



# **Part I**

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## **Financial Accounting**



# Chapter 1

# Principle of Financial Accounting

## Mini Case

Matt is a freshman intern in the financial department of ABC Company. During the accounting process, he found that there were complicated business transactions and they're not easy for him to deal with, so he went to ask Harry, an experienced accountant.

**Matt:** “Harry, I found that there were various business transactions such as purchasing new machines or raw materials, paying salaries to the workers, receiving new investments or acquiring sales revenues. They are complicated and I have no idea how to record these transactions by an appropriate method.”

**Harry:** “Well, before you deal with these transactions, you should make a classification of them and understand the inner relationship.”

**Matt:** “And I saw that when purchasing a new machine, it will be recognized as cash outflow even if we haven't paid for it. Why?”

**Harry:** “Actually, there are some accounting principles and rules that you should consider before starting accounting computation. After you learn them, you will understand.”

### Identify:

1. How could we classify the transactions such as purchasing new machines or raw materials?
2. What are the basic principles and rules of accounting?

## Learning Objectives

**After studying Chapter 1, you should be able to:**

1. Explain the nature of accounting and its types.
2. Interpret the qualitative characteristics of accounting information.

3. Understand the basic assumptions and principles of accounting.
4. Identify the effects of business transactions on the accounting equation.
5. Apply the Double-entry Bookkeeping.



## **Topic 1 : Nature of Accounting**

### **1. Accounting Is an Information System**

Accounting is often described as an information system that identifies, records, and communicates relevant, reliable, and comparable information about an organization's business activities that can be expressed in monetary terms. Identifying business activities requires selecting transactions and events relevant to all organizations. Recording business activities requires keeping a chronological log of transactions and events measured in monetary unit and classified and summarized in a useful format. Communicating business activities requires preparing accounting reports, for example, financial statements. It also requires analyzing and interpreting the reports. Accounting is often confused with bookkeeping. Bookkeeping is a mechanical process that records the routine economic activities of a business. Accounting includes bookkeeping but goes beyond it in scope.

### **2. The Purposes of Accounting**

The primary purpose of accounting is to provide information to help people make decisions about economic activities. Accounting is not an end, but a means to an end. To some extent, accounting has something in common with a map, and it helps decisionmakers determine where they have been, where they are and where they will go.

Accounting information is required to answer day-to-day questions about business operation. Financial statements report accounting information that provides answers to questions about resources, earning prospects, expected cash collection, expenses to be incurred, debt-paying ability, tax collection, and negotiating wage agreements. Examples of specific questions are: Is the business profitable? Did the business achieve its expected profit? How well is the business doing compared to the competitors? Do costs appear reasonable compared to earnings? How was cash raised during the period? What was done with these cash? Can the business afford to increase wages?

To address these questions, you need to understand the following:

- ① The nature of economic activities that accounting information describes.
- ② The assumptions and measurement techniques involved in developing accounting information.
- ③ The information that is most relevant for making various types of decisions.

### 3. Types of Accounting Information

Because there are many types of economic decisions, there must be many types of accounting information. The terms financial accounting, management accounting, and tax accounting are always applied to describe three types of accounting information that are widely used in the business community.

- ① **Financial accounting.** Financial accounting refers to information describing the financial resources, obligations and activities of an economic entity, either an organization or an individual. Financial accounting information appears in financial statements that are intended primarily for external use, although managements also use them for certain internal decisions, so it is often called “general purpose” accounting information.
- ② **Management accounting.** Management accounting involves the development and interpretation of accounting information which is for internal use and provides special information for the managers of a company. Much management accounting information is financial in nature, but often includes evaluations of “nonfinancial” factors.
- ③ **Tax accounting.** Tax accounting is a special branch of accounting which involves the preparation of income tax returns. The most challenging aspect of tax accounting is not the preparation of an income tax return, but tax planning. Tax planning means anticipating the tax effects of business transactions and structuring these transactions in a manner that will minimize the income tax burden.

### 4. Users of Accounting Information

Decisionmakers need accounting information. The more important the decision is, the greater the need for accurate information will be. In fact, all businesses and most individuals keep accounting records to be aided in making decisions. Most of the information describes business situations, but the principles of accounting apply to the financial affairs of other organizations and individuals as well. The following sections discuss some of the people and groups who use accounting information.

- ① **Individuals.** Individuals often keep accounting records to make decisions. People use accounting information in day-to-day affairs to manage bank accounts, to evaluate job prospects, to make investments, and to decide whether to rent or buy a house.
- ② **Managers of business.** Managers of businesses use accounting information to set goals for their organizations, to evaluate progress toward those goals, and to take corrective action if necessary. Decisions based on accounting information may include which building to purchase, how much merchandise inventory to keep on hand, and how much cash to borrow.
- ③ **Investors and creditors.** Investors and creditors provide the money a business needs for initial operations. To decide whether to help start a new venture, potential

investors evaluate what income they can expect on their investment. This means analyzing the financial statements of the new business. Moreover, potential investors monitor the progress of the business by analyzing the company's financial statements. They also keep updated with the developments of business press such as the *Wall Street Journal*, *Business Week*, and so on. Before making a loan, banks determine the borrower's ability to meet scheduled payments. This evaluation includes a projection of future operations, which is based on accounting information.

- ④ **Government regulatory agencies.** Most of the organizations follow governmental rules and regulations. For example, the Securities and Exchange Commission (SEC), a federal agency, requires businesses to disclose certain financial information to the public. Like many other government agencies, the SEC bases its regulations in part on the accounting information it receives from firms.
- ⑤ **Tax authorities.** Tax authorities levy taxes on individuals and businesses. The amount of the tax is figured out using accounting information. Businesses determine their goods and services tax and sales tax based on their accounting records of total sales. Individuals and businesses compute their income tax based on how much that business earned. Taxing authorities, such as the Internal Revenue Service, want to know whether the company complies with the tax laws.
- ⑥ **Nonprofit organization.** Nonprofit organizations such as churches, government agencies, and college, which operate for purposes other than profit, use accounting information in much the same way that profit-oriented business do. Both profit seeking organizations and nonprofit organizations deal with budgets, payrolls, rent payments, and the others from the accounting system.
- ⑦ **Employees and labor unions.** Employees and labor unions make wage demands based on their employer's reported income. Consumer groups and the general public are also interested in the amount of income businesses earn. For example, during fuel shortages consumer groups have charged that oil companies have earned "obscene profits". A newspaper reports "improved profit pictures" of companies as the nation emerges from an economic recession. Such news, based on accounting information, is related to our standard of living.



## **Topic 2: Qualitative Characteristics of Accounting Information**

The accounting information should be useful to the existing and potential investors, lenders, and other creditors in making economic decisions about the reporting entity on the

basis of information in its financial reports. There are three primary qualitative characteristics and four enhanced qualitative characteristics.

## 1. Primary Qualitative Characteristics

If financial information is to be useful, it must be relevant, material and faithful representation of information that it purposes to represent.

- ① **Relevance**. Relevant accounting information is capable of making a difference in the decisions made by users. Accounting information is capable of making a difference in decisions if it has a predictive value, confirmatory value, or both. In other words, it must be useful in helping users assess the future performance of the firm as well as provide feedback about prior decisions.
- ② **Materiality**. Materiality means that the requirements of accounting principles may be ignored if their effects on the financial statements are unimportant to users. An accountant makes a judgment that considers whether an amount is large enough to influence or change the decisions of people who rely on certain information. If the amount does not affect the decision, a more expedient accounting method may be used for that item (for example, ignore the item). An item may be relevant to users because of its nature, and therefore it needs separate disclosure, even if its amount is not material.
- ③ **Faithful Representation**. Faithful Representation also called reliability. To be useful, financial information must not only represent relevant phenomena, but also faithfully represent the phenomena that it purports to represent. To be a perfectly faithful representation, a depiction should have three characteristics; complete, neutral, and free from error.

A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations. For example, a complete depiction of all assets in the group would include a description of what the numerical depiction represents (for example, original cost, adjusted cost, or fair value). For some items, a complete depiction may also entail explanations of significant facts on the quality and the process used to determine the numerical depiction.

A neutral depiction means selecting or presenting the financial information without bias. A neutral depiction is not slanted, weighted, emphasized, deemphasized, or otherwise manipulated to increase the probability that financial information will be received favorably or unfavorably by users. Neutral information does not refer to information with no purpose or has no influence on behavior. On the contrary, relevant financial information is, by definition, capable of making a difference in users' decisions.

Free from error means there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has

been selected and applied with no errors in the process. In this context, free from error does not mean perfectly accurate in all respects. For example, an estimate of an unobservable price or value cannot be determined to be accurate or inaccurate. However, a representation of that estimate can be faithful if the amount is described clearly and accurately, the nature and limitations of the estimating process are explained, and no errors have been made in selecting and applying the appropriate process for developing the estimate.

## 2. Enhanced Qualitative Characteristics

The usefulness of relevant and faithfully represented financial information is enhanced if it is comparable, verifiable, timely, and understandable. The enhancing qualitative characteristics also may help determine which of two ways should be used to depict a phenomenon if both are considered equally relevant and faithfully represented.

- ① **Comparability.** Users' decisions involve choosing between alternatives, for example, selling or holding an investment, or investing in one reporting entity or another. Consequently, information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date. Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among items. Comparability at least relates to two items instead of a single item. Comparability is not uniformity. A faithful representation of a relevant economic phenomenon should naturally possess some degree of comparability with a faithful representation of a similar relevant economic phenomenon by another reporting entity.
- ② **Verifiability.** Verifiability helps assure users that the information faithfully represents the economic phenomena it purports to represent. Verifiability means that different knowledgeable and independent observers can reach consensus, although not necessarily complete agreement, that a particular depiction is faithfully represented. Quantified information need not be a single point estimate to be verifiable. A range of possible amounts and the related probabilities can also be verified. To help users decide whether they want to use that information, normally it would be necessary to disclose the underlying assumptions, the methods of compiling the information, and other factors and circumstances that support the information.
- ③ **Timeliness.** Timeliness means having information that could influence decisions available to decisionmakers in time. Generally, the older the information is, the less useful it is. However, some information may continue to be timely long after the end of a reporting period. For example, some users may need to identify and assess the trends of the entity.
- ④ **Understandability.** Accounting information should be understandable to users who



have a reasonable knowledge of business and economic activities and who are willing to study the information with reasonable diligence. Some phenomena are inherently complex and cannot be easily understood. Excluding information about those phenomena from financial reports might make the information easier to understand. Classifying, characterizing, and presenting information clearly and concisely makes it understandable.



### **Topic 3: The Assumption and Principle of Accounting**

#### 1. Basic Assumptions of Accounting

It is necessary for the accountants to develop some assumptions, principles and conventions which may be regarded as fundamentals of accounting. Such fundamentals having wide acceptance, give reliability and creditability to the financial statements prepared by the accountants.

An assumption is a statement that is presumed to be true without concrete evidence to support it. In the business world, perhaps the most common use of assumptions is in the accounting function, which uses assumptions to facilitate financial measurement, forecasting and reporting. Thus, accounting assumptions may be defined as: basic postulates or assumptions which serve as the basis of actual recording.

In developing generally accepted accounting principles (GAAP), certain basic assumptions are made. These assumptions provide a foundation for the accounting process. Four main assumptions are business entity assumption, going concern assumption, monetary unit assumption, and accounting period assumption.

- ① **Business entity assumption.** One of the basic principles of accounting is that information is compiled for a clearly defined accounting entity. Each business venture is a separate unit, accounted for separately. Therefore, financial statements are identified as a particular business entity.

Business entity means that every business unit or enterprise is treated in accounting as a separate entity. The entity can be a business enterprise (such as proprietorship, partnership, corporation, or even a group of corporations), a governmental unit (the provincial government of Hunan, Ministry of Finance, etc.), and an individual or non-profit organizations. The entity for which the accounting is being done is defined by the accountant. In accumulating financial information, we must separate the activities of an accounting entity from the other economic and personal activities of its owners.

- ② **Going concern assumption.** Going concern refers to presumption that the entity will continue to operate in the future, that it is not being liquidated. In most cases, the

amount of time that a business will be able to continue in operation is not known. So an assumption must be made. We normally assume that a business expects to continue operating at a profit for an indefinite period of time.

- ③ **Monetary unit assumption.** Monetary unit assumption requires that all the transaction data of an entity should be measured and entered in terms of money in the accounting records. This assumption enables accounting to quantify (measure) economic events. It also assumes that the monetary unit is stable, that is, changes in its general purchasing power are not considered sufficiently important to require adjustments to the basic financial statements. By expressing all assets and equities in terms of money, the accountant creates a common denominator that permits addition and subtraction of all forms of assets and equities and makes the preparation of financial statements possible.
- ④ **Accounting period assumption.** Accounting period concept means the period of time selected for reporting results of operations and changes in financial position. Financial position will be reported at the end of this period of time. It requires that the total life of a business be divided into segments based on annual periods. The idea of accounting periods is useful. Many taxes are assessed on an annual basis, and comprehensive reports to corporation stockholders are made annually. The annual accounting period adopted by a business is known as its fiscal year. Fiscal year begins with the first day of the month selected and ends on the last day of the following twelfth month. The period most commonly used is the calendar year.

## 2. Basic Principles of Accounting

- ① **Cost principle.** Cost principle requires that the assets of an entity be recorded at their original cost. Original cost is the value exchanged at the time something is acquired. For example, if a piece of land were purchased by a firm for \$2 million even though an appraisal showed the land to be worth \$2.5 million, the purchase transaction would be reflected in the accounting records and financial statements at its cost of \$2 million. If the land is still owned and being used 15 years later, even though its market value has increased to \$30 million, it continues to be reported in the balance sheet at its original cost of \$2 million.
- ② **Accrual-basis principle.** Accrual-basis principle means that revenues and expenses are recognized in the accounting period in which they are earned or incurred, even though the cash receipt or payments occurs at another time or in another accounting period. Thus many activities of the firm will involve two transactions: one that recognizes the revenue or expense and the other that reflects the receipt or payment of cash. It is the use of accrual procedures that accomplishes much of the matching of revenues and expenses, because most transactions between business firms (and between many firms and individuals) involve purchase/sale at one point in time and cash payment/receipt at some other points.

- ③ **Matching principle.** Matching principle requires that all expenses incurred in generating revenues during a period of time be deducted from the revenue earned. In other words, all the expenses related to given revenue should be matched with and deducted from that revenue for the determination of periodic income. This results in an accurate measure of the net income or net loss for the period. Under the matching principle, revenues are normally recorded first, followed by the recording of the related expense. The recording of revenue is often referred to as the recognition of revenue. After revenues have been recorded, all expenses related to producing the revenue must be recorded so that the amount of net income or net loss can be properly determined.
- ④ **Realization principle.** Realization principle specifies that revenue is recognized at the time of sale, which happens when title (ownership) to the product being sold passes from the seller to the buyer or when the services involved in the transaction have been performed. Passing of legal ownership is the critical event, not the cash payment from the buyer to the seller.
- ⑤ **Full disclosure principle.** Full disclosure principle means that the financial statements and notes or explanations should include all necessary information to prevent a reasonably wise user of the financial statements from being misled. Under this principle, all the information (including the facts or conditions that may not be specially a part of the financial statement data for the period reported, but have a considerable influence on the firm's financial status) necessary for the users' understanding of the financial statements must be disclosed. For example, certain provisions of leases, significant amounts of purchases commitments, and notices of pending lawsuits or settlements should be disclosed in the notes to the financial statements. This principle also requires that an economic entity should disclose a summary of the accounting principles it follows in preparing its financial statements.
- ⑥ **Materiality principle.** Materiality principle relates to the extent to which information can be omitted, misstated or grouped with other information without misleading the financial information users when they are making their economic decisions. Thus the prices paid for insignificant items, such as for each piece of stationary, may not be shown separately in the financial reports because they are insignificant, or immaterial, in the overall context of the decision being made by the user. It is important, however, when assessing materiality, for the accountant to be aware of the particular decision being made by the user. The same information may be material for one decision and immaterial for another. Thus, considerable judgment is needed by the accountant in order to assess which information is material and which is immaterial for the particular decision in hand.
- ⑦ **Conservatism principle.** Conservatism principle in accounting relates to making

judgments and estimates that resulting in lower profit and asset valuation estimates rather than higher profit and asset valuation estimates. Accountants try to avoid wishful thinking or pie-in-the-sky estimates that could result in overstating profit for a current period. This is not to say that accountants always look at issues from a gloom-and-doom viewpoint, rather, they seek to be realistic but are conservative when in doubt.

In summary, accounting assumptions and principles are not laws of nature but man-made rules. They only reflect generally accepted practices that have evolved over time. They are broad guidelines that are developed as a way of describing current accounting practices and prescribing new and improved practices.



## **Topic 4 : The Accounting Equation and Double-entry Bookkeeping**

### 1. Accounting Elements

Accounting elements are the basic classification of the accounting object, the basic ingredients to constitute accounting statements. China has promulgated and implemented the Accounting Standards for Business Enterprises and Accounting System. Accounting elements have been divided into six parts: assets, liability, owner's equity, income, expenses and profit.

- ① **Assets**. Assets refer to the resources incurred by the past transactions, which are owned or controlled by the enterprises and are expected to bring economic returns to the enterprises. Controlling a certain number of assets is a prerequisite for production and business activities of enterprises. Assets include property, claims and other rights.
- ② **Liability**. Liability refers to the financial obligations entered in the balance sheet of a business enterprise. Besides the investor fund, borrowed funds from banks or financial institutions are also an important source that an enterprise needs. In addition, the money that enterprises purchase materials, receive labor and pay to the suppliers, the profits that investors accept as input of funds, unpaid taxes and wages and welfare of workers, all belong to the liabilities.
- ③ **The owner's equity**. The owner's equity refers to the economic interests that the owner is blessed with in an enterprise assets; it is the amount of assets minus liabilities. The owner's equity constitutes a major source of enterprise assets, namely, the property rights of enterprises, and owners of the enterprises.
- ④ **Revenue**. Revenue refers to the total inflow of economic interest when selling

products, providing labor services, and transferring assets, including discounts and deductions for returned merchandise. It is the “top line” or “gross income” figure from which costs are subtracted to determine net income.

- ⑤ **Expense.** Expense refers to the interest outflow of sale, provision of services and other daily activities. Manufacturing expense by a certain period of time consists of production expense and expense during the period. The production expense consists of direct materials, direct wages, other direct expenses and the manufacturing expenses. Expense during the period consists of management, financial and business expenses.
- ⑥ **Profit.** Profit refers to operating results of enterprises in a certain accounting period, including the operating profit plus other business profits, minus operating expenses, management expenses and the amount of financial expenses.

## 2. Accounting Equation

Accounting elements are basic classification of accounting practices. They are essential units to present the financial position and operation results of an entity. We were introduced to the balanced sheet. The relationship between assets and the claims against the assets can be summarized in the following equation:

$$\text{Assets} = \text{Liability} + \text{Owner's Equity}$$

A business transaction is an exchange of goods or services that affect this equation. It is essential to understand the effects of transaction on the accounting equation in order to understand the accounting function.

According to the income statement, we learned the relationship between revenues and expenses:

$$\text{Net Income (Net Loss)} = \text{Revenues} - \text{Expenses}$$

Next net income or net loss will be closed to owner's equity. And we can have the following presentation of accounting equation.

$$\text{Assets} = \text{Liability} + [\text{Owner's Equity} + (\text{Revenues} - \text{Expenses})]$$

## 3. Effects of Business Transactions upon the Accounting Equation

Any business event that alters the amount of assets, liabilities or owner's equity or that affects the accounting equation is called a transaction. Now example 1-1 deals with transactions using the accounting equation,

**Example 1-1:** We assume that during the month of January, 2017, Scarlett's Bar had some transactions.

**Transaction 1:** Scarlett started her business and deposited \$14,000 into a bank account opened specially for her business Scarlett's Bar.

