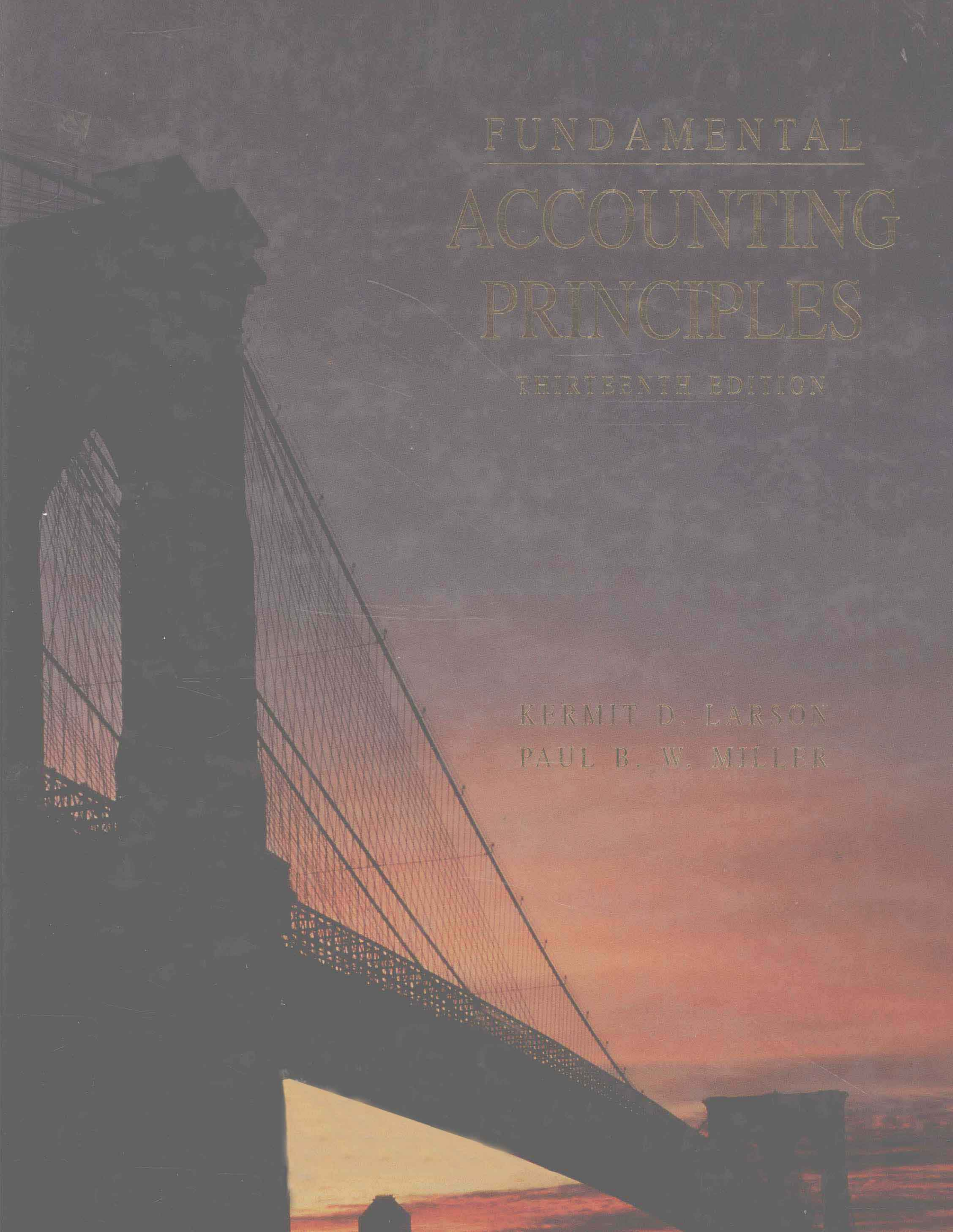


FUNDAMENTAL ACCOUNTING PRINCIPLES

THIRTEENTH EDITION

KERMIT D. LARSON
PAUL B. W. MILLER

FUNDAMENTAL ACCOUNTING PRINCIPLES

THIRTEENTH EDITION

KERMIT D. LARSON
University of Texas-Austin

PAUL B. W. MILLER
University of Colorado-Colorado Springs

IRWIN
Homewood, IL 60430
Boston, MA 02116

Part opening photos: Part I: © Mark Downey, Viesti Associates, Inc.
Part II: © Peter Bennett, Viesti Associates, Inc.
Part III: © Jay Maisel
Part IV: © Mark Weidman
Part VI: © Jay Maisel
Part VII: © Jay Maisel
Part VIII: © Jay Maisel
Part IX: © Jay Maisel

All chapter and appendix openers photographed by *Sharon Hoogstraten*. Styled by *Anne Dawson*.

Federal Express trademarks used by permission.
International Business Machines Corporation trademarks used by permission.
Lands' End, Inc. trademarks used by permission.
McDonald's Corporation trademarks used by permission.

