

WEYGANDT • KIESO • KELL

ACCOUNTING PRINCIPLES

THIRD EDITION

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Dedicated to
our teachers—from whom we learned
and
our students—from whom we continue to learn

and to our families,
most especially our wives

Enid

Donna

Linda

ABOUT THE AUTHORS

Jerry J. Weygandt, Ph.D., CPA, is Arthur Andersen Alumni Professor of Accounting at the University of Wisconsin-Madison. He holds a Ph.D. in accounting from the University of Illinois. Articles by Professor Weygandt have appeared in the *Accounting Review*, *Journal of Accounting Research*, the *Journal of Accountancy*, and other professional journals. These articles have examined such financial reporting issues as accounting for price-level adjustments, pensions, convertible securities, stock option contracts, and interim reports. He is a member of the American Accounting Association, the American Institute of Certified Public Accountants, and the Wisconsin Society of Certified Public Accountants. He has served on numerous committees of the American Accounting Association and as a member of the editorial board of the *Accounting Review*. In addition, he is actively involved with the American Institute of Certified Public Accountants and has been a member of the Accounting Standards Executive Committee (AcSEC) of that organization. He has served as a consultant to a number of businesses and state agencies on financial reporting issues and served on the FASB task force that examined the reporting issues related to "accounting for income taxes." Professor Weygandt has received the Chancellor's Award for Excellence in Teaching; he also has served as Secretary-Treasurer of the American Accounting Association. Recently he received the Wisconsin Institute of CPA's Outstanding Educator's Award.

Donald E. Kieso, Ph.D., CPA, received his bachelors degree from Aurora University and his doctorate in accounting from the University of Illinois. He has served as chairman of the Department of Accountancy and is currently the Peat Marwick Professor of Accountancy at Northern Illinois University. He has public accounting experience with Price Waterhouse & Co. (San Francisco and Chicago) and Arthur Andersen & Co. (Chicago) and research experience with the Research Division of the American Institute of Certified Public Accountants (New York). He has done postdoctorate work as a Visiting Scholar at the University of California at Berkeley and is a recipient of NIU's Teaching Excellence Award and the Executive MBA Golden Apple Teaching Award. Professor Kieso is the author of other accounting and business books and is a member of the American Accounting Association, the American Institute of Certified Public Accountants, the Financial Executives Institute, and the Illinois CPA Society. He has served as a member of the Board of Directors of the Illinois CPA Society, the Board of Governors of the American Accounting Association's Administrators of Accounting Programs Group, the AACSB's Accounting Accreditation and Visitation Committees, the State of Illinois Comptroller's Commission, as Secretary-Treasurer of the Federation of Schools of Accountancy, and as Secretary-Treasurer of the American Accounting Association. Professor Kieso is currently serving as a member of the Board of Directors of Aurora University, the chairman of the AAA/AECC Liaison Committee, the National Accounting Education Change Commission, and committees of the Illinois CPA Society. In 1988 he received the Outstanding Accounting Educator Award from the Illinois CPA Society, and in 1992 he received the FSA's Joseph A. Silvos Award of Merit and the NIU Foundation's Humanitarian Award for Service to Higher Education.

Walter G. Kell, Ph.D., CPA, received his doctorate in accounting from the University of Illinois. He is Professor Emeritus of Accounting at the University of Michigan, where he has served as Chairman of the Department of Accounting.

He also has served as the Chairman of the Accounting Department of Syracuse University. He has been an active member of the American Institute of Certified Public Accountants and has served on its Committee on Auditing Procedure (predecessor to the Auditing Standards Board) and Auditing Standards Advisory Council. He is a past president of the American Accounting Association. Professor Kell has been a consulting editor and co-editor of the *Accountant's Handbook* and is the co-author of an auditing textbook. He is a member of the Michigan Association of Certified Public Accountants and has served on its Committee on Accounting and Auditing Procedures and Board of Directors. In 1986 Professor Kell received the Association's Distinguished Service Award because of his significant contributions to the public accounting profession. He recently served as a member and chairman of the CPA Examination Review Board of the National Association of State Boards of Accountancy.

TO THE STUDENT

Welcome to your first course in accounting! We have good news for you. This textbook has been specifically designed to make your first accounting experience meaningful and interesting. You will be using a textbook that has met the test of the marketplace in previous editions. Each chapter contains special features that show you how accounting really works, and how you can use these features as a guide in studying each chapter. These features are highlighted below. We wish you every success in your first course in accounting.

Features that Show You How Accounting Really Works

- Whether you realize it or not, accounting is a part of your life *right now*! Each chapter opens with a **Chapter-Opening Vignette**, a true story that shows you accounting in action on a college campus. These real-life scenarios will help you understand how accounting relates to your own life, and the role accounting plays in all our lives.
- **Accounting in Action** boxes within each chapter show you how real companies put accounting to work. You'll get special insight into business, ethics, and international problems and challenges real accountants face, and the role accounting plays in dealing with these issues.
- One of the most important tools in accounting is the computer. **Technology in Action** boxes show you how computers are continuing to revolutionize accounting, and how they are used in accounting practice today. These boxes will also give you some idea of what the future holds.

Features that Guide You as You Study Each Chapter

- Before you begin a chapter, you'll see a **Concepts for Review** box that lists concepts and skills that you've encountered in previous chapters, and that you will see in the chapter to come. If you review these concepts before you start reading the chapter, the new material will be easier to understand. The page numbers after each concept in the box tell you where to turn to review any concepts you aren't clear about.
- You'll also find a list of **Study Objectives** at the beginning of each chapter. They tell you what you should be able to do after completing the chapter. For example, you might be asked to explain a concept, identify the steps to perform a particular computation, or interpret a type of statement. This helps you focus your attention on what you're expected to learn from the chapter right up front.
- To make sure you stay on track, each chapter includes **Before You Go On** sections. These sections appear in the middle of the text, and ask you to stop and answer a few brief questions before you continue reading. That way, you can check to make sure that you thoroughly understand each concept as it is being developed.
- Sometimes the theoretical discussion of a concept needs to be reinforced. To help you in such cases, your text includes **Helpful Hints** in the margins. These notes help to clarify the particular concept under discussion.
- **Summary of Study Objectives** appears at the end of each chapter. The Study Objectives listed at the beginning are now repeated with complete answers.

