Chapter 3

Accrual Accounting and Income

Short Exercises

(10 min.) S 3-1

a.

	(Millions)
Sales revenue	$ 700
Cost of goods sold	(300)
All other expenses	(350)
Net income	$ 50

b.

Beginning cash	$ 100
Collections ($700 – $30)	670
Payments for: costs	(680)
Ending cash	$ 90

(10 min.) S 3-2

Statement	Reports *(Amounts in millions)*	
Income statement	**Interest expense**	**$1.0**
Balance sheet	**Notes payable**	
	($4.0 + $2.6 – $2.5)	**$4.1**
	Interest payable	**0.2**

(10 min.) S 3-3

Ford Canada should record sales revenue when the revenue is earned by delivering automobiles to the auto rental companies. Ford should not record any revenue prior to delivery of the vehicles to the auto rental companies because Ford hasn't earned the revenue yet. The *revenue principle* governs this decision.

When Ford records the revenue from the sale, at that time—and not before or after—Ford should also record cost of goods sold, the expense.

(10 min.) S 3-4

Req. 1a)

Dec. 31	**Rent Expense ($6,000 × 2/3) ...**	**4,000**	
	Prepaid Rent		**4,000**
	To record rent expense.		

Prepaid Rent

Nov. 1	**6,000**	**Dec. 31**	**4,000**
Bal.	**2,000**		

Rent Expense

Dec. 31	**4,000**		
Bal.	**4,000**		

Req. 2

Dec. 31	**Supplies Expense ($800 – $500) ....**	**300**	
	Supplies		**300**
	To record supplies expense.		

Supplies

Dec. 1	**800**	**Dec. 21**	**300**
Bal.	**500**		

Supplies Expense

Dec. 31	**300**		
Bal.	**300**		

(10 min.) S 3-5

Req. 1

			Amounts in dollars ($)	
1.	Jan. 1	Computer Equipment	30,000	
		Cash		30,000
		Purchased computer equipment.		
2.	Dec. 31	Depreciation Expense – Computer Equipment ($30,000 / 3)	10,000	
		Accumulated Depreciation – Computer Equipment		10,000
		To record computer depreciation expense for the year.		

Req. 2

Computer Equipment

Jan. 1	30,000		
Bal.	30,000		

Accumulated Depreciation – Computer Equipment

		Dec. 31	10,000
		Bal.	10,000

Depreciation Expense – Computer Equipment

Dec. 31	10,000		
Bal.	10,000		

Req. 3

Computer equipment	$30,000
Less accumulated depreciation................................	(10,000)
Carrying amount	$20,000

Req. 4

Income statement:

Depreciation expense – computer equipment ...	**$10,000**

Balance sheet:

Computer equipment	**$30,000**
Less accumulated depreciation...........................	**(10,000)**

(10 min.) S 3-6

	Income Statement 2014
Salary expense	$40,000,000
	2,000,000
	$42,000,000

	Balance Sheet 2014
Accrued salary .... (or salary payable)	$2,000,000

(10 min.) S 3-7

Req. 1

Oct. 31	Interest Expense	500	
	Interest Payable		500
	To accrue interest expense for October.		
Nov. 30	Interest Expense	500	
	Interest Payable		500
	To accrue interest expense for November.		
Dec. 31	Interest Expense	500	
	Interest Payable		500
	To accrue interest expense for December.		

Req. 2

Interest Payable

	Oct. 31	500
	Nov. 30	500
	Dec. 31	500
	Bal.	1,500

Req. 3

Dec. 31	Interest Payable	1,500	
	Cash		1,500
	To pay interest.		

(10 min.) S 3-8

Req. 1

Oct. 31	Interest Receivable....................................	500	
	Interest Revenue....................................		500
	To accrue interest revenue for October.		
Nov. 30	Interest Receivable....................................	500	
	Interest Revenue....................................		500
	To accrue interest revenue for November.		
Dec. 31	Interest Receivable....................................	500	
	Interest Revenue....................................		500
	To accrue interest revenue for December.		

Req. 2

Interest Receivable

Oct. 31	500	
Nov. 30	500	
Dec. 31	500	
Bal.	1,500	

Req. 3

Dec. 31	Cash	1,500	
	Interest Receivable		1,500
	To collect interest.		

(5-10 min.) S 3-9

Unearned revenues are *liabilities* because *Macleans Magazine* has received cash from subscribers in advance of providing them with magazines. Receiving the cash in advance creates an obligation (a liability) for *Macleans Magazine*. As *Macleans Magazine* delivers magazines to subscribers, *Macleans Magazine* earns the revenue, and the dollar amount of the earned revenue is transferred from the unearned revenue to earned revenue.

a)	**Cash**	**40,000**	
	Unearned subscription revenue		**40,000**
	To record subscriptions received.		

b)	**Adjusting entry:**	**Unearned Subscription Revenue**	**10,000**	
		Subscription Revenue		**10,000**
		To record unearned subscription revenue that has been earned during the period.		

(5-10 min.) S 3-10

Unadjusted amount of Prepaid Rent:	**$6,000**
Adjusted amount of Prepaid Rent:	**$0**
Unadjusted amount of rent expense:	**$0**
Adjusted amount of rent expense:	**$6,000**

(10 min.) S 3-11

a.	Accounts Receivable......................	50,000	
	Service Revenue..........................		50,000
	To record service revenue provided on account.		
	Cash	40,000	
	Accounts Receivable		40,000
	To record collection of accounts receivable.		

b.	Cash	7,000	
	Unearned Revenue		7,000
	To record cash in advance of service performed.		
	Unearned Revenue	6,000	
	Service Revenue		6,000
	To record prepaid services performed.		

(15-30 min.) **S 3-12**

Entertainment Centre Ltd.
Income Statement
For the Year Ended March 31, 2014

	(Thousands)
Net revenues	$174,500
Cost of goods sold	(126,000)
All other expenses..............................	(45,000)
Net income..	$ 3,500

Entertainment Centre Ltd.
Statement of Retained Earnings
For the Year Ended March 31, 2014

	(Thousands)
Retained earnings, March 31, 2013	$1,300
Add: Net income	3,500
Retained earnings, March 31, 2014	$4,800

Entertainment Centre Ltd.
Balance Sheet
March 31, 2014

	(Thousands)
ASSETS	
Current	
Cash	$ 900
Accounts receivable	27,700
Inventories	33,000
Other current assets	4,800
Total current assets	66,400
Property and equipment, net	7,200
Other assets	24,300
Total assets	$97,900
LIABILITIES	
Total current liabilities	$53,600
Long-term liabilities	13,500
Total liabilities	67,100
SHAREHOLDERS' EQUITY	
Common shares	26,000
Retained earnings	4,800
Total shareholders' equity	30,800
Total liabilities and shareholders' equity	$97,900

(5-10 min.) SP 3-13

CLOSING ENTRIES

March 31	Net Revenues	174,500	
	Retained Earnings		174,500
31	Retained Earnings	171,000	
	Cost of Goods Sold		126,000
	All Other Expenses....................		45,000

Retained Earnings

March 31, 2014 Expenses	171,000	March 31, 2014 Bal.	1,300
		March 31, 2014 Revenues	174,500
		March 31, 2014 Bal.	4,800

Retained Earnings' ending balance agrees with the amounts reported on the statement of retained earnings and the balance sheet. It is important that this balance agrees with the amounts reported to confirm the amounts reported as recorded in the post-closing trial balance.

(5 min.) S 3-14

a.

Entertainment Centre Ltd.'s current ratio is

$$\frac{\text{Current assets}}{\text{Current liabilities}} = \frac{66{,}400}{53{,}600} = 1.24$$

b.

Entertainment Centre Ltd.'s debt ratio is

$$\frac{\text{Total liabilities}}{\text{Total assets}} = \frac{67{,}100}{97{,}900} = 0.69$$

Entertainment Centre Ltd.'s current ratio of 1.24 is in the mid-range of current ratio. This current ratio indicates ECL should be able to pay all current liabilities with current assets.

Entertainment Centre Ltd.'s debt ratio of 0.69 is within the normal debt ratio range. This ratio indicates that ECL is not financing a high proportion of its assets by debt.

All ratios indicate a satisfactory performance by ECL; however, there is room for improved performance.

(10-15 min.) S 3-15

1. **The net revenue was high enough to cover ECI's costs; however,not by much.**

2. **To improve this situation, net revenues must be increased either by increased sales prices, increased sales volumes, and/or the addition of new products. It may also be improved by reducing expenses, thereby increasing net income.**

Exercises

(5-10 min.) E 3-16

(All amounts in millions)

	Statement	Report	
1.	Income statement	Sales revenue	$4,000
		Operating expenses....	800
	Balance sheet	Accounts receivable ...	$ 400
		Accounts payable	700

2. Cash basis would report only the cash transactions of the company.

Statement	Report	
Income statement	Sales revenue	$4,100
	Operating expenses...	800
Balance sheet	Accounts receivable ..	0
	Accounts payable	0

(5-10 min.) E 3-17

Valley Sales Inc.
Income Statement
For the year ending December 31, 2014

	Cash basis	Accrual basis
Revenue	$410,000	$500,000
Expenses	400,000	420,000
Net income	$ 10,000	$ 80,000

The cash basis income statement understates revenue by $90,000 and understates expenses by $20,000. In addition neither the revenue principle nor the matching principle are followed.