Sponsoring editor:	Jeff Shelstad
Developmental editor:	Cheryl D. Wilson
Developmental editor, supplements:	Jackie Scruggs
Marketing manager:	Cindy L. Ledwith
Project editor:	Margaret Haywood
Production manager:	Irene H. Sotiroff
Designer:	Michael Warrell
Art manager:	Kim Meriwether
Photo research coordinator:	Patricia A. Seefelt
Compositor:	York Graphic Services
Typeface:	10/12 Times Roman
Printer:	Von Hoffmann Press

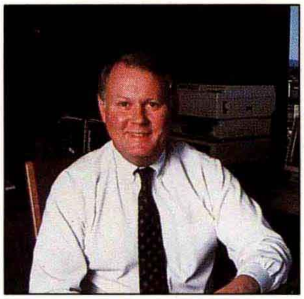
Library of Congress Cataloging-in-Publication Data

Larson, Kermit D.
Fundamental accounting principles/Kermit D. Larson, Paul B.W. Miller.—13th ed.
p. cm.
Includes bibliographical references.
ISBN 0-256-10128-0
1. Accounting. I. Miller, Paul B. W. II. Title.
HF5635.P975 1993
657—dc20 92-21073

Printed in the United States of America
2 3 4 5 6 7 8 9 0 VH 9 8 7 6 5 4 3

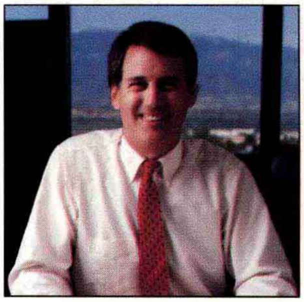
Dedicated to
Nancy, Julie, Tim, Cindy, Albrecht, and Megan
and to
Diana, David, and Greg

About the Authors



Kermit D. Larson is the Arthur Andersen & Co. Alumni Professor of Accounting at The University of Texas at Austin, where he has been a member of the faculty since 1966. He served as chairman of the U. T. Department of Accounting from 1971 to 1975 and was Visiting Associate Professor at Tulane University in 1970. His scholarly articles have been published in a variety of journals such as *The Accounting Review*, *Journal of Accountancy*, and *Abacus*. He is the author of several books, including *Financial Accounting*, published by Richard D. Irwin, Inc.

Professor Larson's professional activities range from service as chairman of the American Accounting Association's Committee on Concepts and Standards, vice president of the American Accounting Association, Southwest regional vice president of the AAA, and director of the AAA Doctoral Consortium, to member of the Constitutional Drafting Committee of the Federation of Schools of Accountancy and member of the Commission on Professional Accounting Education. He has served on the Accounting Accreditation Committee and on the Accounting Standards Committee of the AACSB and has been an expert witness on cases involving mergers, antitrust litigation, and expropriation of assets by foreign governments. Professor Larson has served on the board of directors and executive committee of Tekcon, Inc., the Strategic Planning Committee of the American Accounting Association, and the National Accountant's Advisory Board of Safeguard Business System, Inc. Presently he serves as president of the Richard D. Irwin Foundation.



Paul B. W. Miller is professor of accounting at The University of Colorado at Colorado Springs, where he has been a member of the faculty since 1988. After receiving his Ph.D. from The University of Texas at Austin, he joined the faculty of the University of Utah in 1972. His publications include articles in *The Journal of Accountancy, Accounting Horizons, Advances in Accounting, The Chartered Accountant in Australia, Research in Accounting Regulation,* and *Management Accounting*. He has written other books, including *Financial Accounting* and *The FASB: the People, the Process, and the Politics,* both published by Richard D. Irwin, Inc. In addition, he is the author of *Pension Accounting: A New Approach for Employers,* published by the American Institute of Certified Public Accountants. He received two Teaching Excellence Awards from the Beta Alpha Psi chapter of the University of Utah and, in 1991, received the first Outstanding Accounting Educator Award ever presented by the Colorado Society of CPAs.

In 1982–83, Professor Miller served as faculty fellow on the research and technical activities staff of the Financial Accounting Standards Board, where he worked on the conceptual framework and pension accounting projects. In 1987–88, he was the academic fellow in the office of the chief accountant of the Securities and Exchange Commission in Washington, D.C. He served three years as a member of the Technical Standards Subcommittee of the Ethics Executive Committee of the AICPA and has chaired and been a member of various committees of the American Accounting Association. He is licensed as a CPA by the state of Texas.

Preface

The tradition of *Fundamental Accounting Principles* includes clear explanations of accounting concepts and practices with closely related assignment material. Recent editions also reflect an educational philosophy we call *action learning*. We are firmly convinced that students learn most effectively when their study activities are designed to emphasize active behavior. The 13th edition continues this focus on the effective use of student study time.

By providing a wide variety of action-oriented items in the text and in support of the text, we hope to encourage student involvement within the classroom as well as during out-of-class study. Newly developed and thoroughly revised assignment materials provide an extensive basis for varied assignments that stimulate interest, promote a sense of accomplishment, show the real-world relevance of the subject matter, and sharpen the analytical and communications ability of each student. In addition, the study guides and the computerized tutorial give students a number of action-learning opportunities.

The *Fundamental Accounting Principles* package provides a fully integrated system for the first two-semester course at the college and university level. The system helps instructors and students meet the course objectives, which include providing a strong foundation for future courses in business and finance and initiating course work leading to a major and career in accounting. Both objectives are also served by the continuous development of the concepts that guide financial and managerial accounting practices.

Responses to the Accounting Education Change Commission

The 13th edition reflects many of the proposals of the AECC. A few examples include the integrated treatment of ethics, the revised overview of the accounting profession in Chapter 1, the expanded discussion of information systems in Chapter 6, and the analytical discussion of accounting concepts in Part V. Perhaps most notable is the inclusion of approximately 120 new problem assignments that require students to think analytically and to express their analyses in written essays. Many of the following features of the 13th edition respond to the AECC's objectives for the first accounting course.

Selected Features

Some of the key features of the 13th edition are listed in the following paragraphs.

