- Revised **Target** and **Air France–KLM** cases and made them auto-gradable.

Chapter 8

INVENTORIES: MEASUREMENT

- Updated all real-world illustrations to the most recent information.
- Revised Illustration 8–4 to include cost of goods sold entry.
- Revised Illustration 8–7C for greater clarity.
- Revised Illustration 8–7D for greater clarity.
- Created a new Illustration 8–10 and revised discussion of LIFO reserve.
- Revised the Concept Review Exercise on inventory cost flow assumptions.
- Added Analysis Case for **Coca-Cola** and **Pepsico**.
- Decision Makers' Perspective cases are now auto-gradable.

Chapter 9

INVENTORIES: ADDITIONAL ISSUES

- Updated all real-world illustrations to the most recent information.
- Revised the introduction to the retail inventory method.
- Revised Illustration 9–8.
- Decision Makers' Perspective cases are now auto-gradable.

Chapter 10

PROPERTY, PLANT, AND EQUIPMENT AND INTANGIBLE ASSETS: ACQUISITION

- Updated all real-world illustrations to most recent information.
- Changed the feature story to **Microsoft Corporation**.
- Revised Illustration 10–1 and Illustration 10–2 to include **Microsoft Corporation**.
- Added additional intangible assets to Illustration 10–3.
- Revised the discussion of the categories of intangible assets.
- Revised the discussion of deferred payments and Illustration 10–10.
- Clarified the discussion of donated assets and government grants.
- Added Analysis Case for **Darden Restaurants** and Real World Case for **Salesforce.com**.
- Decision Makers' Perspective cases are now auto-gradable.

Chapter 11

PROPERTY, PLANT, AND EQUIPMENT AND INTANGIBLE ASSETS: UTILIZATION AND DISPOSITION

- Updated all real-world illustrations to the most recent information.
- Revised Illustration 11–1 and its discussion.
- Revised Illustration 11–9 to include **Kinder Morgan**.
- Revised Illustration 11–21 to include **Starbucks Corporation** and the impact of COVID-19 on impairment of property, plant, and equipment.
- Revised Illustration 11–24 to include **Carnival Corporation** and the impact of COVID-19 on goodwill impairment.
- Added a COVID-19 box related to impairment of property, plant, and equipment.
- Added a COVID-19 box related to goodwill impairment.
- Decision Makers' Perspective cases 11–1 through 11–9 are now auto-gradable.

Chapter 12

INVESTMENTS

- Revised Illustration 12–15 to better convey calculations relevant to the equity method.

- Revised the discussion of changes in levels of ownership using **SoftBank**, **T-Mobile**, **Toyota**, and **Subaru** as examples.
- Added a COVID-19 box discussing delayed CECL implementation under the CARES Act.
- Added an exercise covering recovery of impairments under IFRS.
- Added a Research Case regarding codification.
- Added a Real World Case regarding **Cisco Systems'** accounting for available-for-sale investments.
- Added a Real World Case regarding **General Motors'** accounting for other comprehensive income related to available-for-sale investments.
- Added a Trueblood case regarding accounting for equity for which fair value is not readily determinable.
- Revised multiple Decision Makers' Perspective cases to make them auto-gradable.
- Revised **Target** and **Air France–KLM** cases and made them auto-gradable.

Chapter 13

CURRENT LIABILITIES AND CONTINGENCIES

- Added a Where We're Headed box discussing potential changes to the definition of a liability in the FASB's conceptual framework.
- Changed Illustration 13–14 to cover **Microsoft's** discussion of a loss contingency.
- Changed Illustration 13–15 to cover **Gilead Sciences, Inc.'**s discussion of a loss contingency.
- Changed Illustration 13–21 to cover **Yum! Brands, Inc.'**s disclosure of a lawsuit.
- Added a COVID-19 box discussing **Dave & Buster's Entertainment, Inc.'**s disclosure of that subsequent event.
- Added a COVID-19 box discussing deferral of FICA taxes.
- Added an exercise including **Marriott International, Inc.'**s classification of debt.
- Added a Real World Case covering **Honda Motor Company, Ltd.'**s disclosure of lawsuits.
- Revised multiple Decision Makers' Perspective cases to make them auto-gradable.
- Revised **Target** and **Air France–KLM** cases and made them auto-gradable.

Chapter 14

BONDS AND LONG-TERM NOTES

- Added a real-world disclosure on callable bonds.

- Revised the discussion of bond issuance to include Google owner **Alphabet, Inc.'**s \$10 billion issue of corporate debt for environment and social endeavors.
- Expanded and highlighted assignment materials focusing on financial statement effects.
- Added a COVID-19 box to discuss the effect of the pandemic on bond accounting issues.
- Revised the Decision Makers' Perspective demonstrating the calculation and interpretation of risk ratios.
- Added two COVID-19 exercises to illustrate accounting for Payroll Protection Program forgivable loans.
- Added a Real World Case on the way long-term debt is reported in **Macy's** financial statements.
- Added an Analysis Case debating two approaches to account for convertible debt.
- Added a Research Case using a disclosure note to illustrate accounting for convertible bonds and find the Codification citation to support that accounting.

Chapter 15

LEASES

- Revised the Financial Reporting Case introducing the chapter.
- Expanded the Decision Makers' Perspective discussion on the motivation for manipulate lease terms to have leases structured as operating leases.
- Expanded the discussion of the effect of a residual value (guaranteed and unguaranteed) on the lessor's accounting for sale-type leases.
- Added a COVID-19 box to discuss the effect of the pandemic on lease accounting issues.
- Added an Exercise using a **Microsoft** disclosure note to examine how leases are reporting in a statement of cash flows.
- Added a Real World Case using a **Microsoft** disclosure note to illustrate differences between finance leases and operating leases.
- Added a Real World Case using information from **Walmart's** financials to illustrate reporting requirements for finance leases and operating leases and lease accounting concepts.
- Added a COVID-19 case to practice the CARES Act impact on accounting for the modification of lease terms.
- Added a Real World Case (**FedEx**) using a disclosure note to illustrate how leases are reporting in a statement of cash flows.

Chapter 16

ACCOUNTING FOR INCOME TAXES

- Modified Illustration 16–6 to include **Pier 1 Imports, Inc.**'s Valuation Allowance.
- Modified Illustrations 16–7A–7C and 16–10 to demonstrate deferred tax accounting with the financial statements of **Citi Trends, Inc.**
- Revised an Additional Consideration to discuss taxes on unrepatriated foreign earnings using the financial statements of **Goldman Sachs Group, Inc.** as well as **JPMorgan Chase & Co.**
- Added a COVID-19 box detailing how the CARES Act modified accounting for the tax effects associated with NOLs.
- Modified Illustration 16–14 to show **Walmart, Inc.**'s disclosure of deferred taxes.
- Added questions, brief exercises, exercises, problems, and cases dealing with accounting for the effects of COVID-19.
- Added a brief exercise regarding **Uber Technologies, Inc.**'s valuation allowance.
- Added an exercise showing accounting for net operating loss carryforwards.
- Added Real World Cases to illustrate accounting for taxes for **Buckle, Francesca's Holdings Corporation, CVS Health**, and **Marathon Petroleum Corporation**.
- Added a Research Case regarding codification.
- Revised multiple Decision Makers' Perspective cases to make them auto-gradable.
- Revised **Target** and **Air France–KLM** cases and made them auto-gradable.

Chapter 17

PENSIONS AND OTHER POSTRETIREMENT BENEFIT

- Expanded the discussion of the financial reporting effects to provide additional emphasis that the PBO and plan assets are netted together on the balance sheet rather than being separately reported.
- Added a real-world disclosure note (**General Mills**) on components of pension expense.
- Added a new problem using a **Clorox** disclosure note to illustrate financial statement effects of actuarial gains and losses.
- Revised and expanded a Real World Case using **FedEx** disclosure notes to illustrate reporting postretirement plans.
- Added a Research Case asking students to research the way changes in postretirement

benefit estimates are reported and to find the Codification citation to support that accounting.

Chapter 18

SHAREHOLDERS' EQUITY

- Revised the Financial Reporting Case introducing the chapter.
- Added a discussion of a statement of retained earnings as an alternative for some companies to a statement of changes in shareholder's equity.
- Added a COVID-19 box to discuss the effect of the pandemic on shareholders' equity.
- Replaced a Microsoft Brief Exercise with a **Target** Brief Exercise.
- Added a **Tesla** news release concerning a five-for-one stock split.
- Added a COVID-19 exercise to practice the CARES Act impact on accounting for Payroll Support Program loans.
- Added an Analysis Case using a disclosure note to demonstrate accounting for the issuance of stock and share issue costs.

