Case 1-1 Solutions

Requirement (1):

Assume the role of accountant Justin Phillips and complete the following:

Using the account titles provided for you in *Exhibit 1.1* and referring back to the ***Narrative*** as needed, please prepare journal entries (using good form) *as necessary* for the transactions and events described in the accompanying exhibits for this case.* That is, you should prepare only those *specific* entries required to record the transactions described in these materials. You are not to consider adjusting entries that would be recorded after the events described in these exhibits.

*The accompanying footnote reads: Before preparing your entries, take some time to review *Exhibit 1.1* and consider the nature of the accounts provided (asset, liability, equity, revenue, or expense).

SOLUTIONS: *(See page 24 for general discussion about this requirement.)*

Exhibit 1.2 Reference	Account Title	Debit	Credit	Page Number: Additional Discussion	Page Number: T-Account Reference
Saturday, November 15					
	No entry required.*				
Sunday, November 30					
	No entry required.*				
Monday, December 1					
(i)	**Cash**	**$35,000.00**			pp. 14,15 [01]
	Common Stock		**$35,000.00**		
	(to record issuance of stock in exchange for cash)				
(ii)	**Cash**	**$25,000.00**			pp. 14,15 [02]
	Note Payable		**$25,000.00**		
	(to record the start-up loan)				
(iii)	**Music Equipment**	**$35,000.00**		pp. 24-25	pp. 14,15 [03]
	Music Library	**$5,000.00**			
	Accounts Receivable	**$4,000.00**			
	Customer Deposits		**$2,950.00**		
	Rent Payable		**$2,200.00**		
	Cash		**$38,850.00**		
	(to record the purchase of certain assets from the Lowrys)				

***Be sure to allocate points for students who appropriately make no entries.**

(CONTINUED)

Exhibit 1.2 Reference	Account Title	Debit	Credit	Page Number: Additional Discussion	Page Number: T-Account Reference
Friday, December 5					
(i)	**Prepaid Advertising**	**$4,500.00**		pp. 25-26	p. 14 [04]
	Cash		**$4,500.00**		
	(to record the advance purchase of advertising)				
(ii)	**Cash**	**$600.00**		p. 26	pp. 14,15 [05]
	Service Fees Earned		**$600.00**		
Saturday, December 6					
(i)	**Customer Deposits**	**$200.00**		pp. 26-27	pp. 14,15 [06]
	Accounts Receivable	**$700.00**			
	Service Fees Earned		**$900.00**		
	(to record service fees earned from completed gigs)				
(ii) & (iii)	**No entry required.***				
Sunday, December 7					
(i)	**Cash**	**$300.00**		p. 27	pp. 14,15 [07]
	Service Fees Earned		**$300.00**		
	(to record service fees earned from completed gigs)				
Monday, December 8					
(i)	**Customer Deposits**	**$400.00**		p. 27	pp. 14,15 [08]
	Accounts Receivable	**$1,900.00**			
	Service Fees Earned		**$2,300.00**		
	(to record service fees earned from completed gigs)				
(ii)	**Prepaid Insurance**	**$2,730.00**		pp. 27-28	p. 14 [09]
	Cash		**$2,730.00**		
	(to record the advance purchase of insurance)				
(iii)	**Rent Payable**	**$2,200.00**		p. 28	pp. 14,15 [10]
	Cash		**$2,200.00**		
	(to record November rent credited at closing (Dec. 1))				

***Be sure to allocate points for students who appropriately make no entries.**

(CONTINUED)

Exhibit 1.2 Reference	Account Title	Debit	Credit	Page Number: Additional Discussion	Page Number: T-Account Reference
Tuesday, December 9					
(i)	**Advertising Expense**	**$300.00**		p. 28	pp. 14,16 [11]
	Cash		**$300.00**		
	(to record the cost of advertising incurred).				
(ii)	**Cash**	**$2,800.00**		pp. 28-29	pp. 14,15 [12]
	Accounts Receivable		**$1,500.00**		
	Customer Deposits		**$1,300.00**		
	(to record customer payments)				
Wednesday, December 10					
(i)	**Professional Fees**	**$1,300.00**			pp. 15,16 [13]
	Accounts Payable		**$1,300.00**		
	(to record the cost of legal fees incurred)				
(ii)	**Other Receivable**	**$750.00**		p. 29	p. 14 [14]
	Cash		**$750.00**		
	(to record payment of utilities expected to be reimbursed)				
Thursday, December 11					
(i)	**Music Library**	**$600.00**		p. 29	pp. 14,15 [15]
	Cash		**$600.00**		
	(to record the purchase of music demos)				
(ii)	**No entry required.***			p. 29	
Friday, December 12					
(i)	**Cash**	**$600.00**		p. 30	pp. 14,15 [16]
	Customer Deposits		**$600.00**		
	(to record deposit collected for July 2009 wedding)				
(ii)	**Cash**	**$1,400.00**		p. 30	p. 14 [17]
	Accounts Receivable		**$1,400.00**		
	(to record customer payments)				
Saturday, December 13					
	No entry required.*			p. 30	