"As a Matter of Fact" Articles. Several chapters contain newly selected excerpts from relevant articles that originally appeared in publications such as *Accounting Today, Forbes, Fortune,* and *The Wall Street Journal.*

"As a Matter of Ethics" Cases. Each chapter that contains a case entitled As a Matter of Ethics also includes a provocative problem requiring students to analyze and discuss the case. These problems are identified as As a Matter of Ethics: Essay. The AICPA's Code of Professional Conduct and the IMA's Standards of Ethical Conduct for Management Accountants are provided as resource material in Appendix L.

"As a Matter of Opinion" Interviews. A new feature in this edition, these inserts provide professional testimony about the relevance of the topical coverage to real-world decisions. Brief biographical sketches of the interviewees disclose the variety of career paths that relate to accounting.

Expanded Use of Visual Learning Aids. A significant number of new graphical illustrations have been created to appeal to today's students. These diagrams focus the readers' attention on relationships among concepts, actions, and financial measures.

Computer Systems and Assignments. Chapter 6 includes a new introduction to the computerized accounting systems used in today's businesses. In addition, a large number of homework assignments throughout the text are preloaded on the spreadsheet (SPATS) and general ledger (GLAS) software packages that are available with the text.

Excerpts and Assignments from Annual Reports. Most chapters contain a problem assignment related to the annual report of IBM in Appendix J. In addition, questions at the end of each chapter relate to the financial statements of McDonald's, Federal Express, and Lands' End contained in Appendix K.

Major Revision of Chapter 1. Essentially all of the sections in Chapter 1 have been thoroughly rewritten. We believe the revision is more interesting, more informative, and more effective in helping students prepare for the changing environment of accounting and business.

Part V. This separate learning unit describes the FASB's conceptual framework and now includes a presentation of the theoretical and practical dimensions of accounting measurement bases other than historical cost. The identification of this unit as Part V highlights its conceptual significance. Its placement between Chapters 13 and 14 facilitates its use as a capstone for the first semester or as a lead-in to the second semester.

Managerial Accounting

Perhaps the most significant revisions in this edition appear in the final eight chapters. During the last decade, many companies have begun to embrace a variety of new production management concepts that are affecting managerial accounting practices. These new concepts include customer orientation, total quality management, just-in-time manufacturing, the theory of constraints, and continuous improvement. As a result, many schools are putting more emphasis on managerial accounting in the principles course. We have responded to these developments with a major upgrade of the managerial accounting coverage in Chapters 20 through 27. The most important revisions are listed in the following paragraphs.

Introduction to Managerial Accounting. Chapter 20 opens with a thorough description of 10 differences between financial and managerial accounting, including their users, their purposes, their structures, and their reports. This discussion allows the course to make a clear transition from financial to managerial accounting.

Transparency Overlays. Following the very favorable response by adopters and students to the use of transparency overlays in Chapter 4 of the 12th edition, the 13th edition extends this form of presentation to Chapter 20. We use overlays to show the flows of materials, labor, and overhead information through the accounting system.

New Production Management Concepts. Chapter 21 begins with discussions of the new production management concepts listed earlier, with an emphasis on how they affect managers' needs for useful information. Subsequent chapters integrate these ideas in their presentations.

Separate Chapters on Job Order and Process Cost Accounting. To provide more thorough explanations of job order and process cost accounting systems, the 13th edition allocates a full chapter to each of these topics.

Parallel Examples. Chapters 20, 21, and 22 present parallel examples of production activities and the accounting records used to capture and report information about those events. The activities are represented in similar flowcharts and journal entries to clearly show how the same basic concepts are applied in increasingly complex situations.

Activity-Based Costing. Chapter 23 introduces the new topic of activity-based costing and contrasts it with traditional methods of cost allocation. The discussion focuses on the underlying concepts and advantages of the approach without undue attention to the mechanics.

Managerial Accounting for Service Oriented Businesses. Several of the managerial accounting chapters now include discussions showing the relevance of the topics to service businesses as well as manufacturing and merchandising businesses.

The Master Budget. Chapter 25 includes new flowcharts and illustrations that provide a clearer framework for understanding why and how the master budget is prepared. A new table ties together the sources of information used to develop the budgeted financial statements.

Management Decisions. Chapter 27 is now divided into two sections on capital budgeting and other management decisions. New discussions contrast alternative methods and new examples help the reader understand and apply the analytical tools described in the chapter.

Appendixes and End-of-Text Items

To provide instructors flexibility in planning course content, the 13th edition includes several appendixes. Those that clearly relate to a single chapter are placed at the end of the chapter. Others appear at the end of the book. Appendixes E, F, and I are new to this edition.

Appendix E. Located at the end of Chapter 12, this appendix explains accounting for deferred income taxes. It reflects the most basic requirements of FASB *Statement of Financial Accounting Standards No. 109,* which was issued in 1992.

Appendix F. Also at the end of Chapter 12, this appendix extends the chapter's discussion of payroll liabilities with a more detailed description of payroll records and procedures.

Appendix I. This appendix at the end of the book replaces the 12th edition's Chapter 28 with a concise discussion of federal income taxes.

Comprehensive List of Accounts Used in Exercises and Problems. This list exposes students to the large variety of accounts that companies use and that are needed to solve the exercises and problems provided in the text.

Professional Codes of Ethics. The AICPA's Code of Professional Conduct and the IMA's Standards of Ethical Conduct for Management Accountants are provided as a resource for students to use in preparing their answers to the ethics essay problems in the text.

Check Figures. In response to the request of adopters, the check figures are now listed at the end of the text.

New and Improved Supplements

Several new items have been added to the *Fundamental Accounting Principles* package and several others have been improved. New items include additional lecture enhancement videos, lecture review videos, additional practice sets, and a book of readings. Other significantly improved supplements include the General Ledger Applications Software (GLAS), the Solutions Manual, the Tutorial software, and Irwin's Computerized Testing Software. The test bank for the 13th edition has been substantially expanded. Also, the Working Papers now include forms for the exercises as well as the problems and alternate problems.