This ensures that you understand exactly what you are expected to know once you've completed the chapter.

- In this course you will be required to solve numerous exercises and problems. To give you some help, each chapter includes **Demonstration Problems**. You'll see how particular kinds of problems are solved in a step-by-step manner. You will also get lots of helpful hints to avoid common pitfalls.
- Accounting includes a lot of terms and concepts that will be unfamiliar to you at first. Each chapter includes an **End-of-Chapter Glossary** that defines all the major terms that were introduced in the chapter, so you can quickly refresh your memory as you study.

Features that Show You How You're Doing as You Go Along

- An important element of successful study is knowing how you're doing so far. **Self-Study Questions** in each chapter allow you to check yourself so you'll know which topics you have mastered and which are giving you trouble. These multiple-choice questions are answered at the end of the chapter.
- **Brief Exercises** help you build your confidence and test your basic skills. Each brief exercise focuses on *one* of the study objectives listed at the beginning of the chapter.
- **Broadening Your Perspective** is a section at the end of every chapter that lets you put it all together. This section contains a Critical Thinking Case tied to the chapter-opening vignette, a Financial Reporting Problem, a Decision Case, and an Ethical Case. All of these cases let you integrate and coordinate all the concepts you've encountered in the chapter. In addition, they give you an opportunity to improve your communication skills.

All these features have been carefully interwoven to make the study of accounting as easy as possible for you. If you take advantage of the study features, we are confident that you will be pleased with your performance in accounting principles.

Special Supplements that Help You Get the Best Grade You Can

Working Papers, Volume I: Chapters 1–14 and Volume II: Chapters 14–28

These partially completed accounting forms can be used in all end-of-chapter exercises, problems, and cases. They show you how to correctly set up solution formats.

Student Study Guide, Volume I: Chapters 1–14 and Volume II: Chapters 14–28

This item provides a comprehensive review of accounting! In addition to guiding you through chapter content and the Study Objectives, it gives you additional opportunities to practice your knowledge and skills. Each chapter includes: Study Tips, a Chapter Review consisting of 20–30 key points, a Demonstration Problem linked to study objectives in the textbook, and much more.

Self-Study Problems/Solutions Book

This tutorial is designed to improve your ability in solving accounting principles homework assignments and examination questions. It also provides additional insights and tips on how to study accounting.

Career Supplement

This valuable resource introduces you to the opportunities available in business for people with an accounting background. It gives a broad perspective of accounting and its many applications in business and presents various career paths.

Practice Sets

Practice sets expose you to a real-world simulation of maintaining a complete set of books for a business. You'll find that practice sets reinforce the concepts and procedures learned in each chapter of the textbook, and show you how they are all brought together to generate the accounting information that is essential in assessing the financial position and operating results of a company. The practice sets are:

Campus Cycle Shop: A Business Papers Practice Set
Heritage Home Furniture
Olympic Mowers Co.

General Ledger

An exciting new software supplement developed for the Third Edition, it allows you to solve selected end-of-chapter problems on a computer. It also allows you to do the Campus Cycle Shop and Heritage Home Furniture practice sets on a computer.

Solving Principles of Accounting Problems Using Lotus 1-2-3

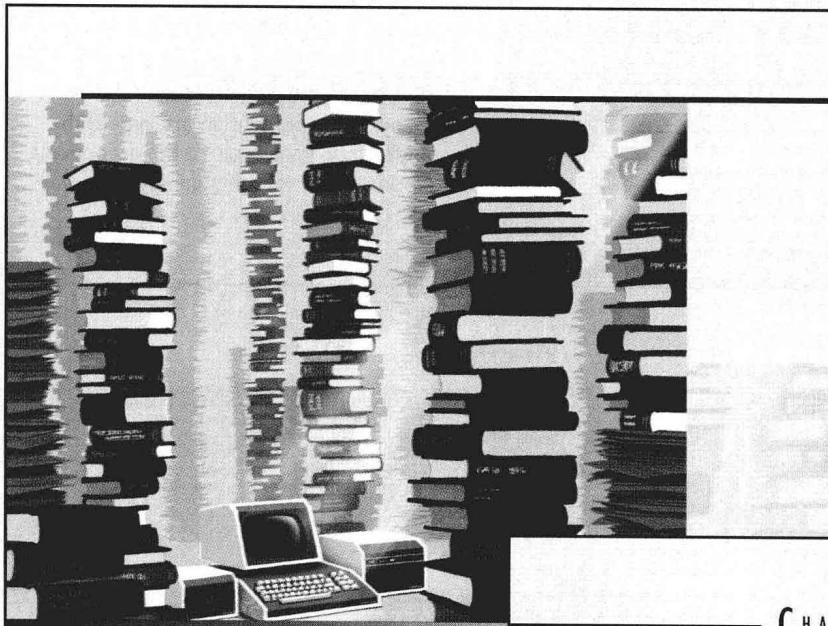
These electronic spreadsheets (templates) allow you to complete selected end-of-chapter exercises and problems using Lotus 1-2-3.

Computerized Study Guide

Microstudy is designed to reinforce the material and problems in the Student Study Guides I and II. It offers students both extensive review information and hundreds of self-testing questions from every chapter in the text. You can select from a number of self-study options including: chapter summaries; chapter learning objectives; and multiple choice questions. The multiple choice section of Microstudy offers explanations of why the wrong choices are not correct.

Jerry J. Weygandt
Donald E. Kieso
Walter J. Kell

HOW TO USE THE STUDY AIDS IN THIS BOOK



2. Study Objectives

Provide a learning framework and appear at beginning of chapter and in main body of the text where addressed.

CONCEPTS FOR REVIEW

Before studying this chapter, you should know or, if necessary, review:

- a. How to prepare a work sheet. (Ch. 4, p. 133–7)
- b. How to close revenue, expense, and drawing accounts. (Ch. 4, p. 139–42)
- c. The steps in the accounting cycle. (Ch. 4, p. 146–7)

1. Concepts for Review

List accounting concepts you need to know in order to comprehend the topics discussed in the chapter. Gives page references if you need to review before reading the chapter.

3. Chapter Opening Vignettes

Help you understand how accounting topics relate to campus life through real-life scenarios.