***Be sure to allocate points for students who appropriately make no entries.**

Exhibit 1.2 Reference	Account Title	Debit	Credit	Page Number: Additional Discussion	Page Number: T-Account Reference
Monday, December 15					
(i)	**Accounts Receivable**	**$700.00**		p. 30	pp. 14,15 [18]
	Service Fees Earned		**$700.00**		
	(to record service fees earned from completed gigs)				
(ii)	**Repair & Maintenance**	**$650.00**			pp. 14,16 [19]
	Cash		**$650.00**		
	(to record the cost of painting the reception area)				
(iii)	**Supplies**	**$800.00**			pp. 14,15 [20]
	Accounts Payable		**$800.00**		
	(to record purchase of office supplies on account)				
Tuesday, December 16					
	Cash	**$400.00**			p. 14 [21]
	Accounts Receivable		**$400.00**		
	(to record customer payments)				
Monday, December 22					
	Cash	**$9,000.00**		pp. 30-31	pp. 14,15 [22]
	Customer Deposits	**$1,200.00**			
	Accounts Receivable	**$3,800.00**			
	Service Fees Earned		**$14,000.00**		
	(to record service fees earned from completed gigs)				
Tuesday, December 23					
	Dividend paid to owner	**$2,500.00**		p. 31	pp. 14,15 [23]
	Cash		**$2,500.00**		
	(to record personal expenditure for February-2009 cruise)				
Friday, December 26					
(i)	**Accounts Receivable**	**$825.00**		p. 31	p. 14 [24]
	Cash		**$825.00**		
	(to record NSF check)				
(ii)	**Accounts Payable**	**$1,800.00**		p. 31	pp. 14,15 [25]
	Cash		**$1,800.00**		
	(to record payments on account)				

(CONTINUED)

Exhibit 1.2 Reference	Account Title	Debit	Credit	Page Number: Additional Discussion	Page Number: T-Account Reference
Friday, December 26 (cont.)					
(iii)	**Cash**	**$700.00**		p. 32	p. 14 [26]
	Accounts Receivable		**$700.00**		
	(to record customer payments)				
Monday, December 29					
	Vehicles	**$30,000.00**		p. 32	pp. 14,15 [27]
	Cash		**$7,500.00**		
	Note Payable		**$22,500.00**		
	(to record purchase of new van)				
Wednesday, December 31					
	Accounts Receivable	**$3,000.00**		p. 32	pp. 14,15 [28]
	Cash	**$3,000.00**			
	Customer Deposits	**$500.00**			
	Service Fees Earned		**$6,500.00**		
	(to record service fees earned from completed gigs)				

<u>Requirement (2)</u>:

Using the journal entries that you prepared in requirement (1), post the entries to "T" accounts and calculate the overall account balances as of 12/31/08.

SOLUTIONS: "T" accounts are organized here by type of account (i.e., assets, liabilities, stockholder's equity, revenue, or expense) and follow the order in which they would be listed in the financial statements. In order to facilitate grading, we suggest that you request that the students use this same order when submitting their work. *The numbers in brackets [ ], which are listed to the bottom right of the t-account entries, correspond to the related journal entries on pp. 9-13 and are cross-referenced in the t-account reference column.*

ASSETS

Cash

DEBIT	CREDIT
0.00 11/30	
35,000.00 [01]	
25,000.00 [02]	
	38,850.00 [03]
	4,500.00 [04]
600.00 [05]	
300.00 [07]	
	2,730.00 [09]
	2,200.00 [10]
	300.00 [11]
2,800.00 [12]	
	750.00 [14]
	600.00 [15]
600.00 [16]	
1,400.00 [17]	
	650.00 [19]
400.00 [21]	
9,000.00 [22]	
	2,500.00 [23]
	825.00 [24]
	1,800.00 [25]
700.00 [26]	
	7,500.00 [27]
3,000.00 [28]	
78,800.00	63,205.00
15,595.00	

Accounts Receivable

DEBIT	CREDIT
0.00 11/30	
4,000.00 [03]	
700.00 [06]	
1,900.00 [08]	
	1,500.00 [12]
	1,400.00 [17]
700.00 [18]	
	400.00 [21]
3,800.00 [22]	
825.00 [24]	
	700.00 [26]
3,000.00 [28]	
10,925.00	