Chapter 19

SHARE-BASED COMPENSATION AND EARNINGS PER SHARE

- Abbreviated the discussion on the debate leading to the requirement to expense stock options given the time lapse since that debate.
- Replaced a **Facebook** exercise with a **FedEx** Exercise centered on a share-based compensation disclosure note.
- Replaced a **Tesla** exercise with a **Microsoft** Exercise centered on an employee stock purchase plan disclosure note.
- Replaced the **Air France Case** to highlight the similarities and terminology differences in EPS reporting.

Chapter 20

ACCOUNTING CHANGES AND ERROR CORRECTIONS

- Added a disclosure note describing a change in inventories from the FIFO method to the LIFO method by **Mueller Industries**.
- Added a disclosure note describing an error correction by **Kraft Heinz**.

- Added an auto-gradable Judgment Case on reporting a change in inventory method.
- Added an auto-gradable Analysis Case on the impact of an error and its correction.

Chapter 21

STATEMENT OF CASH FLOWS REVISITED

- Revised a **CVS Health Corp.** illustration of presenting cash flows from operating activities by the direct method.
- Revised an **Amazon** illustration of presenting cash flows from operating activities by the indirect method.
- Added a discussion of "free cash flow" analysis.
- Added a Real World Case (**General Mills**) employing "free cash flow" analysis.
- Added a Real World Case (**Microsoft**) using a disclosure note to illustrate how leases are reporting in a statement of cash flows.

Appendix A

DERIVATIVES

- Revised Illustration A–1 and its discussion.
- Added a COVID-19 box to discuss the effect of the pandemic on accounting for derivatives.
- Revised Illustrations A–2, A–3, and A–5 and the related discussion.
- Clarified the discussion of hedge effectiveness.
- Added an exercise for an interest rate swap on a fixed rate investment.
- Added an exercise for a cash flow hedge on a forecasted purchase.
- Replaced P A–1 and P A–2 for clarity and to update for the LIBOR to SOFR transition.
- Added **Target** and **Air France–KLM** cases.

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CHAPTER

2

Review of the Accounting Process

OVERVIEW

Chapter 1 explained that the primary means of conveying financial information to investors, creditors, and other external users is through financial statements and related notes. The purpose of this chapter is to review the fundamental accounting process used to produce the financial statements. This review establishes a framework for the study of the concepts covered in intermediate accounting.

Actual accounting systems differ significantly from company to company. This chapter focuses on the many features that tend to be common to any accounting system.

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- **LO2-1** Understand routine economic events—transactions—and determine their effects on a company's financial position and on specific accounts. (p. 46)
- **LO2-2** Describe the steps in the accounting processing cycle. (p. 49)
- **LO2-3** Analyze and record transactions using journal entries. (p. 53)
- **LO2-4** Post the effects of journal entries to general ledger accounts and prepare an unadjusted trial balance. (p. 58)
- **LO2-5** Identify and describe the different types of adjusting journal entries. (p. 61)
- **LO2-6** Record adjusting journal entries in general journal format, post entries, and prepare an adjusted trial balance. (p. 62)
- **LO2-7** Describe the four basic financial statements. (p. 70)
- **LO2-8** Explain the closing process. (p. 74)
- **LO2-9** Convert from cash-basis net income to accrual-basis net income. (p. 78)



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FINANCIAL REPORTING CASE

Engineering Profits

After graduating from college last year, two of your engineering-major friends started an Internet consulting practice. They began operations on July 1 and felt they did quite well during their first year. Now they would like to borrow \$20,000 from a local bank to buy new computing equipment and office furniture. To support their loan application, the friends presented the bank with the following income statement for their first year of operations ending June 30:

Consulting revenue		\$ 96,000
Operating expenses:		
Salaries	\$32,000	
Rent	9,000	
Supplies	4,800	
Utilities	3,000	
Advertising	1,200	(50,000)
Net income		<u>\$ 46,000</u>

The bank officer noticed that there was no depreciation expense in the income statement and has asked your friends to revise the statement after making year-end adjustments. After agreeing to help, you discover the following information:

- The friends paid \$80,000 for equipment when they began operations. They think the equipment will be useful for five years.
- They pay \$500 a month to rent office space. In January, they paid a full year's rent in advance. This is included in the \$9,000 rent expense.
- Included in consulting revenue is \$13,000 they received from a customer in June as a deposit for work to be performed in August.

By the time you finish this chapter, you should be able to respond appropriately to the questions posed in this case. Compare your response to the solution provided at the end of the chapter.

- What purpose do adjusting entries serve?
- What year-end adjustments are needed to revise the income statement? Did your friends do as well their first year as they thought?

QUESTIONS

Chapter 1 introduced the theoretical structure of financial accounting and the environment within which it operates. The primary function of financial accounting—to provide financial information to external users that possesses the fundamental decision-specific qualities of relevance and faithful representation—is accomplished by periodically disseminating financial statements and related notes. In this chapter we review the process used to identify, analyze, record, summarize, and then report the economic events affecting a company's financial position. A solid foundation of this process is vital to a sound understanding of intermediate accounting.

Computers are used to process accounting information. In this chapter we provide an overview of the basic model that underlies computer software programs.

• LO2-1

Economic events cause changes in the financial position of the company.

External events involve an exchange between the company and another entity.

Internal events do not involve an exchange transaction but do affect the company's financial position.

The basic accounting equation

Owners' equity, for a corporation called shareholders' equity, is classified by source as either *paid-in capital* or *retained earnings*.

To accomplish the accounting process, many large and medium-sized companies have their own company-specific data processing systems. Smaller companies can take advantage of technology with relatively inexpensive desktop and laptop computers and generalized data software packages such as QuickBooks and Peachtree Accounting Software. Enterprise Resource Planning (ERP) systems are now being installed in companies of all sizes. The objective of ERP is to create a customized software program that integrates all departments and functions across a company onto a single computer system that can serve the information needs of those different departments, including the accounting department. *In this chapter, we describe and illustrate a manual accounting information system to provide an overview of the basic model that underlies the computer software programs actually used to process accounting information.*

The Basic Model

The first objective of any accounting system is to identify the **economic events** that can be expressed in financial terms by the system.¹ An economic event for accounting purposes is any event that *directly* affects the financial position of the company. Economic events can be classified as either external events or internal events.

External events involve an exchange between the company and a separate economic entity. Examples are transactions involving purchasing merchandise inventory for cash, borrowing cash from a bank, and paying salaries to employees. In each instance, the company receives something (inventory, cash, and services) in exchange for something else (cash, assumption of a liability, or both).

Internal events directly affect the financial position of the company but don't involve an exchange transaction with another entity. Examples are the depreciation of equipment and the use of supplies. As we will see later in the chapter, these events must be recorded to properly reflect a company's financial position and results of operations in accordance with the accrual accounting model.

The Accounting Equation

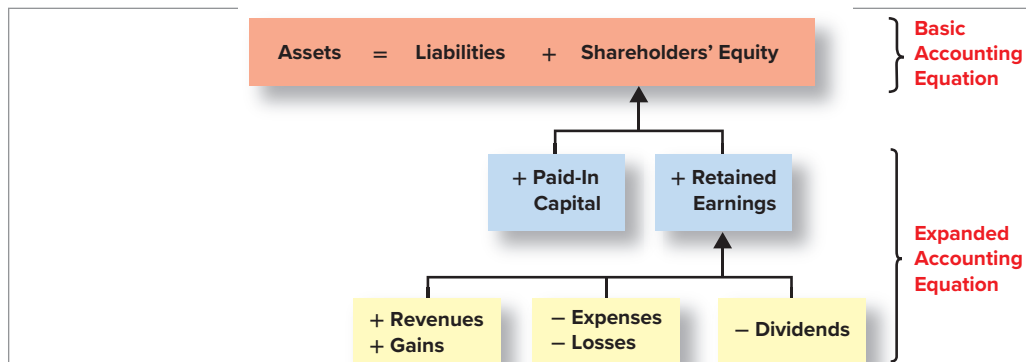
The **accounting equation** underlies the process used to capture the effect of economic events.

Assets	=	Liabilities	+	Shareholders' Equity
		(creditors' claims)		(owners' claims)
Resources		Claims to Resources		

This general expression portrays the equality between the total economic resources of an entity (its assets)—shown on the left side of the equation—and the total claims to those resources by creditors and owners (liabilities and equity)—shown on the right side. Look at that equation again, it's the key to all the discussion that follows.