CHAPTER 5 ACCOUNTING FOR MERCHANDISING OPERATIONS

Study Objectives

After studying this chapter, you should be able to:

1. Identify the components in measuring net income in a merchandising company.
2. Explain the entries for sales revenues.
3. State the steps in determining cost of goods sold.
4. Explain the computation and importance of gross profit.
5. Identify the unique features of the income statement for a merchandising company.
6. Explain the steps in the accounting cycle for a merchandising company.
7. Distinguish between a multiple-step and a single-step income statement.

Larry Martin is in charge of procuring textbooks for the Washington State University bookstore in Pullman, Washington. The bookstore sells about \$4 million in textbooks each year. The average inventory at any point in time is 2,500 titles.

Mr. Martin's big challenge is to order enough books to satisfy demand—but not too many. For example, say a course historically has sold 75 books. He'll order 85 to be on the safe side. The reason: if he orders short, he'll have to order additional books by second-day air express—which is expensive and cuts into profits. If Martin orders too many, the publisher won't accept for return more than 20% of his original order.

Of course, returns occur all the time, especially when students drop courses during the first week of class. If the returned books are in "new and resellable" condition, the publisher will accept return of such books and issue Mr. Martin a credit memo.

Accounting in Action • Business Insight



How high is too high? Returns can become so high that it is questionable whether sales revenue should have been recognized in the first place. An example of high returns is Florafax International Inc., a floral supply company, which was alleged to ship its product without customer authorization on 10 holiday occasions, including 8,562 shipments of its product to customers for Mother's Day and 6,575 for Secretary's Day. The return rate on these shipments went as high as 69% of sales. As one employee noted: "products went out the front door and came in the back door."

An offshoot of high returns is "channel stuffing." In channel stuffing, the seller "sells" its product by providing substantial inducement to buy. Although this helps the sellers' revenue in the short run, the long term can be devastating when the merchandise bought remains on the purchasers' shelves for a long period of time.

Sales Returns and Allowances is a **contra revenue** account to Sales. The normal balance of Sales Returns and Allowances is a debit. A contra account is used, instead of debiting Sales, to disclose the amount of sales returns and allowances in the accounts and in the income statement. Disclosure of this information is important to management: excessive returns and allowances suggest inferior merchandise, inefficiencies in filling orders, errors in billing customers, and mistakes in delivery or shipment of the goods. Moreover, a debit directly to Sales would obscure the relative importance of sales returns and allowances as a percentage of sales. It also could distort different accounting periods.

Sales Discounts

The terms of a credit sale may include an **discount**, to the customer for prompt payment, offers advantages to both parties. The purpose is to convert the accounts receivable into cash.

The credit terms specify the amount and the length of time in which the customer must pay the full invoice price. In the sales invoice in Illustration 5-1, the terms are **2/10, net 30**, which is read "two-ten, net thirty." This means that the customer may take a 2% discount on the invoice price (less any discounts already taken) if payment is made within 10 days of the invoice date. Alternatively, the discount period may be extended to the end of the month in which the sale occurred. A 1% discount is available if payment is made within the first 10 days of the next month.

When the seller elects not to offer a cash discount, the time period may be stated as **net 30**. For example, the time period may be stated as **net 30**.

When cash discounts are taken by customers, To illustrate, assume Chelsea Video (Sales \$3,800 less Sales Returns and Allowances \$300) takes a 2% discount on the cash paid by Chelsea is \$3,430 (\$3,500 - \$70 by Highpoint Electronic on May 15, the end of the discount period).

Helpful hint The term "net" in "net 30" means the remaining amount due after subtracting any sales returns and allowances and partial payments.

4. Accounting in Action

Presents insights into business, ethics, and international problems faced by accountants.

5. Technology in Action

Shows how computers are one of the most important tools to the accountant and users of accounting information.

Alternatively, passing up the discount may be viewed as **paying an interest rate** of 2% for the use of \$3,500 for 20 days. This is the equivalent of an annual interest rate of 36% ($2\% \times 360/20$).² Obviously, it would be better for Chelsea Video to borrow at prevailing bank interest rates of 8–12% than to lose the discount.

So as not to miss purchase discounts, unpaid invoices should be filed by due dates. For example, Chelsea Video should have a file folder dated May 14 in which all bills to be paid on this date are filed. This procedure helps the purchaser remember the discount date. It also prevents early payment of bills and maximizes the time that available cash can be used for other business purposes.



Technology in Action

In many computer systems, the purchase of goods and the subsequent payment are closely linked. The due date, discount terms, and discount date are entered into the system along with the account names and dollar amounts. When the data have been entered and approved, the system can automatically generate payment checks by the discount date to take advantage of any discounts offered. Such a level of automation may not be necessary for a small firm with only 10 to 20 suppliers. The advantages of such a system quickly surface, though, when hundreds of suppliers are used on a continuous basis, as is the case with many large retailers.

Freight Costs

The sales agreement should indicate whether the seller or the buyer is to pay the cost of transporting the goods to the buyer's place of business. When a common carrier such as a railroad, trucking company, or airline is used, the transportation company prepares a freight bill (often called a bill of lading) in accordance with the sales agreement. Freight terms are expressed as either **FOB shipping point** or **FOB destination**. The letters **FOB** mean **free on board**. Thus, **FOB shipping point** means that goods are placed free on board the carrier by the seller, and the freight costs are the buyer's.

Conversely, **FOB destination** means that the goods are placed free on board at the buyer's place of business, and the seller pays the freight. For example, the sales invoice in Illustration 5-2 on page 182 shows **FOB shipping point**. Thus, the buyer (Chelsea Video Inc.) pays the freight charges.

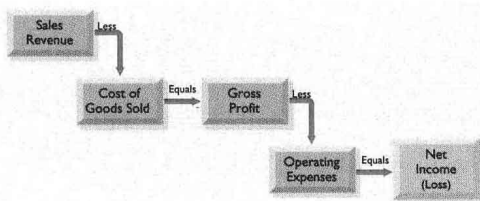
When the purchaser directly incurs the freight costs, the account **Freight-in** (a contra revenue account) is debited. For example, if upon delivery of the goods on May 15, Chelsea Video Inc. pays Acme Freight Company \$150 for freight charges, Chelsea's books is:

| | | |
|--------------------------------------------------------|-----|-----|
| Debit | 150 | |
| Credit | | 150 |
| To record payment of freight, terms FOB shipping point | | |

Freight-in is a temporary account whose normal balance is a debit. It is **part of cost of goods purchased**. The reason is that cost of goods purchased should include any freight charges necessary to bring the goods to the buyer's place of business.

