Chpt 4: Completing the Accounting Cycle

LO 1 Prepare a worksheet

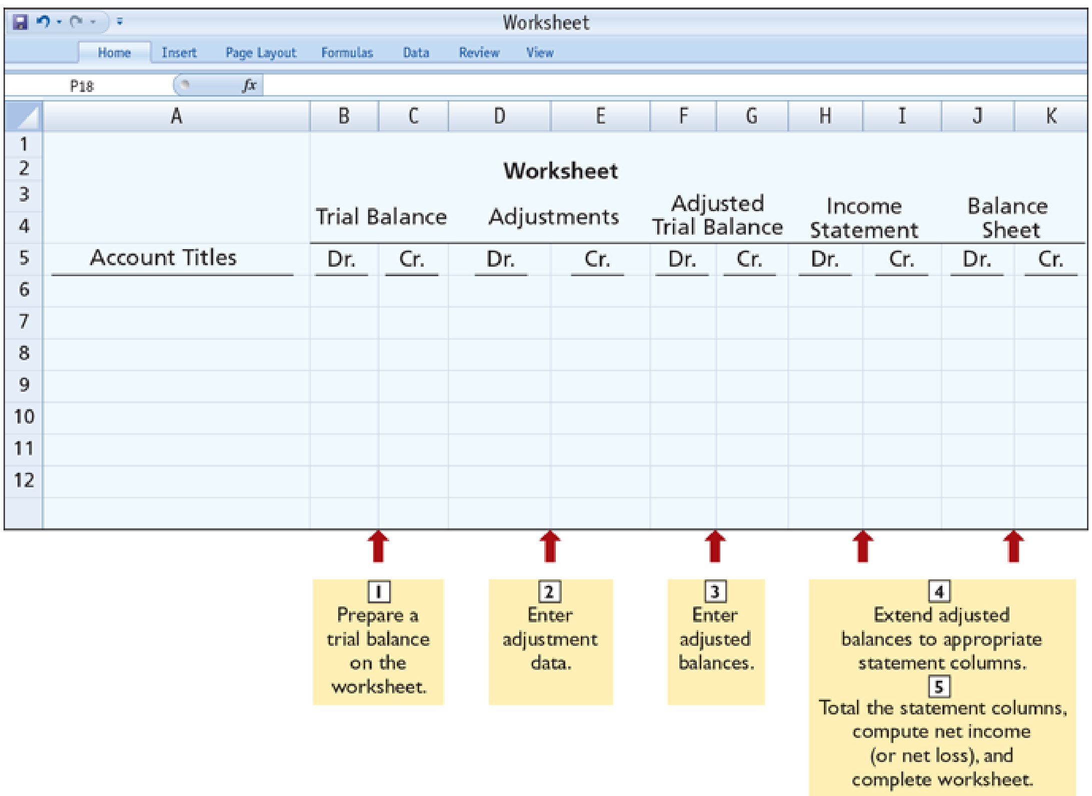
Below is a table demonstrating the basic form of a worksheet and the five steps for preparing it. Each step is performed in sequence – see steps 1 – 5 in graph below. **The use of a worksheet is optional.**

A worksheet is <u>not</u> a journal, and it cannot be used as a basis for posting to ledger accounts.

To adjust the accounts, the company must journalize the adjustments and post them to the ledger.

The adjusting entries are prepared from the adjustments columns of the worksheet.

or a worksheet



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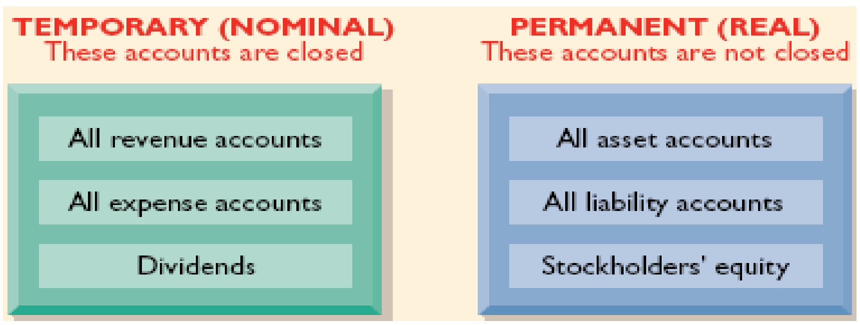
LO 2: Prepare closing entries and post close trial balance