On the cash basis income statement important information has been omitted, thus making the income statement incomplete.

(5-10 min.) E 3-18

a. **Dish Networks should report revenue of $700 million.**

The amount of revenue reported is what Dish Networks earned, regardless of when cash is collected.

b. **Dish Networks should report total expenses of $540 million.**

All expenses incurred to earn revenues in the accounting period should be recorded.

c. **The *income statement* reports revenues and expenses. The *statement of cash flows* reports cash receipts and cash payments.**

(5-10 min.) E 3-19

Depreciation is a process whereby the cost of a long-lived tangible asset, such as buildings, furniture, or equipment, is allocated to expenses over its useful life. These long-lived tangible assets are resources that will be used over more than one fiscal accounting period. Depreciation is calculated based on the useful life of the asset. This process matches the expense of the asset against the revenue it produces.

(5-10 min.) E 3-20

a. Yes, the company is obligated to pay its employees for the work they did during the current month, so the $20,000 in wages should be accrued as a liability and expense at the end of the month.

b. Under accrual accounting, expenses must be recorded when they are incurred, not when they are paid. This treatment is therefore not acceptable.

c. Revenue should be recorded now as it has been earned.

d. Revenue should be recorded as earned. The company should record its revenue based on the percentage of the project completed at each year end.

e. It should record utility expense in the year the utilities were consumed, which is the year ended December 31.

(15-20 min.) E 3-21

Req. 1

Adjusting Entries

ACCOUNT TITLES	DEBIT	CREDIT
a. Insurance Expense ($700 + $2,100 – $800)	2,000	
Prepaid Insurance		2,000
b. Interest Receivable	900	
Interest Revenue		900
c. Unearned Service Revenue ($800 – $300)	500	
Service Revenue		500
d. Depreciation Expense	6,200	
Accumulated Depreciation		6,200
e. Salary Expense ($9,000 × 3/5)	5,400	
Salary Payable		5,400
f. Income Tax Expense ($20,000 × 0.25)	5,000	
Income Tax Payable		5,000

Req. 2

Net income *overstated* by omission of:		
Depreciation expense	**$ 6,200**	
Salary expense	**5,400**	
Income tax expense	**5,000**	
Insurance expense	**2,000**	
Total overstatement		**$18,600**
Net income *understated* by omission of:		
Interest revenue	**$ 900**	
Service revenue	**500**	
Total understatement		**1,400**
Overall effect — net income *overstated* by..		**$17,200**

(10-15 min.) E 3-22

Missing amounts in italics.

	1	2	3	4
Beginning Supplies	**$ 500**	**$1,000**	**$ 300**	**$ 900**
Add: Payments for supplies during the year	***800***	**3,100**	***1,100***	**1,100**
Total amount to account for	***1,300***	***4,100***	**1,400**	**2,000**
Less: Ending Supplies	**(400)**	**(500)**	**(700)**	***(600)***
Supplies Expense	**$ 900**	***$3,600***	**$ 700**	**$1,400**

Journal entries:

Situation 1:	**Supplies....................................**	**800**	
	Cash		**800**
Situation 2:	**Supplies Expense.....................**	**3,600**	
	Supplies		**3,600**

(10-20 min.) E 3-23

Adjusting Entries

DATE	ACCOUNT TITLES	DEBIT	CREDIT
Dec. 31			
a.	Interest Expense..	9,000	
	Interest Payable		9,000
b.	Interest Receivable.....................................	3,000	
	Interest Revenue		3,000
c.	Unearned Revenue ($12,000 / 2)	6,000	
	Sales Revenue..		6,000
d.	Salary Expense ($1,000 × 2)	2,000	
	Salary Payable..		2,000
e.	Supplies Expense.......................................	2,300	
	Supplies ($3,100 – $800)........................		2,300
f.	Depreciation Expense ($60,000 / 5)	12,000	
	Accumulated Depreciation....................		12,000

Carrying amount = $48,000 ($60,000 – $12,000)

(10-20 min.) **E 3-24**

Accounts Receivable

	1,300		
(c)	600		
Bal.	1,900		

Supplies

	900	(a)	600
Bal.	300		

Salary Payable

		(b)	2,000
		Bal.	2,000

Unearned Service Revenue

(d)	700		800
		Bal.	100

Service Revenue

			14,400
		(c)	600
		(d)	700
		Bal.	15,700

Salary Expense

	4,200		
(b)	2,000		
Bal.	6,200		

Supplies Expense

(a)	600		
Bal.	600		

Honeybee Hams Inc.
Income Statement
For the Year Ended December 31, 2014

		(thousands)
Revenues:		
Sales revenue		$41,000
Expenses:		
Cost of goods sold	$25,000	
Selling, administrative, and general expense	10,000	
Total expenses		35,000
Income before tax		6,000
Income tax expense		2,000
Net income		$ 4,000

Honeybee Hams Inc.
Statement of Retained Earnings
For the Year Ended December 31, 2014

	(thousands)
Retained earnings, December 31, 2013	$4,500
Add: Net income	4,000
	8,500
Less: Dividends	(1,700)
Retained earnings, December 31, 2014	$6,800

(continued) E 3-25

Honeybee Hams Inc.
Balance Sheet
December 31, 2014
(thousands)

ASSETS			LIABILITIES	
Cash		$ 3,300	Accounts payable	$ 7,700
Accounts receivable		1,800	Income tax payable	600
Inventories		1,100	Other liabilities	2,200
Prepaid expenses		1,900	Total liabilities	10,500
Capital assets	$6,600		SHAREHOLDERS' EQUITY	
Less: Accum. Depreciation	(2,400)	4,200	Common shares	4,900
Other assets		9,900	Retained earnings	6,800
			Total shareholders' equity	11,700
Total assets		$22,200	Total liabilities and shareholders' equity	$22,200

(10-20 min.) E 3-26

One mechanism for solving this exercise is to prepare the relevant T-accounts, insert the given information, and solve for the unknown amounts, shown in italics.

Amounts in millions

Receivables

Beg. bal.	200		
Sales revenue	20,900	Cash receipts	20,800
End. bal.	300		

Prepaid Insurance

Beg. bal.	110		
Cash payment	400	*Insurance expense*	330
End. bal.	180		

Accrued Liabilities

		Beg. bal.	600
Cash payment	4,100	*Other operating expense*	4,200
		End. bal.	700

(10 min.) E 3-27

Req. 1

Mountain's income statement:

Service revenue ($12,000 × 9/12)	**$9,000**

Mountain's balance sheet:

Unearned service revenue ($12,000 × 3/12)	**$3,000**

Req. 2

Squamish's income statement:

Consulting expense ($12,000 × 9/12)..................	**$9,000**

Squamish's balance sheet:

Prepaid consulting expense ($12,000 × 3/12)	**$3,000**

(10-15 min.) E 3-28

Req. 1

	(Millions)
Income statement	
Service revenue ($400 – $90)	**$310**
Balance sheet	
Unearned service revenue	**$90**

Req. 2

Income statement	
Service revenue ($80 + $400 – $90)	**$390**
Balance sheet	
Unearned service revenue	**$90**

Service revenue is greater in (2) because Rogers began the year owing phone service to customers. With collections for the year and the amount of the ending liability unchanged, Rogers must have earned more revenue in situation 2 than in situation 1.

(10-20 min.) E 3-29

Journal

DATE		ACCOUNT TITLES AND EXPLANATION	DEBIT	CREDIT
		Closing Entries		
		(Amounts in thousands)		
Dec.	31	Revenue	23,600	
		Other Revenue	600	
		Retained Earnings		24,200
	31	Retained Earnings	23,000	
		Cost of Services Sold		11,600
		Selling, General, and Administrative Expense		6,900
		Depreciation Expense		4,100
		Income Tax Expense		400
	31	Retained Earnings	400	
		Dividends		400

Net income for 2014 was $1,200 thousand ($24,200 – $23,000).