²Use 360 days rather than 365.

earning sales revenue. Examples of operating expenses are sales salaries, advertising expense, and insurance expense. The income measurement process for a merchandising company may be diagrammed as shown in Illustration 5-1.



The operating expenses of a merchandising company include many of the expenses found in a service enterprise. Hence, this chapter focuses primarily on the recording of sales revenues and the related cost of goods sold that produce gross profit.

Sales Revenue

In accordance with the revenue recognition principle, sales revenues, like service revenues, are recorded when earned. Typically, sales revenues are earned when the goods are transferred from the seller to the buyer. At this point, the sales transaction is completed and the sales price is established.

Sales may be made on credit or for cash. Department stores such as J.C. Penney and Sears have significant amounts of both types of sales. Grocery stores such as Safeway and Kroger normally have cash sales. Wholesalers generally sell most goods on credit. Every sales transaction should be supported by a **business**

ILLUSTRATION 5-1
Income measurement process for a merchandising company

Study Objective 2

Explain the entries for sales revenues.

6. Color Illustrations

Use color as a pedagogical tool to enhance understanding and learning.

7. Before You Go On

Serves as a learning check. If you cannot answer these questions, you should reread the prior section(s) before continuing.

(2) The form is simpler and easier to read than the multiple-step form of work problems, the single-step form of income statement should when it is specifically requested.

Accounting in Action • Business Insight

Walgreen Co., Munsingwear, Inc., and Black and Decker are among many companies that use the single-step form of income statement. Companies that use the multiple-step form of income statement are General Electric and Goodyear Tire & Rubber. The PepsiCo income statement is the appendix at the end of this textbook. In a recent survey of 600 of the largest companies in the United States, 368 employed the multiple-step form and 232 employed the single-step form.

Before You Go On . . .

1. What features are found in the income statement of a merchandising company in the income statement of a service enterprise?
2. How is the beginning and ending merchandise inventory shown in a work problem?
3. What are nonoperating activities and how are they reported in the income statement?
4. How does a single-step income statement differ from a multiple-step income statement?

Summary of Study Objectives

1. **Identify the components in measuring net income in a merchandising company.** The major components in measuring net income in a merchandising company are sales revenue, cost of goods sold, and operating expenses.
2. **Explain the entries for sales revenues.** In recording sales revenues, entries are required for (a) cash and credit sales, (b) sales returns and allowances, and (c) sales discounts.
3. **State the steps in determining cost of goods sold.** The steps in determining cost of goods sold are (a) recording the purchase of merchandise, (b) determining the cost of goods purchased, and (c) determining the cost of goods on hand at the beginning and end of the accounting period.
4. **Explain the computation and importance of gross profit.** Gross profit is computed by subtracting cost of goods sold from net sales. Gross profit represents the merchandising profit of a company, and the

amount and trend of gross profit is closely watched by management and other interested parties.

5. **Identify the unique features of the income statement for a merchandising company.** The income statement for a merchandising company contains three sections: sales revenues, cost of goods sold, and operating expenses.
6. **Explain the steps in the accounting cycle for a merchandising company.** Each of the required steps in the accounting cycle for a service enterprise applies to a merchandising company. A fourth step, determining cost of goods sold, is an optional step.
7. **Distinguish between the single-step and multiple-step income statements.** The single-step income statement shows only two categories of income and expense, while the multiple-step income statement shows three categories.

Statement Presentation

As contra revenue accounts, sales returns and allowances and sales discounts are deducted from sales in the income statement to arrive at net sales. The sales revenues section of the income statement based on assumed data for Highpoint Electronic is as follows:

| HIGHPOINT ELECTRONIC, INC. Partial Income Statement | | | |
|--------------------------------------------------------|----------|--------|-----------|
| Sales revenues | | | |
| Sales | | | \$480,000 |
| Less: Sales returns and allowances | \$12,000 | | |
| Sales discounts | 8,000 | 20,000 | |
| Net sales | | | \$460,000 |

ILLUSTRATION 5-4

Statement presentation of sales revenues section

This presentation discloses the significant aspects of the company's principal revenue producing activities.

Before You Go On . . .

1. How do the components in measuring net income in a merchandising company differ from those in a service enterprise?
2. What entries are made to record sales, sales returns and allowances, and sales discounts?
3. How are sales and contra revenue accounts reported in the income statement?

Cost of Goods Sold

As you learned earlier in this chapter, the second factor in measuring net income in a merchandising company is the cost of goods sold. The cost of goods sold may be determined each time a sale occurs or at the end of an accounting period. To make the determination when the sale occurs, a company uses a perpetual inventory system. Under this system, detailed records of the cost of each inventory item are maintained and continuously show the inventory that should be on hand. For example, a Ford dealership will have separate inventory records for each Escort, Tempo, Taurus, and Thunderbird. When a car is sold, its cost is

Study Objective 3

State the steps in determining cost of goods sold.

8. Marginal Notations of Study Objectives

Signal where objectives listed at beginning of chapter are discussed in context. End-of-chapter exercise and problem material is also keyed to study objectives.

APPENDIX C Adjusting Entry Method for Merchandise Inventory

Study Objective

After studying Appendix C you should be able to:

8. Explain how the adjusting entry method is used in the work sheet.

As stated in this chapter, the change between the beginning and ending inventory balances may be made through adjusting entries rather than through closing entries. Some favor this method because they believe that changes in merchandise inventory should receive the same accounting treatment as changes in the cost of supplies on hand between two points in time. The adjusting entry method is just as acceptable as the closing entry method, and it accomplishes the same objective.

The adjusting entry method affects several steps in the accounting cycle, beginning with the use of a work sheet. Again, these effects are explained and illustrated using Highpoint Electronic as an example.

Using a Work Sheet

In Illustration C-1, you will see a work sheet similar to the work sheet presented in the chapter (Illustration 5-12). The major difference in these two work sheets relates to merchandise inventory. In Illustration C-1, the accounting for merchandise inventory uses the adjusting entry method. In Illustration 5-12, the closing entry method was used. The unique accounts for the adjusting entry method are shown in capital letters in red.

