# Chapter 2

**Financial Statements and the Accounting System**

**Exercises**

**Exercise 2-1 (10 minutes)**

**4 a. Prepare and analyze the trial balance.**

**1 b. Analyze each transaction from source documents.**

**2 c. Record relevant transactions in a journal.**

**3 d. Post journal information to ledger accounts.**

**Exercise 2-2 (10 minutes)**

|  |  |  |  |
| --- | --- | --- | --- |
| **a.** | **5 “Three”** | **d.** | **1 “Asset”** |
| **b.** | **2 “Equity”** | **e.** | **3 “Account”** |
| **c.** | **4 “Liability”** |  |  |

**Exercise 2-3 (10 minutes)**

|  |  |  |  |
| --- | --- | --- | --- |
| **a.** | **1 “Chart”** |  |  |
| **b.** | **2 “General ledger”** |  |  |
| **c.** | **5 “Source document”** |  |  |
| **d.** | **4 “Account”** |  |  |
| **e.** | **3 “Journal”** |  |  |

**Exercise 2-4 (15 minutes)**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  |  | **Type of** | **Normal** | **Increase** |
|  | Account | **Account** | **Balance** | **(Dr. or Cr.)** |
| **a.** | **Land** | **asset** | **debit** | **debit** |
| **b.** | **Cash** | **asset** | **debit** | **debit** |
| **c.** | **Legal Expense** | **expense** | **debit** | **debit** |
| **d.** | **Prepaid Insurance** | **asset** | **debit** | **debit** |
| **e.** | **Accounts Receivable** | **asset** | **debit** | **debit** |
| **f.** | **Dividends** | **equity** | **debit** | **debit** |
| **g.** | **License Fee Revenue** | **revenue** | **credit** | **credit** |
| **h.** | **Unearned Revenue** | **liability** | **credit** | **credit** |
| **i.** | **Fees Earned** | **revenue** | **credit** | **credit** |
| **j.** | **Equipment** | **asset** | **debit** | **debit** |
| **k.** | **Notes Payable** | **liability** | **credit** | **credit** |
| **l.** | **Common Stock** | **equity** | **credit** | **credit** |

**Exercise 2-5 (15 minutes)**

**a. Analyze:**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Assets** | **=** | **Liabilities** | **+** | **Equity** |
| **Cash Equipment** |  | **Note Payable** |  | **Revenue** |
| **10,000 + 80,000** | **=** | **28,000** | **+** | **62,000** |

**b. Record:**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Titles and Explanation** | **PR** | **Debit** | **Credit** |
| **May 15** | **Cash** | **101** | **10,000** |  |
|  | **Equipment** | **167** | **80,000** |  |
|  | **Note Payable** | **245** |  | **28,000** |
|  | **Revenue** | **404** |  | **62,000** |
|  | ***Owner invests cash & equipment for stock.*** |  |  |  |

**c. Post**

|  |  |
| --- | --- |
| **Cash 101** | |
| **10,000** |  |

|  |  |
| --- | --- |
| **Note Payable 245** | |
|  | **28,000** |

|  |  |
| --- | --- |
| **Equipment 167** | |
| **80,000** |  |

|  |  |
| --- | --- |
| **Revenue 404** | |
|  | **62,000** |

**Exercise 2-6 (15 minutes)**

|  |  |  |
| --- | --- | --- |
| **a.** | **Beginning accounts payable (credit)** | **$152,000** |
|  | **Purchases on account in October (credits)** | **281,000** |
|  | **Payments on accounts in October (debits)** | **( ?)** |
|  | **Ending accounts payable (credit)** | **$132,500** |
|  |  |  |
|  | **Payments on accounts in October (debits)** | **$300,500** |
|  |  |  |
| **b.** | **Beginning accounts receivable (debit)** | **$102,500** |
|  | **Sales on account in October (debits)** | **?** |
|  | **Collections on account in October (credits)** | **(102,890)** |
|  | **Ending accounts receivable (debit)** | **$ 89,000** |
|  |  |  |
|  | **Sales on account in October (debits)** | **$ 89,390** |
|  |  |  |
| **c.** | **Beginning cash balance (debit)** | **$ ?** |
|  | **Cash received in October (debits)** | **102,500** |
|  | **Cash disbursed in October (credits)** | **(103,150)** |
|  | **Ending cash balance (debit)** | **$ 18,600** |
|  |  |  |
|  | **Beginning cash balance (debit)** | **$ 19,250** |