Retained Earnings

Clo. Expenses	23,000	Dec. 31, 2013	1,900
Clo. Dividends	400	Clo. Revenue	24,200
		Dec. 31, 2014	2,700

Journal

DATE		ACCOUNT TITLES AND EXPLANATION	DEBIT	CREDIT
		Adjusting Entries		
December	31	Unearned Service Revenue	6,700	
		Service Revenue ($19,500 – $12,800)		6,700
	31	Salary Expense ($4,900 – $4,000)	900	
		Salary Payable		900
	31	Rent Expense ($1,400 – $1,200)	200	
		Prepaid Rent		200
	31	Depreciation Expense ($300 – $0)	300	
		Accumulated Depreciation		300
	31	Income Tax Expense ($1,600 – $0)	1,600	
		Income Tax Payable		1,600
		Closing Entries		
	31	Service Revenue	19,500	
		Retained Earnings		19,500
	31	Retained Earnings	8,200	
		Salary Expense		4,900
		Rent Expense		1,400
		Amortization Expense		300
		Income Tax Expense		1,600
	31	Retained Earnings	1,000	
		Dividends		1,000

(20-30 min.) E 3-31

Req. 1

Yosaf Portraits Ltd.
Balance Sheet
December 31, 2014

ASSETS		
Current Assets:		
Cash		$10,200
Prepaid rent [$1,100 – ($1,400 – $1,200)]		900
Total current assets		11,100
Capital Assets:		
Equipment	$32,100	
Less accumulated depreciation ($3,800 + $300)	(4,100)	28,000
Total assets		$39,100
LIABILITIES		
Current Liabilities:		
Accounts payable		$ 4,600
Salary payable ($4,900 – $4,000)		900
Unearned service revenue [$8,400 – ($19,500 – $12,800)]		1,700
Income tax payable		1,600
Total current liabilities		8,800
Note payable, long-term		10,000
Total liabilities		18,800
SHAREHOLDERS' EQUITY		
Common shares		8,700
Retained earnings ($1,300 + $19,500 – $8,200 – $1,000)		11,600
Total shareholders' equity		20,300
Total liabilities and shareholders' equity		$39,100

(continued) E 3-31

Req. 2

					Current Year	Prior Year
Current ratio	=	$\frac{\text{Total current assets}}{\text{Total current liabilities}}$	=	$\frac{\$11,100}{\$8,800}$ =	1.26	1.55

The ability to pay current liabilities with current assets has deteriorated during 2014.

Debt ratio	=	$\frac{\text{Total liabilities}}{\text{Total assets}}$	=	$\frac{\$18,800}{\$39,100}$ =	0.48	0.45

The overall ability to pay total liabilities has deteriorated slightly during 2014.

E 3-32

Req.1

	2014			2013			2012		
Current ratio	$\frac{\$\ 20}{\$\ 10}$	=	2.0	$\frac{\$\ 15}{\$\ 8}$	=	1.88	$\frac{\$\ 8}{\$\ 6}$	=	1.33
Debt ratio	$\frac{\$\ 20}{\$\ 50}$	=	0.40	$\frac{\$\ 20}{\$\ 57}$	=	0.35	$\frac{\$\ 10}{\$\ 35}$	=	0.29

Req. 2

The current ratio improved over the three years. This indicates that Le Gasse is able to pay its current liabilities with its current assets and that the financial position of the company has improved over the three years.

The debt ratio has deteriorated slightly over the last three years; however, it is still in a good range. As LeGasse is earning income, it will have the cashflow to pay its debt.

(240 min.) **E 3-33**

Reqs. 1, 3, 6, and 8

Cash

Jan. 2	5,000	Jan. 2	500
9	800	3	3,000
21	900	12	200
28	600	26	900
		31	1,000
Bal.	1,700		

Accounts Receivable

Jan. 18	1,700	Jan. 28	600
Bal.	1,100		
Adj.	1,000		
Bal.	2,100		

Supplies

Jan. 5	900	Adj.	600
Bal.	300		

Equipment

Jan. 3	3,000		

Accumulated Depreciation – Equipment

		Adj.	100

Furniture

Jan. 4	6,000		

Accumulated Depreciation – Furniture

		Adj.	200

Accounts Payable

Jan. 26	900	Jan. 4	6,000
		5	900
		Bal.	6,000

Reqs. 1, 3, 6, and 8

Salary Payable

		Adj.	1,000

Unearned Service Revenue

Adj.	300	Jan. 21	900
		Bal.	600

Common Shares

		Jan. 2	5,000

Retained Earnings

Clo.	2,600		
Clo.	1,000	Clo.	3,800
		Bal.	200

Dividends

Jan. 31	1,000	Clo.	1,000

Service Revenue

		Jan. 9	800
		18	1,700
		Bal.	2,500
		Adj.	1,000
		Adj.	300
Clo.	3,800	Bal.	3,800

Rent Expense

Jan. 2	500	Clo.	500

Utilities Expense

Jan. 12	200	Clo.	200

Salary Expense

Adj.	1,000	Clo.	1,000

Depreciation Expense – Equipment

Adj.	100	Clo.	100

Depreciation Expense – Furniture

Adj.	200	Clo.	200

Supplies Expense

Adj.	600	Clo.	600

Req. 2

January 2 through 18 entries are repeated from Solution to Exercise 2-25.

Journal

DATE		ACCOUNT TITLES AND EXPLANATION	DEBIT	CREDIT
Jan.	2	Cash	5,000	
		Common shares		5,000
	2	Rent Expense	500	
		Cash		500
	3	Equipment	3,000	
		Cash		3,000
	4	Furniture	6,000	
		Accounts Payable		6,000
	5	Supplies	900	
		Accounts Payable		900
	9	Cash	800	
		Service Revenue		800
	12	Utilities Expense	200	
		Cash		200
	18	Accounts Receivable	1,700	
		Service Revenue		1,700

Req. 2

Journal

DATE		ACCOUNT TITLES AND EXPLANATION	DEBIT	CREDIT
Jan.	21	Cash	900	
		Unearned Service Revenue		900
	21	No entry; no transaction yet		
	26	Accounts Payable	900	
		Cash		900
	28	Cash	600	
		Accounts Receivable		600
	30	Dividends	1,000	
		Cash		1,000

Reqs. 4 and 5 (continued) E 3-33

Web Marketing Services Inc.
Adjusted Trial Balance
January 31, 2014

ACCOUNT TITLE	TRIAL BALANCE DEBIT	TRIAL BALANCE CREDIT	ADJUSTMENTS DEBIT	ADJUSTMENTS CREDIT	ADJUSTED TRIAL BALANCE DEBIT	ADJUSTED TRIAL BALANCE CREDIT
Cash	1,700				1,700	
Accounts receivable	1,100		(a) 1,000		2,100	
Supplies	900			(c) 600	300	
Equipment	3,000				3,000	
Accumulated dep'n. – equip.		—		(d1) 100		100
Furniture	6,000				6,000	
Accumulated dep'n. – furn.		—		(d2) 200		200
Accounts payable		6,000				6,000
Salary payable		—		(e) 1,000		1,000
Unearned service revenue		900	(b) 300			600
Common shares		5,000				5,000
Retained earnings		—				—
Dividends	1,000				1,000	
Service revenue		2,500		(a)1,000		3,800
				(b) 300		
Rent expense	500				500	
Utilities expense	200				200	
Salary expense			(e) 1,000		1,000	
Depreciation expense – equip.			(d1) 100		100	
Depreciation expense – furn.			(d2) 200		200	
Supplies expense			(c) 600		600	
	14,400	14,400	3,200	3,200	16,700	16,700

Req. 6

Journal

DATE		ACCOUNT TITLES AND EXPLANATION	DEBIT	CREDIT
		Adjusting Entries		
(a)	Jan. 31	Accounts Receivable	1,000	
		Service Revenue		1,000
(b)	31	Unearned Service Revenue	300	
		Service Revenue		300
(c)	31	Supplies Expense ($900 – $300)	600	
		Supplies		600
(d1)	31	Depreciation Expense – Equipment	100	
		Accumulated Depreciation – Equip.		100
(d2)	31	Depreciation Expense – Furniture	200	
		Accumulated Depreciation – Furn.		200
(e)	31	Salary Expense	1,000	
		Salary Payable		1,000

Req. 7

Web Marketing Services Inc.
Income Statement
For the Month Ended January 31, 2014

Revenues:		
Service revenue		$3,800
Expenses:		
Salary expense	1,000	
Supplies expense	600	
Rent expense	500	
Utilities expense	200	
Depreciation expense – furniture	200	
Depreciation expense – equipment	100	
Total expenses		2,600
Net income		$1,200

Web Marketing Services Inc.
Statement of Retained Earnings
For the Month Ended January 31, 2014

Retained earnings, January 1, 2013	$ 0
Add: Net income	1,200
	1,200
Less: Dividends	(1,000)
Retained earnings, January 31, 2014	$ 200