Technology in Action

The adjusting entry method is used in most computerized systems since the programming logic involved is more straightforward. That is, in a computerized system, the command to close the books will close all the temporary accounts to Income Summary. However, if the inventory has not been adjusted, it will not be up-to-date and therefore a misstatement can occur. Some accountants favor the adjusting entry method in manual systems as well.

9. End-of-Chapter Appendix

Addresses topics considered optional by some instructors.

(2) The form is simpler and easier to read than the multiple-step form. For homework problems, the single-step form of income statement should be used only when it is specifically requested.

Accounting in Action *Business Insight*

Walgreen Co., Munsingwear, Inc., and Black and Decker are among many companies that use the multiple-step form of income statement. Companies that use the single-step include PepsiCo, General Electric, and Goodyear Tire & Rubber. The PepsiCo income statement is illustrated in the appendix at the end of this textbook. In a recent survey of 600 of the largest companies in the United States, 368 employed the multiple-step form and 232 employed the single-step income statement format.



Before You Go On . . .

1. What features are found in the income statement of a merchandising company that are not in the income statement of a service enterprise?
2. How is the beginning and ending merchandise inventory shown in a work sheet?
3. What are nonoperating activities and how are they reported in the income statement?
4. How does a single-step income statement differ from a multiple-step income statement?

Summary of Study Objectives

1. **Identify the components in measuring net income in a merchandising company.** The major components in measuring net income in a merchandising company are sales revenue, cost of goods sold, and operating expenses.
2. **Explain the entries for sales revenues.** In recording sales revenues, entries are required for (a) cash and credit sales, (b) sales returns and allowances, and (c) sales discounts.
3. **State the steps in determining cost of goods sold.** The steps in determining cost of goods sold are (a) recording the purchase of merchandise, (b) determining the cost of goods purchased, and (c) determining the cost of goods on hand at the beginning and end of the accounting period.
4. **Explain the computation and importance of gross profit.** Gross profit is computed by subtracting cost of goods sold from net sales. Gross profit represents the merchandising profit of a company, and the

amount and trend of gross profit is closely watched by management and other interested parties.

5. **Identify the unique features of the income statement for a merchandising company.** The income statement for a merchandising company contains three sections: sales revenues, cost of goods sold, and operating expenses.

6. **Explain the steps in the accounting cycle for a merchandising company.** Each of the required steps in the accounting cycle for a service enterprise applies to a merchandising company. A work sheet is again an optional step.

7. **Distinguish between a multiple-step and a single-step income statement.** A multiple-step income statement shows numerous steps in determining net income including nonoperating sections. In a single-step income statement all data are classified under two categories, revenues or expenses, and net income is determined by one step.

10. Summary of Study Objectives

Repeats study objectives with brief summary to ensure your understanding.

11. Glossary

Reviews all the new accounting terms introduced in chapter and provides page reference.

GLOSSARY

Administrative expenses • Expenses relating to general operating activities such as personnel management, accounting, and store security. (p. 202).

Cost of goods available for sale • The sum of the beginning merchandise inventory plus the cost of goods purchased. (p. 191).

Cost of goods purchased • The sum of net purchases plus freight-in. (p. 189).

Cost of goods sold • The total cost of merchandise sold during the period, determined by subtracting ending inventory from the cost of goods available for sale. (p. 180).

Credit memorandum • A document issued by a seller to inform a customer that a credit has been made to the customer's account receivable for a sales return or allowance. (p. 183).

Debit memorandum • A document issued by a buyer to inform a seller that a debit has been made to the seller's account because of unsatisfactory merchandise. (p. 186).

FOB destination • Freight terms indicating that the goods will be placed free on board at the buyer's place of business, and the seller pays the freight costs. (p. 188).

FOB shipping point • Freight terms indicating that goods are placed free on board the carrier by the seller, and the buyer pays the freight costs. (p. 188).

Gross profit • The excess of net sales over the cost of goods sold. (p. 180).

Income from operations • Income from a company's principal operating activity determined by subtracting cost of goods sold and operating expenses from net sales. (p. 201).

Multiple-step income statement • An income statement that shows numerous steps in determining net income (or net loss), including operating and nonoperating sections. (p. 200).

Net purchases • Purchases less purchase returns and allowances and purchase discounts. (p. 189).

Net sales • Sales less sales returns and allowances and sales discounts. (p. 185).

Operating expenses • Expenses incurred in the process of earning sales revenues that are deducted from gross profit in the income statement. (p. 180).

Other expenses and losses • A nonoperating section of the income statement that shows expenses from auxiliary operations and losses unrelated to the company's operations. (p. 200).

Other revenues and gains • A nonoperating section of the income statement that shows revenues from auxiliary operations and gains unrelated to the company's operations. (p. 200).

Periodic inventory system • An inventory system in which detailed records are not maintained and the cost of goods sold is determined only at the end of an accounting period. (p. 186).

Perpetual inventory system • A detailed inventory system in which the cost of each inventory item is maintained and the records continuously show the inventory that should be on hand. (p. 185).

Purchase discount • A cash discount claimed by a buyer for prompt payment of a balance due. (p. 187).

Purchase invoice • A document that supports each credit purchase. (p. 186).

Sales discount • A reduction given by a seller for prompt payment of a credit sale. (p. 184).

Sales invoice • A document that provides support for credit sales. (p. 181).

Sales revenue • Primary source of revenue in a merchandising company. (p. 180).

Selling expenses • Expenses associated with the making of sales. (p. 202).

Single-step income statement • An income statement that shows only one step in determining net income (or net loss). (p. 202).

made to the customer's account receivable for a sales return or allowance. (p. 183).

Debit memorandum · A document issued by a buyer to inform a seller that a debit has been made to the seller's account because of unsatisfactory merchandise. (p. 186).

FOB destination · Freight terms indicating that the goods will be placed free on board at the buyer's place of business, and the seller pays the freight costs. (p. 188).

FOB shipping point · Freight terms indicating that goods are placed free on board the carrier by the seller, and the buyer pays the freight costs. (p. 188).

Gross profit · The excess of net sales over the cost of goods sold. (p. 180).

Income from operations · Income from a company's principal operating activity determined by subtracting cost of goods sold and operating expenses from net sales. (p. 201).

Multiple-step income statement · An income statement that shows numerous steps in determining net income (or net loss), including operating and non-operating sections. (p. 200).