CLOSING THE BOOKS

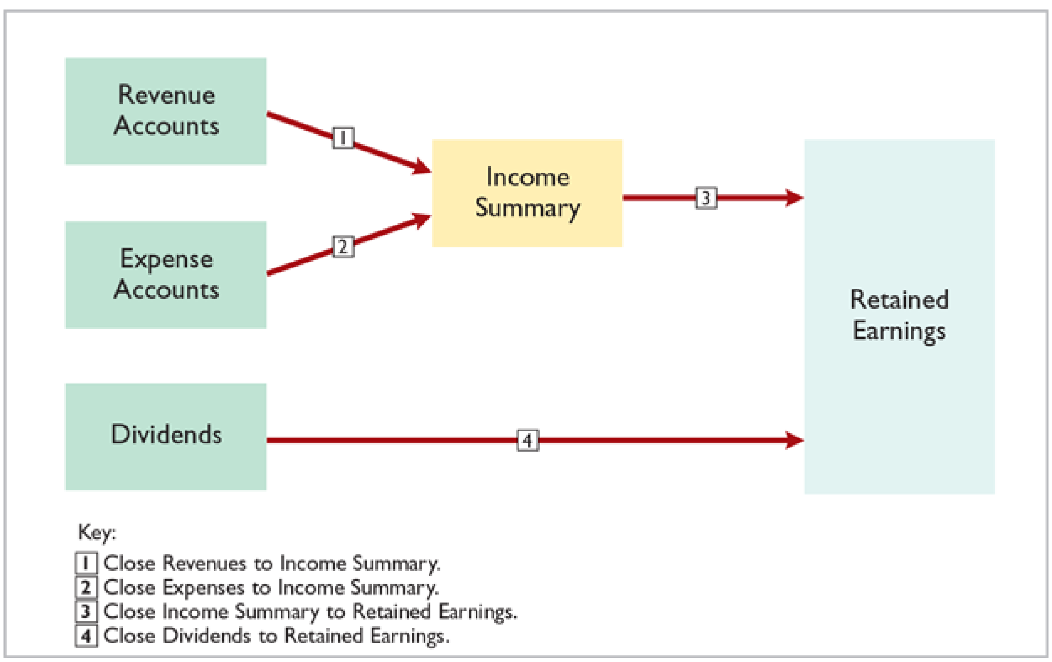
***CLOSE (ZERO OUT) *TEMPOARY ACCOUNTS* SUCH AS REVENUES, EXPENSES, AND DIVIDENDS.**

****PERMANENT ACCOUNTS* (BALANCE SHEET ACCOUNTS) ARE NOT CLOSED AT THE END OF THE PERIOD AND ARE CARRIED FORWARD FROM YEAR TO YEAR.**



Think **"RED"** when trying to remember which accounts are temporary which means they get "Closed Out."

- **Revenue**
- **Expenses**
- **Dividends**



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STEPS TO CLOSING THE BOOKS

STEP 1: Close credit balances in revenue accounts to **INCOME SUMMARY**. Debit each revenue account for its balance and credit Income Summary for the total revenue.

Date	Account Title	Debit	Credit
	Revenue	XXX	
	Income Summary		XXX

STEP 2: Close debit balances in expense accounts to **INCOME SUMMARY**. Credit each expense account for its balance and debit Income Summary for the total expenses.

Date	Account Title	Debit	Credit
	Income Summary	XXX	
	Expenses		XXX

STEP 3: Close Income Summary to RETAINED EARNINGS.