Req. 7

Web Marketing Services Ltd.
Balance Sheet
January 31, 2014

ASSETS			LIABILITIES	
Current assets:			Current liabilities:	
Cash		$ 1,700	Accounts payable	$ 6,000
Accounts receivable		2,100	Salary payable	1,000
Supplies		300	Unearned service revenue	600
Total current assets		4,100	Total current liabilities	7,600
Capital assets:				
Equipment	$3,000			
Less accum. dep'n.	(100)	2,900	SHAREHOLDERS' EQUITY	
			Common shares	5,000
Furniture	$6,000		Retained earnings	200
Less accum. dep'n.	(200)	5,800	Total shareholders' equity	5,200
Total assets		$12,800	Total liabilities and shareholders' equity	$12,800

Req. 8

Journal

DATE		ACCOUNT TITLES AND EXPLANATION	DEBIT	CREDIT
		Closing Entries		
Jan.	31	Service Revenue	3,800	
		Retained Earnings		3,800
	31	Retained Earnings	2,600	
		Rent Expense		500
		Utilities Expense		200
		Salary Expense		1,000
		Depreciation Expense – Equipment		100
		Depreciation Expense – Furniture		200
		Supplies Expense		600
	31	Retained Earnings	1,000	
		Dividends		1,000

Req. 9

$$\text{Current ratio} = \frac{\text{Total current assets}}{\text{Total current liabilities}} = \frac{\$4{,}100}{\$7{,}600} = 0.54$$

$$\text{Debt ratio} = \frac{\text{Total liabilities}}{\text{Total assets}} = \frac{\$7{,}600}{\$12{,}800} = 0.59$$

The current ratio indicates a weak current financial position. The business has $0.54 in current assets for every $1.00 of current liabilities. It could possibly have trouble paying current liabilities with current assets. The debt ratio of 0.59 is low enough to suggest that, overall, the business should be able to pay its debts, as it is not financing its assets with high levels of debt.

(20-25 min.) E 3-34

(Dollar amounts in thousands of dollars)

December 31, 2013

$$\text{Current ratio} = \frac{\$1{,}700 + \$5{,}600 + \$800 + \$1{,}800}{\$2{,}400 + \$1{,}200 + \$1{,}700} = \frac{\$9{,}900}{\$5{,}300} = 1.868$$

December 31, 2014

$$\text{Current ratio} = \frac{\$3{,}700^{1} + \$4{,}600^{2} + \$200^{3} + \$1{,}500^{4}}{\$900^{5} + \$1{,}200^{6} + \$2{,}500^{7}} = \frac{\$10{,}000}{\$4{,}600} = 2.174$$

______

Computations of December 31, 2014, balances:

[1]**Cash = $1,700 + $7,500 – $5,000 – $500 = $3,700**

[2]**Receivables = $5,600 + $6,500 – $7,500 = $4,600**

[3]**Prepaid expenses = $800 – $600 = $200**

[4]**Inventory = $1,800 + $3,500 – $3,800 = $1,500**

[5]**Accounts payable = $2,400 + $3,500 – $5,000 = $900**

[6]**Unearned revenue = $1,200**

[7]**Accrued expenses payable = $1,700 + $1,300 – $500 = $2,500**

Conclusion: The current ratio improved during 2014.

(60 min.) E 3-35

a.	Net income:	Revenues:		
		Service ($155,000 + $1,000 + $2,000).....		$158,000
		Expenses:		
		Salary ($32,000 + $3,000).........	$ 35,000	
		Depreciation – building.............	2,000	
		Supplies....................................	3,000	
		Insurance..................................	1,000	
		Advertising	7,000	
		Utilities.....................................	2,000	50,000
		Net income		$108,000
b.	Total assets:	Cash..		$ 4,000
		Accounts receivable ($7,000 + $2,000).....................		9,000
		Supplies ($4,000 – $3,000).............		1,000
		Prepaid insurance ($3,000 – $1,000)...................		2,000
		Building	$107,000	
		Less: Accum. Dep'n. ($14,000 + $2,000)..................	(16,000)	91,000
		Land		51,000
		Total assets		$ 158,000

c. Total liabilities:

Accounts payable	$	6,000
Salary payable		3,000
Unearned service revenue ($5,000 – $1,000)		4,000
Total liabilities	$	13,000

d. Total shareholders' equity:

Common shares	$	10,000
Retained earnings, beginning		43,000
Add: Net income for the year		108,000
		161,000
Less: Dividends during the year		(16,000)
Total shareholders' equity		$145,000

e.

Total assets	=	Total liabilities	+	Total shareholders' equity
$158,000	=	$13,000	+	$145,000

Quiz

Q3-36	**b)**
Q3-37	**b)**
Q3-38	**a)**
Q3-39	**b)**
Q3-40	**d)**
Q3-41	**d)**
Q3-42	**c)**
Q3-43	**c)**
Q3-44	**c)**
Q3-45	**d)**
Q3-46	**b)**
Q3-47	**c)**
Q3-48	**a)**
Q3-49	**d)**
Q3-50	**c)**

Problems

Group A

(15-20 min.) P 3-51A

(All amounts in millions)

1. **\$35 – \$8 = \$27**

2.

Revenues	**\$ 35**
Expenses....................	**(27)**
Net income	**\$ 8**

3.

Beginning receivables	**\$ 4**
Add: Revenues	**35**
Less: Collections...................	**(33)**
Ending receivables	**\$ 6**

Balance sheet
ASSETS
Current assets:

Receivables	**\$ 6**

(All amounts in millions)

4.

Beginning accounts payable		$ 9
Add:	Expenses	27
Less:	Payments ($27 + $1).............	(28)
Ending accounts payable		$ 8

Balance sheet

LIABILITIES

Current liabilities:

Accounts payable $ 8

(20-30 min.) P 3-52A

Req. 1

Prairies Consultants Inc.
Amount of Revenue (Expense) for August 2014

Date			***Cash Basis***		***Accrual Basis***
August	1	Expense	$(1,000)		$ 0
	4	Expense	(800)	Expense	(30)
	5	Revenue	900	Revenue	900
	8	Expense	(300)	Expense	(300)
	11		0	Revenue	3,000
	19		0	Expense	(30)
	24	Revenue	3,000		0
	26	Expense	(1,600)		0
	29	Expense	(900)	Expense	(900)
	31		0	Expense	(200)*
	31		0	Revenue	800

*$1,000 ÷ 5 = 200

Req. 2

Income (loss) before tax	$(700)	Income before tax	$3,240

Req. 3

The accrual-basis accounting for net income is preferable because it accounts for revenues and expenses when they occur (earned or incurred), not when they are received or paid in cash. For example, on August 11, 2014, the company earned $3,000 of revenue and increased its wealth as a result. The accrual basis records this revenue, but the cash basis ignores it. On August 24, the business collected the receivable that was created by the revenue earned on account at August 11. The accrual basis records no revenue on August 24 because the company's increase in wealth occurred back on August 11. The cash basis waits until cash is received, on August 24, to record the revenue. The example in Req. 2 indicates that income is understated on the cash basis method.

(15-30 min.) P 3-53A

TO: New Employee

FROM: Student Name

The cash basis of accounting regards all cash receipts as revenues and all cash payments as expenses. The accrual basis records revenues as they are earned and expenses as they are incurred, not when cash is received or paid. There is a difference in the timing of the recognition of revenues and expenses using the cash basis and the accrual basis. Under the accrual basis, revenues are recorded when revenue is earned and the amount to record (cash value transferred to customer). Expenses are recorded based on the cost of assets used up and liabilities created in the earning of revenue.

***Note*: Student responses may vary.**

(10-20 min.) P 3-54A

Journal

DATE		ACCOUNT TITLES AND EXPLANATION	DEBIT	CREDIT
2014				
Dec. 31	a.	Insurance Expense	3,100*	
		Prepaid Insurance		3,100
		To record insurance expense.		
31	b.	Salary Expense ($6,000 × 3/5)	3,600	
		Salary Payable		3,600
		To accrue salary expense.		
31	c.	Interest Receivable	500	
		Interest Revenue		500
		To accrue interest revenue.		
31	d.	Supplies Expense	6,600***	
		Supplies		6,600
		To record supplies expense.		
31	e.	Unearned Service Revenue ($12,000 × 1/3)	4,000	
		Service Revenue		4,000
		To record unearned service revenue that was earned during the year.		

	Cost of asset available during the period		Cost of asset on hand at the end of the period		Cost of asset used (expense) during the period
*	($400 + $3,600) $4,000	–	$900**	=	$3,100

** $3,600 × 3/12 = $900 asset at December 31, 2012

***	($2,600 + $6,100) $8,700	–	$2,100	=	$6,600

Journal

DATE	ACCOUNT TITLES AND EXPLANATION	DEBIT	CREDIT
2014			
Dec. 31	f. Depreciation Expense – Office Furniture	1,000	
	Depreciation Expense – Equipment	2,700	
	Accumulated Depreciation – Office Furniture		1,000
	Accumulated Depreciation – Equipment		2,700
	To record depreciation expense.		