Acknowledgments

We are indebted to those adopters who maintained diaries as the basis for their thoughtful reviews and to several other reviewers who provided insight and extremely helpful criticisms. Many of the improvements in the 13th edition are based on the input from these reviewers. In addition, numerous adopters, students, and professional colleagues have made a variety of significant contributions and constructive suggestions. These individuals include:

Marilyn Allan, *Central Michigan University*
Sheila Ammons, *Austin Community College*
John Atella, *Harrisburg Area Community College*
Florence Atiase, *Austin Community College*
Sue Atkinson, *Tarleton State University*
Walter Bednar, *Luzerne County Community College*
Minta Berry, *Berry Publication Services*
Bruce Bridgman, *Community College of the Finger Lakes*
Alice P. Bursey, *Cedar Valley College of Dallas County Community College District*
Nora Coto Busby, *LeCroy Center of Ed. Telecommunications, Dallas County Community College District*
Pam Conrad, *Kirkwood Community College*
Alan Cronauer, *Herkimer County Community College*
Jim Crowther, *Kirkwood Community College*
J. Charles Cunningham, *Kirkwood Community College*
Doris deLespinasse, *Adrian College*
William J. Engel, Jr., *Longview Community College*
Anna Fowler, *The University of Texas at Austin*
Jessica Johnson Frazier, *Eastern Kentucky University*
Debra French, *Coopers & Lybrand*
Margie Hamilton, *Lewis and Clark Community College*
Betty S. Harper, *Middle Tennessee State University*
Phil Harper, *Middle Tennessee State University*
Linda Henderson, *University of South Carolina, Coastal Carolina*
Don Hester, *University of Alaska, Anchorage*
Norma Jean Hunting, *Heald Business College*
Christie W. Johnson, *Montana State University*
Ken Ketelhohn, *Milwaukee Area Technical College*
Frank Korman, *Mountain View College*
Terrie Kroshus, *Inver Hills Community College*
Cathy Xanthaky Larson, *Middlesex Community College*
Linda Lessing, *State University of New York, Farmingdale*

Terry Lindenberg, *Rock Valley College*
Leland E. Mansuetti, *Sierra College*
Kenneth Miller, *San Antonio College*
Timothy D. Miller, *El Camino College*
Laura Morgan, *Los Angeles Times*
Terri Niccum, *Los Angeles Times*
Sylvia Ong, *Maricopa Community College*
Anne M. Oppegard, *Augustana College, SD*
John F. Otto, *Grove City College*
L. J. Podsiadlik, *Oakland Community College*
Allan Reinstein, *Wayne State University*
George Ritchie, *Harrisburg Area Community College*
Tom Robinson, *University of Alaska, Fairbanks*
Fabiola Rubio, *El Paso Community College*
Stephen C. Schaefer, *Contra Costa College*
Joseph Schliep, *Normandale Community College*
Barbara A. Schnathorst, *University of Colorado, Colorado Springs*
Ed Schriefer, *Lewis and Clark Community College*
Eldon Shaefer, *Pacific Lutheran University*
Paul J. Shinal, *Cayuga County Community College*
Daniel P. Small, *J. Sargeant Reynolds Community College*
Dennis (Rocky) Spalazzi, *Bright Lights Productions, Inc.*
Linda Spalazzi, *Bright Lights Productions, Inc.*
John Spillner, *Pace University*
Charlene Spoede, *Baylor University*
Maurice Tassin, *Louisiana Tech University*
Jack E. Terry, *ComSource Associates, Inc.*
Mary Tharp, *Kirkwood Community College*
Leslie Thysell, *John Tyler Community College*
Frank Urbancic, *University of South Alabama*
Jacob Wambsganss, *Emporia State University*
Bill Wells, *Tulsa Junior College*
Kathleen A. Wessman, *Montgomery College*
Jeffrey R. Wright, *Johnson County Community College*
Carol Yacht, *Yavapai College*
Jack Zeller, *Kirkwood Community College*

We are especially indebted to our professional assistants, Betsey Jones, Sue Ann Meyer, and Barbara Schnathorst, for their unfailing and competent help in preparing the many manuscripts that make up this project.

Kermit D. Larson
Paul B. W. Miller

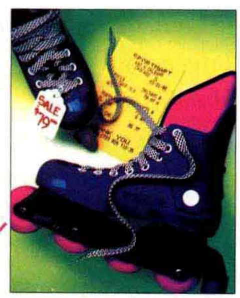
The Bridge

. . . to effective learning
. . . to full understanding
. . . to the language of business

Welcome to *Fundamental Accounting Principles,* your bridge to the world of business. This newest edition offers a wealth of special features to help you master accounting's basic principles and concepts. By listening to your instructor, participating in class, and actively studying the text, you will come away from the course with a solid understanding of accounting, the "language of business." Our hope is that the following learning tools will make your journey both exciting and educational.

CHAPTER 5

Accounting for a Merchandising Concern



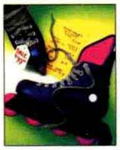
Whether they deal in roller blades or razor blades, many companies earn profits by buying merchandise and selling it to customers. Accounting helps managers determine the amount of income earned by these companies and the cost of the inventory they have on hand.

Topical Coverage

Chapter Opening Photo. A four-color photograph and its accompanying caption open every chapter. The collection of objects in the photo visually illustrate the chapter's key concepts.

Topical Coverage. An outline of the major topics provides a preview of the chapter's discussions.