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Sales revenue · Primary source of revenue in a merchandising company. (p. 180).

Selling expenses · Expenses associated with the making of sales. (p. 202).

Single-step income statement · An income statement that shows only one step in determining net income (or net loss). (p. 202).

DEMONSTRATION PROBLEM

The adjusted trial balance columns of the work sheet for the year ended December 31, 1993, for the Dykstra Company are as follows:

| | Debit | | Credit |
|-----------------------|-----------|--------------------------|-----------|
| Cash | \$ 14,500 | Accumulated Depreciation | \$ 18,000 |
| Accounts Receivable | 11,100 | Notes Payable | 25,000 |
| Merchandise Inventory | 32,000 | Accounts Payable | 10,600 |
| Prepaid Insurance | 2,500 | Gene Dykstra, Capital | 81,000 |
| Store Equipment | 95,000 | Sales | 520,000 |

12. Demonstration Problems

Provide a sample problem before you begin homework.

| | | | |
|------------------------------|------------------|---------------------------------|------------------|
| Gene Dykstra, Drawing | 12,000 | Purchase Returns and Allowances | 9,600 |
| Sales Returns and Allowances | 6,700 | Purchase Discounts | 7,200 |
| Sales Discounts | 5,000 | Interest Revenue | 2,500 |
| Purchases | 352,000 | | <u>\$673,900</u> |
| Freight-in | 8,400 | | |
| Freight-out | 7,600 | | |
| Advertising Expense | 12,000 | | |
| Store Salaries Expense | 56,000 | | |
| Utilities Expense | 18,000 | | |
| Rent Expense | 24,000 | | |
| Depreciation Expense | 9,000 | | |
| Insurance Expense | 4,500 | | |
| Interest Expense | 3,600 | | |
| | <u>\$673,900</u> | | |

Instructions

- Enter the adjusted trial balance data on a work sheet. Complete the work sheet assuming that ending merchandise inventory is \$29,000.
- Prepare an income statement assuming the Dykstra Company does not use subgroups for operating expenses.

Solution to Demonstration Problem

(a)

| DYKSTRA COMPANY Work Sheet For the Year Ended December 31, 1993 | | | | | | |
|-----------------------------------------------------------------------|------------------------|----------------|------------------|----------------|----------------|----------------|
| Account Titles | Adjusted Trial Balance | | Income Statement | | Balance Sheet | |
| | Dr. | Cr. | Dr. | Cr. | Dr. | Cr. |
| Cash | 14,500 | | | | 14,500 | |
| Accounts Receivable | 11,100 | | | | 11,100 | |
| Merchandise Inventory | 32,000 | | 32,000 | 29,000 | 29,000 | |
| Prepaid Insurance | 2,500 | | | | 2,500 | |
| Store Equipment | 95,000 | | | | 95,000 | |
| Accumulated Depreciation | | 18,000 | | | | 18,000 |
| Notes Payable | | 25,000 | | | | 25,000 |
| Accounts Payable | | 10,600 | | | | 10,600 |
| Gene Dykstra, Capital | | 81,000 | | | | 81,000 |
| Gene Dykstra, Drawing | 12,000 | | | | 12,000 | |
| Sales | | 520,000 | | 520,000 | | |
| Sales Returns and Allowances | 6,700 | | 6,700 | | | |
| Sales Discounts | 5,000 | | 5,000 | | | |
| Purchases | 352,000 | | 352,000 | | | |
| Purchase Returns and Allowances | | 9,600 | | 9,600 | | |
| Purchase Discounts | | 7,200 | | 7,200 | | |
| Freight-in | 8,400 | | 8,400 | | | |
| Freight-out | 7,600 | | 7,600 | | | |
| Advertising Expense | 12,000 | | 12,000 | | | |
| Store Salaries Expense | 56,000 | | 56,000 | | | |
| Utilities Expense | 18,000 | | 18,000 | | | |
| Rent Expense | 24,000 | | 24,000 | | | |
| Depreciation Expense | 9,000 | | 9,000 | | | |
| Insurance Expense | 4,500 | | 4,500 | | | |
| Interest Expense | 3,600 | | 3,600 | | | |
| Interest Revenue | | 2,500 | | 2,500 | | |
| Totals | <u>673,900</u> | <u>673,900</u> | <u>538,800</u> | <u>568,300</u> | <u>164,100</u> | <u>134,600</u> |
| Net Income | | | <u>29,500</u> | | | <u>29,500</u> |
| Totals | | | <u>568,300</u> | <u>568,300</u> | <u>164,100</u> | <u>164,100</u> |

Helpful hint

- Make sure in the adjusted trial balance that debits and credits are equal before transferring amounts to the income statement and balance sheet columns.
- Transfer all amounts in the adjusted trial balance to either the income statement or balance sheet columns.
- The merchandise inventory reported in the adjusted trial balance is the beginning inventory.
- Record the ending inventory by debiting the balance sheet column and crediting the income statement column.
- The net income or net loss is the reconciling item in both the income statement and the balance sheet columns.

13. Solutions

Show you how the problem should be solved.

14. Helpful Hints

Give tips for avoiding common pitfalls.

| | | | |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------|---------------------------------------------|-----------|
| (b) | | DYKSTRA COMPANY | |
| | | Income Statement | |
| | | For the Year Ended December 31, 1993 | |
| <p>Helpful hint</p> <p>1. In preparing the income statement, remember that the key components are net sales, cost of goods sold, gross profit, total operating expenses, and net income (loss). These components are reported in the right-hand column of the income statement.</p> <p>2. The most difficult computation is cost of goods sold. Think of beginning inventory + cost of goods purchased - ending inventory = cost of goods sold.</p> <p>3. Nonoperating items follow income from operations.</p> | Sales revenues | | |
| | Sales | | \$520,000 |
| | Less: Sales returns and allowances | \$ 6,700 | |
| | Sales discounts | 5,000 | 11,700 |
| | Net sales | | 508,300 |
| | Cost of goods sold | | |
| | Inventory, January 1 | | 32,000 |
| | Purchases | \$352,000 | |
| | Less: Purchase returns and allowances | \$9,600 | |
| | Purchase discounts | 7,200 | 16,800 |
| | Net purchases | | 335,200 |
| | Add: Freight-in | | 8,400 |
| | Cost of goods purchased | | 343,600 |
| | Cost of goods available for sale | | 375,600 |
| | Inventory, December 31 | | 29,000 |
| | Cost of goods sold | | 346,600 |
| | Gross profit | | 161,700 |
| | Operating expenses | | |
| | Store salaries expense | 56,000 | |
| | Rent expense | 24,000 | |
| | Utilities expense | 18,000 | |
| | Advertising expense | 12,000 | |
| | Depreciation expense | 9,000 | |
| | Freight-out | 7,600 | |
| | Insurance expense | 4,500 | |
| | Total operating expenses | | 131,100 |
| | Income from operations | | 30,600 |
| | Other revenues and gains | | |
| | Interest revenue | 2,500 | |
| | Other expenses and losses | | |
| | Interest expense | 3,600 | 1,100 |
| | Net income | | \$ 29,500 |