**Exercise 2-7 (25 minutes)**

**Aug. 1Cash 6,500**

**Photography Equipment 33,500**

**Common Stock 40,000**

**Owner invests in business for stock.**

**2Prepaid Insurance 2,100**

**Cash 2,100**

**Acquired 2 years of insurance coverage.**

**5Office Supplies 880**

**Cash 880**

**Purchased office supplies.**

**20Cash 3,331**

**Photography Fees Earned 3,331**

**Collected photography fees.**

**31 Utilities Expense 675**

**Cash 675**

**Paid for August utilities.**

**Exercise 2-8 (30 minutes)**

***Part 1***

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Cash | | | | |  | Photography Equipment | | | | |
| **Aug. 1** | **6,500** |  | **Aug. 2** | **2,100** |  | **Aug. 1** | **33,500** |  | |  |
| **20** | **3,331** |  | **5** | **880** |  |  |  |  | |  |
|  |  |  | **31** | **675** |  | **Common Stock** | | | | |
| **Balance** | **6,176** |  |  |  |  |  |  | **Aug. 1** | | **40,000** |
|  |  |  |  |  |  |  |  | |  |  |
| **Office Supplies** | | | | |  | **Photography Fees Earned** | | | | |
| **Aug. 5** | **880** |  |  |  |  |  |  | **Aug. 20** | | **3,331** |
|  | | | | |  |  |  |  | | |
| **Prepaid Insurance** | | | | |  | **Utilities Expense** | | | | |
| **Aug. 2** | **2,100** |  |  |  |  | **Aug. 31** | **675** |  | |  |

***Part 2***

|  |  |  |
| --- | --- | --- |
| **Pose-for-pics** | | |
| **Trial Balance** | | |
| **August 31** | | |
|  | ***Debit*** | ***Credit*** |
| **Cash** | **$ 6,176** |  |
| **Office supplies** | **880** |  |
| **Prepaid insurance** | **2,100** |  |
| **Photography equipment** | **33,500** |  |
| **Common stock** |  | **$40,000** |
| **Photography fees earned** |  | **3,331** |
| **Utilities expense** | **675** | **\_\_\_\_\_\_** |
| **Totals** | **$43,331** | **$43,331** |