**Transaction 2:** Bought equipment like refrigerators, tables and chairs, etc. for \$8,500.

Transaction 3: Bought supplies such as tableware for \$ 2,000.

Transaction 4: Bought beverages, etc. for \$ 7,500 on account.

Transaction 5: Borrowed \$ 5,000 from the bank for duration of 3 months.

Transaction 6: Paid \$ 5,000 owed on inventory.

Transaction 7: Paid electricity and water bills for the month \$ 245.

Now let's see how the accountant makes a meaningful record of the series of transactions, reconciling step by step with the accounting equation.

**Transaction 1: Scarlett started her business and deposited \$ 14,000 into a bank account.**

There are two accounts that are affected: The assets Cash is increased and the capital of the firm is increased by the same amount.

	Assets	=	Liabilities	+	Owner's Equity
	Cash	=		+	Scarlett's Capital
1.	+ \$ 14,000	=		+	\$ 14,000

**Transaction 2: Bought equipment like refrigerators, tables and chairs, etc. for \$ 8,500.**

Here Scarlett is substituting one asset (cash) for another asset (equipment). She is receiving (+) the asset Equipment and paying out (-) the asset Cash. Note that the capital of \$ 14,000 remains unchanged.

	Assets	=	Liabilities	+	Owner's Equity
	Cash + Equipment	=		+	Scarlett's Capital
	\$ 14,000				\$ 14,000
2.	<u>- \$ 8,500</u>		<u>+ \$ 8,500</u>		
	\$ 5,500		\$ 5,500		<u>\$ 14,000</u>

**Transaction 3: Bought supplies such as tableware for \$ 2,000.**

Scarlett again substitutes one asset Cash for another asset Supplies (Tableware is current assets which is grouped under the title Supplies). She receives Supplies (+) and pays out Cash (-).

	Assets	=	Liabilities	+	Owner's Equity
	Cash + Supplies + Equipment	=		+	Scarlett's Capital
	\$ 5,500		\$ 8,500		\$ 14,000
3.	<u>- \$ 2,000 + \$ 2,000</u>				
	\$ 3,500 + \$ 2,000		\$ 5,500		<u>\$ 14,000</u>

**Transaction 4: Bought beverages, etc. for \$ 7,500 on account.**

In this transaction, both sides of the accounting equation are affected: increase on the left side Assets (+) and increase on the right side Liabilities (+) by the same amount. So the accounting equation is still in balance. For Scarlett's Bar such goods as beverages, pastry, refreshment, etc. are grouped under the title Inventories. She therefore is receiving the asset Inventories but is not paying for it with the asset Cash. Instead, she will owe the money. Thus she creates the liability Accounts Payable because she owes that much.

Assets	=	Liabilities	+	Owner's Equity
Cash + Supplies + Inventories + Equipment	=	Accounts Payable	+	Scarlett's Capital
\$ 3,500 \$ 2,000		\$ 8,500		\$ 14,000
4. $\frac{\$ 3,500}{\$ 3,500}$ $\frac{\$ 2,000}{\$ 2,000}$ $\frac{+ \$ 7,500}{\$ 7,500}$ $\frac{\$ 8,500}{\$ 8,500}$		$\frac{- \$ 7,500}{\$ 7,500}$		$\frac{\$ 14,000}{\$ 14,000}$

**Transaction 5: Borrowed \$ 5,000 from the bank for duration of 3 months.**

Like creating Accounts Payable to purchase an asset, both sides of the accounting equation increase by the same amount, but the balancing condition is not impaired. In this case, Scarlett is receiving Cash (+) and creating a current liability or Short-term Borrowings (+).

Assets	=	Liabilities	+	Owner's Equity
Cash + Supplies + Inventories + Equipment	=	Short-term Borrowings + Accounts Payable	+	Scarlett's Capital
\$ 3,500 \$ 2,000 \$ 7,500 \$ 8,500		\$ 7,500		+ \$ 14,000
5. $\frac{+ \$ 5,000}{\$ 8,500}$ $\frac{\$ 2,000}{\$ 2,000}$ $\frac{\$ 7,500}{\$ 7,500}$ $\frac{\$ 8,500}{\$ 8,500}$		$\frac{+ \$ 5,000}{\$ 5,000}$		$\frac{\$ 14,000}{\$ 14,000}$

**Transaction 6: Paid \$ 5,000 owed on inventory.**

This transaction reduced Scarlett's asset Cash since she is paying out money by \$ 5,000 (-). She also reduced her liability Accounts Payable, by \$ 5,000 (-). Now she owes that much less.

Assets	=	Liabilities	+	Owner's Equity
Cash + Supplies + Inventories + Equipment	=	Short-term Borrowings + Accounts Payable	+	Scarlett's Capital
\$ 8,500 \$ 2,000 \$ 7,500 \$ 8,500		\$ 5,000		\$ 7,500 \$ 14,000
6. $\frac{- \$ 5,000}{\$ 3,500}$ $\frac{\$ 2,000}{\$ 2,000}$ $\frac{\$ 7,500}{\$ 7,500}$ $\frac{\$ 8,500}{\$ 8,500}$		$\frac{\$ 5,000}{\$ 5,000}$		$\frac{\$ 7,500}{\$ 2,500}$ $\frac{\$ 14,000}{+ \$ 14,000}$

**Transaction 7: Paid electricity and water bills for the month \$ 245.**

Electricity and water bills constitute Utilities Expenses. This transaction means a deduction from Cash. Incurrence of expense means a deduction of Capital.

Assets	=	Liabilities	+	Owner's Equity
Cash + Supplies + Inventories + Equipment	=	Short-term Borrowings + Accounts Payable	+	Scarlett's Capital
\$ 3,500 \$ 2,000 \$ 7,500 \$ 8,500		\$ 5,000		\$ 2,500 \$ 14,000
7. $\frac{- \$ 245}{\$ 3,255}$ $\frac{\$ 2,000}{\$ 2,000}$ $\frac{\$ 7,500}{\$ 7,500}$ $\frac{\$ 8,500}{\$ 8,500}$		$\frac{\$ 5,000}{\$ 5,000}$		$\frac{\$ 2,500}{\$ 2,500}$ $\frac{- \$ 245}{+ \$ 14,000}$ Utilities Ex

In conclusion, accounting works as it satisfies that:

- ① Every transaction affects at least two items in the accounting equation. Think of a transaction as any economic event that causes a change in assets, liabilities, or owner's equity.
- ② The accounting equation remains in equal balance after each transaction.
- ③ Revenues and owner investments increase owner's equity. Expenses and owner

withdrawals decrease owner's equity. Therefore, owner's equity is directly affected by revenues, expenses, investments and withdrawals.

#### 4. Double-entry Bookkeeping

Preparation of financial statements requires that information about an organization's economic events be captured and recorded in a rational and systematic manner. The origins of modern accounting, the double-entry bookkeeping system, first codified in 1494 in a mathematics book written by Luca Pacioli, who was an Italian and called "Father of Accounting". He was the first to publish a detailed description of the double-entry system, thus enabling others to study and use it. The fundamental rule of double-entry bookkeeping is that debits must equal credits.

*Debits and credits.* Debits and credits are accounting terms with specialized meanings. Essentially, the term debit and credit means left and right respectively. A T-account is used to illustrate the use of debits and credits. A T-account is not really a part of any formal accounting system; it is a device used for illustrative or analytical purposes, whose name is derived from its shape. Following is a T-account for cash.

Cash	
Debit	Credit

When debit is used as a noun, it refers to an amount entered on the left-hand side of an accounting record. The term credit is similar with the term debit whereas it refers to the right-hand side. The debit/credit rules can be correlated with the accounting equation. Assets appear on the left-hand side of the accounting equation. To increase an asset, it must be debited, with the appropriate amount entered on the left-hand side of the account. Liabilities and equity appear on the right-hand side of the accounting equation. An increase in one of these accounts means that the appropriate amount is credited or entered on the right-hand side of account.

As an entity begins its operations, two additional account types are used: revenues, and expenses. Revenues cause equity to increase and because increases in equity are shown as credits, revenues also increase with credits. Alternatively, expense cause equity to decrease, and decreases in equity are shown as debits. The more expenses an entity has, the smaller equity becomes. Thus, expenses increase with debits. As we mentioned before, the expanded accounting equation is as following:

$$\text{Assets} = \text{Liabilities} + \text{Equity} + (\text{Revenues} - \text{Expenses})$$

The normal balance of each account is on the side where increases are recorded. Thus, assets and expenses normally have debit balance whereas liabilities, equity, and revenues typically have credit balances. Exhibit 1-1 summarizes the debit/credit relationships of accounts.



Exhibit 1-1 Debit and Credit Relationships of Accounts

Project	Assets	Liability	Equity	Revenues	Expenses
Increases	Debits	Credits	Credits	Credits	Debits
Decrease	Credits	Debits	Debits	Debits	Credits
Normal balance	Debits	Credits	Credits	Credits	Debits

What should be noted is that a few accounts, which are designed to show offsets to other related accounts, are referred to as contra-accounts and have opposite balance. For example, contra-assets such as accumulated depreciation and allowance for doubtful accounts have credit balances. Contra-revenues include sales discount and sales returns and allowances which have debit balance.

### Core Words and Expressions

accounting principle 会计原则

business entity assumption 会计主体假设

double-entry bookkeeping 复式记账法

going concern assumption 持续经营假设

reliability 可靠性

accrual-basis accounting 权责发生制

comparability 可比性

faithful representation 如实反映

revenue recognition principle 收入确认原则

timeliness 及时性

### More Knowledge

- ◎ **Accrual-basis assumption.** 权责发生制,也称应计制。即根据收入获得的时间和费用发生的时间来确认收入和费用,而不论何时收入或付出现金。权责发生制体现了会计中的收入实现原则、配比原则和会计期间假设,可恰当反映一个期间的经营成果。
- ◎ **Matching principle.** 配比原则,指企业一定时期的收入与费用,应依据权责发生制相配合,确定该期间的净收入。即按照收入与费用的因果关系或收入与产生收入所耗用的费用的期间相配比,确定本期的净收入。
- ◎ **Conservatism.** 谨慎性原则,指企业对交易或者事项进行会计确认、计量和报告应当保持应有的谨慎,不应高估资产或者收益,不应低估负债或者费用。
- ◎ **Materiality.** 重要性原则,即对金额不大或对决策影响不大的交易和事项,可以不在财务报表或附注中予以单独反映。一个交易或事项是否重要,既取决于其金额,也取决于其性质,因此,重要性原则的使用需要会计人员运用专业判断。
- ◎ **Relevance.** 相关性,是衡量会计信息质量的一项重要标准。相关性是指会计信息与使用者的决策需求相关。为了使信息具有相关性,信息的提供必须是及时的,且必须具有预测价值、反馈价值。
- ◎ **Understandability.** 可理解性,明晰性,是会计信息的一项质量标准,指会计所使用的概念和名词以及财务报表的列报必须让报表读者容易理解。当然,报表读者本身必须具备一定的会计知识以便透彻地理解财务报表。

### Discussion Questions

1. How does the job of a bookkeeper differ from that of an accountant?
2. What kind of information can be defined as relevant information?
3. What should be required to do according to Accounting Period Assumption?
4. How do accountants use the concept of materiality?
5. Discuss the principle of accounting equation.
6. How does the debit and credit rule apply to double-entry accounting?

### Exercises

1. The primary objective of financial reporting is \_\_\_\_\_.
  - A. to present information in an ethical manner
  - B. to provide information to the federal government
  - C. to provide information useful for investment and lending decisions
  - D. to provide information useful to managers in making daily decisions
2. An example of an asset is \_\_\_\_\_.
  - A. a bank loan
  - B. worker's wage
  - C. a computer
  - D. profit
3. You own a lawn service business. You pay \$500 for gasoline and store it in a holding tank. What is the gasoline?
  - A. An expense
  - B. A liability
  - C. An asset
  - D. Owner's equity
4. If assets increase \$80,000 during the period and owners' equity decreases \$16,000 during the period, liabilities must have?
  - A. Increased \$64,000
  - B. Increased \$96,000
  - C. Decreased \$64,000
  - D. Decreased \$96,000
5. The idea that a business be accounted for separately and independently from its owner or owners is known as?
  - A. Objectivity principle
  - B. Business entity principle
  - C. Going-concern principle
  - D. Revenue recognition principle
6. The following selected transactions were completed by Castell Delivery Service during November:
  - (1) Received cash from owner as additional investment, \$20,000.
  - (2) Paid advertising expense, \$520.
  - (3) Purchased supplies of gas and oil for cash \$780.
  - (4) Received cash from customers, \$1,500.
  - (5) Charged customers for delivery services on account, \$2,100.
  - (6) Paid creditors on account, \$470.
  - (7) Paid rent for November, \$1,000.
  - (8) Received cash from customers on account, \$1,810.
  - (9) Paid cash to owner for personal use, \$900.

(10) Determined by taking an inventory that \$ 650 of supplies of gas and oil had been used during the month.

Indicate the effect of each transaction on the accounting equation by listing the number identifying the transactions, (1) through (10), in a vertical column, and inserting at the right of each number the appropriate letter from the following list:

- A. Increase in one asset, decrease in another asset.
- B. Increase in an asset, increase in a liability.
- C. Increase in an asset, increase in capital.
- D. Decrease in an asset, decrease in a liability.
- E. Decrease in an asset, decrease in capital.

## Chapter 2

# Accounting Cycle

### Mini Case

John is a new intern in the finance department of ABC Company, and he has to deal with various business transactions in his daily work. Here is a conversation between John and his tutor, Gary.

**Gary:** “How are you getting on with your work, John?”

**John:** “Not bad, sir. But I have a question about the journals. You know that now we are in the computer world, one computer database is enough for all reporting purposes, such as accounting, marketing, and production. It’s obvious that accountants can prepare financial reports upon the information directly abstracted from database. But now we are still using the traditional accounting journals to record business events. I’m wondering, is it still necessary for us?”

**Identify:**

1. How do you think about the function of the traditional accounting journals?
2. Do you think the journals are necessary?

### Learning Objectives

**After studying Chapter 2, you should be able to:**

1. Understand the basics of accounting cycle.
2. Explain the principle of journaling and posting process.
3. Prepare a trial balance.
4. Apply the adjusting procedures.
5. Use of closing the accounts.



## Topic 1 : Basics of Accounting Cycle

The term accounting cycle refers to the steps in preparing financial statements. The accounting cycle includes standardized procedures that are performed in sequence during every accounting period. The sequence of accounting procedures used to record, classify, and summarize accounting information is often termed the accounting cycle. Accounting cycle begins with the initial recording of business transactions and concludes with the preparation of formal financial statements summarizing the effects of these transactions upon the assets, liabilities, and owner's equity of the business. The term "cycle" indicates that these procedures must be repeated continuously to enable the business to prepare new up-to-date statements at reasonable intervals.

Accounting cycle can be divided into the following steps:

- ① Journalize transactions. Analyzing transaction and enter all transactions in the journal, thus creating a chronological record of events;
- ② Post to ledger accounts. Post debits and credits from the journal to the proper ledger accounts, thus creating a record classified by accounts;
- ③ Prepare a trial balance. Prove the equality of debits and credits in the ledger;
- ④ Make end-of-period adjustments. Draft adjusting entries in the general journal, and post to ledger accounts;
- ⑤ Prepare an adjusted trial balance. We can prove again the equality of debits and credits in the ledger. These are the amounts used in the preparation of financial statements;
- ⑥ Prepare financial statements and appropriate disclosures. An income statement shows the results of operation for the period. A statement of owner's equity shows changes in owner's equity during the period. A balance sheet shows the financial position of the business at the end of the period;
- ⑦ Journalize and post the closing entries. The closing entries clear the revenue, expense, and drawing accounts, making them ready for recording the events of the next accounting period. These entries also bring the balance in the owner's capital account up-to-date;
- ⑧ Prepare an after-closing trial balance. This step ensures the remaining balance of the ledger accounts after posting of closing entries.



## Topic 2 : Journals and Ledgers

### 1. Journals

The information about each business transaction is initially recorded in an accounting record called a Journal. Afterward, the data is transferred or posted to the ledger, the book of subsequent or secondary entry. The various transactions are evidenced by sales tickets, purchase invoices, check stubs, and so on. Since the journal is the accounting record in which transactions are first recorded, it is sometimes called the book of original entry. It is also called the day book because the journal is a chronological (day-by-day) record of all business transactions.

#### (1) Advantages of Using Journals

A summary of the functions and advantages of using a journal as follows:

- ① The journal shows all information about a transaction in one place and also provides an explanation of the transaction. In a journal entry, the debits and credits for a given transaction are recorded together, but when the transaction is recorded in the ledger, the debits and credits are entered in different accounts. Since a ledger may contain hundreds of accounts, it would be very difficult to locate all the facts about a particular transaction by looking in the ledger. The journal is the record which shows the complete story of a transaction in one entry.
- ② The journal provides a chronological record of all the financial events in the life of a business. If we want to look up the facts about a transaction of some months or years back, all we need is the date of the transaction in order to locate it in the journal.
- ③ The use of a journal helps to prevent errors. If transactions were recorded directly in the ledger, it would be very easy to make errors such as omitting the debit or the credit, or entering the debit twice or the credit twice. Such errors are not likely to be made in the journal, since the offsetting debits and credits appear together for each transaction.

#### (2) Types of Journals

Many businesses maintain several types of journals. The nature of operation and the volume transactions in the particular business determine the number and type of journals needed. They may be grouped into general journals and specialized journals.

**General Journals.** It is common for a business to have more than one kind of journal. The nature of operations and the volume of transactions in the particular business determine the number and type of journal needed. The simplest and most flexible type is the general journal. The procedural steps can be learned quickly by observing the

following points for the illustration of journal entries:

- ① The year, the month, and the day of the first entry on the page are written in the date column. The year and month need not be repeated for subsequent entries until a new page or a new month is begun.
- ② The name of the account to be debited is written on the first line of the entry and is customarily placed at the extreme left next to the date column. The amount of the debit is entered on the same line in the left-hand money column.
- ③ The name of the account to be credited is entered on the line of the debit entry and is an inch indented, that is, placed about an inch to the right of the date column. The amount credited is entered on the same line in the right-hand money column.
- ④ A brief explanation of the transaction begins on the line immediately below the last account credited and is indented halfway between the accounts debited and credited. A journal entry explanation should be concise and yet complete enough to describe fully the transaction and prove the entry's accuracy. When a journal entry is self-explanatory, we omit the explanation.
- ⑤ An entry which includes more than one debit is called compound journal entry. Regardless of how many debits or credits are contained in a compound journal entry, all the debits are entered before any credits are listed.
- ⑥ The PR (Post Reference) column just to the left of the debit money column is left blank at the time of making the journal entry. When the debits and credits are later transferred to ledger accounts, the numbers of the ledger accounts will be listed in the column to provide a convenient cross-reference with the ledger.

Exhibit 2-1 shows the standard format of a general journal entry.

**Exhibit 2-1 General Journal Entry**

Journal				Page 1	
Date	Accounts titles and explanation	Post. Ref.	Debit	Credit	

Example 2-1: These transactions happened in December 2016 in Anna's Business:

- Dec. 1 She invested \$12,000 cash to start her business.
- Dec. 2 She paid rent of the month for \$500.
- Dec. 3 She purchased equipment for cash at \$3,000.
- Dec. 4 She purchased furniture on account at \$3,600.
- Dec. 5 She purchased supplies on account at \$300.
- Dec. 6 She earned service revenue for cash at \$800.