As discussed in Chapter 1, owners of a corporation are its shareholders, so owners' equity for a corporation is referred to as *shareholders' equity*. Shareholders' equity for a corporation arises primarily from two sources: (1) amounts *paid in* by shareholders of the corporation and (2) amounts *earned* by the corporation (on behalf of its shareholders). These are reported as (1) **paid-in capital** and (2) **retained earnings**. Retained earnings equals net income less distributions to shareholders (primarily dividends) since the inception of the corporation. Illustration 2-1 shows the basic accounting equation for a corporation with

¹There are many economic events that affect a company *indirectly* and are not recorded. For example, when the Federal Reserve changes its discount rate, it is an important economic event that can affect the company in many ways, but it is not recorded by the company.

**Illustration 2-1**

Expanded Accounting Equation for a Corporation

shareholders' equity expanded to highlight its composition. Revenues and gains add to retained earnings, but expenses, losses, and dividends subtract from retained earnings.

The equation also implies that each economic event affecting this equation will have a dual effect because resources always must equal claims to those resources. For illustration, consider the events (we refer to these throughout the text as **transactions**) in Illustration 2-2. As we analyze each transaction to determine its effect on the equation, we also look at

Each event, or *transaction*, has a dual effect on the accounting equation.

Illustration 2-2

Transaction Analysis

1. \$50,000 was received from the owner to open the business.

An investment by the owner causes both assets and shareholders' (owners') equity to increase.

Assets	=	Liabilities	+	Shareholders' Equity
+\$50,000 (cash)				+\$50,000 (paid-in capital)

2. \$40,000 was borrowed from a bank and a note payable was signed.

This transaction causes assets and liabilities to increase. A bank loan increases cash and creates an obligation to repay it.

Assets	=	Liabilities	+	Shareholders' Equity
+\$40,000 (cash)		+\$40,000 (note payable)		

3. Supplies costing \$3,000 were purchased on account.

Buying supplies on account increases both assets and liabilities. The term *on account* indicates no cash was paid at the time of the purchase, but a promise to pay later was made.

Assets	=	Liabilities	+	Shareholders' Equity
+\$3,000 (supplies)		+\$3,000 (accounts payable)		

Transactions 4, 5, and 6 are revenue and expense transactions. Revenues and expenses (and gains and losses) are events that cause shareholders' equity to change. Revenues and gains cause shareholders' equity to increase. Expenses and losses cause shareholders' equity to decrease.

4. Services were performed on account for \$10,000.

Assets	=	Liabilities	+	Shareholders' Equity
+\$10,000 (accounts receivable)				+\$10,000 (revenue↑)

5. Salaries of \$5,000 were paid to employees.

Assets	=	Liabilities	+	Shareholders' Equity
-\$5,000 (cash)				-\$5,000 (expense↑)

6. \$500 of utilities were incurred but not paid.

Assets	=	Liabilities	+	Shareholders' Equity
		+\$500 (accounts payable)		-\$500 (expense↑)

7. \$1,000 was paid on account to the supplies vendor in transaction 3 above.

Assets	=	Liabilities	+	Shareholders' Equity
-\$1,000 (cash)		-\$1,000 (accounts payable)		

A general ledger is a collection of storage areas, called *accounts*, used to keep track of increases, decreases, and balances in financial position elements.

In the double-entry system, *debit* means left side of an account and *credit* means right side of an account.

its effect on specific financial elements, which we call **accounts**. Accounts provide a record, or storage area, of all transactions that increase or decrease a particular financial statement element. The balance of each account will be reported in the financial statements.

Account Relationships

The **general ledger** contains a list of all accounts in the company's accounting system. For each account, we need to keep track of the increases and decreases to the account's balance caused by transactions of the company. We demonstrated this process with pluses and minuses in Illustration 2-2. Here, we demonstrate the effect of transactions on account balances with **debits** and **credits**. *Debit* and *credit* are the terms used in accounting to signify an increase or decrease to an account balance. For each transaction, we'll have at least one debit and at least one credit (with the amount of total debits equaling the amount of total credits). This dual system of debits and credits is the **double-entry system** used in accounting to process transactions.

For instructional purposes we use **T-accounts** instead of formal general ledger accounts. A T-account has space at the top for the account title and two sides for recording debits and credits. Debits are on the *left* side of the account and credits are on the *right* side, as shown below.

Account Title	
Debit side	Credit side

Whether a debit or a credit represents an increase or a decrease to the account balance depends on the type of account.

- Accounts on the left side of the accounting equation (assets) are *increased* (+) by *debit* entries and *decreased* (–) by *credit* entries.
- Accounts on the right side of the accounting equation (liabilities and shareholders' equity) are *increased* (+) by *credit* entries and *decreased* (–) by *debit* entries.

This arbitrary, but effective, procedure ensures that for each transaction the net impact on the left sides of accounts always equals the net impact on the right sides of accounts.

For example, consider the bank loan in our earlier illustration. An asset, cash, increased by **\$40,000**. Increases in assets are *debits* (left side). Liabilities also increased by **\$40,000**. Increases in liabilities are *credits* (right side).

Assets		=	Liabilities		+	Shareholders' Equity	
Cash			Note Payable				
Debit	Credit		Debit	Credit			
+ 40,000				40,000			

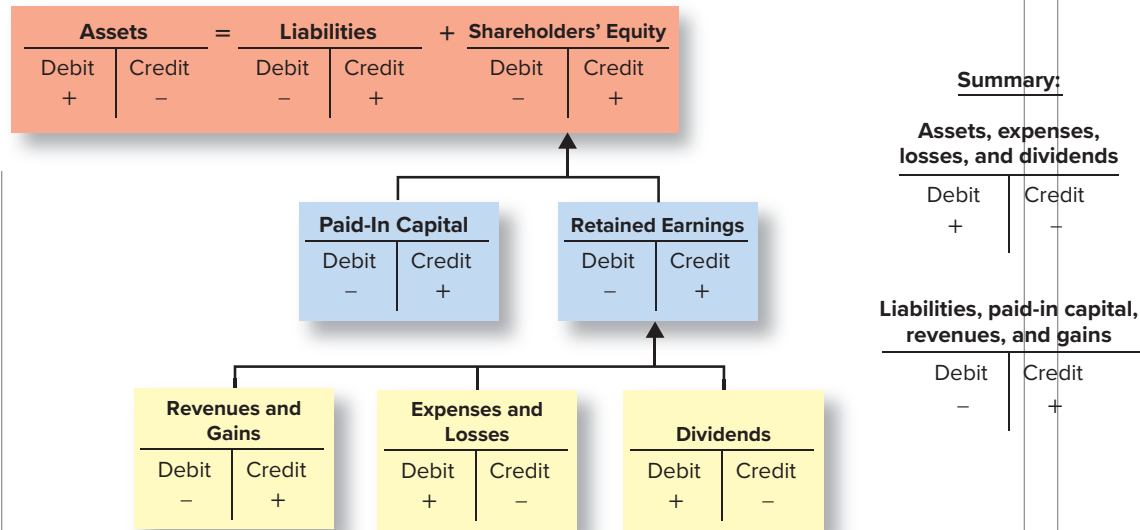
The debits equal the credits in every transaction (dual effect), so both before and after a transaction the accounting equation is in balance.

Illustration 2-3 demonstrates the effects of debits and credits on each element of the expanded accounting equation. As summarized in the illustration, every asset, expense, loss, and dividend account increases with a debit and decreases with a credit. In contrast, every liability, paid-in capital, revenue, and gain account increases with a credit and decreases with a debit.

You can understand the logic in this double-entry system by seeing that accounts on the left side of the basic accounting equation (assets) increase with debits, and accounts on the right side (liabilities and shareholders' equity) increase with credits. As long as total debits equal total credits for each transaction, the accounting equation remains in balance. For debits to equal credits, this means that any *component of shareholders' equity* that increases equity must also increase with a credit. Any component that decreases

Illustration 2-3

Expanded Accounting Equation, Debits and Credits, Increases and Decreases



shareholders' equity must do the opposite and increase with a debit. Once you understand the logic of increasing an account balance with a debit or credit, then you simply do the opposite to decrease the balance.

Each general ledger account can be classified as either *permanent* or *temporary*.

Permanent accounts represent assets, liabilities, and shareholders' equity (paid-in capital and retained earnings) at a point in time. **Temporary accounts** represent changes in the retained earnings component of shareholders' equity for a corporation caused by revenue, expense, gain, loss, and dividend transactions. It would be cumbersome to record each revenue/gain, expense/loss, and dividend transaction directly into the retained earnings account. The different types of events affecting retained earnings should be kept separate to facilitate the preparation of the financial statements. The balances in these temporary accounts are periodically, usually once a year, closed (zeroed out), and the net effect is transferred to the permanent retained earnings account. The temporary accounts need to be zeroed out to measure income on an annual basis. This closing process is discussed in a later section of this chapter.