**Exercise 2-9 (30 minutes)**

**a. Cash 100,750**

**Common Stock 100,750**

**Owner invested in the business for stock.**

**b. Office Supplies 1,250**

**Cash 1,250**

**Purchased supplies with cash.**

**c. Office Equipment 10,050**

**Accounts Payable 10,050**

**Purchased office equipment on credit.**

**d. Cash 15,500**

**Fees Earned 15,500**

**Received cash from customer for services.**

**e. Accounts Payable 10,050**

**Cash 10,050**

**Made payment toward account payable.**

**f. Accounts Receivable 2,700**

**Fees Earned 2,700**

**Billed customer for services provided.**

**g. Rent Expense 1,225**

**Cash 1,225**

**Paid for this period’s rental charge.**

**h. Cash 1,125**

**Accounts Receivable 1,125**

**Received cash toward an account receivable.**

**i. Dividends 10,000**

**Cash 10,000**

**Paid cash dividends.**

**Exercise 2-9 (concluded)**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Cash** | | | | | |  | | **Accounts Payable** | | | | | | |
| **(a)** | **100,750** |  | **(b)** | **1,250** | | |  | **(e)** | | **10,050** | | **(c)** | | **10,050** |
| **(d)** | **15,500** |  | **(e)** | **10,050** | | |  |  | |  | | **Balance** | | **0** |
| **(h)** | **1,125** |  | **(g)** | **1,225** | | |  |  | |  | |  | |  |
|  |  |  | **(i)** | **10,000** | | |  |  | |  | |  | |  |
| **Balance** | **94,850** |  |  |  | | |  | **Common Stock** | | | | | | |
|  |  |  |  |  | |  | |  | |  | | **(a)** | | **100,750** |
|  |  |  |  |  | | |  |  | |  | | **Balance** | | **100,750** |
|  |  |  |  |  | | |  |  | |  | |  | |  |
| **Accounts Receivable** | | | | | |  | | **Dividends** | | | | | | |
| **(f)** | **2,700** |  | **(h)** | | **1,125** |  | | **(i)** | | **10,000** | |  | |  |
| **Balance** | **1,575** |  |  | |  |  | | **Balance** | | **10,000** | |  | |  |
|  |  |  |  | |  |  | |  | |  | |  | |  |
| **Office Supplies** | | | | | |  | | **Fees Earned** | | | | | | |
| **(b)** | **1,250** |  |  | |  |  | |  |  | | **(d)** | | **15,500** | |
| **Balance** | **1,250** |  |  | |  |  | |  |  | | **(f)** | | **2,700** | |
|  |  |  |  | |  |  | |  |  | | **Balance** | | **18,200** | |
|  |  |  |  | |  |  | |  |  | |  | |  | |
| **Office Equipment** | | | | | |  | | **Rent Expense** | | | | | | |
| **(c)** | **10,050** |  |  | |  |  | | **(g)** | **1,225** | |  | |  | |
| **Balance** | **10,050** |  |  | |  |  | | **Balance** | **1,225** | |  | |  | |

**Exercise 2-10 (15 minutes)**

|  |  |  |
| --- | --- | --- |
| SPADE COMPANY | | |
| **Trial Balance** | | |
| **May 31, 2018** | | |
|  | ***Debit*** | ***Credit*** |
| **Cash** | **$ 94,850** |  |
| **Accounts receivable** | **1,575** |  |
| **Office supplies** | **1,250** |  |
| **Office equipment** | **10,050** |  |
| **Accounts payable** |  | **$ 0** |
| **Common stock** |  | **100,750** |
| **Dividends** | **10,000** |  |
| **Fees earned** |  | **18,200** |
| **Rent expense** | **1,225** | **\_\_\_\_\_\_\_\_** |
| **Totals** | **$118,950** | **$118,950** |

**Exercise 2-11 (20 minutes)**

**1.**

**a. Account Payable 2,000**

**Cash 2,000**

**Paid amount owed toward account payable.**

**b. Salaries Expense 1,200**

**Cash 1,200**

**Paid salary of receptionist.**

**c. Equipment 39,000**

**Cash 39,000**

**Paid for equipment purchase.**

**d. Utilities Expense 800**

**Cash 800**

**Paid utilities for the office.**

**e. Dividends 4,500**

**Cash 4,500**

**Paid cash dividends.**

**2. Transactions a, c, and e did not record an expense for the following reasons:**

**e This transaction is a distribution of cash to the owner. Even though equity decreased, that decrease did not occur in the process of providing goods or services to customers.**

**a This transaction decreased cash in settlement of a previously existing liability (equity did not change). Supplies expense is recorded when assets are used, not necessarily when cash is paid.**

**c This transaction involves the purchase of an asset. The form of the company’s assets changed, but total assets did not (and neither did equity).**