Dec. 7 She paid the utilities for the month at \$ 200.

Dec. 8 She earned credit revenue at \$ 1,700.

Required: Please journalize the transactions into the business's general journal.

It should be noted that all transaction are recorded only in terms of debits and credits to specific accounts. The titles used in the entries should be the same as the titles of the accounts in the ledger. The line following an entry is left blank in order to clearly separate each entry. The column headed Post. Ref. (posting reference) is not used until the debits and credits are posted to the appropriate accounts in the ledger.

Journal					Page 1
Date 2016		Accounts titles and explanation	Post. Ref.	Debit \$	Credit \$
Dec.	1	Cash		12,000	
		Anna's Business			12,000
		<i>The investment of the owner</i>			
	2	Rent expense		500	
		Cash			500
		<i>The payment of rent of the month</i>			
	3	Equipment		3,000	
		Cash			3,000
		<i>The purchase of equipment for cash</i>			
	4	Furniture		3,600	
		Accounts payable			3,600
		<i>The purchase of furniture on account</i>			
	5	Supplies		300	
		Accounts payable			300
		<i>The purchase of supplies on account</i>			
	6	Cash		800	
		Service revenue			800
		<i>Received cash as revenue of the month</i>			
	7	Utilities expense		200	
		Cash			200
		<i>The payment of the utilities of the month</i>			
	8	Accounts receivable		1,700	
		Service revenue			1,700
		<i>The credit revenue of the month</i>			

**Special journals.** A business of any size enters into so many transactions that the use of



a single journal would impose intolerable restrictions on its ability to maintain adequate records. It is, therefore, usual to break down or subdivide the journal into a number of specialized journals, each being used to record transactions of certain kind. It is much simpler and more efficient to group together those transactions which are repetitive such as sales, purchases, cash receipts and cash payments and place each of them in a special journal. In particular, it is likely that all the transactions involving credit sales will be recorded in a separate journal known as the sales journal; transactions involving credit purchases of goods in a purchase journal; receipts of cash in a cash receipts journal; cash payments in a cash payments journal.

## 2. Ledgers

A ledger is the complete collection of all the accounts and a record of the changes and balances in the value of an individual item of all organization. It is understandable that an enterprise may use a number of accounts. The complete set of accounts for a business entity is called a ledger. It is the “reference book” of the accounting system and is used to classify and summarize transactions and to prepare data for financial statements. It is also a valuable source of information for managerial purposes, giving, for example, amount of sales for the period or the cash balance at the end of the period. There are two types of ledgers—general ledger and subsidiary ledger.

- ① **General ledger.** A general ledger contains a specific account for each item listed on the financial statements and shows how each transaction changes the balances of these accounts. Company’s size and diversity of operations affect the number of accounts needed. It is desirable to establish a systematic method of identifying and locating each account in the ledger. The chart of accounts, sometimes called the code of accounts, is a listing of the accounts by title and numerical. It serves both as an index to the ledger and a description of the accounting system and also a link between financial statements and the ledger.
- ② **Subsidiary ledgers.** Further simplification of the general ledger is bringing the use of subsidiary ledger. In particular, for those businesses which sell goods on credit and which find it necessary to maintain a separate account with each customer, the use of a subsidiary accounts receivable ledger eliminates the need to make multiple entries in the general ledger. These customers’ accounts are grouped together in a subsidiary ledger known as the accounts receivable ledger. Each time the accounts receivable (control account) increased or decreased; a customer’s account in the accounts receivable ledger must also be increased or decreased by the same amount.

Transactions are first recorded in the journal, and at specified intervals the same transactions are recorded in both the general and, when appropriate, subsidiary ledger accounts. The balances in the general ledger are then used to prepare financial statements.

### 3. Posting Transactions

Posting is the process of copying journal entry information from the journal to the ledger. Cross-referencing account numbers and journal page numbers is necessary to avoid omission and duplication. This is done in the posting reference (PR or folio) column, where a letter is used to indicate which journal the posted entry came from. Notice that there is also a posting reference column in the general journal that is used to record the ledger account the transaction was posted to. The posting of journal entry to ledger is performed in the following steps:

- ① Record the date and the amount of the entry in the account.
- ② Insert the number of the journal page in the Posting Reference column of the account.
- ③ Insert the ledger account number in the Posting Reference column of the journal.

Example 2-2 makes use of the journal entries in Example 2-1 to demonstrate posting to the ledger using the balance column format. Notice that in Example 2-1, posting references are absent because the journal entries had not yet been posted.

Example 2-2: The following is the general ledger of Anna's Business after posting the journal entries in example 2-1. Assume that all of the journal entries were recorded on Page 1 in the general journal (G1).

Cash

Acct. No. 101

Date		Explanation	PR	Debit	Credit	Balance
Dec.	1	The investment of the owner	G1	12,000		12,000
	2	The payment of rent of the month	G1		500	11,500
	3	The purchase of equipment for cash	G1		3,000	8,500
	6	Received cash revenue of the month	G1	800		9,300
	7	Payment of the utilities of the month	G1		200	9,100

Cash

Acct. No. 106

Date		Explanation	PR	Debit	Credit	Balance
Dec.	8	Sales revenue	G1			1,700

Supplies

Acct. No. 124

Date		Explanation	PR	Debit	Credit	Balance
Dec.	5	Accounts payable	G1	300		300

## Equipment

Acct. No. 163

Date		Explanation	PR	Debit	Credit	Balance
Dec.	3	The purchase of equipment for cash	G1	3,000		3,000

## Furniture

Acct. No. 165

Date		Explanation	PR	Debit	Credit	Balance
Dec.	4	Accounts payable	G1	3,600		3,600

## Accounts Payable

Acct. No. 210

Date		Explanation	PR	Debit	Credit	Balance
Dec.	4	Furniture	G1		3,600	3,600
	5	Supplies	G1		300	3,900

## Anna's Business, Capital

Acct. No. 301

Date		Explanation	PR	Debit	Credit	Balance
Dec.	1	Cash	G1		12,000	12,000

## Service Revenue

Acct. No. 401

Date		Explanation	PR	Debit	Credit	Balance
Dec.	6	Cash	G1		800	800
	8	Accounts receivable	G1		1,700	2,500

## Rent Expense

Acct. No. 610

Date		Explanation	PR	Debit	Credit	Balance
Dec.	2	Cash	G1	500		500

## Utilities Expense

Acct. No. 620

Date		Explanation	PR	Debit	Credit	Balance
Dec.	7	Cash	G1	200		200

After posting from the general journal to the general ledger, the general journal would include posting reference as follows:

Journal					Page 1
Date		Accounts titles and explanation	Post. Ref.	Debit	Credit
Dec.	1	Cash	101	12,000	
		Anna's Business	301		12,000
		<i>The invest of the owner</i>			
	2	Rent expense	610	500	
		Cash	101		500
		<i>The payment of the rent of the month</i>			
	3	Equipment	163	3,000	
		Cash	101		3,000
		<i>The purchase of equipment for cash</i>			
	4	Furniture	165	3,600	
		Accounts payable	210		3,600
		<i>The purchase of furniture on account</i>			
	5	Supplies	124	300	
		Accounts payable	210		300
		<i>The purchase of supplies on account</i>			
	6	Cash	101	800	
		Service revenue	401		800
		<i>The cash revenue of the month</i>			
	7	Utilities expense	620	200	
		Cash	101		200
		<i>The payment of the utilities of the month</i>			
	8	Accounts receivable	106	1,700	
		Service revenue	401		1,700
		<i>The credit revenue of the month</i>			



### Topic 3: The Trial Balance

The equality of debits and credits in the ledger is tested periodically by preparing a trial balance, which lists the balance in each account after the posting process has been

completed. The trial balance is prepared using the following procedures:

- ① Determine the balance of each account in the ledger.
- ② List each account and place its balance beside it.
- ③ Compute the total of the debit balances.
- ④ Compute the total of the credit balances.
- ⑤ Verify that the sum of the debit balances equals the sum of the credit balances.

Each amount in the trial balance is simply the final balance of each account in the ledger.

Example 2-3; Refer to example 2-2 where the general ledger was based upon the balance column format. To prepare a trial balance for Anna's business on December 31, 2016, each account balance, beginning with the cash account, is copied into a format below:

<b>Anna's Business</b>		
<b>Trial Balance</b>		
<b>December 31, 2016</b>		
Account Title	Debit	Credit
Cash	\$ 9,100	
Accounts receivable	1,700	
Supplies	300	
Equipment	3,000	
Furniture	3,600	
Accounts payable		\$ 3,900
Anna's business, capital		12,000
Service revenue		2,500
Rent expense	500	
Utilities expense	<u>200</u>	
Totals	<u>\$ 18,400</u>	<u>\$ 18,400</u>

The significance of the trial balance is that it proves whether or not the ledger is in balance. "In balance" means that equal debits and credits have been recorded for all transactions. Exhibit 2-2 reveals the types of errors in trial balance when it does not show the equal balance of debit and credit side amounts.

**Exhibit 2-2 Types of errors in trial balance**

Errors in preparing the trial balance	One of the columns of the trial balance was incorrectly added.
	The amount of an account balance was incorrectly recorded on the trial balance.
	A debit balance was recorded on the trial balance as a credit, or vice versa, or a balance was omitted entirely.

(Continued)

Errors in determining the account balances	A balance was incorrectly computed.
	A balance was entered in the wrong balance column.
Errors in recording a transaction in the ledger	An erroneous amount was posted to the account.
	A debit entry was posted as a credit, or vice versa.
	A debit or a credit posting was omitted.

## **Topic 4 : Adjusting Procedures**

### **1. The Need for Adjustments**

For purposes of measuring income and preparing financial statements, the life of a business is divided into a series of accounting periods. But some transactions affected the revenue or expenses of more than one period. Therefore, adjusting entries are needed whenever transactions affect the revenues or expenses of more than one accounting period. These entries assign revenues to the periods in which they are earned, and expenses to the periods in which the related goods or services are used.

In theory, a business could make adjusting entries on a daily basis. But as a practical matter, these entries are made only at the end of each accounting period. Thus “adjusting the accounts” is an end-of-the-period procedure associated with the preparation of financial statements.

### **2. Adjusting the Accounts**

Adjusting entries can be divided into two classes. These are deferrals and accruals. Each adjustment affects both the balance sheet and income statement. The adjustments can be further divided into four types: prepaid expenses, unearned revenues, accrued expenses, and accrued revenues.

#### (1) Prepaid Expenses

A prepaid expense is an economic benefit that has been paid for in advance of its use. It requires adjustment because the cash is paid in one period, but the resource is not completely used until a later period. The prefix “prepaid” refers to an asset account. Prepaid rent is an asset account, while rent expense is an expense account. As the asset is consumed (expired), the future benefit decreases and the portion of the asset used becomes an expense. The remaining future benefit represents the asset. Examples of prepaid expenses include prepaid rent, prepaid insurance, office supplies, store supplies, and factory supplies.

① *Asset method*. If prepayments are initially recorded as assets, they will be

incorrectly stated during the accounting period as they are consumed. This must be adjusted at the end of the accounting period to reflect the amount used. Part of the asset or the entire asset has become an expense. The adjusting entry requires a debit to an expense account and a credit to an asset accounts, for example:

Example 2-4: On December 1, 2016; ABC Company paid advance rent for office space for the month of December \$100.

December 1, 2016: *At the time of advance payment of cash as rent*

Prepaid rent (Asset increase)	100
Cash (Asset decrease)	100

December 31, 2016: *At the time of service consumed as rent expense*

Rent expense (Expense incurred)	100
Prepaid rent (Asset decrease)	100

- ② **Expense method.** Prepayments initially recorded as expenses will be improperly stated during the accounting period and must be adjusted at the end of the accounting period to reflect the amount of future benefit remaining and to avoid overstating expenses.

(2) Unearned Revenues

Unearned revenue arises when a business receives cash in one period but does not earn all of it until a later period. Thus, unearned revenue is a liability because the business owes the customer a good or service. The receipt of the cash would increase cash as well as increase a liability. When the revenue is earned, the adjustment would usually decrease the liability and increase the revenue.

Example 2-5: On November 1, 2016, Fast Food Industries collected \$12,000 from a customer for services to be provided in the future. On December 31, 2016, Fast Food's year end, it was determined that \$3,000 of this amount remained unearned. That means the other portion of amount of unearned revenue have already earned or service already provided.

To record earned portion of unearned revenue:  $\$12,000 - \$3,000 = \$9,000$

The entries for November 1 and December 31 are:

2016

Nov. 1 Cash	12,000
Unearned revenue	12,000

To record unearned revenue

Dec. 31 Unearned revenue	9,000
Service revenue	9,000

The principle of revenue recognition has been applied to record the entry on December 31. Revenue is recognized as it is earned, and by this date, \$9,000 has been earned.

As illustrated in the previous example, if receipts of payments have been initially recorded as liabilities (unearned revenue), an adjustment must be made at the end of the

accounting period to reflect amounts earned and to show the reduction of the liability (Debit unearned revenue). Alternatively, the receipt of payment can be initially recorded as revenue. If the revenue is earned by the end of the accounting period, no adjusting entry is required.

### (3) Accrued Expense

An accrued expense is recorded by preparing an adjusting entry. An adjusting entry is required because an expense has been incurred during the accounting period but it has not been recorded through the normal course of accounting entries. An accrued liability may exist for interest, wages, taxes, or other expenses that have been incurred in the accounting period but have not been paid by period end. Those who have provided services to the business entity during the period have a claim against the business for any amounts owed to them. According to the matching principle, these accrued expenses must be recorded in the period that the effort was expended.

Payables for accrued expenses differ from regular trade payables. Trade accounts payable are usually documented by invoices already received from suppliers, but accrued expenses are continuous transactions that are determined by careful account analysis.

Example 2-6: On October 31, 2016, Offsite Data Services recorded three days of unpaid salaries of \$ 30,000. The total salaries of \$ 50,000 for the five-day workweek will be paid on November 2, 2016 in cash. The adjustment and subsequent payment of salaries are illustrated as follows:

2016		
Oct. 31 Salaries expense		30,000
Salaries payable		30,000
To record accrued salaries.		
Nov. 2 Salaries payable		30,000
Salaries expense		20,000
Cash		50,000
To record payment of salaries		

### (4) Accrued Revenue

Accrued revenue is recorded by preparing an adjusting entry. An adjustment entry is required because revenue has been earned during the accounting period but has not been recorded through the normal course of accounting entries. The company may record revenue during the period only when payment is received; or the service period may straddle two accounting periods. The revenue recognition principle, however, requires that revenue be recorded during the period that it is earned, regardless of when actual cash is collected.

Example 2-7: Soft Inc. recorded unbilled and uncollected service revenues of \$ 17,000 on March 31, 2017. On April 16, \$ 12,000 of these was collected.

The adjusting entry for accrued revenues, along with their subsequent collections, is



illustrated as follows:

2017			
Mar. 31	Accounts receivable	17,000	
	Service revenue		17,000
	To record accrued revenues.		
Apr. 16	Cash	12,000	
	Accounts receivable		12,000
	To record collection of receivable.		

### 3. Adjusted Trial Balance

After adjusted entries are made, we can go ahead with adjusted trial balance. By preparing and using adjusted trial balance, we can prove that the ledger is still in balance after all the necessary adjusting entries have been journalized and posted. Once an adjusted trial balance has been prepared, the process of recording changes in financial position for this accounting period is complete. The preparation of financial statements, which is illustrated in Chapter 7, is omitted here.

Now let's go on with examples of Anna's Business to demonstrate how to prepare the adjusted trial balance. The unadjusted trial balance numbers reflect the balances in the ledger accounts before the adjusting journal entries at the end of the accounting period. The adjustments show the adjustments that must be made to various accounts to bring them to their proper balances. The adjusted trial balance is the result of the unadjusted trial balance and the adjusting entries.

Example 2-8: (1) Journalize the remaining entries.

Dec. 21 She collected cash from a client in advance at \$ 900.

Dec. 26 She paid \$ 300 to her creditors.

Dec. 28 She collected \$ 600 from her client for her services rendered before.

Dec. 30 She withdraw \$ 1,600 for her personal use.

Journal				Page 2	
Date		Accounts titles and explanation	Post. Ref.	Debit	Credit
Dec.	21	Cash		900	
		Unearned service revenue			900
		<i>Receipt of cash in advance</i>			
	26	Accounts payable		300	
		Cash			300
		<i>Payment for creditors</i>			
	28	Cash		600	
		Accounts receivable			600

(Continued)

Journal				Page 2
Date	Accounts titles and explanation	Post. Ref.	Debit	Credit
	<i>Receipt from client</i>			
30	Anna's Business, withdrawal		1,600	
	Cash			1,600
	<i>Withdrawals of the owner</i>			

(2) Journalize the adjusting entries.

- ① Accrued service revenue at \$ 400.
- ② One third (1/3) of unearned revenue became earned revenue.
- ③ Supplies on hand at \$ 100.
- ④ Accrued salary at \$ 500.

Journal				Page 3
Date	Accounts titles and explanation	Post. Ref.	Debit	Credit
	Adjustments			
Dec. 31	Accounts receivable		400	
	Service revenue			400
	<i>Accrued service revenue</i>			
31	Unearned service revenue		300	
	Service revenue (900×10/30)			300
	<i>1/3 of unearned revenue became earned revenue</i>			
31	Supplies expense (300-100)		200	
	Supplies			200
	<i>Supplies on hand at \$ 100</i>			
31	Salary expense		500	
	Salary payable			500
	<i>Accrued salary at \$ 500</i>			

(3) Based on the journals and adjusting entries, prepared the adjusted trial balance.

Accounts titles	Debit balance	Credit balance
Cash	\$ 8,700	
Accounts receivable	1,500	
Supplies	100	

(Continued)

Accounts titles	Debit balance	Credit balance
Equipment	3,000	
Furniture	3,600	
Accounts payable		3,600
Salary payable		500
Unearned service revenue		600
Anna's Business, capital		12,000
Anna's Business, withdrawals	1,600	
Service revenue		3,200
Rent expense	500	
Utilities expense	200	
Salary expense	500	
Supplies expense	200	
Total	<u>\$20,010</u>	<u>\$20,010</u>



## Topic 5: Closing Process

### 1. The Closing Entries

The term closing the account refers to the end-of-period procedure that closes the revenue and expense accounts for recording the transactions of the next period. Closing entry sets the balances of the revenue and expense accounts back to zero in order to measure the net income of the next period. Since the revenue and expense accounts provide information for the income statement of a given accounting period, these accounts are called the temporary accounts or the nominal accounts, which are also called the income statement accounts.

The accounts opposite to temporary or nominal accounts are the permanent accounts or the real accounts. The permanent accounts are not closed at the end of the accounting period because their balances are not used to measure income or loss. The permanent accounts are also called the balance sheet accounts, which include the asset, liability, and owner's equity accounts.

### 2. The Closing Process

① Closing the revenue accounts—close the various revenue accounts by transferring their balances into the income summary account.

② Closing the expense accounts—close the various expense accounts by transferring their balances into the income summary account.

③ Closing the income summary account—close the income summary account by transferring its balance into the owner’s capital account.

④ Closing the owner’s withdrawals account—close the account of owner’s withdrawals by transferring its balance into the owner’s capital account.

### 3. Preparing the Closing Entries

(1) Closing entries for the revenue accounts

Revenue accounts have credit balances. Closing a revenue account means transferring its credit balance to the income summary account.

Example 2-9: Assume that the only revenue account of Anna’s business is service revenue, which had a credit balance of \$ 3,200 at December 31. On December 31, the closing entry is as follows:

Service Revenue	3,200
Income Summary	3,200

(2) Closing entries for the expense accounts

Expense accounts have debit balances. Closing an expense account means transferring its debit balance to the income summary account.