Other Receivable

DEBIT	CREDIT
0.00 11/30	
750.00 [14]	
750.00	

Supplies

DEBIT	CREDIT
0.00 11/30	
800.00 [20]	
800.00	

Prepaid Advertising

DEBIT	CREDIT
0.00 11/30	
4,500.00 [04]	
4,500.00	

Prepaid Insurance

DEBIT	CREDIT
0.00 11/30	
2,730.00 [09]	
2,730.00	

Music Equipment

DEBIT	CREDIT
0.00 11/30	
35,000.00 [03]	
35,000.00	

Office Equipment

DEBIT	CREDIT
0.00 11/30	
0.00	

Vehicles

DEBIT	CREDIT
0.00 11/30	
30,000.00 [27]	
30,000.00	

Accum. Depreciation

DEBIT	CREDIT
	0.00 11/30
	0.00

Music Library

DEBIT	CREDIT
0.00 11/30	
5,000.00 [03]	
600.00 [15]	
5,600.00	

LIABILITIES

Accounts Payable

DEBIT	CREDIT
	0.00 11/30
	1,300.00 [13]
	800.00 [20]
1,800.00 [25]	
	300.00

Due to owner

DEBIT	CREDIT
	0.00 11/30
	0.00

Insurance Payable

DEBIT	CREDIT
	0.00 11/30
	0.00

Interest Payable

DEBIT	CREDIT
	0.00 11/30
	0.00

Rent Payable

DEBIT	CREDIT
	0.00 11/30
	2,200.00 [03]
2,200.00 [10]	
	0.00

Salaries Payable

DEBIT	CREDIT
	0.00 11/30
	0.00

Utilities Payable

DEBIT	CREDIT
	0.00 11/30
	0.00

Customer Deposits

DEBIT	CREDIT
	0.00 11/30
	2,950.00 [03]
200.00 [06]	
400.00 [08]	
	1,300.00 [12]
	600.00 [16]
1,200.00 [22]	
500.00 [28]	
	2,550.00

Note Payable

DEBIT	CREDIT
	0.00 11/30
	25,000.00 [02]
	22,500.00 [27]
	47,500.00

STOCKHOLDER'S EQUITY

Common Stock

DEBIT	CREDIT
	0.00 11/30
	35,000.00 [01]
	35,000.00

Dividend paid to owner

DEBIT	CREDIT
0.00 11/30	
2,500.00 [23]	
2,500.00	

REVENUES

Service Fees Earned

DEBIT	CREDIT
	0.00 11/30
	600.00 [05]
	900.00 [06]
	300.00 [07]
	2,300.00 [08]
	700.00 [18]
	14,000.00 [22]
	6,500.00 [28]
	25,300.00

EXPENSES

Advertising Expense DEBIT	Advertising Expense CREDIT	Amortization Expense DEBIT	Amortization Expense CREDIT	Depreciation Expense DEBIT	Depreciation Expense CREDIT	Insurance Expense DEBIT	Insurance Expense CREDIT
0.00 11/30		0.00 11/30		0.00 11/30		0.00 11/30	
300.00 [11]							
300.00		0.00		0.00		0.00	

Interest Expense DEBIT	Interest Expense CREDIT	Professional Fees DEBIT	Professional Fees CREDIT	Rent Expense DEBIT	Rent Expense CREDIT	Repair & Maintenance DEBIT	Repair & Maintenance CREDIT
0.00 11/30		0.00 11/30		0.00 11/30		0.00 11/30	
		1,300.00 [13]				650.00 [19]	
0.00		1,300.00		0.00		650.00	

Salaries Expense DEBIT	Salaries Expense CREDIT	Supplies Expense DEBIT	Supplies Expense CREDIT	Travel Expense DEBIT	Travel Expense CREDIT	Utilities Expense DEBIT	Utilities Expense CREDIT
0.00 11/30		0.00 11/30		0.00 11/30		0.00 11/30	
0.00		0.00		0.00		0.00	

Requirement (3):

Using the ending balances in the "T" accounts from requirement (2), prepare a 12/31/08 unadjusted trial balance for Music Express (ME).

SOLUTIONS: Accounts are organized here by type of account (i.e., assets, liabilities, stockholder's equity, revenue, or expense) and follow the order in which they would typically be listed in the financial statements. In order to facilitate grading, we suggest that you request the students use this same order when submitting their work.

Music Express
Unadjusted Trial Balance
12/31/2008

	Debit	Credit	Requirement #4
Cash	**$15,595.00**		Asset, Balance Sheet
Accounts Receivable	**10,925.00**		Asset, Balance Sheet
Other Receivable	**750.00**		Asset, Balance Sheet
Supplies	**800.00**		Asset, Balance Sheet
Prepaid Advertising	**4,500.00**		Asset, Balance Sheet
Prepaid Insurance	**2,730.00**		Asset, Balance Sheet
Music Equipment	**35,000.00**		Asset, Balance Sheet
Vehicles	**30,000.00**		Asset, Balance Sheet
Music Library	**5,600.00**		Asset, Balance Sheet
Accounts Payable		**300.00**	Liability, Balance Sheet
Customer Deposits		**2,550.00**	Liability, Balance Sheet
Note Payable		**47,500.00**	Liability, Balance Sheet
Common Stock		**35,000.00**	Equity, Balance Sheet
Dividend paid to owner	**2,500.00**		Equity*, Balance Sheet
Service Fees Earned		**25,300.00**	Revenue, Income Statement
Advertising Expense	**300.00**		Expense, Income Statement
Interest Expense	**0.00**		Expense, Income Statement
Professional Fees	**1,300.00**		Expense, Income Statement
Repair & Maintenance	**650.00**		Expense, Income Statement
	$110,650.00	**$110,650.00**	

*The "dividend paid to owner" account is a temporary account that is closed to retained earnings at the end of the accounting period. A debit to "dividend paid to owner" is, in essence, a debit or decrease to "retained earnings."