Req. 1 **(45-60 min.) P 3-55A**

The Rock Industries
Adjusted Trial Balance
January 31, 2014

ACCOUNT TITLE	TRIAL BALANCE DEBIT	TRIAL BALANCE CREDIT	ADJUSTMENTS DEBIT	ADJUSTMENTS CREDIT	ADJUSTED TRIAL BALANCE DEBIT	ADJUSTED TRIAL BALANCE CREDIT
Cash	8,000				8,000	
Accounts receivable	10,000		(a) 2,000		12,000	
Prepaid rent	3,000			(b) 1,000*	2,000	
Supplies	2,000			(c) 2,000		
Furniture	36,000				36,000	
Accumulated depreciation		3,000		(d) 1,000**		4,000
Accounts payable		10,000				10,000
Salary payable				(e) 3,000***		3,000
Common shares		26,000				26,000
Retained earnings		13,000				13,000
Dividends	4,000				4,000	
Service revenue		14,000		(a) 2,000		16,000
Salary expense	2,000		(e) 3,000***		5,000	
Rent expense			(b) 1,000*		1,000	
Utilities expense	1,000				1,000	
Depreciation expense			(d) 1,000**		1,000	
Supplies expense			(c) 2,000		2,000	
	66,000	66,000	9,000	9,000	72,000	72,000

* $3,000 ÷ 3 = $1,000
** $36,000 ÷ 3 = $12,000 ÷ 12 = $1,000
*** $5,000 × 3/5 = $3,000

Req. 2

The Rock Industries Ltd.
Income Statement
For the Month Ended January 31, 2014

Revenues:		
Service revenue		$16,000
Expenses:		
Salary expense	$5,000	
Supplies expense	2,000	
Rent expense	1,000	
Utilities expense	1,000	
Depreciation expense	1,000	
Total expenses		10,000
Net income		$ 6,000

The Rock Industries Ltd.
Statement of Retained Earnings
For the Month Ended January 31, 2014

Retained earnings, December 31, 2013	$13,000
Add: Net income for the month	6,000
	19,000
Less: Dividends	(4,000)
Retained earnings, January 31, 2014	$15,000

Req. 2

The Rock Industries Ltd.
Balance Sheet
January 31, 2014

ASSETS			LIABILITIES	
Current assets:			Current liabilities:	
Cash		$ 8,000	Accounts payable	$10,000
Accounts receivable		12,000	Salary payable	3,000
Prepaid rent		2,000	Total current liabilities	13,000
Total current assets		22,000		
Furniture	$36,000		SHAREHOLDERS' EQUITY	
Less: Accum.			Common shares	26,000
dep'n.	(4,000)	32,000	Retained earnings	15,000
			Total shareholders' equity	41,000
			Total liabilities and	
Total assets		$54,000	shareholders' equity	$54,000

(10-20 min.) **P 3-56A**

Req. 1

Journal

DATE		ACCOUNT TITLES AND EXPLANATION	DEBIT	CREDIT
2014				
April	30	Accounts Receivable ($6,800 – $6,300)...	500	
		Rental Revenue		500
		To accrue rental revenue.		
	30	Interest Receivable ($300 – $0)	300	
		Interest Revenue ($300 – $0)................		300
		To accrue interest revenue.		
	30	Supplies Expense ($700 – $0)	700	
		Supplies ($900 – $200)..........................		700
		To record supplies expense.		
	30	Insurance Expense ($1,700 – $0)	1,700	
		Prepaid Insurance ($2,400 – $700)		1,700
		To record insurance expense.		
	30	Depreciation Expense ($2,200 – $0)	2,200	
		Accumulated Depreciation		
		($18,200 – $16,000)............................		2,200
		To record depreciation expense.		
	30	Wages Expense ($2,000 – $1,600)............	400	
		Wages Payable ($400 – $0)		400
		To accrue wages expense.		
	30	Unearned Rental Revenue ($600 – $100)	500	
		Rental Revenue		500
		To record unearned rental revenue that was earned during the period.		

Req. 2

Total assets	**=**	**$68,600 ($8,300 + $6,800 + $300 + $4,100 + $200 + $700 + $66,400 – $18,200)**
Total liabilities	**=**	**$7,400 ($6,900 + $400 + $100)**
Total equity	**=**	**$61,200 ($18,000 + $42,700 + $4,100* – $3,600)**
Net income*	**=**	**$4,100 ($10,900 + $300 – $2,000 – $1,700 – $2,200 – $300 – $700 – $200)**
Assets	**=**	**Liabilities + Shareholders' Equity**
$68,600	**=**	**$7,400 + $61,200**

(20-30 min.) P 3-57A

Req. 1

Marshall Ltd.
Income Statement
For the Year Ended December 31, 2014

Revenues:		
Service revenue		$107,900
Expenses:		
Salary expense	$39,900	
Rent expense	10,300	
Insurance expense	3,800	
Interest expense	3,100	
Supplies expense	2,900	
Depreciation expense	1,600	61,600
Income before tax		46,300
Income tax expense		7,100
Net income		$ 39,200

Marshall Ltd.
Statement of Retained Earnings
For the Year Ended December 31, 2014

Retained earnings, December 31, 2013	$ 1,000
Add: Net income	39,200
	40,200
Less: Dividends	(24,000)
Retained earnings, December 31, 2014	$16,200

Req. 1

Marshall Ltd.
Balance Sheet
December 31, 2014

ASSETS			LIABILITIES	
Cash		$ 1,400	Accounts payable	$ 3,700
Accounts receivable		8,900	Interest payable	800
Supplies		2,300	Unearned service revenue	600
Prepaid rent		1,600	Income tax payable	2,100
			Note payable	18,600
Equipment	$37,100		Total Liabilities	25,800
Less: Accum. dep'n.	(4,300)	32,800	SHAREHOLDERS' EQUITY	
			Common shares	5,000
			Retained earnings	16,200
			Total shareholders' equity	21,200
Total assets		$47,000	Total liabilities and shareholders' equity	$47,000

Req. 2

$$\text{Debt ratio: } \frac{\$25{,}800}{\$47{,}000} = 0.549$$

Marshall Ltd. is in violation of its debt agreement, which requires the company to maintain a debt ratio no higher than 0.50.

To avoid this difficult situation, the company could have paid out less in dividends. By decreasing dividends by $4,600, the company could have kept assets high enough to maintain a debt ratio of 0.50, as required. Or, the company could have borrowed less or could have paid off a liability.

$$\text{Debt ratio: } \frac{\$25{,}800}{\text{Assets}} = 0.50$$

To achieve a debt ratio of 0.50 assets need to be

$$\frac{\$25{,}800}{0.50} = \$51{,}600$$

$51,600 – 47,000 = $4,600, the asset value required to meet debt ratio requirements with liabilities = $25,800.

P 3-58A

Req. 1

Journal

DATE		ACCOUNT TITLES AND EXPLANATION	DEBIT	CREDIT
2014				
		Closing Entries		
March	31	Service Revenue	94,100	
		Retained Earnings		94,100
	31	Retained Earnings	35,800	
		Salary Expense		17,800
		Supplies Expense		4,600
		Depreciation Expense		1,900
		Advertising Expense		10,900
		Insurance Expense		600
	31	Retained Earnings	31,200	
		Dividends		31,200

Req. 2

Retained Earnings

March 31, 2014 Expenses	35,800	March 31, 2013 Bal.	20,200
March 31, 2014 Dividends	31,200	March 31, 2014 Revenues	94,100
		March 31, 2014 Bal.	47,300

Net Income = Revenues – Expenses
= $94,100 – $35,800
= $58,300

Ending Balance of Retained Earnings = $47,300

Req. 3

Retained earnings increased during the year because net income of $58,300 ($94,100 – $35,800) exceeded dividends of $31,200.

(25-40 min.) **P 3-59A**

Req. 1

Marciano Ltd.
Balance Sheet
March 31, 2014

ASSETS		
Current assets:		
Cash		$ 7,500
Accounts receivable		16,500
Prepaid expenses		5,300
Supplies		3,800
Total current assets		33,100
Capital assets:		
Equipment	$43,200	
Less accumulated depreciation	(7,100)	36,100
Other assets		14,100
Total assets		$83,300
LIABILITIES		
Current liabilities:		
Current portion of note payable		$ 800
Accounts payable		14,700
Salary payable		2,400
Unearned service revenue		2,800
Total current liabilities		20,700
Note payable, long-term		6,200
Total liabilities		26,900
SHAREHOLDERS' EQUITY		
Common shares		9,100
Retained earnings		47,300*
Total shareholders' equity		56,400
Total liabilities and shareholders' equity		$83,300

* from P3-58A Req. 2

Req. 2

						2014	2013
Current ratio	=	$\frac{\text{Total current assets}}{\text{Total current liabilities}}$	=	$\frac{\$33,100}{\$20,700}$	=	1.60	1.30
Debt ratio	=	$\frac{\text{Total liabilities}}{\text{Total assets}}$	=	$\frac{\$26,900}{\$83,300}$	=	0.32	0.30

Marciano Ltd.'s debt position is strong based on both the current ratio of 1.60 and debt ratio of 0.32. Both are better than the norm for successful companies. A comparison with ratios in 2013 indicates the current ratio has improved and the debt ratio has had a slight deterioration, although it still is in the strong range.