248 *Part II Processing Accounting Data*



In previous chapters, we used illustrations of businesses that provided services to their customers, such as law firms, accounting firms, and real estate agencies. In this chapter, we shift our attention to merchandising businesses. These entities buy goods or products and then resell them to their customers. Your study of this chapter will focus on the problem of accounting for the goods that merchandising companies purchase for resale. You will learn to identify the elements of cost of goods sold and to complete the end-of-period accounting procedures used by merchandising companies, whether they are organized as corporations or proprietorships.

Learning Objectives

After studying Chapter 5, you should be able to:

1. Analyze and record transactions that involve the purchase and resale of merchandise.
2. Explain the nature of each item entering into the calculation of cost of goods sold and gross profit from sales.
3. Prepare a work sheet and the financial statements for a merchandising business that uses a periodic inventory system and that is organized as a corporation or as a single proprietorship.
4. Prepare adjusting and closing entries for a merchandising business organized as either a corporation or a single proprietorship.
5. Define or explain the words and phrases listed in the chapter glossary.

After studying Appendix C at the end of Chapter 5, you should be able to:

6. Explain the adjusting entry approach to accounting for inventories and prepare a work sheet, adjusting entries, and closing entries according to the adjusting entry approach.

The previous chapters have described the accounting records and financial statements of Jerry Dow, Attorney, which is a service enterprise. Other examples of service enterprises are laundries, taxi companies, airlines, financial planners, hair salons, theaters, and golf courses. Each provides a service to its customers for a commission, fare, or fee, and its net income is the difference between the revenues earned and the operating expenses incurred.

On the other hand, a merchandising company, whether a wholesaler or a retailer, earns revenue by buying and selling goods called **merchandise**. In such a company, net income results when revenue from sales exceeds the cost of the goods sold and the operating expenses, as follows:

Illustrations. Charts, tables, sample forms, and diagrams clarify and summarize the textual discussion.

Learning Objectives. Learning goals are listed after the chapter's introduction. Use them to give your studies direction and purpose. The learning objectives are repeated in the margin where relevant within the chapter. They are also tied to the summary and the end-of-chapter materials.

132 *Part II Processing Accounting Data*

ILLUSTRATION 3–1

Trial Balance Drawn from the Ledger of Jerry Dow, Attorney

JERRY DOW, ATTORNEY
Trial Balance
December 31, 1993

Cash	$ 650	
Office supplies	120	
Prepaid insurance	2,400	
Law library	2,880	
Office equipment	6,880	
Accounts payable		$ 760
Unearned legal fees		3,000
Jerry Dow, capital		9,000
Jerry Dow, withdrawals	1,100	
Legal fees earned		3,900
Salaries expense	1,400	
Rent expense	1,000	
Utilities expense	230	
Totals	$16,660	$16,660

The Adjustment Process

LO 2 Explain why adjustments are required by the revenue recognition and matching principles and why the accrual basis of accounting is preferred to a cash basis.

The adjustment process is based on two accounting principles, the *revenue recognition principle* and the **matching principle**. As explained in Chapter 1, the *revenue recognition principle* requires that revenue be reported in the income statement when it is earned, not before and not after. For most firms, revenue is earned at the time a service is rendered or a product is sold to the customer.

For example, if a lawyer renders legal services to a client during December, the legal fees are earned during December. According to the *revenue recognition principle*, the lawyer must report these legal fees as revenue on the December income statement, even though the cash receipt from the client may take place in November or January. In cases such as this, the adjustment process assigns the revenue to December, when it was earned.

The *matching principle* requires reporting expenses on the income statement in the same accounting period as the revenues that were earned as a result of the expenses. For example, assume that a business uses an office to earn revenues during December. According to the *revenue recognition principle*, the business must report the revenues on the December income statement. One expense the business incurred in the pursuit of those December revenues was the December office rent. Therefore, the *matching principle* requires reporting the rent for December on the December income statement. This must be done even if the December rent was paid in November (or in January). In such cases, the adjustment process is used to match the cost of December's rent with the revenues earned during December.

Chapter 6 Accounting Systems 315

AS A MATTER OF
Opinion

Ms. Smith received her B.A. in accounting from the University of Colorado at Colorado Springs. She is the managing director of Strait Kushinsky and Company, a large public accounting firm in Colorado Springs. Among her partners is Marvin Strait, former chairman of the American Institute of CPAs. She is presently the chairperson of the Colorado Springs Chamber of Commerce, and serves on the governing boards of the American Group of CPAs and the Christian Management Association.

Brenda Smith, CPA

Successful business managers need information, and they need computers to get it for them. Yet, many people are still held back by a fear of computers. We need to learn to be as comfortable with computers as we are with our calculators.

The systems available to today's small businesses are great savers of time and effort. For example, many banks and businesses have linked their computers. This system instantly records deposits to a store's checking account and updates its sales and inventory records at the same time. A lot of paperwork is eliminated, and managers and employees can devote their skills to the business instead of bookkeeping.

Despite the abilities of these new systems, we have to know the appropriate accounting principles to avoid getting "garbage-in-garbage-out" results. While we don't need to understand how to program computers, we do need a basic understanding of their processes. And, we need to understand accounting so that we can make them work for us.

Computers and integrated software programs have dramatically reduced the bookkeeping tasks in accounting. However, do not think that computers have eliminated the need for accountants. Nor should you conclude that success in business no longer requires a knowledge of accounting. *The need for accountants and accounting knowledge is created by the need for information, not by the need for pencil and paper.* Accountants continue to be in demand because their expertise is necessary to determine ... information ... hat data should be us... ...nts

As a Matter of Opinion. New to this edition are interviews with individuals who use accounting information in the performance of their jobs. This feature clearly shows how information you learn in the classroom applies to the working world.