The general ledger accounts serve as control accounts. Subsidiary accounts associated with a particular general ledger control account are maintained in separate subsidiary ledgers. For example, a subsidiary ledger for accounts receivable contains individual account receivable accounts for each of the company's credit customers, and the total of all subsidiary accounts would equal the amount in the control account. Subsidiary ledgers are discussed in more detail in Appendix 2C.

The Accounting Processing Cycle

Now that we've reviewed the basics of the double-entry system, let's look closer at the process used to identify, analyze, record, and summarize transactions and prepare financial statements.

The 10 steps in the accounting processing cycle are listed in Illustration 2-4. Steps 1-4 occur during the accounting period while steps 5-8 are applied at the end of the accounting period. Steps 9 and 10 are needed only at the end of the year.

Permanent accounts represent the basic financial position elements of the accounting equation.

Temporary accounts keep track of the changes in the retained earnings component of shareholders' equity.

• LO2-2

Illustration 2-4

The Accounting Processing Cycle

The Steps of the Accounting Processing Cycle**During the accounting period**

- Step 1 Obtain information about external transactions from **source documents**.
- Step 2 Analyze the **transaction**.
- Step 3 Record the transaction in a **journal**.
- Step 4 **Post** from the journal to the general ledger accounts.

At the end of the accounting period

- Step 5 Prepare an **unadjusted trial balance**.
- Step 6 Record **adjusting entries** and post to the general ledger accounts.
- Step 7 Prepare an **adjusted trial balance**.
- Step 8 Prepare **financial statements**.

At the end of the year

- Step 9 **Close** the temporary accounts to retained earnings.
- Step 10 Prepare a **post-closing trial balance**.

Brief Overview of Accounting Processing Cycle

The first step in the process is to *identify* external transactions affecting the accounting equation. An accountant usually does not directly witness business transactions. A mechanism is needed to relay the essential information about each transaction to the accountant. **Source documents** such as sales invoices, bills from suppliers, and cash register tapes serve this need.

These source documents usually identify the date and nature of each transaction, the participating parties, and the monetary terms. For example, a sales invoice identifies the date of sale, the customer, the specific goods sold, the dollar amount of the sale, and the payment terms. With this information, the second step in the processing cycle, **transaction analysis**, can proceed. Transaction analysis is the process of reviewing the source documents to determine the dual effect on the accounting equation and the specific elements (which we'll be calling accounts) that will be used to classify the item of analysis. Illustration 2-5 provides transaction analysis for the seven events discussed previously in Illustration 2-2.

The third step in the process is to record the transaction in a **journal**. A journal provides a chronological record of all economic events affecting a firm. Each journal entry is expressed in terms of equal debits and credits to accounts affected by the transaction being recorded. As explained earlier, debits and credits represent increases or decreases to specific accounts, depending on the type of account. For example, for credit sales, we record a debit to accounts receivable and a credit to sales revenue in a sales journal.

A sales journal is an example of a **special journal** used to record a repetitive type of transaction. In Appendix 2C we discuss the use of special journals in more depth. In this chapter and throughout the text, we use the **general journal** format to record all transactions.

Any type of transaction can be recorded in a general journal. It has a place for the date of the transaction, a place for account titles, account numbers, and supporting explanations, as well as a place for debit entries and a place for credit entries. A simplified journal entry is used throughout the text that lists the account titles to be debited and credited and the dollar amounts. A common convention is to list the debited accounts first, indent the credited accounts, and use the first of two columns for the debit amounts and the second column for the credit amounts. An explanation is entered for each journal entry (for ease in this example the explanation is located below the entry). For example, the **journal entry** for the

STEP 1Obtain information about transactions from *source documents*.**STEP 2**Analyze the *transaction*.**STEP 3**Record the transaction in a *journal*.

Illustration 2-5

Transaction Analysis, the Accounting Equation, and Debits and Credits

Accounting Equation					Account Entry	
Transaction	Transaction Analysis	Assets	=	Liabilities	+	Shareholders' Equity
1. \$50,000 was received from the owner to open the business.	Assets (cash) and shareholders' equity each increased by \$50,000. <i>Cumulative balances</i>	<u>+50,000</u> 50,000	=		+	<u>+50,000</u> 50,000
2. \$40,000 was borrowed from a bank and a notes payable was signed.	Assets (cash) and liabilities (note payable) each increased by \$40,000. <i>Cumulative balances</i>	<u>+40,000</u> 90,000	=	<u>+40,000</u> 40,000	+	<u>50,000</u> 50,000
3. Supplies costing \$3,000 were purchased on account.	Assets (supplies) and liabilities (accounts payable) each increased by \$3,000. <i>Cumulative balances</i>	<u>+3,000</u> 93,000	=	<u>+3,000</u> 43,000	+	<u>50,000</u> 50,000
4. Services were performed on account for \$10,000.	Assets (accounts receivable) and shareholders' equity (revenue) each increased by \$10,000. <i>Cumulative balances</i>	<u>+10,000</u> 103,000	=	<u>43,000</u> 43,000	+	<u>60,000</u> 60,000
5. Salaries of \$5,000 were paid to employees.	Assets (cash) decreased and shareholders' equity decreased (salaries expense increased) by \$5,000. <i>Cumulative balances</i>	<u>-5,000</u> 98,000	=	<u>43,000</u> 43,000	+	<u>55,000</u> 55,000
6. \$500 of utilities were incurred but not paid	Liabilities (accounts payable) increased and shareholders' equity decreased (utilities expense increased) by \$500. <i>Cumulative balances</i>	<u>98,000</u> 98,000	=	<u>+500</u> 43,500	+	<u>54,500</u> 54,500
7. \$1,000 was paid on account to the supplies vendor in transaction 3 above.	Assets (cash) and liabilities (accounts payable) each decreased by \$1,000. <i>Cumulative balances</i>	<u>-1,000</u> 97,000	=	<u>-1,000</u> 42,500	+	<u>54,500</u> 54,500

bank loan in Illustration 2–5, which requires a debit to cash and a credit to notes payable, is recorded as follows:

Cash	40,000
Notes payable	40,000
<i>To record the borrowing of cash and the signing of a note payable.</i>	

STEP 4

Post from the journal to the general ledger accounts.

The fourth step is to periodically transfer or *post* the debit and credit information from the journal to individual ledger accounts. Recall that a ledger is simply a collection of all of the company's various accounts. Each account provides a summary of the effects of all events and transactions on that individual account. **Posting** involves transferring debits and credits recorded in individual journal entries to the specific accounts affected. As discussed earlier in the chapter, most accounting systems today are computerized. For these systems, the journal input information creates a stored journal and simultaneously posts each entry to the ledger accounts.

STEP 5

Prepare an *unadjusted trial balance*.

The fifth step is to prepare an unadjusted trial balance. The general ledger accounts provide the information needed. A trial balance is simply a list of general ledger accounts and their balances at a particular date. The **unadjusted trial balance** allows us to verify that the total of all debits is equal to the total of all credits after recording all transactions during the period but before any adjusting entries (next step).

STEP 6

Record and post *adjusting entries*.

The sixth step is to record adjusting entries and post those to the general ledger accounts. Before we can prepare the financial statements, we need to bring our account balances up-to-date. We do this using adjusting entries at the end of the period. **Adjusting entries** are used to record changes in assets and liabilities (and their related revenues and expenses) that have occurred during the period but which we have not yet recorded by the end of the period.

STEP 7

Prepare an *adjusted trial balance*.

The seventh step is to prepare an adjusted trial balance. An **adjusted trial balance** is a trial balance that is prepared after all adjusting entries have been recorded.

STEP 8

Prepare the *financial statements*.

The eighth step is to prepare the **financial statements**. In fact, the purpose of all the steps up to this point is so we have the information needed to do this. These statements include:

- the income statement and statement of comprehensive income,
- the balance sheet,
- the statement of cash flows, and
- the statement of shareholders' equity.

Financial statements are the primary means of providing information to investors and other decision makers, which is the purpose of accounting. The adjusted trial balance supplies the necessary information to produce these statements.

STEP 9

Close the temporary accounts to retained earnings.

The ninth step is to record closing entries and post those to the general ledger accounts. **Closing entries** serve two purposes: (1) to transfer the balances of temporary accounts (revenues, expenses, gains, losses, and dividends) to the retained earnings account, and (2) to reduce the balances of these temporary accounts to zero to "wipe the slate clean" and ready them for measuring activity in the next period.

STEP 10

Prepare a *post-closing trial balance*.