Requirement (4):

For each account listed on the unadjusted trial balance prepared in requirement (3), identify the type of account (asset, liability, equity, revenue, or expense), and indicate whether it would be reported on the balance sheet or on the income statement. Consider also whether any account balance is abnormal. (That is, determine whether an account balance that is expected to carry a debit balance has a credit balance and vice versa.) If you determine that a particular account balance is abnormal, label it as such and explain what the abnormal balance communicates.

See page 17 for solutions. We request students identify "abnormal" account balances in an attempt to get them to review their own work, check account balances for reasonableness, and ultimately identify errors in advance of submitting the assignment. As you can see, there are no "abnormal" balances.

The "dividend paid to owner" account is a temporary account that is closed retained earnings at the end of the accounting period. A debit to "dividend paid to owner" is, in essence, a debit or decrease to "retained earnings."

Requirement (5):

Using your unadjusted account balances from requirement (3), calculate the following items as of 12/31/08:

a. Total dollar amount of ME's assets.

b. Total dollar amount of ME's liabilities.

c. Total equity (using the balance sheet equation).

d. The unadjusted net income (or net loss).

(In order to earn credit, you must provide the name and dollar amount of the underlying accounts that make up your answer.)

SOLUTION:

Although all of the above questions are answered using the student's "unadjusted" account balances, it is important for them to really grasp that these are not the final numbers, so the following summary answers do not represent the final measures of December's performance! They have much more to record in *Case 1-2* and the numbers will change accordingly.

(a) Total dollar amount of ME's Assets:

Cash	**$15,595.00**
Accounts Receivable	**10,925.00**
Other Receivable	**750.00**
Supplies	**800.00**
Prepaid Advertising	**4,500.00**
Prepaid Insurance	**2,730.00**
Music Equipment	**35,000.00**
Vehicles	**30,000.00**
Music Library	**5,600.00**
	$105,900.00

(b) Total dollar amount of ME's Liabilities:

Accounts Payable	**$ 300.00**
Customer Deposits	**2,550.00**
Note Payable	**47,500.00**
	$50,350.00

(c) Total equity (using the balance sheet equation):

Assets	**$105,900.00**
Less: Liabilities	**-50,350.00**
Total Equity	**$ 55,550.00**

(d) Unadjusted net income (or net loss):

Revenue		**$25,300.00**
Less Expense:		
Advertising Expense	**$ 300.00**	
Professional Fees	**1,300.00**	
Repair & Maintenance	**650.00**	**2,250.00**
Unadjusted Net Income		**$23,050.00**

Requirement (6):

Using the balance you computed for total equity in requirement 5(c), determine how much of this balance is

a. Total contributed capital.

b. Total retained earnings.

SOLUTION:

Using the balance you computed for total equity in requirement (3a), determine how much of this balance is:

a. Total contributed capital.

SOLUTION:

Common Stock = $35,000 (Unadjusted Trial Balance from Requirement #3)

b. Total retained earnings.

SOLUTION:

Students can take two approaches:

Approach 1: Use the balance sheet equation. (Requirement (5c))

Assets[1]	**-**	**Liabilities**	**= Owners Equity**
$105,900[2]	**-**	**$50,350[3]**	**= $55,550**

Contributed Capital	**+**	**Retained Earnings**	**= Total Equity**
$35,000 (Requirement (6a))	**+**	**X**	**= $55,550 (Requirement (5c))**

Solve for X = $20,550

Approach 2: Independently calculate retained earnings using the unadjusted account balances from *Requirement 3* and the unadjusted Net Income calculated in requirement (5d).

Retained Earnings:

Beginning Retained Earnings	**$ 0**	**(*first year of operations*)**
Plus: Net Income	**23,050**	**(Requirement (5d))**
Less: Dividends Paid	**(2,500)**	**(Rqmt. #3- "Dividends paid to owner")**
Ending Retained Earnings	**$20,550**	**at 12/31/08**

Proof:

Assets	**=**	**Liabilities**	**+**	**Owner's Equity**
				Contributed + Earned
$105,900	**=**	**$50,350**	**+**	**$35,0000 + $20,550**

[1]At this point in the problem, you have a great opportunity to discuss "why" the balance sheet equation balances. Where did the assets come from? Ignoring theft, a company has three ways in which it can obtain funds to purchase assets (which represent the right-hand side of the equation): (i) it can borrow the $, (ii) it can earn the $, or (iii) its owners could contribute the $. Items (ii) and (iii) are the two components of equity being solved for here (see proof).