P 3-60A

Req. 1

			2014		2013		2012	
Current ratio	=	$\frac{\text{Total current assets}}{\text{Total current liabilities}}$	= $\frac{11}{6.5}$	= 1.69	= $\frac{6.0}{5.5}$	= 1.09	= $\frac{4.0}{3.5}$	= 1.14

Req. 2

Debt ratio	=	$\frac{\text{Total liabilities}}{\text{Total assets}}$	= $\frac{15.5}{27.0}$	= 0.574	= $\frac{10.5}{15.5}$	= 0.677	= $\frac{7.0}{7.0}$	= 1.00

Req. 3

The current ratio has improved over the 3 years (some deterioration in 2013 was reversed in 2014). This means that Ojibway Inc. had sufficient cash to pay its accounts payable and salaries payable every year. In 2014, the current ratio is very good and indicates that Ojibway can pay its debts.

The debt ratio has improved over the 3 years. In 2012, Ojibway financed 100% of its assets with debt.At December 31, 2014, only 57% of the assets were financed. This ratio is still high if the company needs to borrow in order to finance more equipment or expand their office space.

Problems

Group B

(15-20 min.) P 3-61B

(All amounts in millions)

1. **Revenue – Expenses = Income**
   Revenue – Income = Expenses
   $19 – $4 = $15

2.

Revenues	**$19**
Expenses	**(15)**
Net income	**$ 4**

3.

Beginning receivables	**$ 6**
Add: Revenue	**19**
Less: Collections	**(20)**
Ending receivables	**$ 5**

Balance sheet
ASSETS
Current assets:
Receivables $5

(All amounts in millions)

4. **Beginning accounts payable**

	$ 9
Add: Expenses	15
Less: Payments	(18)
Ending accounts payable	$ 6

Balance sheet

LIABILITIES

Current liabilities:

Accounts payable	$6

(20-30 min.) P 3-62B

Req. 1

Fred's Catering Ltd.
Amount of Revenue (Expense) for May 2014

Date		Cash Basis			Accrual Basis
May	1	Revenue	$ 800		$ 0
	5	Expense	(700)	Expense	(700)
	9	Revenue	2,000	Revenue	2,000
	14	Expense	(1,800)		0
	23		0	Revenue	700
	31		0	Expense	(900)
	31	Expense	(3,000)		0
Req. 2		Income (loss) before tax	$(2,700)	Income before tax	$1,100

Req. 3

The accrual basis better measures net income. For example, the accrual basis accounts for the rent prepayment on May 31 as an asset because prepaid rent gives the business future use of the building for two months. The cash basis ignores the future benefit (asset nature) of the prepayment and accounts for the prepayment as an expense. The accrual basis records revenue as it is earned and matches expenses incurred to earn the revenue and thus the appropriate income is reported.

(10-15 min.) **P 3-63B**

TO: **New Employee**

FROM: **Student Name, Controller**

At the end of the period, we must make an adjusting entry for accrued utility expense to include among the expenses all our utility expense of the period. Our utility expense includes both the amounts we have paid and the amounts we have used, but which we have not yet paid. The unpaid utility expense is our liability to our service provider. If we fail to make this adjustment, we understate both expense and liabilities. As a result we would overstate net income and owners' equity on our financial statements.

Note: **Student responses may vary.**

Journal

DATE			ACCOUNT TITLES AND EXPLANATION	DEBIT	CREDIT
2014					
Dec.	31	a.	Salary Expense ($5,000 × 2/5)	2,000	
			Salary Payable		2,000
			To accrue salary expense.		
	31	b.	Interest Receivable	1,100	
			Interest Revenue		1,100
			To accrue interest revenue.		
	31	c.	Supplies Expense	11,400*	
			Supplies		11,400
			To record supplies expense.		
	31	d.	Unearned Service Revenue		
			($20,000 × 3/4)	15,000	
			Service Revenue		15,000
			To record unearned service revenue that was earned during the period.		

______

*See next page.

Journal

DATE		ACCOUNT TITLES AND EXPLANATION	DEBIT	CREDIT
Dec. 31	e.	Depreciation Expense – Computer Equipment	6,300	
		Depreciation Expense – Building	3,700	
		Accumulated Depreciation – Computer Equipment		6,300
		Accumulated Depreciation – Building.................................		3,700
		To record depreciation expense.		
31	f.	Insurance Expense	2,700**	
		Prepaid Insurance.........................		2,700
		To record insurance expense.		

	Cost of asset available during the period	–	Cost of asset on hand at the end of the period	=	Cost of asset used (expense) during the period
*	($1,800 + $12,500) $14,300	–	$2,900	=	$11,400
**	($1,800 + $3,600) $5,400	–	$2,700***	=	$2,700

*** $3,600 × 9/12 = $2,700 asset at December 31

Req. 1 **(45-60 min.)P 3-65B**

Creative Advertising Ltd.
Adjusted Trial Balance
October 31, 2014

ACCOUNT TITLE	TRIAL BALANCE DEBIT	TRIAL BALANCE CREDIT	ADJUSTMENTS DEBIT	ADJUSTMENTS CREDIT	ADJUSTED TRIAL BALANCE DEBIT	ADJUSTED TRIAL BALANCE CREDIT
Cash	16,300				16,300	
Accounts receivable	7,000		(a) 2,900		9,900	
Prepaid rent	4,000			(b) 1,000*	3,000	
Supplies	600			(c) 200	400	
Computers	36,000				36,000	
Accumulated depreciation		3,000		(d) 1,000**		4,000
Accounts payable		8,800				8,800
Salary payable				(e) 1,600***		1,600
Common shares		15,000				15,000
Retained earnings		21,000				21,000
Dividends	4,600				4,600	
Advertising revenue		25,400		(a) 2,900		28,300
Salary expense	4,400		(e) 1,600***		6,000	
Rent expense			(b) 1,000*		1,000	
Utilities expense	300				300	
Depreciation expense			(d) 1,000**		1,000	
Supplies expense			(c) 200		200	
	73,200	73,200	6,700	6,700	78,700	78,700

* $4,000 ÷ 4 = $1,000

** $36,000 ÷ 3 = $12,000 ÷ 12 = $1,000

*** $2,000 × 4/5 = $1,600

Req. 2

Creative Advertising Ltd.
Income Statement
For the Month Ended October 31, 2014

Revenues:		
Design revenue		$28,300
Expenses:		
Salary expense	$6,000	
Rent expense	1,000	
Depreciation expense	1,000	
Utilities expense	300	
Supplies expense	200	
Total expenses		8,500
Net income		$ 19,800

Creative Advertising Ltd.
Statement of Retained Earnings
For the Month Ended October 31, 2014

Retained earnings, September 30, 2013	$21,000
Add: Net income	19,800
	40,800
Less: Dividends	(4,600)
Retained earnings, October 31, 2014	$36,200

Req. 2

Creative Advertising Ltd.
Balance Sheet
October 31, 2014

ASSETS			LIABILITIES	
Current assets:			Current liabilities:	
Cash		$16,300	Accounts payable	$ 8,800
Accounts receivable		9,900	Salary payable	1,600
Prepaid rent		3,000	Total current liabilities	10,400
Supplies		400		
Total current assets		29,600		
Computers	$36,000		SHAREHOLDERS' EQUITY	
Less: Accum.			Common shares	15,000
amort.	(4,000)	32,000	Retained earnings	36,200
			Total shareholders' equity	51,200
			Total liabilities and	
Total assets		$61,600	shareholders' equity	$61,600

Req. 3

a. Creative Advertising's net income exceeded dividends for the month. Continuation of this trend will increase both the assets and the shareholders' equity (retained earnings) of the business, as follows:

Assets	=	Liabilities	+	Shareholders' Equity
↑	=	0	+	↑

b. This trend will make it easier to borrow because more and more assets will be available for the business to pay debts as they come due.

c. Current ratio = $29,600 / $10,400 = 2.85

The current ratio is strong. It does not appear that the business will need to borrow. The cash position of $16,300 will cover all the current liabilities.