The final step is to prepare a post-closing trial balance. The **post-closing trial balance** is a list of all permanent accounts and their balances after closing entries have been recorded. Because all temporary accounts have been closed to zero, they are not listed. The final balances in permanent accounts will be used to open (begin) the records in the next period.

Illustration of Accounting Processing Cycle

Now that we have looked at a brief overview of the ten steps of the accounting processing cycle, let's take a closer look at each one. We start by illustrating the first four steps in the processing cycle using the external transactions described in Illustration 2–6 that occurred during the month of July 2024, the first month of operations for Dress Right Clothing

July	1	Received cash of \$60,000 from two investors (\$30,000 each). Each investor was issued 3,000 shares of common stock.
	1	Borrowed \$40,000 from a local bank and signed two notes. The first note for \$10,000 requires payment of principal and 10% interest in six months. The second note for \$30,000 requires the payment of principal in two years. Interest at 10% is payable each year on July 1, 2025, and July 1, 2026.
	1	Paid \$24,000 in advance for one year's rent on the store building.
	1	Purchased office equipment from eTronics for \$12,000 cash.
	3	Purchased \$60,000 of clothing inventory on account from the Birdwell Wholesale Clothing Company.
	6	Purchased \$2,000 of supplies for cash.
	4–31	During the month, sold clothing inventory for \$35,000 cash. The inventory cost \$20,000.
	9	Sold clothing inventory on account to Briarfield School for \$3,500. The inventory cost \$2,000.
	16	Subleased a portion of the building to a jewelry store. Received \$1,000 in advance for the first two months' rent beginning on July 16.
	20	Paid Birdwell Wholesale Clothing \$25,000 on account.
	20	Paid salaries to employees for the first half of the month, \$5,000.
	25	Received \$1,500 on account from Briarfield.
	30	Paid shareholders a cash dividend of \$1,000.

Illustration 2-6

External Transactions for July 2024

Corporation. The company operates a retail store that sells men's and women's clothing. Dress Right is organized as a corporation so owners' equity is classified by source as either paid-in capital or retained earnings.

The local bank requires that Dress Right furnish financial statements on a monthly basis. The transactions listed in the illustration are used to demonstrate the accounting processing cycle for the month of July 2024.

Journal, Ledger, and Trial Balance

Now that we've overviewed the ten steps in the accounting processing cycle, we look closer at the process.

STEPS 1, 2, AND 3 Obtain information about transactions from *source documents*, *analyze the transaction* and *record the transaction in a journal*.

For each transaction, a source document provides the necessary information to complete steps two and three in the processing cycle: transaction analysis and recording the appropriate journal entry. Each transaction described in Illustration 2-6 is analyzed below, preceded by the necessary journal entry.

JOURNAL ENTRIES

July 1		
Cash.....	60,000	
Common stock		60,000

● LO2-3

To record the issuance of common stock.

54 **SECTION 1** The Role of Accounting as an Information System

	<p>This first transaction is an investment by owners that increases an asset (cash) and also increases shareholders' equity (common stock). Increases in assets are recorded as debits, and increases in shareholders' equity are recorded as credits. We use the paid-in capital account called common stock because stock was issued in exchange for cash paid in.²</p>									
To record the borrowing of cash and the signing of notes payable.	<table><tr><td colspan="3">July 1</td></tr><tr><td>Cash.....</td><td>40,000</td><td></td></tr><tr><td>Notes payable</td><td></td><td>40,000</td></tr></table> <p>Borrowing from the bank causes increases in both an asset (cash) and a liability (notes payable). Increases in assets are debits, and increases in liabilities are credits. The notes require repayment of \$40,000 in principal plus 10% interest. At this point, we record only the principal amount borrowed. As time passes, we'll begin to owe interest. We discuss later how interest is recorded.</p>	July 1			Cash.....	40,000		Notes payable		40,000
July 1										
Cash.....	40,000									
Notes payable		40,000								
To record the payment of one year's rent in advance.	<table><tr><td colspan="3">July 1</td></tr><tr><td>Prepaid rent.....</td><td>24,000</td><td></td></tr><tr><td>Cash</td><td></td><td>24,000</td></tr></table> <p>Paying rent in advance increases one asset (prepaid rent) and decreases another asset (cash). Increases in assets are recorded as debits, and decreases in assets are recorded as credits. Dress Right acquired the right to use the building for one full year. This right is an asset because it represents a future benefit to the company. As we will see later, this asset expires over the one-year rental period.</p>	July 1			Prepaid rent.....	24,000		Cash		24,000
July 1										
Prepaid rent.....	24,000									
Cash		24,000								
To record the purchase of office equipment.	<table><tr><td colspan="3">July 1</td></tr><tr><td>Office equipment.....</td><td>12,000</td><td></td></tr><tr><td>Cash</td><td></td><td>12,000</td></tr></table> <p>Purchasing equipment increases one asset (office equipment) and decreases another (cash).</p>	July 1			Office equipment.....	12,000		Cash		12,000
July 1										
Office equipment.....	12,000									
Cash		12,000								
To record the purchase of inventory on account.	<table><tr><td colspan="3">July 3</td></tr><tr><td>Inventory.....</td><td>60,000</td><td></td></tr><tr><td>Accounts payable.....</td><td></td><td>60,000</td></tr></table> <p>Purchasing inventory on account increases an asset (inventory) and increases a liability (accounts payable). Increases in assets are debits. Increases in liabilities are credits.</p> <p>Dress Right uses the <i>perpetual inventory system</i> to keep track of its inventory. This system requires that the cost of inventory purchased be recorded in inventory, an asset account. When inventory is sold, the inventory account is decreased by the cost of the item sold. An alternative method, the <i>periodic system</i>, is briefly discussed later in this chapter. We explore the topic of inventory in depth in Chapters 8 and 9.</p>	July 3			Inventory.....	60,000		Accounts payable.....		60,000
July 3										
Inventory.....	60,000									
Accounts payable.....		60,000								
To record the purchase of supplies.	<table><tr><td colspan="3">July 6</td></tr><tr><td>Supplies</td><td>2,000</td><td></td></tr><tr><td>Cash</td><td></td><td>2,000</td></tr></table> <p>Purchasing supplies increases one asset (supplies) and decreases another asset (cash). Supplies are an asset because they represent future benefits. We won't record those supplies as an expense until we use them.</p>	July 6			Supplies	2,000		Cash		2,000
July 6										
Supplies	2,000									
Cash		2,000								

²The different types of stock are discussed in Chapter 18. Also, some stock has a stated par value. In that case, the amount recorded to common stock is the par value, and the amount of the issuing price in excess is recorded to a separate account. Paid-in capital.

²The different types of stock are discussed in Chapter 18. Also, some stock has a stated par value. In that case, the amount recorded to common stock is the par value, and the amount of the issue price above par value is recorded to a separate account, Paid-in capital—excess of par.

July 4–31			To record the month's cash sales and the cost of those sales.
Cash.....	35,000		
Sales revenue.....		35,000	
Cost of goods sold (expense).....	20,000		
Inventory.....		20,000	
<p>We record cash sales to customers in two parts. First, cash sales increase an asset (cash) and increase shareholders' equity for the amount of the sale to the customer. The increase in equity is recorded by a credit to the temporary account, sales revenue.</p> <p>Second, cash sales decrease another asset (inventory) and decrease shareholders' equity for the cost of the inventory sold. The decrease to shareholders' equity is recorded by a debit to the temporary account, cost of goods sold (an expense).</p> <p>For both transactions combined, the net increase in assets (cash received minus inventory used) equals the net increase in shareholders' equity (sales revenue minus cost of goods sold).</p> <p>Both of these transactions are <i>summary</i> transactions. Normally each sale made during the month requires a separate and similar entry in a special journal, which we discuss in Appendix 2C.</p>			

July 9			To record a credit sale and the cost of that sale.
Accounts receivable	3,500		
Sales revenue		3,500	
Cost of goods sold	2,000		
Inventory		2,000	

Selling inventory on account is similar to the cash sale shown in the previous transaction. The only difference is that the asset acquired is accounts receivable rather than cash.

Additional Consideration

Periodic Inventory System

The principal alternative to the perpetual inventory system is the periodic system. By this approach, we record the cost of inventory purchased in a temporary account called *purchases*. When inventory is sold, the inventory account is not decreased and cost of goods sold is not recorded. Instead, we determine the balance in the inventory account only at the end of a reporting period (periodically), and then we can determine the cost of goods sold for the period.

For example, the purchase of \$60,000 of inventory on account by Dress Right is recorded as follows:

Purchases	60,000	
Accounts payable		60,000

No cost of goods sold entry is recorded when sales are made in the periodic system.