When a company has Net Income: Debit Income Summary for its balance (net income) and credit the retained earnings account.

When a company has Net Loss: Credit Income Summary for the amount of its balance and debit the retained earnings account for the amount of the net loss.

INCOME SUMMARY

Net Loss

If DEBITS > CREDITS, that is

EXPENSES > REVENUES, then

Date	Account Title	Debit	Credit
	Retained Earnings	XXX	
	Income Summary		XXX

Net Income

If DEBITS < CREDITS, that is

EXPENSES< REVENUES, then

Date	Account Title	Debit	Credit
	Income Summary	XXX	
	Retained Earnings		XXX

EXAMPLE:

Income Summary

500	1,000
Closing 500	

***CREDITS > DEBITS, so journal entry would be**

Date	Account Title	Debit	Credit
	Income Summary	500	
	Retained Earnings		500

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STEP 4: Close dividends account to RETAINED EARNINGS ACCOUNT. Debit the retained earnings account for the balance of the dividends account and credit the dividends account.

Date	Account Title	Debit	Credit
	Retained Earnings	XXX	
	Dividends		XXX

***After the closing entries are posted, **ALL OF THE TEMPORARY ACCOUNTS HAVE ZERO BALANCES** and they **ARE NOT SHOWN ON THE POST-CLOSING TRIAL BALANCE**.

- **Income Summary: temporary account that is ONLY used during the closing process.**
    - After the closing entries are posted, ALL OF THE TEMPORARY ACCOUNTS HAVE ZERO BALANCES.
    - During the closing process, revenue and expense accounts are cleared by debiting or crediting Income Summary for their amounts.

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Post-Closing Trial Balance

- Proves the equality of the permanent account balances that the company carries forward into the next accounting period
- All temporary accounts will have zero balances.

Post-closing trial balance

Harper Inc. Adjusted Trial Balance January 31, 2021		
	Debit	***Credit***
Cash	$15,200	
Accounts Receivable	200	
Supplies	1,000	
Prepaid Insurance	550	
Equipment	5,000	
Accumulated Depreciation—Equipment		$40
Notes Payable		5,000
Accounts Payable		2,500
Unearned Service Revenue		800
Salaries and Wages Payable		1,200
Interest Payable		50
Common Stock		10,000
Retained Earnings		2,360
	$21,950	**$21,950**

- Harper prepares the post-closing trial balance from the permanent accounts in the ledger. The example above shows the **permanent** accounts in Harper's general ledger.