Example 2-10: From the previous example of Anna’s business, there are four expense accounts in the ledger (Rent expense \$ 500; Utilities expense \$ 200; Salaries expense \$ 1,000; Supplies expense \$ 2,000). On December 31, the total amount of the debit balances for the four accounts expense accounts is \$ 1,400. On December 31, the closing entry of expense accounts for Wood Service Company is as follows:

Income Summary	1,400
Rent Expense	500
Utilities Expense	200
Salaries Expense	500
Supplies Expense	200

(3) Closing the income summary account

Example 2-11: From the above examples, we can see that there are the total debit amounts of \$ 1,400 and the total credit amount of \$ 3,200 in the income summary account for Anna’s business. On December 31, the income summary account has a credit balance of \$ 1,800, which represents the net income for December. The net income of \$ 1,800 causes the owner’s equity to increase its amount by \$ 1,800.

Income Summary	1,800
Owner’s Capital	1,800

(4) Closing the accounts of withdrawals

The account of withdrawals has debit balance. Closing the account of withdrawals means transferring its debit balance to the owner’s capital account.

Example 2-12: The account of withdrawals for Anna's business had a debit balance of \$1,600 at December 31, the closing entry is as follows:

Wood, Capital	1,600
Owner's Withdrawal	1,600

In our illustration the business has operated profitably with revenue in excess of expense. If expense of a business is larger than its revenue, the income summary account will have a debit balance, representing a net loss for the accounting period. Note that the income summary account is used only at the end of the accounting period when the accounts are being closed.

#### 4. Post-Closing Trial Balance

A post-closing trial balance is a trial balance taken after the closing entries have been posted. The only accounts that should be open are assets, liabilities, and owner's capital accounts. List all the account balances in the debit and credit columns and total them to make sure debits and credits are equal. Look at Exhibit 2-3, a post-closing trial balance for Anna's Business as of December 31, 2016. The amounts in the post-closing trial balance are from the ledger after the closing entries have been posted.

**Exhibit 2-3 Anna's Business**  
**Post-closing Trial Balance**  
**As on December 31, 2016**

Accounts titles	Debit balance	Credit balance
Cash	\$ 8,700	
Accounts receivable	1,500	
Supplies	100	
Equipment	3,000	
Furniture	3,600	
Accounts payable		3,600
Salary payable		500
Unearned service revenue		600
Anna's Business, capital (12000+1800-1600)		12,200
Total	<u>\$ 16,900</u>	<u>\$ 16,900</u>

After you have completed the closing process, the only accounts in the general ledger that have not been closed are the permanent balance sheet accounts. Because these accounts contain the opening balances for the coming accounting period, debit balance totals must equal credit balance totals. The preparation of a post-closing trial balance serves as a check on the accuracy of the closing process and ensures that the books are in balance at the start of the new accounting period. The post-closing trial balance differs from the adjusted trial

balance in only two important respects: it excludes all temporary accounts since they have been closed and it updates the owner's equity account to its proper ending balance.

### Core Words and Expressions

accounting cycle 会计循环	cash receipts journal 现金收入日记账
closing entries 结账分录	journal 日记账
posting 过账	prepaid expense 预付费用
revenue expenditure 收益性支出	sales journal 销售日记账
trial balance 试算平衡表	unearned revenue 未实现收入

### More Knowledge

- ◎ **Accounting cycle.** 会计循环,指会计按一定顺序处理业务的一套程序。即从确认应进入会计系统的交易和事件开始,经过登记日记账、过记分类账、编制各个阶段的试算表直到编制财务报表的整个核算过程。
- ◎ **Bank statement.** 银行对账单,是企业的开户银行定期发给企业的关于其账户增加和减少及余额的清单,企业需将其与自己的库存现金(银行存款)日记账记录进行核对,以验证库存现金(银行存款)记录的准确性。
- ◎ **Adjusting entries.** 调整分录,指在会计期间结束时所做的有关应计和摊销等会计分录,如计提折旧、计列应计费用、预提坏账准备等项目,这是由权责发生制所要求的。
- ◎ **Closing entries.** 结账分录,即将本期的临时性账户变为零余额的会计分录。需要通过结账分录完成结转的账户有各个收入账户、费用账户和收益汇总账户。如果企业使用股利账户的话还要结转股利账户。
- ◎ **General ledger.** 总分类账,包括一个企业所使用的全部账户的正式分类账,是以账户为分类标准所设置的整体性账户,用于分类汇总登记初始记录于日记账的经济业务。
- ◎ **Subsidiary ledger.** 明细分类账,也称辅助分类账,由一组辅助性或明细账户构成,一类明细账户的余额之和要等于总分类账中的统制账户余额。总分类账中某一账户的内容比较烦琐,均可设置明细分类账。常见的明细分类账有应收账款明细分类账、应付账款明细分类账等。
- ◎ **Prepaid expense.** 预付费,指企业为了获得未来收益而发生的一项预付性支出,在会计上一般先记录为资产,再按其受益期调整为费用。
- ◎ **Unearned revenue.** 预收收入,通常指客户的预付款,对企业来说是一项负债,这种负债的清偿方式是向客户提供商品或服务。

### Discussion Questions

1. List and describe the steps of accounting cycle.
2. What do you mean by journal and its relationship with the ledger?
3. Explain the process of journalizing.
4. Specify the types of adjustments that need to be made at the end of each accounting

period.

5. What purpose does the adjusted trial balance serve?
6. What are the major steps in preparing closing entries?

### Exercises

1. Why do accountants record transactions in the journal?
  - A. To ensure that all transactions are posted to the ledger.
  - B. To ensure that total debits equal total credits.
  - C. To have a chronological record of all transactions.
  - D. To help prepare the financial statements.
2. Posting is the process of transferring information from the \_\_\_\_\_.
  - A. journal to the trial balance
  - B. ledger to the trial balance
  - C. ledger to the financial statements
  - D. journal to the ledger
3. Which of these accounts has a normal debit balance?
  - A. Rent expense.
  - B. Withdrawals.
  - C. Service revenue.
  - D. Both A and B have a normal debit balance.
4. An adjusting entry could contain all of the following except \_\_\_\_\_.
  - A. a debit to unearned revenue
  - B. a credit to cash
  - C. a debit to interest receivable
  - D. a credit to salary payable
5. Failure to record an adjusting entry for an accrued expense, will result in the following \_\_\_\_.

<u>Liabilities</u>	<u>Net Income</u>
A. No effect	Understate
B. Understate	Overstate
C. Overstate	Understate
D. Understate	No effect

## Chapter 3

## Assets

### Mini Case

The following is an excerpt from a conversation between John, the warehouse manager for Leo Wholesale Co. , and its accountant, Mike. Leo Wholesale operates a large regional warehouse that delivers supplies products and other grocery products to grocery stores in smaller communities.

**John:** Mike, can you explain what's going on here with these monthly statements?

**Mike:** Sure, john. How can I help you?

**John:** I don't understand this Last-In, First-Out (LIFO) inventory procedure. It just doesn't make sense.

**Mike:** Well, what it means is that we assume that the last goods we receive are the first ones sold. So the inventory is made up of the items we purchased first.

**John:** Yes, but that's my problem. It doesn't work that way! We always distribute the oldest products first. Some of that product is perishable! We can't keep any of it very long or it'll spoil.

**Mike:** John, you don't understand. We only assume that the products we distribute are the last ones received. We don't actually have to distribute the goods in this way.

**John:** I always thought that accounting was supposed to show what really happened, it all sounds like "make believe" to me! Why not report what really happens?

**Identify:**

1. What's wrong with John's understanding to last-in, first-out inventory procedure?
2. How do you respond to John if you were Mike?



## Learning Objectives

**After studying Chapter 3, you should be able to:**

1. Explain the nature of current assets and non-current assets.
2. Understand internal control over cash.
3. Compute cost of goods sold and ending inventory by using different methods.
4. Understand the depreciation process of plant assets.
5. Account for the disposal of plant assets.
6. Understand measurement and report of long-term investment.



## Topic 1 : Current Assets

The current assets are equal to the sum of cash and cash equivalents, accounts receivable, inventory, marketable securities, prepaid expenses, and other assets that could be converted into cash in less than one year; or consumed during the normal operating cycle of the business or one year whichever is longer. Current assets are usually listed in the order of their liquidity or convertibility into cash. They include cash and cash equivalent, short-term investments, receivables (including notes receivable, accounts receivable and interest receivable), prepayments and inventories.

### 1. Cash

#### (1) The Definition of Cash

Cash includes currency and coins, balance in checking accounts, and items acceptable for deposit in these accounts, such as checks and money orders received from customers. These forms of cash represent amounts readily available to pay off debt or use in operations without any legal or contractual restriction. On the other hand, notes receivable, postdate checks (checks dated in the future), and uncollected customer's check—returned by the bank stamped “NSF” (not sufficient funds)—are not accepted for immediate deposit and are not included in the accountants' definition of cash.

#### (2) Internal Control over Cash

Cash is more accessible to theft than any other asset. Furthermore, a large portion of the total transactions of a business involve the receipt or disbursement of cash. If internal controls over cash are adequate, theft without detection is virtually impossible except through the collusion of two or more employees. The major steps in establishing internal controls over cash include the following:

The major steps in establishing internal controls over cash include the following:

- ① Separate the function of handling cash from the maintenance of accounting records.

Employees who handle cash should not have access to the accounting records, and accounting personal should not have access to cash.

- ② Prepare an immediate control listing of cash receipts at the time and place that the money is received. This initial listing may consist of a cash register tape or serially numbered sales tickets rather than formal entries in the accounting records. A list of incoming checks should be prepared by the employees assigned to open the mail.
- ③ Require that all cash receipts be deposited daily in the bank.
- ④ Make all payments by check. The only exception should be for small payments to be made in cash from a petty cash fund. Payments should never be made out of cash receipts and checks should never be drawn payable to cash. A check drawn to a named payee requires endorsement by the payee on the back of the check before it can be cashed or deposited. This endorsement provides permanent evidence identifying the person who received the funds. On the other hand, a check payable to cash can be deposited or cashed by anyone.
- ⑤ Require that the validity and amount of all expenditures be verified before a check is issued in payment.
- ⑥ Separate the function of approving expenditures from the function of signing checks.

### (3) Bank Reconciliation

Bank reconciliation is a schedule explaining any difference between the balance shown in the bank statement and the balance shown in the depositor's accounting records. The bank and the depositor are maintaining independent records of deposits, checks, and current balance of the bank account. Each month, the depositor should prepare a bank reconciliation to verify that these independent sets of records are in agreement. This reconciliation may disclose internal control failures, such as unauthorized cash disbursements or failure to deposit cash receipts, as well as errors in either the bank statement or the depositor's account records. In addition, the reconciliation identifies certain transactions which must be recorded in the depositor's accounting records and helps to determine the "actual" amount of cash on deposit.

- ① *Differences between bank statement and accounting records.* Normally there are differences between bank statement and accounting records. The balance shown in a monthly bank statement seldom equals that balance appearing in depositor's accounting records. Certain transactions recorded by the depositor may not have been records by the bank. The most common examples are:
  - A. Outstanding checks. Checks issued and recorded by the company but not yet presented to the bank for payment.
  - B. Deposits in transit. Cash receipts recorded by the depositor but which reached the bank too late to be included in the bank statement for the current month. In addition, certain transaction appearing in the bank statement may not have been

recorded by the depositor. Such as: Service charges; Charges for depositing NSF checks; Credits for interest earned by the depositor; Miscellaneous bank charges and credits. To determine the reasons for any differences and to correct any errors that may have been made by the bank or the depositor, the depositor's own records should be reconciled with the bank statement.

- ② *Steps in preparing bank reconciliation.* The following procedures have to be gone through for preparing a bank reconciliation statement;
- A. Compare the deposits listed on the bank statement with the deposits shown in the company's records. Any deposits not yet recorded by the bank are deposits in transit and should be added to the balance shown in the bank statement.
  - B. Arrange the paid checks in sequence by serial numbers and compare each check with the corresponding entry in the check register. Any checks issued but not yet paid by the bank should be listed as outstanding checks to be deducted from the balance reported in the bank statement.
  - C. Add to the balance per the depositor's accounting records any debit memoranda issued by the bank which have not been recorded by the depositor.
  - D. Deduct from the balance per the depositor's accounting records any credit memoranda issued by the bank which have not been recorded by the depositor.
  - E. Make appropriate additions or deductions to correct any errors in the balance per bank statement or the balance per depositor's records.
  - F. Determine that the adjusted balance of the bank statement is equal to the adjusted balance in the depositor's records.

## 2. Trading Securities

### (1) The Definition of Trading Securities

Trading securities consist of surplus cash invested in government or corporate debt obligations, or in shares (equity securities) that can be readily sold (marketable) and are held as a source of mature or be sold within the next year or operating period to be classified as current assets, although it is probable that they will. Trading securities are considered current assets if they are marketable, and management's intent is to hold them for a longer period. They should be classified as long-term investment in securities.

### (2) The Accounting of Trading Securities

Accounting for trading securities is similar to that of other assets. For example, acquisitions of trading securities are recorded at historical cost. Interest earned on debt obligations and dividends earned on equity securities are credited to revenue accounts such as Interest Earned and Dividends Earned. Sales of trading securities may generate a gain or a loss representing the differences between cost and proceeds. Gains or losses are created by the differences between the cash proceeds and the cost of the asset recorded in the accounting records (book value).

### 3. Accounts Receivables

#### (1) The Definition of Accounts Receivables

A receivable is an amount due from another party. The two most common receivables are accounts receivable and notes receivable. Other receivable includes interest receivable, rent receivable, tax refund receivable, and receivables from employees.

Accounts receivable are amounts due from customers for credit sales. The amount of credit sales has increased in recent years, reflecting several factors including an efficient financial system.

#### (2) The Accounting of Accounts Receivables

① *Making allowance for doubtful accounts*. In measuring business income, one of the most fundamental principles of accounting is that revenue should be matched with (offset by) the expenses incurred in generating that revenue. Uncollectible accounts expense is caused by selling goods on credit to customers who fail to pay their bills. Therefore, this expense is incurred in the month in which the related sales are made, even though specific accounts receivable may not be determined to be uncollectible until the next accounting period. Thus, an account receivable that originates from a credit sale in January and is determined to be uncollectible in August represents an expense in January. There is no way of telling in advance which accounts receivable will prove to be uncollectible. It is therefore not possible to credit the accounts of specific customers for our estimate of probable uncollectible accounts. Neither should we credit the accounts receivable controlling account in the general ledger. If the accounts receivable controlling account were to be credited with the estimated amount of doubtful accounts, this controlling account would no longer be in balance with the total of the numerous customers' accounts in the subsidiary ledger. The only practical alternative, therefore, is to credit a separate account called "allowance for doubtful accounts" with the amount estimated to be uncollectible. The allowance for doubtful accounts is often described as a contra-asset account. This term indicates that the allowance for doubtful accounts has a credit balance, which is offset against the asset—accounts receivable, to produce the proper balance sheet value for this asset.

② *Estimating the amount of uncollectible accounts*. Before financial statements are prepared at the end of the accounting period, an estimate of the expected amount of uncollectible accounts receivable should be made. This estimate is based upon past experience and modified in accordance with current business conditions. Losses from uncollectible receivables tend to be greater during the periods of recession than in periods of growth and prosperity. Because the allowance for doubtful accounts is necessarily an estimate and not a precise calculation; professional judgment plays a considerable part in determining the size of this valuation account.

③ *Writing off uncollectible account receivable*. Whenever an account receivable from a

specific customer is determined to be uncollectible, it no longer qualifies as an asset and should be written off. To write off an account receivable means to reduce the balance of the customer's account to zero. The journal entry to accomplish this consists of a credit to the accounts receivable controlling account in the general ledger (and to the customers' account in the subsidiary ledger) and an offsetting debit to the Allowance for Doubtful Accounts. The important thing to note in this entry is that the debit is made to the allowance for doubtful accounts and not to the uncollectible accounts expense account. The estimated expense of credit losses is charged to the uncollectible accounts expense account at the end of each accounting period. When a particular account receivable is later determined to be worthless and is written off, this action does not represent an additional expense, but merely confirms our previous estimate of the expense. If the Uncollectible Accounts Expense account were first charged with estimated credit losses and then later charged with proven credit losses, we would be double-counting the actual uncollectible accounts expense.

- ④ *Recovery of account receivable previously written off.* Occasionally a receivable, which has been written off as worthless will later be collected in full or in part. When this happens, the receivable and the allowance should be reinstated. In other words, the entry to write off the account simply is to reverse the previous computations.
- ⑤ *Monthly estimates of credit losses.* At the end of each month, management should again estimate the probable amount of uncollectible accounts and adjust the allowance for doubtful accounts to this new estimate.

Example 3-1: Assume that at the end of February, the credit manager of ABC Company analyzes the accounts receivables and estimate that approximately \$11,000 of these accounts will prove uncollectible. Currently, the Allowance for Doubtful Accounts has credit balance of only \$6,000, determined as follows:

Balance at January 31 (credit)	10,000
Less: write-offs of accounts considered worthless:	
XYZ Company	4,000
MM Company	<u>200</u> 4,200
Subtotal	5,800
Add: Recoveries of accounts previously written off:	
MM Company	<u>200</u>
Balance at the end of February (prior to adjusting entry)	<u>6,000</u>

To increase the balance in the allowance account to \$11,000 at February 28, the month-end adjusting entry must add \$5,000 to the allowance. To increase the allowance for doubtful accounts to \$11,000, the entry will be:

Uncollectible Accounts Expense	5,000
--------------------------------	-------

Allowance for Doubtful Accounts

5,000

## 4. Inventories

### (1) The Definition of Inventory

Inventory is defined as the merchandise on hand at the end of the accounting period representing goods that will eventually be sold to customers. All costs associated with manufacture, acquisition, storage, or preparation of inventory items should be capitalized and included in the inventory account. It also includes the costs required to bring inventory items to saleable condition, such as the costs of purchasing, shipping in (called freight-in or transportation-in), manufacturing, and packaging.

### (2) The Accounting of Inventory

Carrying Inventory	Perpetual Method	The perpetual method maintains a continuous record in the inventory account, recording inventory when items are sold.
	Periodic Method	Inventory purchases are recorded as they occur, but the ending balance in the inventory account and cost of goods sold is not determined until the end of the period after an inventory count is taken.
Pricing for the Inventory	Weighted Average Method	The weighted average method prices the quantity of goods in the ending inventory by multiplying the quantity by the average unit price for all goods available during period.
	Specific Identification Method	The specific identification method requires that detailed records be kept for the inventory so that each sale can be identified as pertaining to a specific purchase.
	FIFO Method	The first-in, first-out (FIFO) method assumes that goods purchased first are the goods to be sold first so that the ending inventory is priced at the latest purchase price.
	LIFO Method	The last-in, first-out (LIFO) method of inventory costing assumes that the costs of the most recent purchases are the first costs charged to cost of goods sold when the company actually sells the goods.
Estimating Inventory	Gross Profit Method	If the rate of gross profit is known, the amount of net sales for a period can be divided into two components: (1) the gross profit and (2) the cost of goods sold.
	Retail Method	The retail inventory method is widely used by the departmental stores and other types of retail business that are likely to keep periodic inventory records.



## Topic 2 : Non-current Assets

Long-term assets are relatively long-lived assets used in operating an organization, which are characterized by high economic value, many accounting periods and a wide range of forms. They may be further divided into long-term investments, fixed assets, intangible assets, deferred assets and other assets.