At the end of July, the amount of ending inventory is determined (either by means of a physical count of goods on hand or by estimation) to be \$38,000 and cost of goods sold for the month is determined as follows:

Beginning inventory	\$ 0
Plus: Purchases	60,000
Less: Ending inventory	(38,000)
Cost of goods sold	<u>\$ 22,000</u>

We record the cost of goods sold for the period and adjust the inventory account to the actual amount on hand (in this case from zero to \$38,000) this way:

Cost of goods sold	22,000	
Inventory	38,000	
Purchases		60,000

We discuss inventory in depth in Chapters 8 and 9.

To record the receipt of rent in advance.	<p>July 16</p> <p>Cash 1,000</p> <p>Deferred rent revenue (liability) 1,000</p> <p>Receiving cash from a customer prior to the rental services being provided increases an asset (cash) and increases a liability (deferred rent revenue). We don't yet record revenue because services have not yet been provided. Instead, at the time cash is received, we <i>owe</i> future services to the customer. We'll recognize the revenue as those services are provided.</p>
To record the payment of accounts payable.	<p>July 20</p> <p>Accounts payable 25,000</p> <p>Cash 25,000</p> <p>Paying cash on accounts payable decreases both an asset (cash) and a liability (accounts payable). A debit decreases the liability, and a credit decreases the asset.</p>
To record the payment of salaries for the first half of the month.	<p>July 20</p> <p>Salaries expense 5,000</p> <p>Cash 5,000</p> <p>Paying cash to employees for work in the current period decreases an asset (cash) and decreases shareholders' equity. The decrease to shareholders' equity is recorded in the temporary account, salaries expense.</p>
To record receipt of cash on account.	<p>July 25</p> <p>Cash 1,500</p> <p>Accounts receivable 1,500</p> <p>Receiving cash from customers on account is an exchange of one asset (cash) for another asset (accounts receivable).</p>
To record the payment of a cash dividend.	<p>July 30</p> <p>Dividends 1,000</p> <p>Cash 1,000</p> <p>Paying a cash dividend is a distribution to owners that reduces both cash and retained earnings. Dividends is a temporary account that later is closed (transferred) to retained earnings along with the other temporary accounts (revenues, expenses, gains, and losses) at the end of the fiscal year. We discuss and illustrate the closing process later in the chapter.</p> <p>Additional Consideration</p> <p>An alternative method of recording a cash dividend is to debit retained earnings at the time the dividend is paid rather than reducing retained earnings during the closing process. The entry to record the dividend using this approach is as follows:</p> <p>Retained earnings 1,000</p> <p>Cash 1,000</p> <p>As an expedient, we apply this approach when discussing dividends in Chapter 18.</p>

Illustration 2–7 summarizes each of the transactions as they would appear in a general journal. In addition to the date, account titles, and debit and credit columns, the journal also has a column titled Post Ref. (Posting Reference). In this column we enter the number assigned to the general ledger account that is being debited or credited. For purposes of this illustration, all asset accounts have been assigned numbers in the 100s, all liabilities are 200s, permanent shareholders' equity accounts are 300s, revenues are 400s, expenses are 500s, and dividends are 600.

General Journal				Page 1
Date 2024	Account Title and Explanation	Post Ref.	Debit	Credit
July 1	Cash	100	60,000	
	Common stock	300		60,000
	<i>To record the issuance of common stock.</i>			
1	Cash	100	40,000	
	Notes payable	220		40,000
	<i>To record the borrowing of cash and the signing of notes payable.</i>			
1	Prepaid rent	130	24,000	
	Cash	100		24,000
	<i>To record the payment of one year's rent in advance.</i>			
1	Office equipment	150	12,000	
	Cash	100		12,000
	<i>To record the purchase of office equipment.</i>			
3	Inventory	140	60,000	
	Accounts payable	210		60,000
	<i>To record the purchase of inventory.</i>			
6	Supplies	125	2,000	
	Cash	100		2,000
	<i>To record the purchase of supplies.</i>			
4–31	Cash	100	35,000	
	Sales revenue	400		35,000
	<i>To record cash sales for the month.</i>			
4–31	Cost of goods sold	500	20,000	
	Inventory	140		20,000
	<i>To record the cost of cash sales.</i>			
9	Accounts receivable	110	3,500	
	Sales revenue	400		3,500
	<i>To record a credit sale.</i>			
9	Cost of goods sold	500	2,000	
	Inventory	140		2,000
	<i>To record the cost of a credit sale.</i>			
16	Cash	100	1,000	
	Deferred rent revenue	230		1,000
	<i>To record the receipt of rent in advance.</i>			
20	Accounts payable	210	25,000	
	Cash	100		25,000
	<i>To record the payment of accounts payable.</i>			
20	Salaries expense	510	5,000	
	Cash	100		5,000
	<i>To record the payment of salaries for the first half of the month.</i>			
25	Cash	100	1,500	
	Accounts receivable	110		1,500
	<i>To record the receipt of cash on account.</i>			
30	Dividends	600	1,000	
	Cash	100		1,000
	<i>To record the payment of a cash dividend.</i>			

Illustration 2–7

The General Journal

The ledger accounts also contain a posting reference, usually the page number of the journal in which the journal entry was recorded. This allows for easy cross-referencing between the journal and the ledger.

• LO2-4

LEDGER ACCOUNTS Step 4 in the processing cycle is to transfer (post) the debit/credit information from the journal to the general ledger accounts. Illustration 2-8 contains the ledger accounts (in T-account form) for Dress Right *after* all the general journal transactions have been

Illustration 2-8

General Ledger Accounts

Balance Sheet Accounts							
Cash 100				Prepaid Rent 130			
July 1 GJ1	60,000	24,000	July 1 GJ1	July 1 GJ1	24,000		
1 GJ1	40,000	12,000	1 GJ1				
4-31 GJ1	35,000	2,000	6 GJ1				
16 GJ1	1,000	25,000	20 GJ1				
25 GJ1	1,500	5,000	20 GJ1				
		1,000	30 GJ1				
July 31 Bal.	68,500			July 31 Bal.	24,000		
Accounts Receivable 110				Inventory 140			
July 9 GJ1	3,500	1,500	July 25 GJ1	July 3 GJ1	60,000	20,000	July 4-31
						2,000	9 GJ1
July 31 Bal.	2,000			July 31 Bal.	38,000		
Supplies 125				Office equipment 150			
July 6 GJ1	2,000			July 1 GJ1	12,000		
July 31 Bal.	2,000			July 31 Bal.	12,000		
Accounts Payable 210				Notes Payable 220			
July 20 GJ1	25,000	60,000	July 3 GJ1		40,000	July 1 GJ1	
		35,000	July 31 Bal.		40,000	July 31 Bal.	
Deferred Rent Revenue 230				Retained Earnings 310			
		1,000	July 16 GJ1				
		1,000	July 31 Bal.				
Common Stock 300				Dividends 600			
		60,000	July 1 GJ1				
		60,000	July 31 Bal.	July 30 GJ1	1,000		
				July 31 Bal.	1,000		
Income Statement Accounts							
Sales Revenue 400				Cost of Goods Sold 500			
	35,000	July 4-31 GJ1		July 4-31 GJ1	20,000		
	3,500	9 GJ1		9 GJ1	2,000		
	38,500	July 31 Bal.		July 31 Bal.	22,000		
Salaries Expense 510							
July 20 GJ1	5,000						
July 31 Bal.	5,000						

posted. The reference GJ1 next to each of the posted amounts indicates that the source of the entry is page 1 of the general journal. An alternative is to number each of the entries in chronological order and reference them by number. Note that each account shows the balance that we call a *normal balance*—that is, the balance is the debit or credit side used to increase the account.

TRIAL BALANCE Before preparing financial statements and adjusting entries at the end of an accounting period, we prepare an **unadjusted trial balance**—step 5. A trial balance is simply a list of the general ledger accounts along with their balances at a particular date, listed in the order that they appear in the ledger. The purpose of the trial balance is to allow us to check for completeness and to verify that the sum of the accounts with debit balances equals the sum of the accounts with credit balances. The fact that the debits and credits are equal, though, does not necessarily ensure that the equal balances are correct. The trial balance could contain offsetting errors. As we will see later in the chapter, this trial balance also helps with preparing adjusting entries. The unadjusted trial balance on July 31, 2024, for Dress Right appears in Illustration 2–9.

STEP 5

Prepare an *unadjusted trial balance*.