As a Matter of Fact. Excerpts of articles from publications such as *Fortune* and *The Wall Street Journal* show the relevance of accounting topics to contemporary business issues.

Chapter 7 Internal Control and Accounting for Cash 367

AS A MATTER OF
Fact

Cash: Once Trash, Now Treasure

Ex-billionaire Donald Trump knows a hot idea when he hears one. Several months ago, when he was trying to unload the Trump shuttle, he announced that cash was in, debt was out. Poor Donald—if only he had put his money where his mouth was, he wouldn't be in hock to banks and bondholders today.

In the decade of debt financing, cash was trash. It wasn't smart to sit with it when other assets were going to the moon. But in the past 12 months, everything except cash has come crashing down to earth. Mergers and acquisitions are off nearly 50% because few corporations can borrow the money to swing a deal. Reputable real estate developers are going bust, and heavily mortgaged homeowners cannot afford to sell at rock-bottom prices. Meanwhile, cash in the form of Treasury bills is returning a steady 7% to 8%.

The ascendancy of cash implies that credit will be tighter in the Nineties than in the Eighties. Lenders will discriminate against corporations with weak balance sheets, putting them at a competitive disadvantage. Compare Nordstrom, the well-financed Seattle-based department store chain that is steadily expanding, with R. H. Macy, which is selling equity and trying to shed assets to pay down debt.

For homeowners and commercial real estate developers, King Cash means that property prices will likely remain depressed. Why? Explains investment banker Lewis Ranieri, chairman of Ranieri Wilson & Co.: "In today's environment, where asset values are falling, tighter credit standards are being imposed." Take, for example, a $100 million office building. In the good old days of debt, you could finance its purchase by putting up only 5% cash—$5 million. Today, not only has the value of the property fallen to, say, $60 million, but a potential buyer must also come up with 25% cash—$15 million. That's a high enough hurdle to forestall any rapid recovery in real estate.

The implications of cash as an appreciating asset may not be pretty. James Grant, for one, thinks that deflation—that rare bird not seen on the American continent since the 1930s—is a distinct possibility. Says he: "If people decide that cash is a better store of value, then prices for houses and companies can only decline further. Potential buyers will demand that sellers capitulate on price before they will exchange the safety of cash for the illiquidity of other assets."

Source: Brett D. Fromson, *Fortune*, January 14, 1991, pp. 54 and 58. © 1991 The Time Inc. Magazine Company. All rights reserved.

responsibility for making all change. Alternatively, the business can use a register with separate cash drawers for each operator.

Maintain Adequate Records

140 *Part II Processing Accounting Data*

AS A MATTER OF
Ethics

Bill Pena is the accountant for Cryer Company. Just before Pena prepared the adjusting entries to record accrued expenses at the end of the company's first year of operations, he was called into the company president's office. The president asked about the accrued expenses and then told Pena not to make the adjustments. Although Pena expressed concern about these instructions, the president said that because the bills will not be received until January, they should not be reported as expenses until the next year.

In addition, the president asked how much this year's revenues will be increased by the purchase order recently received from Broker Company. Pena explained that there will be no effect on sales until January because Broker Company will not take delivery until after the first of the year. The president was exasperated and pointed out that the order had already been received and Cryer was ready to make the deliveries. Even though Broker Company's order indicated that the merchandise should not be delivered until late January, the president told Pena to record the sale in December.

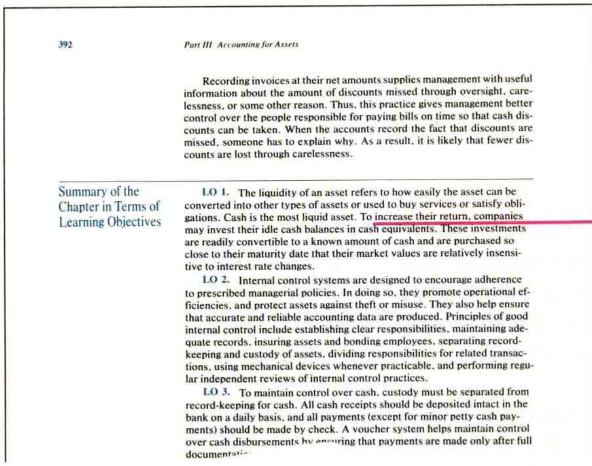
Pena knows that the combination of recording the sale to Broker Company and not accruing the expenses will increase the reported income by a large amount and is not sure what to do. He also wonders what reaction the company's auditors will have when they review the adjustments. What should Pena do?

accounts payable also bear interest.) Interest expense is incurred with the passage of time. Therefore, unless the interest has been paid and recorded on the last day of the accounting period, some additional interest will have accrued since the last payment date. Record this accrued interest with an adjusting entry similar to the preceding entry to record accrued salaries.

Accrued Revenues

Many revenues are recorded when cash is received. Others are recorded at the time the goods or services are sold on credit ... bill is given to the customer.

As a Matter of Ethics. These brief scenarios illustrate the many ethical challenges faced by accounting professionals. End-of-chapter questions related to these cases are presented to help you understand the ramifications of various courses of action.


392 *Part III Accounting for Assets*

Recording invoices at their net amounts supplies management with useful information about the amount of discounts missed through oversight, carelessness, or some other reason. Thus, this practice gives management better control over the people responsible for paying bills on time so that cash discounts can be taken. When the accounts record the fact that discounts are missed, someone has to explain why. As a result, it is likely that fewer discounts are lost through carelessness.