(10-20 min.) P 3-66B

Req. 1

Journal

DATE		ACCOUNT TITLES AND EXPLANATION	DEBIT	CREDIT
2014				
Dec.	31	Accounts Receivable ($12,400 – $11,200)	1,200	
		Commission Revenue		1,200
		To accrue commission revenue.		
	31	Supplies Expense ($300 – $0)	300	
		Supplies ($1,000 – $700)		300
		To record supplies expense.		
	31	Insurance Expense ($1,700 – $0)	1,700	
		Prepaid Insurance ($2,600 – $900)		1,700
		To record insurance expense.		
	31	Depreciation Expense ($1,100 – $0)	1,100	
		Accumulated Depreciation ($9,300 – $8,200)		1,100
		To record depreciation expense.		
	31	Salary Expense ($27,500 – $26,600)	900	
		Salary Payable ($900 – $0)		900
		To accrue salary expense.		
	31	Interest Expense ($1,200 – $800)	400	
		Interest Payable ($400 – $0)		400
		To accrue interest expense.		
	31	Unearned Commission Revenue ($1,500 – $1,100)	400	
		Commission Revenue		400
		To record unearned commission revenue that was earned during the period.		

Req. 2

Total assets	**=**	**\$30,400 (\$4,100 + \$12,400 + \$700 + \$900 + \$21,600 – \$9,300)**
Total liabilities	**=**	**\$14,700 (\$6,300 + \$900 + \$400 + \$6,000 + \$1,100)**
Total equity	**=**	**\$15,700 (\$5,000 + \$3,500 + \$25,500*** – \$18,300)**
*****Net income**	**=**	**\$25,500 (\$74,400 – \$1,100 – \$300 – \$4,900 – \$27,500 – \$12,200 – \$1,200 – \$1,700)**

Assets	**=**	**Liabilities**	**+**	**Shareholders' Equity**
\$30,400	**=**	**\$14,700**	**+**	**\$15,700**

(20-30 min.) **P 3-67B**

Req. 1

Reid and Campbell Ltd.
Income Statement
For the Year Ended December 31, 2014

Revenues:		
Sales		**$165,900**
Expenses:		
Salary expense	**$44,000**	
Rent expense	**12,000**	
Depreciation expense	**11,300**	
Interest expense	**1,200**	**68,500**
Income before tax		**97,400**
Income tax expense		**18,800**
Net income		**$ 78,600**

Reid and Campbell Ltd.
Statement of Retained Earnings
For the Year Ended December 31, 2014

Retained earnings, December 31, 2013	**$ 20,300**
Add: Net income	**78,600**
	98,900
Less: Dividends	**(48,000)**
Retained earnings, December 31, 2014	**$ 50,900**

Req. 1

Reid and Campbell Ltd.
Balance Sheet
December 31, 2014

ASSETS			LIABILITIES	
Cash		$ 11,600	Accounts payable	$ 3,600
Accounts receivable		41,400	Deposits	4,500
Prepaid rent		1,300	Interest payable	2,100
			Salary payable	900
Store furnishing	$67,600		Income tax payable	8,800
Less: Accum.			Note payable	26,200
dep'n.	(12,900)	54,700	Total liabilities	46,100
			SHAREHOLDERS' EQUITY	
			Common shares	12,000
			Retained earnings	50,900
			Total shareholders' equity	62,900
			Total liabilities and	
Total assets		$109,000	shareholders' equity	$109,000

Req. 2

$$\textbf{Debt ratio:} \quad \frac{\$46{,}100}{\$109{,}000} = 0.42$$

Reid and Campbell's debt ratio is low, which indicates a strong financial position. This ratio indicates the company will have no difficulty paying its debt.

(20 min.) P 3-68B

Req. 1

Journal

DATE		ACCOUNT TITLES AND EXPLANATION	DEBIT	CREDIT
2014				
		Closing Entries		
Dec.	**31**	**Service Revenue**	**93,500**	
		Retained Earnings		**93,500**
	31	**Retained Earnings**	**34,600**	
		Salary Expense		**24,600**
		Supplies Expense		**5,700**
		Advertising Expense		**2,200**
		Depreciation Expense		**1,300**
		Interest Expense		**800**
	31	**Retained Earnings**	**47,400**	
		Dividends		**47,400**

Req. 2

Retained Earnings			
Dec. 31, 2014 Expenses	**34,600**	**Dec. 31, 2013 Bal.**	**5,300**
Dec. 31, 2014 Dividends	**47,400**	**Dec. 31, 2014 Revenues**	**93,500**
		Dec. 31, 2014 Bal.	**16,800**

Net Income	**=**	**Revenues**	**–**	**Expenses**
	=	**$93,500**	**–**	**$34,600**
	=	**$58,900**		

Ending Balance of Retained Earnings = $16,800

Req. 3

Retained Earnings increased during the year because net income of $58,900 ($93,500 – $34,600) exceeded dividends of $47,400.

(30-40 min.) **P 3-69B**

Req. 1

For You eTravel Inc.
Balance Sheet
December 31, 2014

ASSETS		
Current assets:		
Cash		$ 7,300
Accounts receivable		6,600
Supplies		7,700
Total current assets		21,600
Capital assets:		
Furniture	$41,400	
Less accumulated depreciation	(11,600)	29,800
Other assets		3,600
Total assets		$55,000
LIABILITIES		
Current liabilities:		
Accounts payable		$ 5,100
Salary payable		3,900
Unearned service revenue		3,600
Total current liabilities		12,600
Note payable, long-term		10,600
Total liabilities		23,200
SHAREHOLDERS' EQUITY		
Common shares		15,000
Retained earnings		16,800*
Total shareholders' equity		31,800
Total liabilities and shareholders' equity		$55,000

Req. 1

______

***Computation: (see P3-68B, Req. 1)**

Retained earnings, December 31, 2013	**$ 5,300**
Add: Net income ($93,500 – $34,600)	**58,900**
	64,200
Less: Dividends	**(47,400)**
Retained earnings, December 31, 2014	**$16,800**

Req. 2

					2014	**2013**
Current ratio	=	$\frac{\text{Total current assets}}{\text{Total current liabilities}}$	=	$\frac{\$21,600}{\$12,600}$	= **1.71**	**1.50**

The ability to pay current liabilities with current assets improved during 2014.

Debt ratio	=	$\frac{\text{Total liabilities}}{\text{Total assets}}$	=	$\frac{\$23,200}{\$55,000}$	= **0.42**	**0.45**

The overall ability to pay total liabilities was greater in 2014than it was in 2013.

Overall the company's debt position is strong with current and debt ratios better than the norm.

P 3-70B

Req. 1

			2014		2013		2012	
Current ratio	=	$\frac{\text{Total current assets}}{\text{Total current liabilities}}$	= $\frac{17}{12.5}$	= 1.36	= $\frac{12}{11}$	= 1.09	= $\frac{10}{9.5}$	= 1.05

Req. 2

Debt ratio	=	$\frac{\text{Total liabilities}}{\text{Total assets}}$	= $\frac{24.5}{36}$	= 0.681	= $\frac{17}{24.5}$	= 0.694	= $\frac{15}{16}$	= 0.938

Req. 3

The current ratio has improved over the 3 years (some deterioration in 2013 was reversed in 2014). This means the company had sufficient cash to pay its accounts payable and salaries payable every year. In 2014, the current ratio is very good and indicates that the company can pay its debts.

The debt ratio has improved over the 3 years. In 2012, the company financed almost 100% of its assets with debt.At December 31, 2014, only 68% of the assets were financed. This ratio is still high if the company needs to borrow in order to finance more equipment or expand their office space.

Decision Cases

(25 min.) Decision Case 1

Req. 1 **Unadjusted trial balance:**

Cash	$ 6,000	
Accounts receivable	2,200	
Supplies	800	
Prepaid rent	12,000	
Land	41,000	
Accounts payable		$10,000
Salary payable		0
Unearned service revenue		1,500
Note payable, due in three years		25,400
Common shares		15,000
Retained earnings		7,300
Service revenue		9,100
Salary expense	3,400	
Rent expense	0	
Advertising expense	900	
Supplies expense	0	
Totals	$66,300	$68,300

$2,000
out of balance

Req. 2 **Adjusted trial balance:**

Cash	**$ 6,000**	
Accounts receivable	**2,200**	
Supplies ($800 – $600)	**200**	
Prepaid rent ($12,000 – $1,000)	**11,000**	
Land ($41,000 + $2,000)	**43,000**	
Accounts payable		**$10,000**
Salary payable		**400**
Unearned service revenue ($1,500 – $800)		**700**
Note payable, due in 3 years		**25,400**
Common shares		**15,000**
Retained earnings		**7,300**
Service revenue ($9,100 + $800)		**9,900**
Salary expense ($3,400 + $400)	**3,800**	
Rent expense ($12,000 × 1/12)	**1,000**	
Advertising expense	**900**	
Supplies expense	**600**	
Totals	**$68,700**	**$68,700**

Req. 3

$$\textbf{Current ratio} = \frac{\$6{,}000 + \$2{,}200 + \$200 + \$11{,}000}{\$10{,}000 + \$400 + \$700}$$

$$= \frac{\$19{,}400}{\$11{,}100}$$

$$= 1.748$$

Yes, we could sleep at night with a current ratio of 1.748. It's a great current ratio.