[2]See answer for requirement (5a).

[3]See answer for requirement (5b).

Requirement (7):

As of 12/31/08, how much money is owed to ME by its customers? On which financial statement would this balance be reported?

SOLUTION:

Accounts Receivable $10,925.00 Balance Sheet

[from requirement (3)]

Requirement (8):

Consider each of the liabilities identified in requirement 5(b) and comment on how the liability will eventually be settled.

SOLUTION:

Accounts Payable and Note Payable

These liabilities will be reduced by ME when it makes a cash payment for the amount owed. Further, the Note Payable account balance, which is comprised of the business start-up loan (*Exhibit 1.4*) and the loan with the auto dealership (*Exhibit 1.2*, Monday, December 29), will be reduced through monthly payments that will be applied towards both interest and principal.

Customer Deposits

In order to secure an event date, customers pay Ted a portion of the total event price up front. Upon receiving this payment, Ted is obligated to the customer to either (i) return the deposit, or (ii) provide DJ services on the date requested. Eventually, when Ted performs his services he keeps the deposit and it reduces the amount the customer owes him for the event. Unlike the previous liabilities, this particular one will not be settled with a cash payment, but with the performance of services.

Requirement (9):

Consider the holiday gift that Ted treated himself to on 12/23 (*Exhibit 1.2*). Using the accounts listed in *Exhibit 1.1*, provide at least two possible alternatives for the debit portion of the resulting journal entry and explain how the economic entity assumption impacts your choices. Given your two options, please clarify what additional information you would need from Ted in order to determine which specific classification best captures the economic reality of this situation.

SOLUTION:

The economic entity assumption is the notion that economic events should be identified with a particular business entity. Further, the economic events of one entity should be kept separate and not commingled with the economic events of another entity. Implicit in this assumption is that the business owner is a separate entity from the business.

Here we have Ted, the owner of the business, using $2,500 of cash that belongs to the business for personal purposes. Students often misunderstand the economic entity assumption and believe that

they should ignore this event (as it involves a separate entity). Given that $2,500 of business assets are now gone, clearly something must be recorded! Some introductory students will jump to the conclusion that Ted is stealing or breaking the law. In the small business context, situations such as this happen quite frequently as the sole owner does not see a difference between himself and the business. What is important is that the economic event is recorded accurately on the books so that it faithfully represents the underlying transaction that occurs between the two separate entities. For starters, even though this is an economic outflow, it should not be recorded as a "business expense" on ME's books. If it were recorded in this manner, the economic entity assumption would be violated!

There are two possibilities for how this cost could be classified given that the owner is personally using assets belonging to the business. Specifically:

a. **Ted will pay back the business the $2,500, in which case it should increase the receivable "due from owner."**

b. **(Our choice): Ted will not pay back the $2,500, in which case it should increase "dividend paid to owner." This is no different than if Ted had been paid a $2,500 cash dividend and then used the money to personally pay for the cruise.**

General Discussion

Please keep in mind the following information as you are grading this portion of the case:

- ***Case 1-1*** **(Requirement 1):**
    - We instruct the students to prepare only those *specific* entries required to record the transactions described in ***Case 1-1*** and the accompanying exhibits (*Exhibits 1.2*). Further, we tell them not to consider adjusting entries that would be recorded after the events described in these materials**.**

      However, even with these instructions, students may still occasionally record what is considered an adjusting entry. We recommend that you do not take off points if they happen to make an entry based on such an assumption. In our opinion, they should not be punished for what is actually the recognition of a higher-level concept. Instead, we suggest that you clarify to them that this entry *will* be made and that they are not wrong to consider this. The project has been structured so that all adjusting journal entries will be recorded in ***Case 1-2***. Here, in ***Case 1-1***, students simply record the monthly transactions as they occur. The trial balance they create for requirement (3) of ***Case 1-1*** is *unadjusted*. Students who continue on to later cases will make numerous adjustments and entries to finalize these unadjusted balances.
    - We further instruct the students to use the account titles listed in *Exhibit 1.1* (for purposes of recording their entries). We advise students that if they need to create a new account title, they must clearly label it as to its type (i.e., asset, liability, equity, revenue, or expense).

Additional Discussion

Monday, December 1

iii. ME paid the Lowrys $38,850 for the following items:

$35,000	**for used music equipment**
5,000	**for digitized music files**
4,000	**for accounts receivable relating to October and November 2008 events**
-2,950	**less obligations to customers for advance deposits**
-2,200	**less amounts owed for November rent**
$38,850	

This transaction can be viewed as summarizing the closing statement. There are certain amounts that Ted owes to Joe and Donna Lowry as a result of the purchase, but there are also amounts that they, in return, owe back to Ted. The net effect is paid at closing.

Ted owes the Lowrys for the following three assets purchased:

$35,000	**for used music equipment**
5,000	**for digitized music files**
4,000	**for accounts receivable relating to October and November 2008 events**
$44,000	

At the same time, there are two items that Joe and Donna owe to Ted. However, it makes no sense for them to physically pay him, because he is already writing them a much bigger check. Instead, he will take these two items in to account and reduce the amount he ultimately pays to them.