Illustration 2–9

Unadjusted Trial Balance

DRESS RIGHT CLOTHING CORPORATION
Unadjusted Trial Balance
July 31, 2024

Account Title	Debits	Credits
Cash	\$ 68,500	
Accounts receivable	2,000	
Supplies	2,000	
Prepaid rent	24,000	
Inventory	38,000	
Office equipment	12,000	
Accounts payable		\$ 35,000
Notes payable		40,000
Deferred rent revenue		1,000
Common stock		60,000
Retained earnings		0
Sales revenue		38,500
Cost of goods sold	22,000	
Salaries expense	5,000	
Dividends	1,000	
Totals	<u>\$174,500</u>	<u>\$174,500</u>

At any time, the total of all debit balances should equal the total of all credit balances.

Concept Review Exercise

The Wyndham Wholesale Company began operations on August 1, 2024. The following transactions occur during the month of August.

- The company receives \$50,000 cash from owners and issues 5,000 shares of common stock.
- Equipment is purchased for \$20,000 cash.
- On the first day of August, \$6,000 rent on office space is paid for the months of August, September, and October (\$2,000/month).
- Inventory costing \$38,000 is purchased on account. The company uses the perpetual inventory system.
- \$30,000 is borrowed from a local bank, and a note payable is signed.

JOURNAL ENTRIES FOR EXTERNAL TRANSACTIONS

- f. Credit sales for the month are \$40,000. The cost of inventory sold is \$22,000.
 g. \$15,000 is collected on account from customers.
 h. \$20,000 is paid on account to suppliers of inventory.
 i. Cash of \$2,000 was received from a customer for consulting services to begin later in August. Services were completed in early September.
 j. Salaries of \$7,000 are paid to employees for August.
 k. A bill for \$2,000 is received from the local utility company for the month of August.
 l. \$20,000 cash is loaned to another company, evidenced by a note receivable.
 m. The corporation pays its shareholders a cash dividend of \$1,000.

Required:

1. Prepare a journal entry for each transaction.
2. Prepare an unadjusted trial balance as of August 31, 2024.

Solution:

1. Prepare a journal entry for each transaction.

- a. The issuance of common stock for cash increases both cash and shareholders' equity (common stock).

Cash	50,000	
Common stock		50,000

- b. The purchase of equipment increases equipment and decreases cash.

Equipment	20,000	
Cash		20,000

- c. The payment of rent in advance increases prepaid rent and decreases cash.

Prepaid rent	6,000	
Cash		6,000

- d. The purchase of inventory on account increases both inventory and accounts payable.

Inventory	38,000	
Accounts payable		38,000

- e. Borrowing cash and signing a note increases both cash and notes payable.

Cash	30,000	
Notes payable		30,000

- f. The sale of inventory on account increases both accounts receivable and sales revenue. Also, cost of goods sold increases and inventory decreases.

Accounts receivable	40,000	
Sales revenue		40,000
Cost of goods sold	22,000	
Inventory		22,000

- g. The collection of cash on account increases cash and decreases accounts receivable.

Cash	15,000	
Accounts receivable		15,000

- h. The payment to suppliers on account decreases both accounts payable and cash.

Accounts payable	20,000	
Cash		20,000

i. Receiving cash from customers in advance of services to be provided increases cash and increases deferred revenue (a liability).

Cash	2,000	
Deferred revenue		2,000

j. The payment of salaries for the period increases salaries expense and decreases cash.

Salaries expense	7,000	
Cash		7,000

k. The receipt of a bill for utilities used increases both utilities expense and accounts payable.

Utilities expense	2,000	
Accounts payable		2,000

l. The lending of cash to another entity and the acceptance of a note increases notes receivable and decreases cash.

Notes receivable	20,000	
Cash		20,000

m. Cash dividends paid to shareholders increase dividends and decrease cash.

Dividends ³	1,000	
Cash		1,000

2. Prepare an unadjusted trial balance as of August 31, 2024.

Account Title	Debits	Credits
Cash	\$ 23,000	
Accounts receivable	25,000	
Prepaid rent	6,000	
Inventory	16,000	
Notes receivable	20,000	
Equipment	20,000	
Accounts payable		\$ 20,000
Deferred revenue		2,000
Notes payable		30,000
Common stock		50,000
Retained earnings		0
Sales revenue		40,000
Cost of goods sold	22,000	
Salaries expense	7,000	
Utilities expense	2,000	
Dividends	1,000	
Totals	<u>\$ 142,000</u>	<u>\$ 142,000</u>

Adjusting Entries

Step 6 in the processing cycle is to record **adjusting entries** and post them to the ledger accounts. These transactions often do not involve an exchange transaction with another entity and, therefore, are not initiated by a source document.

³An alternative is to debit retained earnings at the time the dividend is distributed.

• LO2-5

STEP 6

Record *adjusting entries* and post to the ledger accounts.

Prepayments are transactions in which the cash flow precedes expense or revenue recognition.

Prepaid expenses represent assets recorded when a cash disbursement creates benefits beyond the current reporting period.

The adjusting entry required for a prepaid expense is a *debit to an expense* and a *credit to an asset*.

● LO2-6

Supplies	
Beg. bal.	0
	2,000
	800
End bal.	1,200
Supplies Expense	
Beg. bal.	0
	800
End bal.	800

To record the cost of supplies used during the month of July.

Adjusting entries are required to implement the *accrual accounting model*. More specifically, these entries help ensure that balances of all assets, liabilities, revenues and expenses are correctly stated by the end of the period, regardless of when cash is received or paid. You might think of adjusting entries as a method of bringing the company's financial information up-to-date before preparing the financial statements.

Adjusting entries are necessary for three situations:

1. **Prepayments**, sometimes referred to as *deferrals*
2. **Accruals**
3. **Estimates**

Prepayments

Prepayments occur when the cash flow *precedes* either expense or revenue recognition. For example, a company may buy supplies in one period but use them in a later period. The cash outflow creates an asset (supplies) which then must be expensed in a future period as the asset is used (supplies expense).

Similarly, a company may receive cash from a customer in one period but provide the customer with a good or service in a future period. For instance, online subscription companies usually receive cash in advance from customers. At the time of the cash inflow, a liability (deferred revenue) is created. This liability represents goods or services owed to customers who have paid in advance. Revenue is then recognized (and the liability is settled) over time as the goods or services are provided to customers.

PREPAID EXPENSES **Prepaid expenses** are the costs of assets acquired in one period and expensed in a future period. Whenever cash is paid, and it is not to (1) satisfy a liability or (2) pay a dividend or return capital to owners, it must be determined whether or not the payment creates future benefits or whether the payment benefits only the current period. The purchase of buildings, equipment, or supplies or the payment of rent in advance are examples of payments that create future benefits and should be recorded as assets. These costs will be recognized as expenses in future periods as the assets are used.

To illustrate this concept, assume that a company paid a radio station \$2,000 in July for advertising. If that \$2,000 were for advertising provided by the radio station during the month of July, the entire \$2,000 would be expensed in the same period as the cash disbursement. However, if the \$2,000 was a payment for advertising to be provided in a future period, say the month of August, then the cash disbursement creates an asset called *prepaid advertising*. Then, an adjusting entry is required at the end of August to increase advertising expense (decrease shareholders' equity) and to decrease the asset, prepaid advertising, by \$2,000. So, the adjusting entry for a prepaid expense is a *debit to an expense* and a *credit to an asset*.

The unadjusted trial balance can provide a starting point for determining which adjusting entries are required for a period, particularly for prepayments. Review the July 31, 2024, unadjusted trial balance for the Dress Right Clothing Corporation in Illustration 2-9 and try to anticipate the required adjusting entries for prepaid expenses.

The first asset that requires adjustment is supplies, \$2,000 of which were purchased during July. This transaction created an asset as the supplies will be used in future periods. The company could either track the supplies used or simply count the supplies at the end of the period and determine the dollar amount of supplies remaining. Assume that Dress Right determines that at the end of July, \$1,200 of supplies remain. This indicates that \$800 of supplies have been used, but the Supplies account in the unadjusted trial balance does not yet reflect this amount. The following adjusting journal entry is required to update account balances.

July 31

Supplies expense.....	800	
Supplies		800

The next prepaid expense requiring adjustment is rent. Recall that at the beginning of July, the company paid \$24,000 to its landlord representing one year's rent in advance. As it is reasonable to assume that the rent services provided each period are equal, the monthly rent is \$2,000. At the end of July, one month's prepaid rent has expired and must be recognized as expense.

July 31

Rent expense (\$24,000 ÷ 12).....	2,000	
Prepaid rent		2,000

After this entry is recorded and posted to the ledger accounts, the prepaid rent account will have a debit balance of \$22,000, representing 11 remaining months at \$2,000 per month, and the rent expense account will have a \$2,000 debit balance.

The final prepayment involves the asset represented by office equipment that was purchased for \$12,000. This asset has a long life but, nevertheless, will expire over time. For the previous two adjusting entries, it was fairly straightforward to determine the amount of the asset that expired during the period.