*Note: All asterisked Questions, Exercises, and Problems relate to material contained in the Appendix to this chapter.

SELF-STUDY QUESTIONS

- Answers are at the end of the chapter.
- (S/O 1) 1. Gross profit will result if:
 - operating expenses are less than net income.
 - sales revenues are greater than operating expenses.
 - operating expenses are greater than cost of goods sold.
 - sales revenues are greater than cost of goods sold.
 - (S/O 2) 2. The sales accounts that normally have a debit balance are:
 - sales.
 - sales returns and allowances.
 - sales discounts.
 - both (b) and (c).
 - (S/O 3) 3. A credit sale of \$850 is made on June 13, terms 2/10, net/30, on which a return of \$50 is granted on June 16. The amount received as payment in full on June 23 is:
 - \$833.
 - \$800.
 - \$784.
 - \$850.
 - (S/O 3) 4. When goods are purchased for resale by a company:
 - purchases on account are debited to Merchandise Inventory.

inventory is \$50,000, cost of goods sold is:

- \$390,000.
- \$370,000.
- \$330,000.
- \$420,000.

- (S/O 4) 7. If sales revenues are \$400,000, cost of goods sold is \$250,000, and operating expenses are \$60,000, the gross profit is:
 - \$90,000.
 - \$150,000.
 - \$340,000.
 - \$400,000.
- (S/O 5) 8. The income statement for a merchandising company shows each of the following features *except*:
 - gross profit.
 - cost of goods sold.

15. Self-Study Questions

Present an opportunity to check your knowledge of important topics in a practice test. Answers are included on last page of chapter. (Self-study Questions keyed to Study Objectives.)

Questions • 211

- operating income section.
 - sales revenue section.
- (S/O 6) 9. In a work sheet, ending merchandise inventory is shown in the following columns (assuming the closing entry method is used):
 - Adjusted trial balance credit and balance sheet debit.
 - Income statement debit and balance sheet debit.
 - Income statement credit and adjusted trial balance debit.
 - Income statement credit and balance sheet debit.
 - (S/O 7) 10. In a single-step income statement:
 - gross profit is reported.
 - sales revenues and other revenues and gains are reported in the revenues section of the income statement.
 - cost of goods sold is not reported.
 - operating income is separately reported.
 - (S/O 8) *11. In using the adjusting entry method to prepare a work sheet:
 - financial statements can be prepared only after closing entries are made.
 - changes in merchandise inventory are made in the adjustments columns of the work sheet.
 - ending inventory appears only in the balance sheet debit column.
 - beginning inventory is not reported on the trial balance before adjustment.

16. Questions

Allow you to explain your understanding of concepts and relationships covered in the chapter.

QUESTIONS

- How does income measurement differ between a merchandising company and a service company?
- Cisco Systems has sales revenue of \$100,000, cost of goods sold of \$60,000, and operating expenses of \$20,000. What is its gross profit?
- Joan Collins believes revenues from credit sales may be earned before they are collected in cash. Do you agree? Explain.
- (a) What is the primary source document for recording (1) cash sales, (2) credit sales, and (3) sales returns and allowances? (b) Using XXs for amounts, give the journal entry for each of the transactions in part (a).
- A credit sale is made on July 10 for \$700, terms 2/10, n/30. On July 12, \$50 of goods are returned for credit. Give the journal entry on July 19 to record the receipt of the balance due within the discount period.
- Identify the accounts that are added to or deducted from purchases to determine the cost

Identify work sheet columns using adjusting entry method.
(S.O. 8)

*E5-11 The J. Candy Company prepares adjusting entries for merchandise inventory at the end of the accounting period. On January 1, the balance in Merchandise Inventory is \$27,500 and the inventory on hand at December 31 is \$34,700.

Instructions

- Determine the amounts and the work sheet columns in which merchandise inventory will appear.
- Journalize the adjusting entries for merchandise inventory at December 31.

PROBLEMS

Journalize, post, and prepare partial income statement.

(S.O. 2, 3, 4, 5)



P5-1 The Dorn Hardware Store completed the following merchandising transactions in the month of May. At the beginning of May, the ledger of Dorn showed Cash of \$5,000 and S. Dorn, Capital of \$5,000.

- May 1 Purchased merchandise on account from Depot Wholesale Supply \$5,000, terms 2/10, n/30.
- 2 Sold merchandise on account \$4,000, terms 2/10, n/30.
- 5 Received credit from Depot Wholesale Supply for merchandise returned \$200.
- 9 Received collections in full, less discounts, from customers billed on sales of \$4,000 on May 2.
- 10 Paid Depot Wholesale Supply in full, less discount.
- 11 Purchased supplies for cash \$900.
- 12 Purchased merchandise for cash \$2,400.
- 15 Received refund for poor quality merchandise from supplier on cash purchase \$230.
- 17 Purchased merchandise from Harlow Distributors \$1,900, FOB shipping point, terms 2/10, n/30.
- 19 Paid freight on May 17 purchase \$250.
- 24 Sold merchandise for cash \$6,200.
- 25 Purchased merchandise from Horicon Inc. \$1,000, FOB destination, terms 2/10, n/30.
- 27 Paid Harlow Distributors in full, less discount.
- 29 Made refunds to cash customers for defective merchandise \$80.
- 31 Sold merchandise on account \$1,600, terms n/30.