- ME has already collected $2,950 of customer deposits for certain future events. Although Ted is not getting the cash, he is going to perform at these events and is obligated to honor these advance deposits.
- $2,200 of November rent will be due in early December. The Lowrys occupied the building during November and this accordingly is their obligation. By reducing the $44,000 that Ted owes them, the Lowrys are effectively reimbursing Ted for the November rent that he will be paying.

$44,000
-2,950
-2,200
$38,850 Amount Ted pays to Joe and Donna at closing.

It should be noted that later in the problem (12/10 (ii); Project, p. 15), it is determined that another deduction item should have been taken into account at closing but was overlooked. Specifically, Joe and Donna owed $750 for past due utilities. As the current resident of the building, Ted was forced to pay the bill or have the power shut off. Had he known about these utilities, he would have reduced his $38,850 payment (made at closing) by another $750. Joe and Donna are contacted and they promise to reimburse Ted. Accordingly, the $750 payment is debited to a receivable.

Friday, December 5

i. **ME paid the local radio station $4,500, and in return, received 90 days of radio advertising. The advertising spots will begin on 12/15 and run on a daily basis through 3/14/2009.**

The prepaid advertising account is a deferred expense (an asset) on the balance sheet. This account is used when a company prepays the cost of its advertising contracts (as is done here). Recording this event as an asset is consistent with the economic reality of the underlying transaction. Specifically, ME has the rights to receive future advertising spots without additional cost, which is something of value controlled by the business. The advertising expense should be reported in the period the ads run and the prepayment is consumed. This provides proper matching.

The expenditure is initially deferred or postponed on the balance sheet. As the prepayment expires and the advertisements occur, the cost is moved from the balance sheet to the income statement as an expense. This entry is the adjusting entry that will be recorded in ***Case 1-2***.

Students may mistakenly book an adjustment that moves a portion of the prepaid to expense. This is because they realize that, as of December 31, some of the advertising spots have occurred and the prepayment has therefore been partially consumed. Remind them that at this point in the problem, they really don't know how many advertising spots have run. This information will be provided in ***Case 1-2.*** See the bullet point under General Discussion on page 24.

ii. ME got off to a great start by performing at a local Chamber of Commerce holiday function. Before leaving the event, Ted collected a check for $600.

The earnings process is complete with respect to this gig, and accordingly, it can be recorded as revenue. Students may wonder if there was an advance deposit paid by the Chamber of Commerce or if the $600 represents the entire balance for the event. At this point, they can only record what they know. These questions will be answered when they get to the description for Saturday, December 6.

<u>Saturday, December 6</u>

i. Ted mailed a bill for the balance owed for the 12/5 Chamber of Commerce event.

Total charges for event	**$1,500**
Less: credit for deposit already made	**-200**
Less: payment made on the day of event	**-600**
Balance due	**$ 700**

The total revenue of $1,500 can be recognized as it has been earned. The offsetting debit is made up of three components:

- Ted's obligation to the Chamber of Commerce (as a result of a $200 advance deposit) is reduced with a debit. The advance deposit (when originally received) was recorded by increasing the "customer deposits" account. Because Ted has now performed the agreed-upon services, he is no longer obligated to the customer, and accordingly, this same liability account ("customer deposits") is reduced.
- The $600 cash collected on the day of the event (see Friday, December 5; Project, p. 14). Some students may wait to record this cash here on December 6 while others will record it on December 5. The date of the entry should correspond with the date of the bank deposit, which is not evident from the facts provided.

- The $700 "accounts receivable," which represents the balance still owed by the customer.

Sunday, December 7:

Ted served as DJ at an afternoon event at a local church. Before leaving, he collected $300.

The earnings process is complete with respect to this gig, and accordingly, it can be recorded as revenue. Students may wonder if there was an advance deposit related to this event or if the $300 represents the entire balance for the event. At this point, they can only record what they know. These questions will be answered when they get to the description for Monday, December 8 (Project, p. 15).

Monday, December 8:

i. **Ted mailed bills for the 12/6 and 12/7 events:**

	12/6	12/7	Total
Total charges for event	$1,900	$700	$2,600
Less: credit for deposit already made	-400	-0	-400
Less: payment made on the day of the event	-0	-300	-300
Balance due	$1,500	$400	$1,900

The total revenue of $2,600 can be recognized as it has been earned. The offsetting debit is made up of three components:

- Ted's obligation to a customer (as a result of a $400 advance deposit) is reduced with a debit. The advance deposit (when originally received) was recorded by increasing the "customer deposits" account. Because Ted has now performed the agreed-upon services, he is no longer obligated to the customer, and accordingly, this same liability ("customer deposits") is reduced.
- The $300 cash collected on the day of the event (see Sunday, December 7; Project, p. 15). Some students may wait to record this cash here on December 8 while others will record it on December 7. The date of the entry should correspond with the date of the bank deposit, which is not evident from the facts provided.
- The $1,900 "accounts receivable," which represents the balance still owed by the customer.