Summary of the Chapter in Terms of Learning Objectives

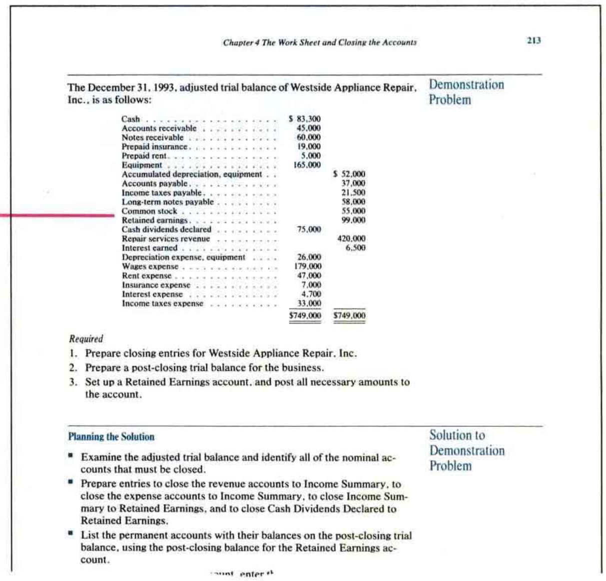
LO 1. The liquidity of an asset refers to how easily the asset can be converted into other types of assets or used to buy services or satisfy obligations. Cash is the most liquid asset. To increase their return, companies may invest their idle cash balances in cash equivalents. These investments are readily convertible to a known amount of cash and are purchased so close to their maturity date that their market values are relatively insensitive to interest rate changes.

LO 2. Internal control systems are designed to encourage adherence to prescribed managerial policies. In doing so, they promote operational efficiencies, and protect assets against theft or misuse. They also help ensure that accurate and reliable accounting data are produced. Principles of good internal control include establishing clear responsibilities, maintaining adequate records, insuring assets and bonding employees, separating record-keeping and custody of assets, dividing responsibilities for related transactions, using mechanical devices whenever practicable, and performing regular independent reviews of internal control practices.

LO 3. To maintain control over cash, custody must be separated from record-keeping for cash. All cash receipts should be deposited intact in the bank on a daily basis, and all payments (except for minor petty cash payments) should be made by check. A voucher system helps maintain control over cash disbursements by ensuring that payments are made only after full documentation

Summary. A recap of the main ideas presented concludes every chapter. All summary points are keyed to the opening learning objectives. The list format makes it an excellent review tool.

Demonstration Problem with Solution. Each chapter includes an illustrative example that shows how the chapter's concepts are applied in problem-solving. *Planning the Solution* shows you the steps that should be taken to arrive at the correct answer. This is followed by the complete solution to the problem.


Chapter 4 The Work Sheet and Closing the Accounts 213

Demonstration Problem

The December 31, 1993, adjusted trial balance of Westside Appliance Repair, Inc., is as follows:

Cash	$ 83,300	
Accounts receivable	45,000	
Notes receivable	60,000	
Prepaid insurance	19,000	
Prepaid rent	5,000	
Equipment	165,000	
Accumulated depreciation, equipment		$ 52,000
Accounts payable		37,000
Income taxes payable		21,500
Long-term notes payable		58,000
Common stock		55,000
Retained earnings		99,000
Cash dividends declared	75,000	
Repair services revenue		420,000
Interest earned		6,500
Depreciation expense, equipment	26,000	
Wages expense	179,000	
Rent expense	47,000	
Insurance expense	7,000	
Interest expense	4,700	
Income taxes expense	33,000	
	$749,000	$749,000

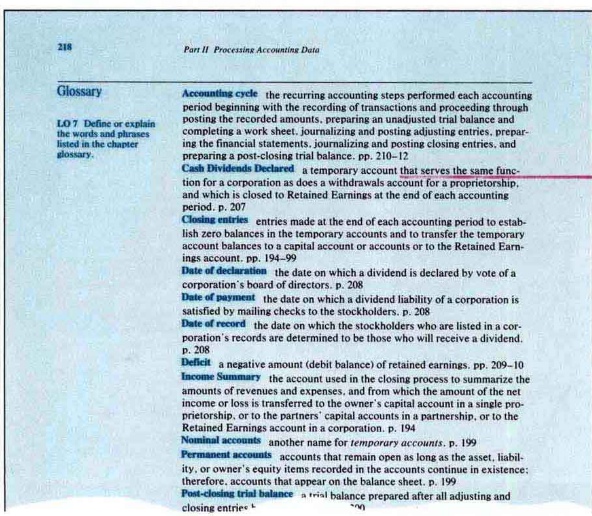
Required

1. Prepare closing entries for Westside Appliance Repair, Inc.
2. Prepare a post-closing trial balance for the business.
3. Set up a Retained Earnings account, and post all necessary amounts to the account.

Solution to Demonstration Problem

Planning the Solution

- Examine the adjusted trial balance and identify all of the nominal accounts that must be closed.
- Prepare entries to close the revenue accounts to Income Summary, to close the expense accounts to Income Summary, to close Income Summary to Retained Earnings, and to close Cash Dividends Declared to Retained Earnings.
- List the permanent accounts with their balances on the post-closing trial balance, using the post-closing balance for the Retained Earnings account.


218 *Part II Processing Accounting Data*

Glossary

LO 7 Define or explain the words and phrases listed in the chapter glossary.