Dorn Hardware's chart of accounts includes the following: No. 101 Cash, No. 112 Accounts Receivable, No. 120 Merchandise Inventory, No. 126 Supplies, No. 201 Accounts Payable, No. 301 S. Dorn, Capital, No. 401 Sales, No. 412 Sales Returns and Allowances, No. 414 Sales Discounts, No. 510 Purchases, No. 512 Purchase Returns and Allowances, No. 514 Purchase Discounts, No. 516 Freight-in.

Instructions

- Journalize the transactions.
- Enter the beginning cash and capital balances and post the transactions. (Use 11 for the journal reference.)
- Prepare an income statement through gross profit for the month of May 1993, assuming ending inventory is \$2,400, and no beginning inventory.

P5-2 John Clark, a former professional golf star, operates the pro shop at the Pelican Bay Golf Course. At the beginning of the current season on April 1, the ledger of Clark's Pro Shop showed Cash \$2,300, Merchandise Inventory \$3,500, and J. Clark, Capital \$6,000. The following transactions were completed during April.

Journalize, post, and prepare trial balance and partial income statement.
(S.O. 2, 3, 4, 5)



- 18 Purchased merchandise from Pigeon Distributors \$4,200, FOB terms 2/10, n/30.
- 20 Paid freight on April 18 purchase \$100.
- 23 Sold merchandise for cash \$6,400.
- 26 Purchased merchandise for cash \$2,300.
- 27 Paid Pigeon Distributors in full, less discount.
- 29 Made refunds to cash customers for defective merchandise \$90.
- 30 Sold merchandise on account \$3,700, terms n/30.

Midvale Company's chart of accounts includes the following: No. 101 Cash, No. 120 Merchandise Inventory, No. 201 Accounts Payable, No. 301 S. Dorn, Capital, No. 401 Sales, No. 412 Sales Returns and Allowances, No. 414 Sales Discounts, No. 510 Purchases, No. 512 Purchase Returns and Allowances, No. 514 Purchase Discounts, No. 516 Freight-in, and No. 644 Freight-out.

Instructions

- Journalize the transactions.
- Enter the beginning cash balances and post the transactions (Use reference).
- Prepare the income statement through gross profit for the month of April, assuming ending inventory is \$8,700, and no beginning inventory.

P5-2A John William, a former professional tennis star, operates the tennis shop at the Jackson Tennis Club. At the beginning of the current season, the ledger of William's Tennis Shop showed Cash \$2,500, Merchandise Inventory \$1,700, and J. William, Capital \$4,200. The following transactions were completed during April.

- Apr. 4 Purchased racquets and balls from Robert Co. \$640 FOB shipping point, terms 3/10, n/30.
- 6 Paid freight on Robert purchase \$40.
- 8 Sold merchandise to members \$900, terms n/30.
- 10 Received credit of \$40 from Robert Co. for a damaged racquet that was returned.
- 11 Purchased tennis shoes from King Sports, Inc. for cash, \$300.
- 13 Paid Robert Co. in full.
- 14 Purchased tennis shirts and shorts from Events Sportswear, \$700, FOB shipping point, terms 2/10, n/60.
- 15 Received cash refund of \$50 from King Sports, Inc. for damaged merchandise that was returned.
- 17 Paid freight on Events Sportswear purchase \$30.
- 18 Sold merchandise to members, \$800, terms n/30.
- 20 Received \$500 in cash from members in settlement of their accounts.
- 21 Paid Events Sportswear in full.
- 27 Granted credit of \$30 to members for tennis clothing that did not fit.
- 30 Sold merchandise to members \$900, terms n/30.
- 30 Received cash payments on account from members, \$500.

Journalize, post, and prepare a trial balance and partial income statement.
(S.O. 2, 3, 4, 5)



19. Problems

Stress the applications of concepts presented in the chapter. Keyed to multiple Study Objectives to guide your homework. (Problems keyed to Study Objectives.)

erations

ance of Global Enterprises for the year ending December 31, 1993 is shown

GLOBAL ENTERPRISES Trial Balance December 31, 1993

| | Debit | Credit |
|------------------------------------------|------------------|------------------|
| Cash | \$ 14,000 | |
| Accounts Receivable | 27,600 | |
| Merchandise Inventory | 27,500 | |
| Prepaid Insurance | 1,800 | |
| Accumulated Depreciation—Store Equipment | 42,000 | |
| Accounts Payable | | \$ 9,000 |
| Common Stock | | 31,200 |
| Retained Earnings | | 50,300 |
| Sales | | 238,500 |
| Sales Returns and Allowances | 3,600 | |
| Freight | 4,900 | |
| Purchases | 172,000 | |
| Purchase Discounts | 5,000 | |
| Sales Discounts | | 1,200 |
| Cost of Sales | 27,700 | 2,000 |
| Interest Expense | 6,100 | |
| Total | \$332,200 | \$332,200 |

Merchandise inventory on hand at December 31, \$38,600.

Expired \$800.

Expense, \$3,000.

Company uses the adjusting entry method for merchandise inventory.

Instructions

- Enter the trial balance on a work sheet and complete the work sheet using the adjusting entry method.
- Journalize the adjusting entries.
- Prepare the closing entries.
- Post the entries in (b) and (c) to Merchandise Inventory, and Income Summary.

ALTERNATE PROBLEMS

Journalize, post, and prepare a partial income statement.

(S.O. 2, 3, 4, 5)



P5-1A The Midvale Distributing Company completed the following merchandising transactions in the month of April. At the beginning of April, the ledger of Midvale showed cash of \$9,000 and S. Midvale capital of \$9,000.

- Apr. 2 Purchased merchandise on account from Kentucky Supply Co. \$4,900, terms 2/10, n/30.
- 4 Sold merchandise on account \$5,000, FOB destination, terms 2/10, n/30.
- 5 Paid \$200 freight on April 4 sale.
- 6 Received credit from Kentucky Supply Co. for merchandise returned \$300.
- 11 Paid Kentucky Supply Co. in full, less discount.
- 13 Received collections in full, less discounts, from customers billed on April 4.
- 14 Purchased merchandise for cash \$4,400.
- 16 Received refund from supplier on cash purchase of April 14, \$500.

20. Alternate Problems

Provide additional opportunities to apply concepts learned in chapter. (Alternate problems keyed to Study Objectives.)

21. General Ledger Problems

Icons identify selected problems that can be solved using the new General Ledger Software.