ii. **Ted met with an insurance agent and paid $2,730 total for the following two policies: (a) a $1,200 12-month liability policy effective 12/1, and (b) a $1,530 18-month property insurance policy also effective 12/1.**

The two new policies were effective on December 1. Consequently, as of December 31, one month of coverage has expired. We anticipate students taking one of two approaches with this payment:

a. Our approach: Record the entire payment as prepaid insurance, and then later in ***Case 1-2*** record an adjusting journal entry to move the appropriate portion of the prepaid to expense. We have selected this as the approach to use in the solution as it is consistent with the requirement 1 instructions indicating that all adjusting entries will be recorded in ***Case 1-2***. See the first bulleted point in the General Discussion on page 24.

b. Some students will recognize that as of the date of payment, 8 days of the policy term has expired, and as of 12/31, a full month will have expired. Accordingly, they will expense a portion of the payment and record the remaining balance as prepaid. As indicated in the General Discussion on page 24, we recommend that you do not take off points if they choose this approach, even though it is inconsistent with our solution.

Some students will create two separate prepaid accounts, and that is perfectly fine. This segues well into a tangential discussion of subsidiary accounts versus a control account. For example, a company can have numerous individual prepaid accounts included in its general ledger, but on the face of its financial statements, it will combine these balances into a single line item, "prepaid expense."

iii. Paid $2,200 for the November rent.

The Lowrys occupied the building in November. At the time of closing, it was anticipated that Ted would make the November rental payment to the landlord, and consequently, the Lowrys reimbursed him for this expenditure. Students will need to remember that they already made an entry increasing "rent payable" for this situation (entry [03]; page 9). Now that the payment is made, Ted's obligation is fulfilled, and accordingly, the liability is reduced.

<u>Tuesday, December 9</u>:

i. Paid $300 to the local newspapers for an employment ad which ran on 12/7 in the weekend job finder supplement.

Students should compare this payment to the advance payment made on Friday, December 5 (pp. 25-26). Unlike December 5, which was an advance payment, the advertising here has already occurred, and accordingly, should be expensed.

ii. The mail contained $2,800 of customer payments. $1,500 represented payments for events held in October and November of 2008, and $1,300 represented deposits toward events to be held in 2009.

The payments collected for October and November have already been billed and the related accounts receivable should be reduced (entry [03]; page 9). The $1,300 deposit for 2009 has not yet been earned, and accordingly, should increase the liability account, "customer deposits." This is consistent with the fact that, as a result of receiving the deposit, Ted is obligated to perform future services.

<u>Wednesday, December 10</u>:

ii. **Received a utility bill in the mail totaling $750! The bill was for October and November utilities plus late fees. Concerned that his utilities would be shut off, Ted paid the bill. Ted then called his attorney who confirmed that he (the attorney) had overlooked these items when negotiating with the Lowrys. His attorney immediately sent a letter to the Lowrys requesting they reimburse Ted for this payment.**

See discussion on Monday, December 1 (pp. 24-25).

<u>Thursday, December 11</u>:

i. **Ted paid $600 to Ripped Music Company for use of its current music demos to record various music sets.**

The music sets will be used in operations for years to come and will be amortized in ***Case 1-2***. In *Exhibit 1.3* (footnote 2; Project, p. 20), student are provided with a useful life and told that "the music library is considered an intangible asset and would be amortized using straight-line over its useful life."

For now, students need only record the purchase of the music demos. The amortization, along with all adjusting journal entries, will be recorded in ***Case 1-2***.

ii. **Ted received a good response to his employment ad, and as a result, he interviewed three potential candidates. He ultimately signed employment contracts with two part-time employees. The employees will start work on 12/22, and are anticipated to work between 15 and 20 hours per week. Both individuals had experience in the entertainment industry and were willing to come in the week before they started for a quick training session on the equipment. Ted plans to pay his employees every other Friday with their first pay-period beginning Friday, January 2.**

Although no entry is required now, this information will be relevant in subsequent cases. Some of your stronger students may note that the first pay-period overlaps December and January. This is good and it indicates that the students really understand the course material! Remind them that for now, they are only recording the transactions as described here. In ***Case 1-2***, they will be given more information about the January 2 payroll and they can make their entry at that time. The December account balances are still considered *unadjusted* balances and much more will be recorded before the balances are considered finalized.

Friday, December 12:

i. **Ted was enthused when a bride and her mother unexpectedly stopped in to discuss the music for an upcoming July 2009 wedding. Even though they were not aware that ME was under new ownership, they knew of Ted and were excited to find out that he would be the DJ. Before leaving, they made a $600 deposit to lock in the date. Ted quoted them a price of $2,100 to provide 5 hours of music at the wedding reception.**

   The deposit for the July 2009 wedding has not yet been earned, and accordingly, should increase a liability account. This is consistent with the fact that as a result of receiving the deposit, Ted is obligated to perform future services.

ii. **The mail contained $1,400 of customer payments relating to events held in October and November 2008.**

   The $1,400 of payments collected for October and November have already been billed and the related accounts receivable should be reduced.