(20-30 min.) Decision Case 2

Silver Skates Ltd.
Income Statement
For the Month Ended October 31, 2014

Sales revenue		$32,000
Cost of goods sold	$14,000	
Wages expense	5,000	
Rent expense	4,000	
Insurance expense	1,000	
Depreciation expense	1,000	25,000
Net income		$ 7,000

Silver Skates Ltd.
Statement of Retained Earnings
For the Month Ended October 31, 2014

	Retained earnings, October 1, 2013	$ 0
+	Net income	7,000
–	Dividends	(3,000)
	Retained earnings, October 31, 2014	$ 4,000

Silver Skates Ltd.
Balance Sheet
October 31, 2014

ASSETS			LIABILITIES		
Cash		$ 6,000	Accounts payable		$ 5,000
Food inventory		3,000	Unearned revenue		3,000
Prepaid insurance		1,000			8,000
Dishes, silverware		4,000			
Fixtures	$19,000		OWNERS' EQUITY		
Less: Accum.			Common shares	$20,000	
amort.	(1,000)	18,000	Retained earnings	4,000	24,000
Total assets		$32,000	Total liability and equity		$32,000

***Recommendation*: The business is profitable, but it is not meeting Skate's criteria for expansion. She needs to focus on reaching $10,000 net income in the short term. Total assets could have reached $35,000 if dividends had not been paid.**

(30-40 min.) Decision Case 3

Req. 1 **(your highest price)**

Revenue ($20,000 + 5,000)		**$ 25,000***
Expenses:		
Salary	**$4,000**	
Utilities	**900**	
Other (unrecorded)	**1,100**	
Salary of your manager	**6,000**	**12,000****
Your expected monthly net income		**$ 13,000**
Multiplier to compute price		**× 20**
Your highest price		**$260,000**

Req. 2 **(Walter Liu's lowest price)**

LW Media Inc.
Statement of Shareholders' Equity
June 30, 2014

Unadjusted retained earnings		**$ 88,000**
Add: Net income		
***Revenue**	**$25,000**	
****Less: Expenses**		
($12,000 – $6,000)	**(6,000)**	**19,000**
		107,000
Less: Dividends		**(9,000)**
Ending retained earnings		**$ 98,000**
Common shares		**50,000**
Shareholders' equity, June 30, 2014		**$148,000**
Multiplier to compute price		**× 1.5**
Walter Liu's lowest price		**$222,000**

Req. 3

Mr. Liu's asking price is less than the highest price you have set for purchasing the business.

You should offer Walter Liu approximately $200,000 for the business because he is willing to take $222,000. If Liu appears especially eager to sell out, you may be able to buy the firm for $200,000. However, if he is not so eager to sell and if you want the business badly enough, you may have to pay his asking price of $222,000. You can always raise your offer, but you cannot decrease it, so start the negotiating process with an offer of $200,000.

Note: **Students may suggest some other number that is less than $222,000, but, as was pointed out above, they should offer less than the asking price, especially if it is less than their highest price.**

Ethical Issue 1

1. The journal entry to record the revenue is as follows:

Dec.	**Accounts Receivable.............**	**XXX**	
	Sales Revenue		**XXX**

The debit to Accounts Receivable will increase total current assets and, as a result, increase (improve) the current ratio.

The credit to Sales Revenue will increase total owners' equity and, as a result, decrease (improve) the debt ratio.

2. To record this transaction in December is *unethical*. In this case ARAS has not performed the service for the client and, therefore, has not earned the revenue prior to December 31. Revenue should be recorded no earlier than when it is earned. ARAS expects to earn the revenue in January. After performing the service, ARAS can ethically record the revenue.

3. The authors would suggest that ARAS report the current ratio of 1.47 and the debt ratio of 0.51 because these are the true values. ARAS can tell the bank of the signed contract for work to be performed in January and the hope for a better set of ratio values in the next year. ARAS may have to renegotiate the agreement with the bank and ask for less stringent ratio requirements.

Ethical Issue 2

1. **These transactions—recorded as directed by Smith—overstate the store's reported income by $26,000 ($20,000 + $5,000 + $1,000).**

2. **It appears that Smith wants to improve the store's income in order to borrow on favourable terms. His action is *unethical* because he is deliberately overstating the store's reported income and manipulating the current ratio.**

   Smith would be helped by his unethical actions. The business will need a bank loan, and perhaps the money would be used to pay bills, expand the business, and so on. However, based on Smith's lack of integrity shown in this case, the money may be destined for his own use. Regardless of its use, the money is obtained under false pretenses.

   The bank is harmed by Smith's actions. Lending money to Smith under false pretenses may lead the bank to charge an unrealistically low interest rate that robs the bank of interest revenue. In the extreme, the public is robbed if taxpayers wind up financing the bailout of a failed financial institution.

If the accountant holds an accounting designation, he is putting himself in danger of losing his designation or being suspended by becoming party to what is in effect fraudulent accounting records and reporting.

3. **Personal advice will vary from student to student. The purpose of asking this question is to challenge students to take the high road of ethical conduct by having nothing to do with Smith's scheme. The authors would advise the accountant to take these actions, in order:**
   a. **Refuse to take any part in Smith's scheme, explaining that the result is an overstatement of reported income and is therefore wrong. Accountants are bound to standards of ethical conduct that these actions violate.**
   b. **To remain ethical, the accountant must be willing to lose his/her job. It is better to protect one's reputation and retain any professional designation held even if that causes short-term hardship.**

Focus on Financials

(15-20 min.) Telus Corporation

Req. 1

Prepaid expenses aren't true expenses because they provide a future benefit for the business. All future benefits are assets, so prepaid expenses are assets.

Req. 2 (balances in millions)

Accounts Payable and Accrued Liabilities

	1,477

Prepaid Expenses

113	

Req. 3 (amounts in millions)

Journal

DATE	ACCOUNT TITLES AND EXPLANATION	DEBIT	CREDIT
a.	Accounts Payable and Accrued Liabilities	1,477	
	Cash		1,477
b.	Goods and Services Purchased	113	
	Prepaid Expenses		113
c.	Goods and Services Purchased	1,419	
	Accounts Payable and Accrued Liabilities		1,419
d.	Prepaid Expenses	144	
	Cash		144

Req. 4 (in millions)

Accounts Payable and Accrued Liabilities

Debit	Credit
1,477	1,477
	1,419
	1,419

Prepaid Expenses

Debit	Credit
113	113
144	
144	

The balances of both accounts agree with the amounts from the balance sheet.

Req. 5

Current ratio:

	2011		2010	
	(Dollar amounts in millions)			
$\frac{\text{Total current assets}}{\text{Total current liabilities}}$ =	$\frac{\$2,051}{\$3,845}$	= 0.53	$\frac{\$1,797}{\$4,098}$	= 0.44

Debt ratio:

$\frac{\text{Total liabilities}}{\text{Total assets}}$ =	$\frac{\$12,418}{\$19,931}$	= 0.62	$\frac{\$11,843}{\$19,624}$	= 0.60

Telus's current ratio is very low compared to the general standard of 1.50, but has improved in the past year and the company also generates significant cash flows from operations (over $2.5 billion in each of 2010 and 2011), so liquidity is not a concern for Telus.

Its debt ratio held relatively steady at 0.62 compared to 0.60 in the prior year. This is within the acceptable range of 0.60-0.70, so its debt level is not a concern.

Focus on Analysis

(15-20 min.) TELUS Corporation.

Req. 1 (amounts in millions)

The beginning receivables balance of $1,318 represents revenue earned in 2010 and the ending receivables balance of $1,428 represents revenues earned in 2011 (assuming all receivables are paid within a reasonable period of time).

The 2011 receivable balance of $1,428 would be included in TELUS's 2011 revenue of $10,325.

Req. 2

	(amounts in millions)
Accumulated depreciation, December 31, 2010	**$19,269**
less:	
Adjustment for assets disposed during 2011	**(253)**
	19,016
Accumulated depreciation, December 31, 2011	**(20,347)**
Depreciation expense for 2011	**$1,331**

Depreciation expense matches amount on the 2011 statement of income.

(continued) TELUS Corporation

Req. 3

Operating revenues	**→ Accounts receivable**
Goods and services purchased	**→ Accounts payable and accrued liabilities**
	→ Inventories
	→Prepaid expenses
Depreciation	**→ Property, plant, and equipment**
Amortization of intangible assets	**→Intangible assets**
Financing costs	**→Short-term borrowings**
	→Current maturities of long-term debt
	→ Long-term debt
Income taxes	**→ Income and other taxes receivable (Asset)**
	→ Income and other taxes payable
	→ Deferred income taxes (Liability)