Accounting cycle the recurring accounting steps performed each accounting period beginning with the recording of transactions and proceeding through posting the recorded amounts, preparing an unadjusted trial balance and completing a work sheet, journalizing and posting adjusting entries, preparing the financial statements, journalizing and posting closing entries, and preparing a post-closing trial balance. pp. 210–12

Cash Dividends Declared a temporary account that serves the same function for a corporation as does a withdrawals account for a proprietorship, and which is closed to Retained Earnings at the end of each accounting period. p. 207

Closing entries entries made at the end of each accounting period to establish zero balances in the temporary accounts and to transfer the temporary account balances to a capital account or accounts or to the Retained Earnings account. pp. 194–99

Date of declaration the date on which a dividend is declared by vote of a corporation's board of directors. p. 208

Date of payment the date on which a dividend liability of a corporation is satisfied by mailing checks to the stockholders. p. 208

Date of record the date on which the stockholders who are listed in a corporation's records are determined to be those who will receive a dividend. p. 208

Deficit a negative amount (debit balance) of retained earnings. pp. 209–10

Income Summary the account used in the closing process to summarize the amounts of revenues and expenses, and from which the amount of the net income or loss is transferred to the owner's capital account in a single proprietorship, or to the partners' capital accounts in a partnership, or to the Retained Earnings account in a corporation. p. 194

Nominal accounts another name for *temporary accounts*. p. 199

Permanent accounts accounts that remain open as long as the asset, liability, or owner's equity items recorded in the accounts continue in existence; therefore, accounts that appear on the balance sheet. p. 199

Post-closing trial balance a trial balance prepared after all adjusting and closing entries

Glossary. Key terms are briefly defined at the end of each chapter. Page references indicate where they are discussed. All glossary terms are highlighted in color in the index.

400 *Part III Accounting for Assets*

Reconcile to explain or account for the difference between two amounts. p. 385

Vendee the buyer or purchaser of goods or services. p. 375

Vendor the seller of goods or services, usually a manufacturer or wholesaler. p. 374

Voucher an internal business paper used to accumulate other papers and information needed to control the disbursement of cash and to ensure that the transaction is properly recorded. p. 373

Voucher Register a book of original entry in which approved vouchers are recorded. p. 395.

Voucher system a set of procedures designed to control the incurrence of obligations and disbursements of cash. p. 373

Synonymous Terms

Checking account demand deposit
Invoice bill
Purchase order P.O.
Savings account time deposit
Unrecorded deposits deposits in transit
Vendee buyer
Vendor seller
Write a check draw a check

Objective Review

Answers to the following questions are listed at the end of this chapter. Be sure that you decide which is the one best answer to each question *before* you check the answers.

LO 1 Which of the following assets should be classified as a cash equivalent?

a. Land purchased as an investment.
b. Accounts receivable.
c. Common stock purchased as a short-term investment.
d. A 90-day Treasury bill issued by the U.S. government.
e. None of the above.

LO 2 The broad principles of internal control require that:

a. Responsibility for a series of related transactions (such as placing orders for, receiving, and paying for merchandise) should be lodged in one person so that responsibility is clearly assigned.
b. An employee who has custody over an asset should also keep the accounting records for that asset to ensure that the records are kept current.
c. Responsibility for specific tasks should be shared by more than one employee so that one serves as a check on the other.

Synonymous Terms. A list of terms that are often used interchangeably follows the glossary.

Objective Review. See how well you understand the chapter's major concepts by taking the mini-quiz at its end. Since each question is tied to the learning objectives, you quickly see how well you accomplished the chapter goals.

Real-World Emphasis. Questions relating to the business operations of actual companies—Lands' End, Federal Express, IBM, and McDonald's—appear in nearly every chapter. For easy identification, the company logos appear in the margin opposite the questions.

222 *Part II Processing Accounting Data*

21. One corporation uses a Cash Dividenos Declared account and another corporation debits all dividend declarations directly to its Retained Earnings account. What effect does this difference have on the entries to be made by the corporations?
22. Explain why the payment of a cash dividend by a corporation with a deficit generally is illegal.
23. Refer to the financial statements of Lands' End, Inc., shown in Appendix K. What amount of cash dividends were paid to common shareholders during the years ended January 31, 1991? 1990? 1989?
24. Refer to the financial statements of Federal Express Corporation shown in Appendix K. What general journal entry was made on May 31, 1991, to close the Income Summary account?

[B]25. If one company uses reversing entries and another does not, what differences between the two companies will show up on the financial statements?

[B]26. Why do reversing entries make the bookkeeping process easier?

[B]27. If a company made an adjusting entry to accrue salaries expense of $500 at the end of an accounting period, what reversing entry would be made for this accrual?

[B]28. At what stage in the accounting cycle are reversing entries recorded? When are they dated?

Exercises

Exercise 4-1
Sorting account balances on a work sheet
(LO 1)

The balances of the following accounts appeared in the Adjusted Trial Balance columns of a work sheet. Copy the account numbers in a column on a sheet of note paper, and beside each number indicate by letter the Income Statement or Balance Sheet column to which the account's balance would be sorted in completing the work sheet. Use the letter *a* to indicate the Income Statement Debit column, *b* to indicate the Income Statement Credit column, *c* to indicate the Statement of Changes in Owner's Equity or Balance Sheet Debit column, and *d* to indicate the Statement of Changes in Owner's Equity or Balance Sheet Credit column.

1. Donna Munnerlyn, Withdrawals.
2. Machinery.
3. Depreciation Expense, Machinery.
4. Office Supplies.
5. Prepaid Insurance.
6. Rent Expense.
7. Service Revenue.
8. Accounts Receivable.
9. Donna Munnerlyn, Capital.
10. Wages Expense.
11. Accounts Payable.
12. Accumulated Depreciation, Machinery.
13. Cash.
14. Utilities Expense.

Exercise 4-2
Preparing adjusting entries from work sheet information
(LO 1)

The following item amounts are from the adjustments columns of a work sheet. Use this information to prepare adjusting journal entries dated December 31.