**Exercise 2-12 (20 minutes)**

**1.**

**a. Cash 20,000**

**Common Stock 20,000**

**Cash received from owner investment for stock.**

**b. Cash 900**

**Services Revenue 900**

**Provided services for cash.**

**c. Cash 10,000**

**Unearned Services Revenue 10,000**

**Cash received for future services.**

**d. Cash 3,500**

**Accounts Receivable 3,500**

**Cash received toward accounts receivable.**

**e. Cash 5,000**

**Note Payable 5,000**

**Cash received for note payable to bank.**

**2. Transactions a, c, d, and e did not yield revenue for the following reasons:**

**d This transaction changed the form of an asset from receivable to cash. Total assets were not increased (revenue was recognized when the services were originally provided).**

**e This transaction brought in cash (increased assets), and it also increased a liability by the same amount (represented by the signing of a note to repay the amount).**

**a This transaction brought in cash, but this is an owner investment.**

**c This transaction brought in cash, and it created a liability to provide services to a client in the next year.**

**Exercise 2-13 (25 minutes)**

**b 1. The company paid $4,800 cash in advance for prepaid insurance coverage.**

**a 2. D. Belle created a new business and invested $6,000 cash, $7,600 of equipment, and $12,000 in web servers in exchange for stock.**

**c 3. The company purchased $900 of supplies on account.**

**e 4. The company received $4,500 cash for services provided.**

**f 5. The company paid $900 cash towards accounts payable.**

**g 6. The company paid $3,400 cash for equipment.**

**d 7. The company paid $800 cash for selling expenses.**

Exercise 2-14 (30 minutes)

**a. Cash 6,000**

**Equipment 7,600**

**Web Servers 12,000**

**Common Stock 25,600**

**Owner investment in company for stock.**

**b. Prepaid Insurance 4,800**

**Cash 4,800**

**Purchased insurance coverage.**

**c. Supplies 900**

**Accounts Payable 900**

**Purchased supplies on credit.**

**d. Selling Expenses 800**

**Cash 800**

**Paid cash for selling expenses.**

**e. Cash 4,500**

**Services Revenue 4,500**

**Received cash for services provided.**

**f. Accounts Payable 900**

**Cash 900**

**Made payment on accounts payable.**

**g. Equipment 3,400**

**Cash 3,400**

***Paid cash for equipment.***

**Exercise 2-15 (20 minutes)**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Calculation of change in equity for *part* *a* through *part d*** | | | | | | |
|  | | **Assets** | **-** | **Liabilities** | **=** | **Equity** |
| **Beginning of the year** | **$ 60,000** | **-** | **$20,000** | **=** | **$40,000** |
| **End of the year** | **105,000** | **-** | **36,000** | **=** | **69,000** |
| **Net increase in equity** |  |  |  |  | **$29,000** |

|  |  |  |
| --- | --- | --- |
| **a. Net income** | | **$ ?** |
| **Plus owner investments** | | **0** |
| **Less dividends** | | **(0)** | |
| **Change in equity** | | **$29,000** |
| **Net Income = $29,000** | |

Since there were no additional investments or dividends, the net income for the year equals the net increase in equity.

|  |  |  |
| --- | --- | --- |
| **b. Net income** | | **$ ?** |
| **Plus owner investments** | | **0** |
| **Less dividends ($1,250/mo. x 12 mo.)** | | **(15,000)** | |
| **Change in equity** | | **$29,000** |
| **Net Income = $44,000** | |

The dividends were added back because they reduced equity without reducing net income.

|  |  |  |
| --- | --- | --- |
| **c. Net income** | | **$ ?** |
| **Plus owner investment** | | **55,000** |
| **Less dividends** | | **(0)** | |
| **Change in equity** | | **$29,000** |
| **Net Loss = $26,000** | |

The investment was deducted because it increased equity without creating net income.

|  |  |  |
| --- | --- | --- |
| **d. Net income** | | **$ ?** |
| **Plus owner investment** | | **35,000** |
| **Less dividends ($1,250/mo. X 12 mo.)** | | **(15,000)** | |
| **Change in equity** | | **$29,000** |
| **Net Income = $9,000** | |

The dividends were added back because they reduced equity without reducing net income and the investments were deducted because they increased equity without creating net income.