However, it is difficult, if not impossible, to determine how much of the benefits from using the office equipment expired during any particular period. Recall from Chapter 1 that one approach is to recognize an expense "by a systematic and rational allocation to specific time periods."

Assume that the office equipment has a useful life of five years (60 months) and will be worthless at the end of that period, and that we choose to allocate the cost equally over the period of use. The amount of monthly expense, called *depreciation expense*, is \$200 (\$12,000 ÷ 60 months = \$200), and the following adjusting entry is recorded.

July 31

Depreciation expense.....	200	
Accumulated depreciation		200

The entry reduces an asset, office equipment, by \$200. However, the asset account is not reduced directly. Instead, the credit is to an account called *accumulated depreciation*. This is a contra account to office equipment. The normal balance in a contra asset account will be a credit, that is, "contra," or opposite, to the normal debit balance in an asset account. The purpose of the contra account is to keep the original cost of the asset intact while reducing it indirectly. In the balance sheet, office equipment is reported net of accumulated depreciation. When we have multiple depreciable assets, it's helpful to differentiate accumulated depreciation accounts, like accumulated depreciation—office equipment, accumulated depreciation—buildings, etc. This topic is covered in depth in Chapter 11.

After this entry is recorded and posted to the ledger accounts, the accumulated depreciation account will have a credit balance of \$200, and the depreciation expense account will have a \$200 debit balance. If a required adjusting entry for a prepaid expense is not recorded, net income, assets, and shareholders' equity (retained earnings) will be overstated.

DEFERRED REVENUES *Deferred revenues* are created when a company receives cash from a customer in one period for goods or services that are to be provided in a future period. The cash receipt, an external transaction, is recorded as a debit to cash and a credit to a liability. This liability reflects the company's obligation to provide goods or services in the future.

To illustrate a deferred revenue transaction, assume that during the month of June an online subscription service provider received \$24 in cash from a customer for a 24-month subscription. The subscription begins in July. On receipt of the cash, the company records a liability, deferred-subscription revenue, of \$24. Subsequently, revenue of \$1 is recognized

To record the cost of expired rent for the month of July.

Prepaid Rent

Beg. bal.	0
	24,000
End. bal.	22,000

2,000

Rent Expense

Beg. bal.	0
	2,000
End. bal.	2,000

To record depreciation of office equipment for the month of July.

Deferred revenues represent liabilities recorded when cash is received from customers in advance of providing a good or service.

The adjusting entry required when deferred revenues are recognized is a debit to a liability and a credit to revenue.

To record previously deferred rent revenue recognized during July.

Deferred Rent Revenue	
	0 Beg. bal.
250	1,000
	750 End bal.

Rent Revenue	
	0 Beg. bal.
250	
	250 End bal.

Rent Expense	
Beg. bal.	0
24,000	
	22,000
End bal.	2,000

Prepaid Rent	
Beg. bal.	0
22,000	
End bal.	22,000

each month. An adjusting entry is required each month to increase shareholders' equity (revenue) to recognize the \$1 in revenue and to decrease the liability. The adjusting entry for deferred revenues, therefore, is a *debit to a liability*, in this case deferred subscription revenue, and a *credit to revenue*.

Once again, the unadjusted trial balance provides information concerning deferred revenues. For Dress Right Clothing Corporation, the only deferred revenue in the trial balance is deferred rent revenue. Recall that the company subleased a portion of its building to a jewelry store for \$500 per month. On July 16, the jewelry store paid Dress Right \$1,000 in advance for the first two months' rent. The transaction was recorded as a debit to cash and a credit to deferred rent revenue.

At the end of July, how much of the \$1,000 must be recognized? Approximately one-half of one month's rent service has been provided, or \$250, requiring the following adjusting entry.

July 31

Deferred rent revenue	250	
Rent revenue		250

After this entry is recorded and posted to the ledger accounts, the deferred rent revenue account is reduced to a credit balance of \$750 for the remaining one and one-half months' rent, and the rent revenue account will have a \$250 credit balance.

ALTERNATIVE APPROACH TO RECORD PREPAYMENTS The same end result can be achieved for prepayments by recording the external transaction directly into an expense or revenue account. In fact, some companies prefer this approach. For simplicity, bookkeeping instructions might require all cash payments for expenses to be debited to the appropriate expense accounts and all cash receipts for revenues to be credited to the appropriate revenue accounts. In the adjusting entry, then, the *unexpired* prepaid expense (asset) or *deferred* revenue (liability) as of the end of the period are recorded.

For example, on July 1, Dress Right paid \$24,000 in cash for one year's rent on its building. The company could have debited rent expense instead of prepaid rent.

Alternative Approach

July 1

Rent expense	24,000	
Cash		24,000

The adjusting entry then records the amount of prepaid rent as of the end of July, \$22,000, and reduces rent expense to \$2,000, the cost of rent for the month of July.

Alternative Approach—Adjusting Entry

July 31

Prepaid rent	22,000	
Rent expense		22,000

The net effect of handling the transactions in this manner is the same as the previous treatment. Either way, the prepaid rent account will have a debit balance at the end of July of \$22,000 to represent 11 months remaining prepaid rent, and the rent expense account will have a debit balance of \$2,000 to represent the one month of rent used in the period of this income statement being prepared. What's important is that an adjusting entry is recorded to ensure the appropriate amounts are reflected in both the expense and asset *before financial statements are prepared*.

Similarly, the July 16 cash receipt from the jewelry store representing an advance for two months' rent initially could have been recorded by Dress Right as a credit to rent revenue instead of deferred rent revenue (a liability).

Alternative Approach

July 16

Cash	1,000	
Rent revenue		1,000

If Dress Right records the entire \$1,000 as rent revenue in this way, it would then use the adjusting entry to record the amount of deferred revenue as of the end of July, \$750 to represent the one and one-half month of rent revenue remaining as collected in advance, and the rent revenue account will have a credit balance of \$250, which is for the one-half month of July that has passed in the current period.

Alternative Approach—Adjusting Entry

July 31

Rent revenue	750	
Deferred rent revenue		750

Accruals

Accruals occur when the cash flow comes *after* either expense or revenue recognition. For example, a company often uses the services of another entity in one period and pays for them in a subsequent period. An expense must be recognized in the period incurred and an accrued liability recorded. Also, goods and services often are provided to customers on credit. In such instances, a revenue is recognized in the period goods or services are transferred to customers, and an asset, a receivable, is recorded.

Many accruals involve external transactions that automatically are recorded from a source document. For example, a sales invoice for a credit sale provides all the information necessary to record the debit to accounts receivable and the credit to sales revenue. However, there are some accruals that involve internal transactions and thus require adjusting entries. Because accruals involve recognition of expense or revenue before cash flow, the unadjusted trial balance will not be as helpful in identifying required adjusting entries as with prepayments.

ACCRUED LIABILITIES For **accrued liabilities**, we are concerned with expenses incurred but not yet paid. Dress Right Clothing Corporation requires two adjusting entries for accrued liabilities at July 31, 2024.

The first entry is for employee salaries for the second half of July. Recall that on July 20 the company paid employees \$5,000 for salaries for the first half of the month. Salaries for the second half of July probably will be paid in early August. Nevertheless, an expense is incurred in July for services rendered to the company by its employees. The accrual income statement for July must reflect these services for the entire month regardless of when the cash payment is made.

Therefore, an obligation exists at the end of July to pay the salaries earned by employees for the last half of that month. An adjusting entry is required to increase salaries expense (decrease shareholders' equity) and to increase liabilities for the salaries payable. The adjusting entry for an accrued liability always includes a *debit to an expense* and a *credit to a liability*. Assuming that salaries for the second half of July are \$5,500, the following adjusting entry is recorded.

July 31

Salaries expense	5,500	
Salaries payable		5,500

After this entry is recorded and posted to the general ledger, the salaries expense account will have a debit balance of \$10,500 (\$5,000 + 5,500), and the salaries payable account will have a credit balance of \$5,500.

Rent Revenue

	0 Beg. bal.
750	1,000
	250 End bal.

Deferred Rent Revenue

	0 Beg. bal.
750	
	750 End bal.

Accruals involve transactions where the cash outflow or inflow takes place in a period subsequent to expense or revenue recognition.

Accrued liabilities represent liabilities recorded when an expense has been incurred prior to cash payment.

The adjusting entry required to record an accrued liability is a debit to an expense and a credit to a liability.

Salaries Payable

	0 Beg. bal.
5,500	
	5,500 End bal.

Salaries Expense

Beg. bal.	0
July 20	5,000
	5,500
End bal.	10,500