### 1. Plant Assets

#### (1) The Definition and Classification of Plant Assets

① **Definition.** A plant asset is an asset with a useful life of more than one year that is used in producing revenues in a business's operations. Examples of plant assets include land, land improvements, buildings, machinery and equipment, office equipment, furniture, fixtures, vehicles, leasehold improvements, and construction work-in-progress. Plant assets are also referred to as fixed assets and/or property, plant and equipment.

② **Classification.** Plant assets are often classified into the following groups:

A. **Tangible plant assets:** The term tangible denotes physical substance, as exemplified by land, a building, or a machine. This category may be subdivided into two distinct classifications.

Plant and property are subject to depreciation. These include the plant assets of limited useful life such as buildings and office equipment.

Land is the only plant asset not subject to depreciation, which has an unlimited term of existence.

B. **Intangible assets:** The term intangible assets are used to describe assets which are used in the operation of the business but no physical substance, and are noncurrent. Current assets such as accounts receivable or prepaid rent are not included in the intangible classification, even though they are lacking in physical substance.

#### (2) The Accounts of Plant Assets

① **Acquisition of plant assets.** The cost of a plant asset includes all expenditures that are reasonable and necessary for getting the asset to the desired location and ready for use. Thus, many incidentals may be included in the cost assigned to a plant asset. These include, for example, sales taxes on the purchase price, delivery cost and installation costs. Companies often purchase plant assets on an installment basis or by issuing a note payable. Interest charges after the asset is ready for use are recorded as interest expense, not as part of the cost of the asset. But if a company constructs a plant asset for its own use, the interest charges during the construction period are viewed as part of the asset's cost.

② *Depreciation*. Tangible plant assets, with the exception of land, are of use to a company for only a limited number of years. Depreciation, as the term is used in accounting, is the allocation of the cost of a tangible plant asset to expense in the periods in which services are received from the asset. In short, the basic purpose of depreciation is to achieve the matching principle—that is, to offset the revenue of an accounting period with the costs of the goods and services being consumed in the effort to generate that revenue. The use of a plant asset in business operations transforms a plant asset cost into an operating expense. Depreciation, then, is an operating expense resulting from the use of a depreciable plant asset. Because depreciation expense does not require a current cash outlay, it is often called a noncash expense. The purchaser gave up cash in the period when the asset was acquired, not during the periods when depreciation expense is recorded.

A. Account for depreciation. The journal entry to record depreciation expense consists of a debit to Depreciation Expense and a credit to accumulated depreciation. The credit portion of the entry removes from the balance sheet that portion of the asset's cost estimated to have been used up during the current period. The debit portion of the entry allocates this expired cost to expense.

Separate Depreciation Expense and Accumulated Depreciation accounts are maintained for different types of depreciable assets, such as factory buildings, delivery equipment, and office equipment. These separate accounts help accountants to measure separately the cost of different business activities, such as manufacturing, sales, and administration.

Plant assets are shown in the balance sheet at their book values (or carrying values). The book value of a plant asset is its cost minus the related accumulated depreciation. Accumulated depreciation is a contra-asset account, representing that portion of the asset's cost that has already been allocated to expense. Thus, book value represents the portion of the asset's cost that remains to be allocated to expense in future periods.

B. Methods of computing depreciation. Companies may choose from several available depreciation methods. Generally accepted accounting principles require only that a depreciation method result in a rational and systematic allocation of cost over the asset's useful life.

The straight-line method allocates an equal portion of depreciation expense to each period of the asset's useful life. Most of the other depreciation methods e. g. double declining balance method, are various forms of accelerated depreciation. The term accelerated depreciation means that larger amounts of depreciation are recognized in the early years of the asset's life, and smaller amount are recognized in the later years. Over the entire life of the asset, however, both the straight-line method and accelerated methods



recognize the same total amount of depreciation.

**The Straight-line Method.** Under the straight-line method, the annual depreciation expense is computed by deducting the estimated residual value (or salvage value) from the cost of the asset and dividing the remaining depreciable cost by the years of estimated useful life. The formula for calculating straight-line depreciation is:

$$\text{Depreciation per period} = \frac{\text{Asset cost} - \text{Estimated salvage value}}{\text{Number of accounting periods or estimated useful life}}$$

**Example 3-2:** On January 2, ABC Company acquires a new delivery truck. The data and the estimates needed for the computation of the annual depreciation expense are:

Cost	17,000
Estimate residual value	2,000
Estimate useful life	5 years

Using the data in our example, the annual straight-line depreciation is computed as follows:

$$\text{Depreciation per period} = (17,000 - 2,000) / 5 \text{ years} = 3,000 \text{ per year.}$$

The following schedule summarizes the effects of straight-line depreciation over the entire life of the asset:

**Exhibit 3-1 Depreciation Schedule: Straight-line Method**

Year	Computation	Depreciation expense	Accumulated depreciation	Book value
				17,000
1	$15,000 \times 1/5$	3,000	3,000	14,000
2	$15,000 \times 1/5$	3,000	6,000	11,000
3	$15,000 \times 1/5$	3,000	9,000	8,000
4	$15,000 \times 1/5$	3,000	12,000	5,000
5	$15,000 \times 1/5$	3,000	<u>15,000</u>	2,000
Total			<u>15,000</u>	

**The Double-declining-balance Method.** By far the most widely used accelerated depreciation method is called double-declining-balance method. Under the declining-balance (DDB) method of computing periodic depreciation charges begin by calculating the straight-line depreciation rate. To do this, divide 100 per cent by the number of years of useful life of the asset. Then, multiply this rate by 2.

Using the data of example 3-2, the annual straight-line depreciation is computed as follows:  $(100\% / 5 \text{ years}) = 20\%$  are the straight-line rate and  $20\% \times 2 = 40\%$  is the double declining balance rate for this situation. Next, apply the resulting double declining balance rate to the declining book value of the asset. Ignore salvage value in making the calculations. At the point where book value is equal to the salvage value, no more depreciation is taken. The formula for DDB depreciation is:

Depreciation per period =  $2 \times (\text{Straight-Line rate}) \times (\text{Asset cost} - \text{Accumulated depreciation})$

**Exhibit 3-2 Depreciation Schedule: Double-declining Method**

Year	Computation	Depreciation expense	Accumulated depreciation	Book value
				17,000
1	$17,000 \times 40\%$	6,800	6,800	10,200
2	$10,200 \times 40\%$	4,080	10,880	6,120
3	$6,120 \times 40\%$	2,448	13,328	3,672
4	$3,672 \times 40\%$	1,469	14,797	2,203
5	$2,203 \times 40\%$	203	<u>15,000</u>	2,000
Total			<u>15,000</u>	

Notice that the estimated residual value of the delivery truck does not enter into the computation of depreciation expense until the very end. This is because the DDB method provides an automatic residual value. As long as each year's depreciation expense is equal to only a portion of the undepreciated cost of the asset, the asset will never be entirely written off. However, if the asset has a significant residual value and is continued in service, depreciation should only be recorded until the asset's book value equals its estimated salvage value. By limiting the last year depreciation expense in this manner, the book value of the truck at the end of the fifth year will be equal to its \$2,000 estimated residual value.

**Disposal.** All plant assets except land eventually wear out or become inadequate or obsolete and must be sold, retired, or traded for new assets. When disposing of a plant asset, a company must remove both the asset's cost and accumulated depreciation from the accounts. Overall, then, all plant asset disposals have the following steps in common:

- Bring the asset's depreciation up to date.
- Record the disposal by:
  - A. Writing off the asset's cost.
  - B. Writing off the accumulated depreciation.
  - C. Recording any consideration (usually cash) received or paid or to be received or paid.
  - D. Recording the gain or loss, if any.

## 2. Intangible Assets

### (1) Definition of Intangible Assets

An intangible asset, like any other asset, has value because of certain rights and privileges conferred by law upon the owner of the asset. However, an intangible asset has no material or physical substance as do tangible assets. Thus, intangible assets are

characterized by their lack of physical substance and the special rights that ownership confers. Examples of intangible assets are patents, copyrights, franchise, licenses, trademarks, and goodwill. The acquisition of intangible asset usually requires the expenditure of resources. The cost of an intangible asset should be measured and recorded in the accounts and reported on the financial statements of the entity in the same way as a tangible asset.

#### (2) The Accounting of Intangible Assets

At acquisition, an intangible asset is recorded at its cash equivalent cost in accordance with the cost principle. Cost is defined as the sum of all expenditures made to acquire the rights and privileges. Each type of intangible asset should be recorded in a separate asset account when acquired.

### 3. Long-term Investment

#### (1) The Definition of Long-term Investment

Investments that are not intended as a ready source of cash in the normal operations business are as long-term investments. A business may make long-term investment simply because it has cash that it cannot use in its normal operations. A corporation may invest in another corporation by acquiring either equity securities (preferred and common shares) or debt securities (bonds and notes) in order to earn a return on idle cash or obtain influence or control over the other corporation.

#### (2) The Accounting of Long-term Investment

① *Measuring and reporting investments in common shares*. Accounting for long-term investments in voting common shares involves measuring the investment amount that should be reported on the balance sheet and the periodic investment revenue that should be reported on the income statement. In accordance with the cost principle, long-term investments are measured and recorded at the date of acquisition of the shares, at the total consideration given to acquire them. This total includes not only the amount paid to the seller but also other costs related to the purchase, such as brokers' commission and postage charges for delivery. There are two methods of accounting for long-term investments in stock: Cost method and Equity method.

The method used depends upon whether the investor owns enough of the voting stock of the investee (company whose stock is owned by the investor) to have a significant influence over its operating and financing policies. If an investor owns 20% or more of the voting stock of an investee, it should lead to a presumption that the investor has the ability to exercise significant influence over the investee. Then equity method must be used. Conversely, an investment of less than 20% of the voting stock of an investee should lead to a presumption that an investor does not have the ability to exercise significant influence unless such ability can be demonstrated. That directs cost method must be used.

Cost method: Under the cost method, the investment is measured at the acquisition date in the accounts in accordance with the cost principles. Subsequent to acquisition, the investment amount is measured at the current lower of cost or market value, and this amount is reported on the balance sheet under the caption “investments”. Cash dividends declared by the investee corporation are reported by the investing entity as “revenue from investments” in the period declared.

Equity method: When the equity method of accounting is used, a purchase is recorded at cost value under the cost method.

- ② *Measuring and reporting bond investments*. Investors may buy bonds at their date of issuance or at subsequent dates during the life of the bonds. Regardless of the timing of the bonds acquisition at the end of each accounting period, the investor must measure the cost adjusted for the cumulative amount of discount or premium that has been amortized, and interest revenue earned.

At the date of acquisition, a bond investment is measured, recorded and reported in accordance with the cost principle. The purchase cost, including all incidental acquisition cost (such as transfer fees and broker commissions) is debited to an investment account (such as “Long-term Investment ABC Co. bonds”). The amount recorded under the cost principle is the equivalent amount and it may be the same as the maturity amount (if acquired at par), less than the maturity amount (if acquired discount), or more than the maturity amount (if acquired at premium). The premium or discount on a bond investment usually is not recorded in a separate account as it is done for bonds payable; rather, the investment account reflects the current book or carrying amount.

If the bond investment was acquired at par maturity value, the carrying value amount remains constant over the life of the investment. In this situation, revenue earned from the investment of each period is measured as the amount of cash interest collected (or accrued).

When a bond investment is purchased at a discount or premium, measurement of the carrying value of the investment after date of acquisition necessitates the adjustment of the investment account balance from acquisition cost to maturity amount each period over the life of the investment. This adjustment is the periodic amortization of the discount or premium. The period amortization is made as a debit or credit to the investment account, depending on whether there was a discount or premium at acquisition, so that the investment account at the end of each period reflects the current carrying amount.

When a bond investment is acquired at a discount or premium value, the revenue from interest of each period is measured as the cash interest collected (or accrued) plus or minus the periodic amortization of discount or premium. Bond discount or premium may be amortized by using either straight-line or effective-interest method.

## Core Words and Expressions

accelerated amortization 累计摊销

accounts receivable 应收账款

balance sheet 资产负债表

loss from uncollectible accounts 坏账损失

uncollectible accounts expense 坏账费用

accelerated depletion 累计损耗

accumulated depreciation 累计折旧

bank reconciliation 银行往来调节表

long-term investment 长期投资

## More Knowledge

- ◎ **Equity method.** 权益法,是适用于长期股权投资的一种会计核算方法。投资企业要按照其在被投资企业拥有的权益比例和被投资企业净资产的变化来调整“长期股权投资”账户的账面价值。如果收到被投资企业发放的股利(不包括股票股利),投资企业要冲减投资账户的账面价值。
- ◎ **Direct write-off method.** 直接转销法,是指在实际发生坏账时,将坏账损失直接计入期间费用,同时冲销应收账款。在直接转销法下,企业不需设置“坏账准备”科目。当坏账损失实际发生时,直接按其损失金额借记“管理费用—坏账损失”科目,同时冲减已确认为坏账的应收账款,贷记“应收账款”科目。如果已冲销的应收账款以后又收回时,则应借记“应收账款”科目,贷记“管理费用—坏账损失”科目,以恢复企业债权并冲减管理费用,然后借记“银行存款”科目,贷记“应收账款”科目,以反映账款收回的情况。
- ◎ **First-in, first-out method.** 先进先出法,是指根据先入库先发出的原则,对于发出的存货以先入库存货的单价计算发出存货成本的方法。先按存货的期初余额的单价计算发出的存货的成本,领发完毕后,再按第一批入库的存货的单价计算,依此从前向后类推,计算发出存货和结转存货的成本。
- ◎ **Last-in, first-out method.** 后进先出法,是根据后购入的商品先领用或发出的假定计价的,即先买进来的后卖出去。在物价波动较大的情况下,存货额与市价偏离较大,不能反映当时存货的实际成本。但计入销货或生产成本的价格较接近市价,与当期销售收入相配比,较能反映当时损益水平。
- ◎ **Low-of-cost-or-market method.** 成本与市价孰低法,是指按短期投资的总成本与总市价孰低计算提取跌价损失准备的方法。存货的市价低于成本的按市价计价,要求将存货因市价下跌而形成的损失计入当期损益,而对于存货因市价上涨而形成的收益不予预计,最明显地体现了稳健性原则。

## Discussion Questions

1. Why are investments in marketable securities usually regarded as current assets?
2. In making the annual adjusting entry for uncollectible accounts, a company may utilize a balance sheet approach to make the estimate or it may use an income statement approach. Explain these two alternative approaches.
3. Which inventory valuation method should a company use if it wants to minimize

income taxes? Does your response depend on whether prices are rising or falling? Explain your answers.

4. What are the advantages by using the retail method to estimate inventories?

5. Should depreciation continue to be recorded on a building when ample evidence exists that the current market value is greater than original cost and that the rising trend of market value is continuing? Explain.

### Exercises

1. In general terms, financial assets appear in the balance sheet at \_\_\_\_.

- A. face value
- B. current value
- C. market value
- D. estimated future sales value

2. On January 1, CL Company had a \$3,100 credit balance in the allowance for doubtful accounts. During the year, sales totaled \$78,000 and \$6,900 of accounts receivable were written off as uncollectible. A December 31 aging of accounts receivable indicated the amount probably uncollectible to be \$5,300. (No recoveries of accounts previously written off were made during the year.) CL Company's financial statements for the current year should include \_\_\_\_.

- A. uncollectible accounts expense of \$9,100
- B. uncollectible accounts expense of \$5,300
- C. allowance for doubtful accounts with a credit balance of \$1,500
- D. allowance for doubtful accounts with a credit balance of \$8,400

3. Why do companies prefer the LIFO inventory method during a period of rising prices?

- A. Higher reported income.
- B. Lower income taxes.
- C. Lower reported income.
- D. Higher ending inventory.

4. Which of the following statements is true?

A. Separation of duties is not an important element of internal control for inventories.  
 B. The perpetual system is used primarily for low-unit-cost inventory.  
 C. An annual physical count of inventory is needed regardless of the type of inventory system used.

- D. All the above are true.

## Chapter 4

# Liability

### Mini Case

Recently, ABC Company wants to develop a new project, with \$1,500,000 of additional funds. However, the local banks were unwilling to provide the loans. The following is a conversation between Benson, the chief executive of ABC Company, and Aaron, the leading researcher, to discuss about that loan.

**Benson:** “I really can’t understand the bank. Why don’t they want to lend money to us?”

**Aaron:** “Because they think maybe we lack sufficient collateral, so they don’t want to take the risk.”

**Benson:** “If the banks won’t lend us any more money and we’ve got to have \$1.5 million to complete the project, what will happen then? We are so close! It would be a disaster to quit now. The only thing I can think of is to issue additional bonds. Do you have any suggestions?”

**Aaron:** “I guess you’re right. But if the banks won’t lend us any more money, how do you think we can find any investors to buy bonds?”

**Benson:** “I’ve been thinking about that. What if we sell the bonds which have the coupon rate of above the market rate of interest? And we could promise the investors that we will pay them 2 % of net sales as interest?”

**Aaron:** “Yeah, maybe it could work.”

**Identify:**

1. ABC Company wants to sell bonds to raise money, do you agree with this plan?
2. If you were the chief executive, what will you do to deal with the capital insufficiency problem?

## Learning Objectives

**After studying Chapter 4, you should be able to:**

1. Explain the definition of liabilities.
2. Understand the different categories of liabilities.
3. Identify current liability and non-current liability.
4. Explain the terms accounts payable and notes payable.
5. Understand the typical characteristics of bonds.
6. Describe the process of issuance of bonds.



## Topic 1 : Current Liability

In accounting terms, liability describes an obligation, which is defined by Financial Accounting Standard Board (FASB) as “probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events”.

The board states that an obligation must have three characteristics to be reported as a liability: the obligation must involve a future sacrifice of cash, goods, of services; it must be an obligation of the enterprise; the transaction or event giving rise to the enterprise’s obligation must already have occurred.

When preparing a balance sheet, liabilities are classified as either current or long-term. Current liabilities are amounts payable within one year from the date of the balance sheet or within the normal operating cycle, where this is longer in a year. The time dimension that applies to current assets also generally applies to current liabilities.

Among the most common example of current liabilities are accounts payable, short-term notes payable, current portion of long-term debt, accrued liabilities, unearned revenue and contingent liability.



### 1. Accounts Payable

Accounts payable refer to oral or implied promises to pay later and they are the most commonly seen current liabilities. They represent balances owed to outsiders from goods, supplies and services purchased on open account. Accounts payable arise if there is a long time lag between the receipt of services or acquisition of title to assets and the payment for them. At first the satisfactory internal control over accounts payable is essential for the segregation of duties so that a cash disbursement to a creditor will be made only after approval of the purchasing, receiving, accounting, and finance department. All purchase orders, copies of invoices which are sent to the accounts payable department for



comparison with receiving reports and vendors' invoices.

Accounts payable usually don't require the payment of interest. This makes the form of liability very desirable; it represents an "interest-free" loan from the supplier.

**Example 4-1:** Assume that on November 1, a company borrowed \$10,000 from its bank for a period of six months at an annual interest rate of 12 percent. Six months later, on May 1, the company will have to pay the bank the principal amount of \$10,000 plus \$600 interest ( $\$10,000 \times 12\% \times 6/12$ ).

If the company purchased office supplies from supplier on account, invoice for a total of \$10,000. The sum of the amounts company owed to suppliers is listed as a current liability on the company's balance sheet. The journal entry should record in the company's purchases journal as follows:

Office supplies	10,000
Accounts payable	\$10,000

When the company paid the bill, it should be recorded in the cash disbursement journal as follows:

Accounts payable	10,000
Cash	10,000

Company should keep an accounts payable ledger account for each supplier. The accounts payable ledger is a record of what you owe to each vendor. The general ledger contains an accounts payable account, which is called accounts payable control account. The cash disbursements journal has accounts payable of credit and debit columns. Credit purchases and payments on account are entered in these two columns respectively. At the end of the month, they are totaled and posted to the control account in the general ledger.