**Exercise 2-16 (15 minutes)**

**HELP TODAY**

**Income Statement**

**For Month Ended August 31**

**Revenues**

**Consulting fees earned $ 27,000**

**Expenses**

**Rent expense $ 9,550**

**Salaries expense 5,600**

**Telephone expense 860**

**Miscellaneous expenses 520**

**Total expenses 16,530**

**Net income $ 10,470**

**Exercise 2-17 (15 minutes)**

**HELP TODAY**

**Statement of Retained Earnings**

**For Month Ended August 31**

**Retained earnings, August 1 $ 0**

**Add: Net income (from Exercise 2-16) 10,470**

**10,470**

**Less: Dividends 6,000**

**Retained earnings, August 31 $ 4,470**

Exercise 2-18 (15 minutes)

**HELP TODAY**

**Balance Sheet**

**August 31**

**Assets Liabilities**

**Cash $ 25,360 Accounts payable $ 10,500**

**Accounts receivable 22,360 Equity**

**Office supplies 5,250 Common stock 102,000**

**Office equipment 20,000 Retained earnings\* 4,470**

**Land 44,000 Total equity 106,470**

**Total assets $116,970 Total liabilities & equity $116,970**

**\* Amount from Exercise 2-17.**

Exercise 2-19 (15 minutes)

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  | **CBS** |  | **ABC** |  | **CNN** |  | **NBC** |
| **Answers** | **$(28,000)** |  | **$42,000** |  | **$73,000** |  | **$(45,000)** |
| **Computations:** |  |  |  |  |  |  |  |
| **Equity, Dec. 31, Year 1** | **$ 0** |  | **$ 0** |  | **$ 0** |  | **$ 0** |
| **Owner's investments** | **110,000** |  | **42,000** |  | **87,000** |  | **210,000** |
| **Dividends** | **(28,000)** |  | **(47,000)** |  | **(10,000)** |  | **(55,000)** |
| **Net income (loss)** | **22,000** |  | **90,000** |  | **(4,000)** |  | **(45,000)** |
| **Equity, Dec. 31, Year 2** | **$104,000** |  | **$85,000** |  | **$73,000** |  | **$110,000** |

**Exercise 2-20 (20 minutes)**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **Description** | **(1) Difference between Debit and Credit Columns** | **(2)**  **Column with the Larger Total** | **(3)**  **Identify account(s) incorrectly stated** | **(4)**  **Amount that account(s) is overstated or understated** |
| **a.** | **$3,600 debit to Rent Expense is posted as a $1,340 debit.** | **$2,260** | **Credit** | Rent Expense | **Rent Expense is understated by $2,260** |
| **b.** | **$6,500 credit to Cash is posted twice as two credits to Cash.** | **$6,500** | **Credit** | Cash | **Cash is understated by $6,500** |
| **c.** | **$10,900 debit to the Dividends account is debited to Common Stock.** | **$0** | **––** | **Common Stock**  **Dividends** | **Common Stock is understated by $10,900**  **Dividends is understated by $10,900** |
| **d.** | **$2,050 debit to Prepaid Insurance is posted as a debit to Insurance Expense.** | **$0** | **––** | **Prepaid Insurance**  **Insurance Expense** | **Prepaid Insurance is understated by $2,050**  **Insurance Expense is overstated by $2,050** |
| **e.** | **$38,000 debit to Machinery is posted as a debit to Accounts Payable.** | **$0** | **––** | **Machinery**  **Accounts Payable** | **Machinery is understated by $38,000 Accounts Payable is understated by $38,000** |
| **f.** | **$5,850 credit to Services Revenue is posted as a $585 credit.** | **$5,265** | **Debit** | **Services Revenue** | **Services Revenue is understated by $5,265** |
| **g.** | **$1,390 debit to Store Supplies is not posted.** | **$1,390** | **Credit** | **Store Supplies** | **Store Supplies is understated by $1,390** |