Saturday, December 13:

ME provided the music at a local charity function.

Information about this event will come a few days later (on December 15) when the bills are prepared. For now, students do not have enough information to make an entry.

Monday, December 15:

i. **Ted mailed a bill for the 12/13 event detailing the following amount due:**

Total charges for event	**$700**
Less: credit for deposit already made	**-0**
Balance due	**$700**

No cash was collected on the day of the event and no advance deposit was made. As a result, the entire charge of $700 should be debited to "accounts receivable."

Monday, December 22:

With the holiday season well underway, this week was very busy. Between the three employees, ME had worked 9 separate holiday events! Ted still could not believe that he had earned $14,000 in just one week. Most of the event organizers had paid him in cash on the day of the event, but for those events where he had not yet been paid, Ted was sure to email a bill before leaving the venue.

Bills emailed by Ted:

Total charges for events	**$14,000**
Less: credit for deposits already made	**-1,200**
Less: payments made on the day of the events	**-9,000**
Balance due	**$ 3,800**

The total revenue of $14,000 can be recognized as it has been earned. The offsetting debit is made up of three pieces:

- Ted's obligation to a customer (as a result of a $1,200 advance deposit) is reduced with a debit. The advance deposit (when originally received) was recorded by increasing the "customer deposits" account. Because Ted has now performed the agreed-upon services, he is no longer obligated to the customer, and accordingly, this same liability account ("customer deposits") is reduced.
- The $9,000 cash collected at the events.
- The $3,800 "accounts receivable," which represents the balances still owed by the customers.

<u>Tuesday, December 23</u>:

Ted treated himself to a holiday gift and paid $2,500 (out of the business checking account) for reservations on a seven-day luxury cruise scheduled to occur in mid-February of 2009.

Note: Requirement # 9 asks specifically about this transaction. Don't accidently give away the answer by sharing too much information. See pp. 22-23 for requirement (9) solution.

There are two possibilities for how this cost could be classified given that the owner is personally using assets belonging to the business. Specifically:

1. Ted will pay back the business the $2,500, in which case it should increase the receivable "due from owner."
2. (Our choice) Ted does not pay back the $2,500 and it is therefore handled as a dividend. This is no different than if he had been paid a $2,500 cash dividend and then used the money to personally pay for the cruise.

<u>Friday, December 26</u>:

i. **Ted received a call from his banker. An $825 check received as payment from a customer on 12/12 had bounced!**

   When the customer originally paid ME on December 12, students increased cash and decreased accounts receivable. Now, the students learn that this payment bounced, and hence, they should reverse their original entries. It makes sense to move these amounts back into the receivable balance since Ted still expects the customer to pay the amount owed! At the same time, students should reduce the cash balance as ME was never truly paid from the beginning!

ii. **Ted paid the attorney his balance owed, and also paid $500 towards the supplies purchased on 12/15.**

   The professional fees and supplies have already been recorded and students will need to remember that there is an accounts payable balance related to these two items. Now that payment is made, the corresponding "accounts payable" should be reduced.

iii. **Ted collected $700 of the amount owed from the 12/22 events.**

The $700 of payments collected from 12/22 has already been billed, and the related accounts receivable should be reduced.

Monday, December 29:

Ted purchased a Ford van (with a customized logo wrap) to be used to drive to events. The final negotiated price was $30,000. Ted wrote a check for a 25% down payment, and signed a loan with the dealership for the balance owed. He scheduled an appointment to bring the van back in January to have the logo wrap installed.

The van will be used in operations for years to come and will be depreciated in ***Case 1-2***. In *Exhibit 1.3* (January 8(i); Project, p. 20), student are provided with a useful life and depreciation method for the van as well as the details of the new loan. For now, students need to only record the purchase of the van. The depreciation, along with all adjusting journal entries, will be recorded in ***Case 1-2***.

Wednesday, December 31:

Ted performed at two back-to-back New Year's Eve gigs. In each case, he emailed a bill to the event organizers before leaving the venue.

	12/31
Total charges for two events	**$6,500**
Less: credit for deposits already made	**-500**
Less: payments made on the day of the	**-3,000**
Balance due	**$3,000**

The total revenue of $6,500 can be recognized as it has been earned. The offsetting debit is made up of three components:

- Ted's obligation to a customer (as a result of a $500 advance deposit) is reduced with a debit. The advance deposit (when originally received) was recorded by increasing the "customer deposits" account. Because Ted has now performed the agreed-upon services, he is no longer obligated to the customer, and accordingly, this same liability account ("customer deposits") is reduced.
- The $3,000 cash collected at the events.
- The $3,000 "accounts receivable," which represents the balances still owed by the customers.