## 2. Notes Payable

A note (also called a promissory note) is an unconditional written promise by a borrower (maker) to pay a definite sum of money to the lender (payee) on demand or on a specific date. On the balance sheet of the lender (payee), a note is a receivable; on the balance sheet of the borrower (maker), a note is a payable. Since the note is usually negotiable, the payee may transfer it to another party, who then receives payment from the maker and notes payable may be either interest-bearing or non-interest-bearing. On the other hand, current notes payable are normally trade notes payable which are current obligations to suppliers for which there are written promissory notes (it is operating activity). In China, notes payable are just trade notes payable. Business firms borrow funds from banks or other lenders frequently by signing an agreement and that is called short-term loan rather than notes payable in Chinese practice.

In theory, notes payable should be recorded at the present value of the cash outflows (payments of principal and interest) associated with the note. If they are not recorded at present value, the liability reported in the balance sheet will be overstated, and interest expense reported in the income statement will be understated. The generally accepted

practice is to report all trade notes payable at its face amount, because the dollar amount and the relatively short duration of such notes make the difference immaterial between its face amount and its present value.

Example 4-2: Assume that on November 1, X Company borrows \$10,000 from its bank for a period of six months at an annual interest rate of 12%. Six months later on May 1, X Company will have to pay the bank a principal amount of \$10,000 plus \$100 interest per month for those six months. As evidence of this loan, the bank will require X Company to issue a note payable. The journal entry in X Company's accounting records for this Nov. 1 borrowing is:

Cash	10,000
Notes payable	10,000

Notice that no liability is recorded for the interest charges when the note is issued. At the issuing date that money is borrowed, the borrower has a liability only for a principal amount of the loan; the liability for the interest accrues day by day over the life of the loan. At Dec. 31, two months' interest expense has been incurred and the following year-end adjusting entry is made:

Interest expense	200
Interest payable	200

The entry on May 1, to record payment of the note after the end of six months will be:

Notes payable	10,000
Interest payable	200
Interest expense	400
Cash	10,600

### 3. Short-term Loan

Short-term loans usually arise from cash loans and are generally payable to banks or loan companies. It is financing activities in cash flow statement. In most cases, the life of a note is somewhere between thirty days and one year and the bank or loan company lends the borrowing company less cash than is indicated on the face of the note. At the maturity date (when the loan is due), the borrowing company pays the lending institution the face amount of the note. The differences between the face amount and the amount of the loan are treated as interest.

Example 4-3: Suppose that on October 1, X Company borrows \$100,000 from the bank and signs a three-month note with a face amount of \$104,000. The journal entry to record this transaction is provided below.

Cash	100,000
Discount on notes payable	4,000
Notes payable	104,000

The discount on notes payable account serves as a contra account to notes payable on

the balance sheet and represents interest that is not yet owed but will be recognized in the future. Assuming that financial statements are prepared monthly, one-third of the discount would be converted to interest expense each month by an adjusting entry of the following form:

Interest expense	1,000
Discount on notes payable	1,000

#### 4. Current Maturities of Long-term Debt

Companies often have a portion of long-term debt that becomes due in the current year. Companies often identify current maturities of long-term debt on the balance sheet as long-term debt due within one year. It is not necessary to prepare an adjusting entry to recognize the current maturity of long-term debt. At the balance sheet date, all obligations due within one year are classified as current and the remaining obligations are classified as long-term. Changing the classification of a liability does not require a journal entry; the obligation merely is shown in a different section of the balance sheet.

**Example 4-4:** Assume that X Company issues a 5-year interest-bearing \$35,000 note on January 1, 2016. From 2017, every year January 1, \$5,000 of the note is due to be paid. When financial statements are prepared on December 31, 2016; \$5,000 should be reported as a current liability. The remaining \$30,000 on the note would be reported as a long-term liability.

#### 5. Accrued Liability

Accrued liabilities arise from the recognition of expenses for which payment will be made in a future period. Thus, accrued liabilities are also called accrued expenses. The need to record accrued liabilities arises from the fact that certain expenses are incurred by the business before they are actually paid. All companies incur accrued liabilities. In most cases, however, these liabilities are paid at frequent intervals. Therefore they usually do not accumulate to large amounts.

##### (1) Interest Payable

Interest payable is the amount of interest on its debt and capital leases that a company owes to its lenders and lease providers as of the balance sheet date. This amount can be a crucial part of a financial statement analysis, if the amount of interest payable is greater than the normal amount—it indicates that a business is defaulting on its debt obligations. Remember, liabilities arise from the past transaction. Therefore, the only interest obligation which represents a “liability” is the unpaid interest which has already been accrued.

**Example 4-5:** A business owes \$1,000,000 to a lender at a 6% interest rate, and pays interest to the lender every quarter. After one month, the company accrues interest expense of \$5,000, which is recorded as a debit to the interest expense account and a credit to the interest payable account. After the second month, the company records the

same entry, bringing the interest payable account balance to \$10,000. After the third month, the company again records this entry, bringing the total balance in the interest payable account to \$15,000. It then pays the interest, which brings the balance in the interest payable account to zero.

The first month	Interest expense	5,000
	Interest payable	5,000
The second month	Interest expense	10,000
	Interest payable	10,000
The third month	Interest payable	15,000
	Cash	15,000

### (2) Income Taxes Payable

The income tax payable is usually classified as a current liability in the balance sheet, since it is normally payable to the applicable government(s) within one year. Income tax payable is a liability that an entity incurs that is based on its reported level of profitability. The tax can be payable to a variety of governments. Once the organization pays the income tax, the liability is eliminated. As an alternative to payment, the income tax liability can be reduced through the application of offsetting tax credits granted by the applicable government entity. Since tax credits typically expire after a period of time, one must pay close attention to which ones are available and can be applied to an income tax payable.

Example 4-6: If X International Company has \$100,000 of before-tax profits, and the government imposes a 25% income tax, then X should record tax payable as follows:

Income tax expense account	25,000
Income tax payable account	25,000

When X later pays the tax, it debits the income tax payable account for \$25,000, and credits the cash account for \$25,000.

The amount of income tax payable is not necessarily based solely on the accounting profit reported by a business. There may be a number of adjustments allowed by the government that alters the accounting profit to result in a taxable profit, against which the income tax rate is then applied. These adjustments can result in timing differences between the recognition of profits for accounting and tax reporting that can, in turn, create differences in the amount of income tax payable (as calculated on a tax return) and the income tax expense reported in a company's income statement.

For example, governments typically allow the use of accelerated depreciation for the purposes of calculating income taxes, which tends to delay the payment of taxes to a later period. This varies from the more common straight-line depreciation used by businesses for all other reporting purposes. The result is a timing differences between the recognition of income for financial and tax reporting purposes.

### (3) Payroll Accounting

Every business incurs a number of accrued liabilities relating to its payroll. The largest

of these liabilities is the obligation to pay employees for services rendered during the period. Payroll expense often is among the largest expenses of a business organization. Accrued payroll liabilities, however, seldom accumulate to large amounts because they are paid at frequent intervals.

The primary journal entry for payroll is the summary-level entry that is compiled from the payroll register, and which is recorded in either the payroll journal or the general ledger. This entry usually includes debits for the direct labor expense, salaries, and the company's portion of payroll taxes. There will also be credits to a number of accounts, each one detailing the liability for payroll taxes that have not been paid, as well as for the amount of cash already paid to employees for their net pay.

## 6. Unearned Revenue

Unearned revenue arises when a seller has received a payment, but has not yet shipped goods or provided services to the buyer. Unearned revenue is typically considered a short-term liability account, since the amounts stored in it are usually settled within 12 months, in which is stored all payments from customers for goods or services that have not yet been delivered. Once the related goods or services have been delivered, the amount in this account is shifted to a revenue account.

**Example 4-7:** X Company provides credit evaluation service to businesses. When a company pays in advance to have X Company investigate the credit history of a potential customer, X Company collects cash incurring a liability to provide future service. The liability account is called unearned subscription revenue or unearned subscription income. Assume that X Company charges a client \$150 for a three-year subscription starts in January 1, 2014. X Company's entries would be as follows:

January 1, 2014:	Cash	150
	Unearned Subscription Revenue	150

To receive cash for a three-year subscription, X Company's assets and liabilities increase equally. There is no revenue yet. So the entry would be as follows for next two consecutive years:

	50
Unearned Subscription Revenue	50
Subscription Revenue	50

To record revenue earned at the end of each year, X Company's financial statements would report the following:

<i>Balance Sheet</i>	2014	2015	2016
Current Liabilities:			
Unearned Subscription Revenue	\$ 50	\$ 50	0
Long-term Liabilities:			
Unearned Subscription Revenue	\$ 50	0	0

(Continued)

<i>Income Statement</i>	Year 1	Year 2	Year 3
Revenue:			
Subscription Revenue	\$ 50	\$ 50	\$ 50

## 7. Contingent Liability

Various lawsuits and claims, including those involving ordinary routine litigation incidentals to its business, to which the Company is a party, are pending, or have been asserted, against the Company. A contingent liability may be regarded as a possible liability, which may develop into a full-fledged liability or may be eliminated entirely by a future event.

The Financial Accounting Standards Board (FASB) provides these guidelines to account for contingent losses (or expenses) and their related liabilities:

① Record an actual liability if it is probable that the loss (or expenses) will occur and the amount can be reasonably estimated.

② Report the contingency in a financial statement note if it is reasonably possible that a loss (or expense) will occur. Lawsuits in progress are a prime example.

③ There is no need to report a contingent loss that is remote—unlikely to occur. Instead wait until an actual transaction clears up the situation.

Contingent liabilities may be reported in a short presentation, after total liabilities on the balance sheet, but with no amounts given.

A common contingent liability is the possibility of loss relating to a lawsuit filed against a company. Until the lawsuit is resolved, uncertainty exists as to the amount, if any, of the company's liability. Central to the definition of a contingent liability is the element of uncertainty—uncertainty both as to the amount of loss and whether, in fact, a loss actually has occurred.

Example 4-8: X Company is involved in a lawsuit at December 31, 2016. (a) Prepare the entry assuming it is probable that Justice League will be liable for \$ 700,000 as a result of this suit. (b) Prepare the entry, if any, assuming it is not probable that Justice League will be liable for any payment as a result of this suit.

(a) Lawsuit loss	700,000
Lawsuit liability	700,000

(b) No entry is necessary. The loss is not accrued because it is not probable that a liability has been incurred on December 31, 2016.



## Topic 2 : Non-current Liability

Non-current liabilities are those obligations that are not due for settlement within one year. These liabilities are separately classified in an entity's balance sheet, away from current liabilities. The major portion of non-current liabilities consists of long-term portion of bonds payable and long-term portion of debt payable.

### 1. Bonds Payable

#### (1) The Basic Concepts of Bonds

A bond is a fixed obligation to pay that is issued by a corporation or government entity to investors. Bonds are used to raise cash for operational or infrastructure projects.

Bonds payable are a liability account that contains the amount owed to bond holders by the issuer. This account typically appears within the long-term liabilities section of the balance sheet, since bonds typically mature in more than one year. If they mature within one year, then the line item instead appears within the current liabilities section of the balance sheet.

Terms of bonds payable are contained within a bond indenture agreement, which states the face amount of the bonds, the interest rate to be paid to bond holders, special repayment terms, and any covenants imposed on the issuing entity.

#### (2) Types of Bonds

- ① **Registered Bond.** A registered bond is a bond for which the issuing entity maintains a list of the owners. A registered bond may state the name of its owner on its face, and is only transferable with the owner's endorsement. This approach is useful for the issuer, since it can send dividend payments to bond owners based on its internal records.
- ② **Coupon Bond.** A coupon bond, also known as a bearer bond, is unregistered, so the issuing entity has an obligation to pay interest and principal to whomever holds the bond. That is, the bond holder is presumed to be its owner. The issuer does not maintain a record of who is holding each outstanding bond certificate.
- ③ **Term Bond.** A term bond is one of a group of bonds that all share the same maturity date. This approach is usually taken by the issuer to maximize its use of investor cash. Conversely, if the issuer had sold serial bonds, it would instead have to pay back some of the bonds at an earlier date, thereby reducing the period over which it could use the cash.
- ④ **Serial Bond.** A serial bond is a bond issuance where a portion of the total number of bonds is paid off each year. This results in a gradual decline in the total amount of the issuer's debt outstanding. Serial bond is designed to support the financing

needs of a capital project that delivers a steady stream of funds to pay down the debt over time.

- ⑤ **Convertible Bond.** A convertible bond is a bond that can be converted to stock using a pre-determined conversion ratio. The conversion option is usually available only at set intervals, and conversion is at the discretion of the bondholder. The presence of conversion rights typically reduces the interest cost of such a bond, since investors assign some value to the conversion privilege.
- ⑥ **Callable Bond.** A callable bond is a bond that can be redeemed by its issuer before the maturity date. The issuer will usually only redeem a bond when interest rates fall, so that it can issue replacement bonds at a lower interest rate, thereby reducing its interest expense.
- ⑦ **Secured Bond.** A secured bond is a debt instrument that is backed by collateral. If the issuer defaults on bond payments, this means that title to the underlying assets will be passed to the bond holders. Examples of these assets are production equipment and real estate. The assets should have useful lives at least as long as the duration of the bonds.
- ⑧ **Debenture Bond.** A debenture bond is a bond that is not secured by any assets of the issuer. Instead, the bond is only backed by the reputation and integrity of the issuer. This type of bond typically carries a higher rate of interest than a secured bond, to compensate investors for the increased risk of not having their funds repaid.

(3) Bonds Issued

- ① **Bonds Issued at Face Amount.** If the coupon rate of a bond coincides with the market rate of interest when the bonds are actually sold to investors, then the bonds will sell at face value. The market value of a bond is equal to the present value of all the future cash payments promised by the bond. The process of finding the present value is referred to as discounting the future amounts. When a bond is issued at its face amount, the issuer receives cash from the buyers of the bonds (investors) and records a liability for the bonds issued. The liability is recorded because the issuer is now liable to pay back the bond. The entry is:

Cash	×××
Bonds payable	×××

Example 4-9: Three-year bonds are issued at face value of \$100,000 on January 1, 2014, a stated interest rate of 8%, and market rate of 8%. Prepare a bond amortization schedule and necessary journal entries.

Date	Cash Paid	Interest Expense	Carrying Amount
1/1/14			\$ 100,000
12/31/15	\$ 8,000	\$ 8,000	100,000



(Continued)

Date	Cash Paid	Interest Expense	Carrying Amount
12/31/16	8,000	8,000	100,000
12/31/17	8,000	8,000	100,000

Stated rate=8%. Market rate=8%. Journal entries for 2014:

January 1, 2014	Cash	100,000
	Bonds payable	100,000
December 31, 2014	Interest expense	8,000
	Cash	8,000

② *Bonds Issued at Discount*. Bond issued at discount is either a bond that was originally sold at less than its face value, or which now trades at a price below its face value (or both). A bond sells at a discount to its face value for one of the following reasons:

- A. Interest rate differential. The current market interest rate is higher than the interest rate being paid by the issuer, so investors pay less for the bond in order to derive a higher effective interest rate on their investment.
- B. Default risk. Investors perceive the issuer as being at risk of not redeeming the bonds it has issued, and so are willing to sell their bonds at a reduced price in order to avoid the risk of default.
- C. Credit rating reduction. When a bond rating agency reduces the credit rating of an issuer, this can trigger a high volume of selling by investors on the secondary market, which lowers the price of a bond; this is a similar issue to the preceding default risk comment.

Example 4-10: Three-year bonds are issued at face value of \$100,000 on January 1, 2015, and a stated interest rate of 8%. Calculate the issue price of the bonds assuming a market interest rate of 10%. Prepare a bond amortization schedule and necessary journal entries.

Market Rate 10% (Present value factor for 3 periods at 10%)					
Principal	\$ 100,000	×	0.75132	=	\$ 75,132
Interest	8,000	×	2.48685	=	19,895
			Present value		95,027
			Face value		100,000
			Discount		\$ (4,973) *

**Bond Amortization Schedule**

Date	8% Cash Paid	10% Interest Expense	Discount Amortized	Carrying Amount
1/1/15				\$ 95,027
12/31/15	\$ 8,000	\$ 9,503	\$ 1,503	\$ 96,530
12/31/16	8,000	9,653	1,653	98,183
12/31/17	8,000	9,817	1,817	100,000

Stated rate=8%. Market rate=10%. Journal entries for 2015:

January 1, 2015	Cash	95,027
	Discount on bonds payable	4,973
	Bonds payable	100,000
December 31, 2015	Interest expense	9,503
	Discount on bonds payable	1,503
	Cash	8,000

③ *Bonds Issued at Premium*. Bonds issued at premium are the excess amount by which bonds are issued over their face value. This is classified as a liability, and is amortized to interest expense over the remaining life of the bonds. In this case, investors are willing to pay extra for the bond, which creates a premium, because the stated interest rate is higher than the market interest rate. They will pay more in order to create an effective interest rate that matches the market rate.

Example 4-11: Three-year bonds are issued at face value of \$100,000 on January 1, 2015, and a stated interest rate of 8%. Calculate the issue price of the bonds assuming a market interest rate of 6%. Prepare a bond amortization schedule and necessary journal entries.

Market Rate 6% (Present value factor for 3 periods at 6%)					
Principal	\$ 100,000	×	0. 83962	=	\$ 83,962
Interest	8,000	×	2. 67301	=	21,384
Present value					105,346
Face value					100,000
Premium					\$ 5,346

Bond Amortization Schedule

Date	8% Cash Paid	6% Interest Expense	Discount Amortized	Carrying Amount
1/1/15				\$ 95,027
12/31/15	\$ 8,000	\$ 6,321	\$ 1,679	\$ 105,346
12/31/16	8,000	6,220	1,780	101,887
12/31/17	8,000	6,113	1,887	100,000

Stated rate=8%. Market rate=6%. Journal entries for 2015:

January 1, 2015	Cash	105,346
	Premium on bonds payable	5,346
	Bonds payable	100,000
December 31, 2015	Interest expense	6,321
	Premium on bonds payable	1,679
	Cash	8,000

④ *Bonds Retirement or Redemption.* When bonds are retired, the retirement is recorded by a debit to bonds payable and a credit to cash. The bonds discount or premium will have been completely amortized by the maturity date so no additional entry is required for discount or premium at that time.

If the bonds are callable bonds, they are redeemable by the issuing corporation within the period of time and at the price stated in the bond indenture. Usually the call price is above the face value. If the market interest rate declines after the issuance of the bond, the corporation may sell new bonds at a lower interest rate and use the funds to redeem the original issue. This activity may save the cost of issuing bonds. The reduction of future interest expense is always an incentive to bond redemption. A corporation may also redeem all or a portion of its bonds before maturity by purchasing them in the open market.

Example 4-12: Three-year 8% bonds of \$100,000 issued on January 1, 2016, are recalled on December 31, 2013. Expenses of recall are \$2,000. Market interest on issue date was 10%. Prepare a bond amortization schedule and necessary journal entries.

Bond Amortization Schedule

Date	8%	10%		
	Cash	Interest	Discount	Carrying
	Paid	Expense	Amortized	Amount
1/1/16				\$ 95,027
12/31/16	\$ 8,000	\$ 9,503	\$ 1,503	\$ 96,530
12/31/17	8,000	9,653	1,653	98,183

Account Balances on Dec. 31, 2017:

Bonds payable = \$ 98,183

Discount on bonds payable ( \$ 4,973 - 1,503 - 1,653 ) = 1,817

Journal entry on Dec. 31, 2013:

Bonds payable	100,000
Loss on redemption of bond	8,817
Cash	107,000
Discount on bonds payable	1,817

## 2. Long-term Notes Payable

Long-term notes payable are similar to short-term interest-bearing notes payable except that the terms of the notes exceed one year. A long-term note may be secured by a document called a mortgage that pledges title to specific assets as security for a loan.