**Exercise 2-21 (15 minutes)**

|  |  |  |
| --- | --- | --- |
|  | **Overstated, Understated, or Correctly-Stated** | **Amount** |
| **a.** | **Correctly-stated. The debit column is correctly stated because the erroneous debit (to Accounts Payable) is deducted from an account with a (larger assumed) credit balance.** | **$0** |
| **b.** | **Understated. The credit column is understated by $37,900 because Accounts Payable was debited — it should have been credited.** | **$37,900** |
| **c.** | **Correctly-stated. The Automobiles account balance is correctly stated.** | **$0** |
| **d.** | **Understated. The Accounts Payable account balance is understated by $37,900. It should have been increased (credited) by $18,950 but the posting error decreased (debited) it by $18,950.** | **$37,900** |
| **e.** | **The credit column is $37,900 less than the debit column, or $162,100 in total ($200,000 - $37,900).** |  |

**Exercise 2-22 (15 minutes)**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | **Co.** | **Liabilities** | **/** | **Assets** | **=** | **Debt**  **Ratio** |  | **Net**  **Income** | **/** | **Average**  **Assets** | | **=** | | **ROA** | |
|  | **1** | **$11,765** |  | **$ 90,500** |  | **0.13** |  | **$20,000** |  | **$100,000** |  | | **0.200** | |
|  | **2** | **46,720** |  | **64,000** |  | **0.73** |  | **3,800** |  | **40,000** |  | | **0.095** | |
|  | **3** | **26,650** |  | **32,500** |  | **0.82** |  | **650** |  | **50,000** |  | | **0.013** | |
|  | **4** | **55,860** |  | **147,000** |  | **0.38** |  | **21,000** |  | **200,000** |  | | **0.105** | |
|  | **5** | **31,280** |  | **92,000** |  | **0.34** |  | **7,520** |  | **40,000** |  | | **0.188** | |
|  | **6** | **52,250** |  | **104,500** |  | **0.50** |  | **12,000** |  | **80,000** |  | | **0.150** | |

**b. Company 3 relies most heavily on creditor (non-owner) financing with 82% of its assets financed by liabilities.**

c. Company 1 relies least on creditor (non-owner) financing at only 13%. This implies that 87% of the assets are financed by equity (owners).

**d. The companies with the highest debt ratios indicate the greatest risk. The two companies with the highest debt ratios are 2 and 3.**

**e. Company 1 yields the highest return on assets at 20%; followed by Company 5 at 18.8%.**

**f. As an investor, one prefers high returns at low risk. Company 1 is the preferred investment since it yields the lowest risk (debt ratio is 13%) and highest return on assets (20%).**

**Exercise 2-23 (15 minutes)**

**Heineken N.V.**

**Balance Sheet (in Euro millions)**

**December 31, 2016**

**Assets Equity and liabilities**

**Noncurrent assets € 31,184 Total equity € 14,573**

**Current assets 8,137 Noncurrent liabilities 14,351**

**Current liabilities 10,397**

**Total assets € 39,321 Total equity and liabilities € 39,321**

**Exercise 2-24 (25 minutes)**

**June 1Cash 11,000**

**Common Stock 11,000**

**Owner invests in business in exchange for stock.**

**2Furniture 4,000**

**Accounts Payable 4,000**

**Purchased furniture on credit.**

**3Prepaid Insurance 600**

**Cash 600**

**Paid premium in advance for insurance.**

**4Accounts Receivable 3,000**

**Fees Earned 3,000**

**Billed customer for services provided.**

**12Accounts Payable 4,000**

**Cash 4,000**

**Made payment toward account payable.**

**20Cash 3,000**

**Accounts Receivable 3,000**

**Received cash toward account receivable.**

**21Cash 10,000**

**Common Stock 10,000**

**Owners invest in business in exchange for stock.**

**30 Cash 5,000**

**Unearned Revenue 5,000**

**Cash received in advance for future services.**