Mortgage notes payable are widely used in the purchase of homes by individuals and in the acquisition of plant assets by many small and some large companies. When a mortgage note is issued, the borrower pledges title to specific assets as collateral for the loan. If the borrower defaults on the notes, the lender may foreclose upon these assets. Mortgage notes are usually payable in equal monthly installments. These monthly installments may continue until the loan is completely repaid, or the note may contain a “due date” at which the remaining unpaid balance of the loan must be repaid in a single, lump-sum payment. Like other long-term notes payable, the mortgage loan terms may stipulate either a fixed or an adjustable interest rate.

### Core Words and Expressions

account payable 应付账款	accrued liability 应计负债
bonds payable 应付债券	callable bond 可赎回债券
contingent liability 或有事项	convertible bond 可转换债券
coupon bond 付息债券	current liability 流动负债
current portion of long-term debt 一年内到期的长期负债	discount 折价
debenture bond 无担保债券	interest payable 应付利息
face amount 面值, 票面金额	non-current liability 非流动负债
long-term notes payable 应付长期票据	premium 溢价
payroll liability 应付薪金	secured bond 有担保债券
registered bond 记名债券	short-term notes payable 短期应付票据
serial bond 分期还本债券	
stated interest rate 票面利率	

### More Knowledge

◎ **Payroll and payroll tax.** 雇主应付给雇员的工薪是指在工薪结算期间雇员的所得, 其中应包括加班工薪。该金额减去雇员的代扣项目, 便得到实际支付给员工的净工

薪酬。工薪税是指政府对企业支付工资或薪金所征收的税。

- ◎ **Accounting system for payroll and payroll tax.** 工薪及工薪税的会计系统包括工薪登记簿、雇员所得记录及普通日记账。工薪登记簿是指企业在一定时期内,雇员工资或薪金的多栏式会计账簿。其中包括工薪总额、代扣税款、医疗和保险费等。
- ◎ **Credit rating.** 信用等级评定有专门的征信机构。信用好的公司容易以某种优惠条件取得借款或通过发行信用债券融资。信用不好的公司再融资将会受到限制。
- ◎ **Stated interest rate.** 票面利率是指在债券上标识的利率,是一年的利息与票面金额的比例。如果债券的市场价格低于其面值(当债券贴水出售时),则债券的到期收益率高于其票面利率。反之,如果债券的市场价格高于其面值(债券以升水出售时),则债券的到期收益率低于票面利率。
- ◎ **Market interest rate.** 市场利率是市场资金借贷成本的真实反映,而能够及时反映短期市场利率的指标有银行间同业拆借利率、国债回购利率等。市场利率因受到资金市场上的供求变化而经常变化。
- ◎ **Present value.** 现值指资金折算至基准年的数值,也称折现值或在用价值,是指对未来现金流量以恰当的折现率进行折现后的价值。在现值计量下,资产按照预计从其持续使用和最终处置中所产生的未来净现金流入量的折现金额计量。负债按照预计期限内需要偿还的未来净现金流出量的折现金额计量。

### Discussion Questions

1. What is the difference between current liability and non-current liability?
2. What are the common current liabilities?
3. Give examples of accounts payable and notes payable.
4. How to deal with contingent liability?
5. What are bonds? Discuss the typical characteristics of bonds.
6. How to account the bond under different methods of issuance?

### Exercises

1. A basic difference between loss contingencies and “real” liabilities is \_\_\_\_\_.
  - A. Liabilities stem from past transactions; loss contingencies stem from future events.
  - B. Liabilities always are recorded in the accounting records, whereas loss contingencies never are.
  - C. The extent of uncertainty involved.
  - D. Liabilities can be large in amount, whereas loss contingencies are immaterial.
2. Which of following is not a characteristic of corporate bonds?
  - A. A highly liquid, transferable investment.
  - B. A specified maturity date.
  - C. Represents ownership of the issuing corporation.
  - D. Pays interest, usually semi-annually.

3. The balance in the discount on bonds payable account would usually be reported in the balance sheet in the \_\_\_\_.

- A. current assets section
- B. current liabilities section
- C. long-term liabilities section
- D. investments section

4. Debenture bonds are \_\_\_\_.

- A. bonds secured by specific assets of the issuing corporation
- B. bonds that have a single maturity date
- C. issued only by the federal government
- D. issued on the general credit of the corporation and do not pledge specific assets as collateral

5. If a corporation plans to issue \$1,000,000 of 12% bonds at a time when the market rate for similar bonds is 10%, the bonds can be expected to sell at \_\_\_\_.

- A. their face amount
- B. a premium
- C. a discount
- D. a price below their face amount

6. If bonds payable account has a balance of \$500,000 and the discount on bonds payable account has a balance of \$40,000, what is the carrying amount of the bonds?

- A. \$460,000
- B. \$500,000
- C. \$540,000
- D. None of the above.

7. On June 1, 2012, Smith's Company issued \$2,000,000 of 10-year, 12% bonds interest. Interest is payable semiannually, each April 1 and October 1. The bonds are issued at par plus accrued interest for the months since April 1. The journal entry to record the issuance of the bonds includes \_\_\_\_.

- A. a debit to bond interest expense of \$40,000
- B. a debit to cash of \$2,040,000
- C. a credit to premium on bonds payable of \$40,000
- D. a credit to bond interest payable of \$80,000

8. On January 5, X Company bought office furniture from Y Company for \$15,000 on credit and agreed to pay the amount by the end of June. X Company cannot pay its \$15,000 account with Y Company on time. As an accommodation, on July 1, Y Company agrees to accept X Company's 3 months note with the face value of \$15,000 at the rate of 5%. Please write the necessary accounting entries for X Company.

9. On March 1, Lucky Travel Agency Company received \$5,000 advance payment from ABC Company for its employee training tour. By the end of March, \$3,000 has been earned by Lucky Travel Agency Company by providing tour guide service. Make the journal entry for Lucky Travel Company.

10. On the first day of the current fiscal year, \$2,000,000 of 10-year, 7% bonds, with interest payable annually, were sold for \$2,125,000. Present entries to record the following transactions for the current fiscal year:

- A. Issuance of the bonds.
- B. First annual interest payment.

C. Amortization of bond premium for the year, using the straight-line method of amortization.

11. Smith's Company issues bonds on January 1, 2012, with a principal amount of \$ 500,000, to be repaid in 5 years and a 12% coupon rate of interest payable semiannually. If the market interest rate is more than coupon rate of 12% when the bonds are issued, the issues price is \$ 482,000. Prepare journal entry to record issued bond, the payment of bond interest and the amortization of bond discount on the first date (July 1, 2012), and the maturity date of redemption of the bonds. Please write the necessary accounting entries.

## Chapter 5

# Owners' Equity

### Mini Case

ABC Company has decided to expand its operations to own and operate theme parks. The following is the conversation between the chief executive officer, Joann Hanson, and the vice-president of finance, Chris Fowler.

**Joann:** “Chris, have you given any thought to how we’re going to finance the acquisition of Water Wave Corporation?”

**Chris:** “Well, we have two basic options. We can issue either preferred stocks or bonds. The equity market is a little depressed right now. The rumor is that the PBOC (People’s Bank of China) is going to increase the interest rates either this month or next.”

**Joann:** “Yes, I’ve heard the rumor. The problem is that we can’t wait around to see what’s going to happen. We’ll have to move on this next week if we want any chance to complete the acquisition of Water Wave.”

**Chris:** “Well, the bond market is strong right now. Maybe we should issue debt around this time.”

**Joann:** “That’s what I would have guessed as well. Water Wave’s financial statements look pretty good, except for the volatility of their income and cash flows. But that is also the characteristic of their industry.”

**Identify:**

What are the advantages and disadvantages of issuing preferred stocks as well as bonds?



### Learning Objectives

**After studying this chapter, you should be able to:**

1. Identify the forms of business organization.
2. Describe the equity types in a company.
3. Understand the classification of shares in a company.
4. Apply the accounting treatments for different equities.



## **Topic 1 : Forms of Business Organization**

### **1. Sole Proprietorship**

A business owned and run by one person is called a sole or single proprietorship. Often the owner also acts as the manager. This form of business organization is common for small retail stores and service enterprises, for farms, and for professional practice in law, medicine, and public accounting. In fact, the single proprietorship is the most common form of business organization in western economy. Most of these businesses, however, tend to be relatively small.

#### (1) Characteristics of Sole Proprietorship

From a legal viewpoint, an important characteristic of the sole proprietorship is that the business and its owner are not regarded as separate entities. Thus, the owner is personally liable for the debts of the business. From an accounting viewpoint, however, a single proprietorship is regarded as an entity separate from the other affairs of its owner. The owner's personal assets, such as his house, furniture, and savings account, would not appear in the financial statements of the business.

#### (2) Advantages and Disadvantages of the Sole Proprietorship

The principal virtue of sole proprietorship is its simplicity—it is necessary only to set up a shop and begin operations. A sole proprietorship itself is not subject to taxation of income. Rather, the income or loss derived from this proprietorship is included and taxed in the personal tax return of the proprietor. The principal disadvantages of sole proprietorship are unlimited liability and limitations on size. It is not able to raise a large amount of money.

### **2. Partnerships**

A partnership is an unincorporated business that is jointly owned by two or more people. Partnerships are widely used for small businesses and professional practices, like sole proprietorship. In the case of a single proprietorship, a partnership is not legally an

entity separate from its owners; consequently, a partner is personally responsible for the debts of the partnership. From an accounting standpoint, however, a partnership is a business entity separate from the personal activities of the partners.

(1) Significant Features of a Partnership

- ① *Ease of formation*. A partnership can be created without any legal formalities. When two or more people agree to become partners, such agreement constitutes a contract and a partnership is automatically created. The contract should be in writing in order to lessen the chances of misunderstanding and future disagreement.
- ② *Limited life*. A partnership may be ended at any time by the death or withdrawal of any member of the firm. Other factors which may bring an end to a partnership include the bankruptcy or incapacity of a partner, or the completion of the project for which the partnership was formed. The admission of a new partner or the retirement of an existing member means an end to the old partnership, although the business may be continued by the formation of a new partnership.
- ③ *Mutual agency*. Each partner acts as an agent of the partnership, with authority to enter into contracts. The partnership is bound by the acts of any partner as long as these acts are within the scope of normal operations.
- ④ *Unlimited liabilities*. Each partner is personally responsible for all the debts of the firm. The lack of any ceiling on the liability of a partner may deter a wealthy person from entering a partnership.
- ⑤ *Co-ownership of partnership property and profits*. When a partner invests a building, inventory, or other property in a partnership, he or she does not retain any personal right to the assets contributed. The property becomes jointly owned by all partners. Each member of a partnership also has an ownership right in the profits.

(2) Advantages and Disadvantages of a Partnership

It is convenient to bring together sufficient capital and specialized talents to carry on a business. To form a partnership is much easier and less expensive than to organize a corporation. Members of a partnership firm enjoy more freedom from government regulation and more flexibility of action than the owners of a corporation. Operating as a partnership may in some cases produce income tax advantages compared with doing business as a corporation. The partnership itself does not have to pay income taxes as does a corporation.

Offsetting these advantages, partnership also has some serious disadvantages as limited life, unlimited liability, mutual agency, and limited ability to raise funds.

### 3. Corporations

A corporation is a legal entity having an existence separate and distinct from that of its owners. In the eyes of the law, a corporation is an artificial person having many of the rights and responsibilities of a real person. As a separate legal entity, a corporation may

own property in its own name. A corporation has legal status in court and is responsible for its own debts, and pays income taxes on its earnings.

(1) Advantages of the Corporate Form of Organization

- ① **No personal liability for stockholders.** Creditors of a corporation have claims against the assets of the corporation, not against the personal property of the stockholders. Thus, the amount of money which stockholders risk by investing in a corporation is limited to the amount of their investment.
- ② **Ease of accumulating capital.** Ownership of a corporation is evidenced by transferable shares of stock. The sale of corporate ownership in units of one or more shares permits both large and small investors to participate in ownership of the business for this reason. Large corporations are often said to be publicly owned.
- ③ **Ownership shares are readily transferable.** Shares of stock may be sold by one investor to another without dissolving or disrupting the business organization. Investments in these shares have the advantage of liquidity, because investors may easily convert their corporate ownership into cash by selling their stock.
- ④ **Continuous existence.** A corporation is a separate legal entity with a perpetual existence. The continuous life of the corporation despite changes in ownership is made possible by the issuance of transferable shares of stock. The continuity of the corporate entity is essential to most large-scale business activities.
- ⑤ **Professional management.** The stockholders own the corporation, but they do not manage it on a daily basis. To administer the affairs of the corporation, the stockholders elect a board of directors. The directors, in turn, hire a president and other corporate officers to manage the business.

(2) Disadvantages of the Corporate Form of Organization

- ① **Heavy taxation.** The income of a corporation is subject to income taxes which must be paid by the corporation. If a corporation distributes its earnings to stockholders, the stockholders must pay personal income taxes on the amounts they receive. The practice of taxing corporate income to the corporation first and then taxing distributions of the income to the stockholders is sometimes called double taxation.
- ② **Greater regulation.** A corporation comes into existence under the terms of state laws and these same laws may provide for considerable regulation of the corporation's activities. Securities and Exchange Commission (SEC) requires large corporations to make extensive public disclosure of their affairs.
- ③ **Separation of ownership and control.** The separation of the functions of ownership and management may be an advantage in some cases but a disadvantage in others. On the whole, the excellent record of growth and earnings in most large corporations indicates that the separation of ownership and control has benefited rather than injured stockholders. However, management might choose to operate a

corporation for the benefit of insiders. The stockholders may find it difficult in such cases to take the rigorous action necessary to exile the managers.

## **Topic 2: Equity in Company**

Accounting for a company is similar in most respects to accounting for a sole trader or partnership. The income statement and the asset and liability sections of the statement of financial position are essentially the same for all forms of business organization. There is a major difference, however, in accounting for equity.

The equity of a typical company is split into three major categories: paid-in capital (also called contributed capital), retained earnings, and other reserves.

### **1. Paid-in Capital**

Paid-in capital is an equity account representing the amount of assets invested in the company by its shareholders. When a company is set up for the first time, it issues shares, which are paid for by investors, who then become shareholders of the company. Shares are denominated in units of \$1. The face value of the shares is called their par value or legal value (or sometimes the nominal value). A distinction must be made between authorized, issued, called-up and paid-up share capital before we move further.

- ① **Authorized (or legal) capital.** It is the maximum amount of share capital that a company is empowered to issue. The amount of authorized share capital varies from company to company, and can change by agreement. For example, a company's authorized share capital might be 5,000,000 ordinary shares of \$1 each. This would be the maximum number of shares it could issue, unless the maximum were to be changed by agreement.
- ② **Issued capital.** It is the par value of share capital that has been issued to stockholders. The amount of issued capital cannot exceed the amount of authorized capital. Continuing the example above, the company with authorized stock capital of 5,000,000 ordinary shares of \$1 might have issued 4,000,000 shares. This would leave it the option to issue 1,000,000 more shares at some time in future. When share capital is issued, shares are allotted to stockholders.
- ③ **Called-up capital.** When shares are issued, or allotted, a company does not always expect to be paid the full amount for the shares at once. It might instead call up only a part of the issue price, and wait until a later time before it calls up the remainder. For example, if a company allocates 400,000 ordinary shares, it might call up only. The issued share capital would be \$400,000, but the called-up share capital would only be \$300,000.
- ④ **Paid-up capital.** When capital is called up, some stockholders might delay their

payment (or even default on payment). Paid-up capital is the amount of called-up capital that has been paid. In China, we use legal capital system. Legal capital is specified in China as the par value of the authorized shares. In China, issued shares should equal to the authorized shares. Maintenance of legal capital means that a company must refrain from paying dividends when their effect would be to impair legal capital.

## 2. Retained Earnings

After a period of time, where a company has been generating profits, the stockholders' equity will include retained earnings. Retained earnings are a special type of reserve account which reflects the amount of profits (after tax) earned by the company and retained in the business. Thus, retained earnings represent a company's accumulated net income that has not been distributed to stockholders as dividends. This is the most significant reserve and is variously described, such as revenue reserve, retained profits, accumulated profits, undistributed profit, or inappropriate profits.

## 3. Other Reserves

Other reserves represent another element of stockholders' equity recorded separately from retained earnings and capital. They are another category of equity created as a result of the application of generally accepted accounting practice or under accounting standards. Retained earnings are regarded as a subcategory of reserves.

Some reserves are created by transferring to them some part of retained earnings, in order to identify the retention with a particular purpose such as an asset replacement reserve. This does not provide cash for replacement—it merely identifies the reserve as not being available to fund distributions to stockholders. Creating a reserve by transferring retained earnings does not affect the aggregate of the stockholders' interest.

Other reserves may arise from unrealized gains—such as from revaluation of property. A revaluation reserve (also called revaluation surplus) is created by revaluing upwards an asset (usually property) and showing the amount of the revaluation gain as a reserve. This is non-distributable as it represents unrealized profits on the revalued assets. The relevant part of a revaluation surplus can only become realized if the asset in question is sold or consumed, thus realizing the gain. The revaluation surplus may fall, however, if an asset which had previously been revalued upwards, suffered a fall in value in the next revaluation.



## **Topic 3: Classification of Shares**

The owners of a company are called stockholders (also shareholders). In many small

companies, there are only one or two stockholders. But in large companies, such as IBM, there are literally millions of stockholders. The shares of capital stock of large publicly held companies trade on organized stock exchanges.

## 1. Ordinary Shares

Ordinary shares (also called common stock) are shares which are not preferred with regard to dividend payments. Thus, a holder only receives a dividend after fixed dividends have been paid to preference stockholders.

The common stockholder in a company usually carries the following basic rights:

① To vote for directors and on certain other key issues. A stockholder has one vote for each share owned. The issues on which stockholders may vote are specified in the company's by laws or agreements.

② To receive profits of the corporation through selling their shares and dividends. A stockholder has a right to a dividend only when the directors declare they are to be paid; directors are not required to pay out the dividends. A preferred stockholder receives any declared dividends before common stockholders; this compensates the preferred stockholder for not having voting rights. A holder who sells stocks can realize the increased value through the corporation's retained profits.

③ Common stockholders can buy new shares issued by the corporation before others if the articles of incorporation allow it. These preemptive rights are not available to preferred stockholders or stocks held by directors, officers, employees and agents of the corporation. All prospective stockholders have equal opportunities to any stock issued six months after the corporation files its articles of incorporation with the secretary of state or corporation's office.

④ A stockholder does not own the corporation's property but has a right to its equity. This consists of the difference between the value of the corporation's assets and its liabilities to people such as lenders, sellers and employees. If a corporation decides to end its existence or sell its property, the company pays its creditors. Stockholders get the remaining funds, with preferred stockholders being paid before common stockholders. Until the corporation is liquidated, a stockholder is not entitled to its property.

Ordinary stockholders are thus the effective owners of a company. They own the equity of the business, and any reserves of the business (described later) belong to them.

## 2. Preference Shares

Capital stock which provides a specific dividend that is paid before any dividends are paid to common stock holders, and which takes precedence over common stock in the event of liquidation. Like common stock, preferred stocks represent partial ownership in a company, although preferred stock shareholders do not enjoy any of the voting rights of common stockholders. Also unlike common stock, a preferred stock pays a fixed dividend that does not fluctuate, although the company does not have to pay this dividend if it lacks

the financial ability to do so.

#### (1) Types of Preferred Stock

- ① **Stock preferred as to dividends**. Stock preferred as to dividends is entitled to receive each year a dividend of specified amount before any dividend is paid on the common stock. The dividend usually is stated as a dollar amount per share. Some preferred stocks state the dividend preference as a percentage of par value.
- ② **Cumulative preferred stock**. The dividend preference carried by most preferred stocks is a cumulative one. If all or any part of the regular dividend on the preferred stock is omitted in a given year, the amount omitted is said to be in arrears and must be paid in a subsequent year before any dividend can be paid on the common stock.
- ③ **Stock preferred as to asset**. Most preferred stocks carry a preference as to assets in the event of liquidation of the corporation. If the business is terminated, the preferred stock is entitled to payment in full of its par value or a higher stated liquidation value before any payment is made on the common stock. This priority also includes any dividends in arrears.
- ④ **Callable preferred stock**. Most preferred stocks include a call provision. This provision grants the issuing corporation the right to repurchase the stock from the stockholders at a stipulated call price. The call price is usually slightly higher than the par value of the stock. In addition to paying the call price, a corporation which redeems its preferred stocks must pay any dividends in arrears.
- ⑤ **Convertible preferred stock**. In order to add to the attractiveness of preferred stock as an investment, corporations sometimes offer a conversion privilege which entitles the preferred stockholders to exchange their shares for common stock into a stipulated ratio.

#### (2) Preferential Rights

Preference shares are shares which confer certain preferential rights on their holder. In general, the preference shares carry the following preferential rights:

- ① A priority right over ordinary stockholders to dividends (dividends are often expressed as a percentage of their par value).
- ② If the preference shares are cumulative, it means that before a company can pay an ordinary dividend it must not only pay the current year's preference dividend, but must also make good any arrears of preference dividends unpaid in previous years.
- ③ If the preference shares are non-cumulative, it means the claims for dividends do not accumulate from year to year, if the earnings of a particular year do not warrant the declaration of dividends, there is no carry-over of dividends to succeeding years.
- ④ The holder of non-cumulative preferred share is only entitled to receive dividends if the earnings for the year are sufficient to pay such dividends and if the board of

directors declares them.

- ⑤ A priority right over ordinary stockholders toes to a return of their capital when the company goes into liquidation. However, claims of creditors must be satisfied first. Preferred stockholders are next in line to receive any remaining assets, followed by the common stockholders.



## Topic 4 : Accounting for Different Equity



### 1. Stockholders' Equity

In the balance sheet of a corporation, the term stockholders' equity is used instead of owner's equity. State laws require that the stockholders' equity section of a corporate balance sheet clearly indicate the source of the owners' equity.

Capital invested by stockholders is recorded in the corporation's accounting records by a credit to an account entitled by capital stock. The capital paid in by stockholders is regarded as permanent capital, not ordinary subject to withdrawal. The increase in stockholders' equity arising from profitable operations is called retained earnings. At the end of the year, the balance of the income summary account is closed into the retained earnings account.



### 2. Illustration of a Stockholders' Equity Section

The two basic sources of owners' equity are: Investment by the stockholders (paid-in capital), and Earnings from profitable operation of the business (retained earnings). An example of the stockholders' equity section of a corporate balance sheet appears as follows:

Example 5-1:		Stockholders' equity
Capital stock:		
8% preferred stock, \$ 100 par value, call price \$ 110		
Per share, authorized and issued 2000 shares		\$ 200,000
common stock, \$ 5 par value, authorized 100,000		
Shares, issued 33,000 shares (of which 3,000 are held in the treasury)		165,000
Additional paid-in capital:		
From issuance of common stock	\$ 25,000	
From stock dividends	50,000	
From treasury stock transactions	<u>10,000</u>	<u>310,000</u>
Total paid-in capital \$ 675,000		
Retained earnings (of which \$ 87,000, an amount equal to the cost of treasury stock owned, is not available for dividends)		<u>232,000</u>



Subtotal \$ 907,000	
Less: treasury stock (3,000 shares of common, at cost)	87,000
Total stockholder's equity	<u>\$ 820,000</u>

### 3. Authorization and Issuance of Capital Stock

The articles of incorporation specify the number of shares that a corporation is authorized to issue by the state of incorporation. Issues of capital stock that will be sold to the general public must be approved by the Securities and Exchange Commission (SEC).

The numbers of share which have been issued and are in the hands of stockholders are called the outstanding shares. At any time, these outstanding shares represent 100% of the stockholders' equity in the corporation.

#### (1) Par Value

Par value (or stated value) represents the legal capital per share—the amount below which stockholders' equity cannot be reduced except by losses from business operation. The directors cannot declare a dividend that would cause total stockholders' equity to fall below the par value of the outstanding shares. Par value, therefore, may be regarded as minimum threshold of equity capital existing for the protection of creditors.

#### (2) Issuance of Par Value Stock

Mere authorization of a stock issue does not bring an asset into existence, nor does it give the corporation any capital. The obtaining of authorization from the state for a stock issue merely affords a legal opportunity to obtain assets through the sale of stock.

When par value stock is issued, the Capital Stock account is credited with the par value of the shares issued, regardless of whether the issuance price is more or less than par.

Example 5-2: Assuming that 50,000 shares of \$ 2 par value stock have been authorized and that 10,000 of these authorized shares are issued at a price of \$ 2 each, cash would be debited and capital stock would be credited for \$ 20,000. When stock is sold for more than par value, the additional paid-in capital account is credited for the excess of selling price over par. If our 10,000 shares were issued at a price of \$ 10, per share, the entry would be:

Cash	100,000
Capital stock	20,000
Additional paid-in capital	80,000

The additional paid-in capital does not represent a profit to the corporation. It is part of the invested capital and it will be added to the capital stock in the balance sheet to show the total paid-in capital.

#### (3) No-par Stock

Some states allow corporations to issue stock without designating a par or stated value. When this “no-par” stock is issued, the entire issue price is credited to the capital Stock account and is viewed as legal capital not subject to withdrawal.

## 4. Common Stocks and Preferred Stocks

The “basic” type of capital stock issued by every corporation is often called common stock. Common stock possesses the traditional rights of ownership—voting rights, participation in dividends, and a residual claim to assets in the event of liquidation. When any of these rights is modified, the term preferred stock is used to describe the resulting type of capital stock. A few corporations issue two or more classes of preferred stock, with each class having distinctive features designed to appeal to a particular type of investor.

### (1) Book Value per Share of Common Stock

Book value per share is equal to the net assets represented by one share of stock. The term net assets mean total assets minus total liabilities; in other words, net assets are equal to total stockholders’ equity. Thus, in a corporation which has issued common stock only, the book value per share is computed by dividing total stockholders’ equity by the number of shares outstanding.

Book value is usually computed only for common stock. If a company has both preferred and common stock outstanding, the computation of book value per share of common stock requires two steps. First, the redemption value or call price of the entire preferred stock issue and any dividends in arrears are deducted from total stockholders’ equity. Second, the remaining amount of stockholders’ equity is divided by the number of common shares outstanding to determine book value per common share.

### (2) Earnings per Share

To compute earnings per share, the common stockholders’ share of the company’s net income is divided by the weighted-average number of common shares outstanding. Notice that the concept of earnings per share applies only to common stock. When a company has preferred stock outstanding, we first deduct from net income the amount of current year preferred stock dividends.

Example 5-3: Let us assume that TR Company has 200,000 shares of common stock and 10,000 shares of \$6 cumulative preferred stock outstanding throughout the year. Net income for the year totals \$560,000. Earnings per share of common stock would be computed as follows:

Net income	\$ 560,000
Less: Dividends on preferred stock	<u>60,000</u>
Earnings applicable to common stock	\$ 500,000
Weighted-average number of common shares outstanding	<u>200,000</u>
Earnings per share of common stock	<u><u>\$ 2.50</u></u>

## 5. Dividends

### (1) Cash Dividends

Three requirements for the payment of a cash dividend are: retained earnings, an adequate cash position and dividend action by the board of directors. Dividends are paid

only through action by the board of directors. Once the declaration of a dividend has been announced, the obligation to pay the dividend is a current liability of the corporation and cannot be rescinded.

**Example 5-4:** Because a dividend is declared on one date by the board of directors and paid at a later date, two separate journal entries are necessary. To illustrate, assume that a corporation declares a dividend of \$1 per share on 100,000 shares of outstanding stock. The dividend is declared on December 15, 2016 and is payable on January 25, 2017. The two entries would be as follows:

Dividends	100,000
Dividends payable	100,000
Dividends payable	100,000
Cash	100,000

The account dividends payable, which was credited at the date of declaring the dividend, is a current liability. The dividends account is a “temporary” owners’ equity account, similar to the owner’s drawing account in a sole proprietorship. A closing entry is required at the end of the year to transfer the debit balance in the dividends account into the retained earnings account.

### (2) Liquidating Dividends

A liquidating dividend occurs when a corporation pays a dividend that exceeds the balance in the retained earnings account. Thus, the dividend returns to stockholders all or part of their paid-in capital investment. Liquidating dividends usually are paid only when a corporation is going out of existence or is making a permanent reduction in the size of its operations.

### (3) Stock Dividends

Stock dividend is a term used to describe a distribution of additional shares of stock to a company’s stockholders in proportion to their present holdings. An important distinction must be drawn between a cash dividend and a stock dividend. A cash dividend reduces both assets and stockholders’ equity. A stock dividend causes no change in assets or in total stockholders’ equity. Each stockholder receives additional shares, but his or her percentage ownership in the corporation is no larger than before.

In accounting for small stock dividends (less than 20%), the market value of the new shares is transferred from the retained earnings accounts to the paid-in capital accounts. This process sometimes is called capitalizing retained earnings. The overall effect is the same as if the dividend had been paid in cash, and the stockholders had immediately reinvested the cash in the business in exchange for additional shares of stock. Of course, no cash actually changes hands—the new shares of stock are sent directly to the stockholders.

**Example 5-5:** Assume that on June 1, AP Company has outstanding 100,000 shares of \$5 par value common stock with a market value of \$25 per share. On this date, the

company declares a 10% stock dividend, distributable on July 15 to stockholders of record on June 20. The entry on June 1 to record the declaration of this dividend is:

Retained earnings	250,000
Stock dividends to be distributed	50,000
Additional paid-in capital: stock dividends	200,000

The stock dividend account is not a liability, because there is no obligation to distribute cash or any other asset. On July 15, the entry to record the distribution of the dividend shares is:

Stock dividend to be distributed	50,000
Common stock	50,000

Large stock dividends (for example, those in excess of 20% to 25%) should be recorded by transferring only the par or stated value of the dividend shares from the retained earnings account to the common stock account. Large stock dividends generally have the effect of proportionately reducing the market price of the stock. A 100% stock dividend is very similar to the 2-for-1 stock split.

#### (4) Stock Splits

A corporation may split its stock by increasing the number of outstanding shares of common stock and reducing the par or stated value per share in proportion. As with a large stock dividend, the purpose of a stock split is to reduce substantially the market price of the common stock, with the intent of making the stock more affordable to investors.

A stock split does not change the balance of any ledger account; consequently, the transaction may be recorded merely by a memorandum entry in the general journal.

There is very little difference between a 2-for-1 stock split and a 100% stock dividend; both will double the number of outstanding shares without changing total stockholders' equity, and both should serve to cut the market price of the stock approximately in half. The stock dividend, however, will cause a transfer from the retained earnings account to the common stock account equal to the par or stated value of the dividend shares. A 2-for-1 stock split will reduce the par value per share by one-half, but it will not change the dollar balance of any account.

## 6. Treasury Stock

Treasury stock may be defined as shares of a corporation's own capital stock that have been issued and later reacquired by the issuing company, but that have not been canceled or permanently retired. Treasury shares may be held indefinitely or may be issued again at any time. Shares of capital stock held in the treasury are not entitled to receive dividends, to vote, or to share in assets upon dissolution of the company.

### (1) Purchase of Treasury Stock

Example 5-6: Purchases of treasury stock should be recorded by TY Company reacquires 1,500 shares of its own \$5 par stock at a price of \$100 per share, the entry is as follows:

Treasury stock	150,000
Cash	150,000

When treasury stock is purchased, the corporation is eliminating part of its stockholders' equity by a payment to one or more stockholders. The purchase of treasury stock should be regarded as a reduction of stockholders' equity, not as the acquisition of an asset. For this reason, the treasury stock account should appear in the balance sheet as a deduction in the stockholders' equity section.

### (2) Reissuance of Treasury Stock

When treasury shares are reissued, the treasury stock account is credited for the cost of the shares reissued and additional paid-in capital from treasury stock transactions is debited or credited for any differences between cost and the reissue price.

Example 5-7: Assume that 1,000 of the treasury shares acquired by TY Company at a cost of \$100 per share are now reissued at a price of \$115 per share. The entry to record the reissuance of these shares at a price above cost would be:

Cash	115,000
Treasury stock	100,000
Additional paid-in capital; Treasury stock transactions	15,000

If treasury stock is reissued at a price below cost, additional paid-in capital from previous treasury stock transactions is reduced (debited) by the excess of cost over the reissue price.

If there is no additional paid-in capital from previous treasury stock transactions, the excess of the cost of the treasury shares over the reissue price may be recorded as a debit to retained earnings. Notice that no gain or loss is recognized on treasury stock transactions, even when the shares are reissued at a price above or below cost. Thus, any changes in stockholders' equity resulting from treasury stock transactions are regarded as changes in paid-in capital and not included in the measurement of net income.

### Core Words and Expressions

book value per share 每股账面价值  
 cash dividend 现金股利  
 earnings per share 每股收益  
 par value 面值  
 retained earnings 留存收益

capital stock 实收资本、股本  
 common stock 普通股  
 other reserves 其他公积金  
 preference shares (preferred shares) 优先股  
 treasury stock 库存股

### More Knowledge

- ◎ **Sole proprietorship**. 独资、独资企业,指企业净资产归一个所有者。不属于独立法人组织,设立容易,但是融资能力有限,所有者对企业债务负无限责任。从会计角度说,独资企业是独立的会计主体。

- ◎ **Partnership.** 合伙企业,两个或更多的人以书面约定为基础,合并他们的资产组成一个企业,并分享企业的收益或分担损失。成立合伙企业不需要经过法律程序,也不需要缴纳企业所得税。但合伙人对企业的债务负无限责任,合伙人之间存在相互代理关系。从会计角度说,合伙企业也是独立的会计主体。
- ◎ **Corporation.** 公司、股份公司,公司有公司章程,并根据公司章程从事融资和经营活动。公司是独立于所有者的法律实体,要缴纳企业所得税。
- ◎ **Authorized stock.** 法定股本,指公司章程中所规定的股份发行量。
- ◎ **Stated value.** 设定价值,有时公司在发行无面值股票时,由董事会为股票确定的价值。
- ◎ **Residual claim.** 剩余索取权,指公司所有者对公司资产所拥有的索取权,因为债权人的索取权需要被优先满足,股东的索取权只能是第二位,即偿还负债之后剩余的权益。
- ◎ **Paid-in capital.** 实收资本,指股东向公司投入的资本,可能表现为股本和股票溢价两种形式。股本账户不经法定程序不得减少。
- ◎ **Retained earnings.** 留存收益,来源于企业的生产经营活动所实现的净利润,包括企业的盈余公积金和未分配利润两个部分,其中盈余公积金是有特定用途的累积盈余,未分配利润是没有指定用途的累积盈余。
- ◎ **Treasury stock.** 库存股,指公司已发行又买回的股本。回购股份的主要目的是增加每股收益率,刺激股票市价的上升。
- ◎ **Stock split.** 股票分割,指将一个公司的股份分为更多的股数,目的是相应降低股票的价格,以吸引投资者,尤其是小额投资者的投资。股票分割在会计上通常不需要进行处理,因为公司资本总额并未发生变化,只要在股票登记簿上更新股份数即可。

### Discussion Questions

1. Why are large corporation often said to be publicly owned?
2. Explain the meaning of the term double taxation as it applies to corporate profits.
3. Distinguish between paid-in capital and retained earnings of corporation. Why is such a distinction useful?
4. What is the purpose of a stock split?
5. What does book value per share of common stock represent? Does it represent the amount common stockholders would receive in the event of liquidation of the corporation?
6. What is treasury stock? Why do corporations purchase their own shares? Is treasury stock an asset? How should it be reported in the balance sheet?
7. How is book value per share of common stock computed when a company has both preferred and common stock outstanding?

## Exercises

1. When a business is organized as a corporation, which of the following is true?
  - A. Stockholders are liable for the debts of the business only in proportion to their percentage ownership of capital stock.
  - B. Stockholders do not have to pay personal income taxes on dividends received, because the corporation is subject to income taxes on its earnings.
  - C. Fluctuations in the market value of outstanding shares of capital stock do not affect the amount of stockholders' equity shown in the balance sheet.
  - D. Each stockholder has the right to bind the corporation to contracts and to make other managerial decision.
2. GP Company was organized with authorization to issue 100,000 shares of \$1 par value common stock. Forty thousand shares were issued to Tom Morgan, the company's founder, at a price of \$5 per share. No other shares have yet been issued. Which of the following statements is true?
  - A. Morgan owns 40% of the stockholders' equity of the corporation.
  - B. The corporation should recognize a \$160,000 gain on the issuance of these shares.
  - C. If the balance sheet includes retained earnings of \$50,000, total paid-in capital amounts to \$250,000.
  - D. In the balance sheet, the additional paid-in capital will have a \$160,000 balance, regardless of the profits earned or losses incurred since the corporation was organized.
3. Which of the following is not a characteristic of the common stock of a large, publicly owned corporation?
  - A. The shares may be transferred from one investor to another without disrupting the continuity of business operations.
  - B. Voting rights in the election of the board of directors.
  - C. A cumulative right to receive dividends.
  - D. After issuance, the market value of the stock is unrelated to its par value.
4. The following information is taken from the balance sheet and related disclosures of Blue Oyster Corporation:
 

Total paid-in capital \$5,400,000	
Outstanding shares:	
Common stock, \$5 par value	100,000 shares
6% preferred stock, \$100 par value, callable at \$108 per share	10,000 shares
Preferred dividends in arrears	2 years
Total stockholders' equity	\$4,700,000

Which of the following statements is true?

  - A. The preferred dividends in arrears amount to \$120,000 and should appear as a

liability in the corporate balance sheet.

- B. The company has paid no dividend on its common stock during the past two years.
- C. The stockholders' equity section of the balance sheet should indicate a deficit of \$ 700,000.
- D. The book value per share of common stock is \$ 35.



## Chapter 6

# Revenues and Expenses

### Mini Case

ABC Company is building an apartment for XYZ Company; the contract cost is \$20,000,000. For the discovery of the geothermal resources, XYZ Company asked ABC Company to change their original design and add hot water piping and equipment. XYZ Company adds \$500,000 for this change. When the main project reached fifth layers, they found ABC Company made a big mistake on procedure, so the construction was ordered to stop. XYZ Company required keeping their workers and tools in the construction area. After two months, the construction started again. ABC Construction Company asked XYZ Company to pay for their loss: Crane \$50,000 per month, small machine \$10,000 per month, and rental fee of the tube \$30,000 per month. After negotiation, XYZ Company agreed to pay \$180,000.

#### Identify:

1. How should the revenue of this contract be recognized?
2. If XYZ Company has some economic problem and can't pay for this construction on time, how to recognize the revenue and expense?

### Learning Objectives

#### After studying Chapter 6, you should be able to:

1. Explain what revenue is.
2. Outline the main types of revenue.
3. Describe what kinds of expenses may occur in a company.
4. Define the difference between period cost and product cost.