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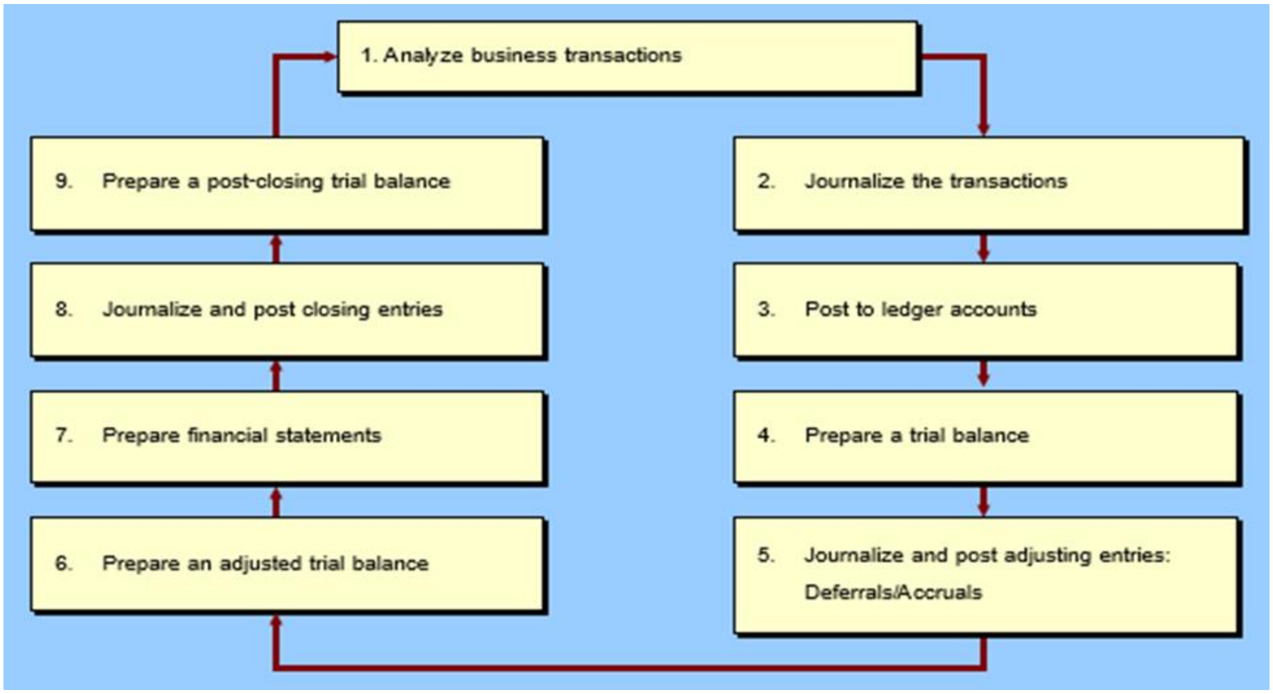
LO 3: Explain the steps in the accounting cycle and how to prepare correcting entries.

Summary of the Accounting Cycle



Correcting Entries

Errors that occur in recording transactions should be corrected as soon as they are discovered by preparing correcting entries. Correcting entries:

a. are unnecessary if the records are free of errors.
b. are journalized and posted whenever an error is discovered.
c. may involve any combination of balance sheet and income statement accounts.

Adjusting entries always affect at least one balance sheet account and one income statement account. In contrast, **correcting entries may involve any combination of accounts in need of correction.**

Correcting entries must be posted **before** closing entries.

To determine the correcting entry

1. Compare the incorrect entry with the correct entry
2. Then make a correcting entry

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Example: On July 4th, Harper Co. journalized and posted a $150 cash collection on account from a customer as a debit to Cash $150 and a credit to Service Revenue $150 (see **below**).

The company discovered the error on July 31, when the customer paid the remaining balance in full.

1. **Comparison of entries**

***Incorrect* Entry (July 4)**			***Correct* Entry (July 31)**		
Cash	150		Cash	150	
Service Revenue		150	*Accounts Receivable*		150

Comparison of the incorrect entry with the correct entry reveals that the debit to Cash $150 is correct.

However, the $150 credit to **Service Revenue** should have been credited to **Accounts Receivable.**

As a result, both Service Revenue and Accounts Receivable are overstated in the ledger. Harper makes the correcting entry.

2. **Correcting Entry Necessary**

Correcting entry			
July 31	Dr Service Revenue	150	
	Cr Accounts Receivable		150
	(To correct entry of July 4)		

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LO 4: Identify the sections of a classified balance sheet.

- Describes a company's financial position (types and amounts of assets, liabilities, and equity) at a **point in time**.

- Example: A balance sheet would be prepared "As of December 31, 20XX" because it gives a snapshot of the company's financial position as of that date.

- **Basic Accounting Equation**: **ASSETS = LIABILITIES + STOCKHOLDERS'EQUITY**

Assets	Liabilities and Stockholders' Equity
Current assets	Current liabilities
Long-term investments	Long-term liabilities
Property, plant, and equipment	Stockholders' equity
Intangible assets	

FRANKLIN CORPORATION
Balance Sheet
October 31, 2017

Assets

Current assets			
Cash		$ 6,600	
Debt investments		2,000	
Accounts receivable		7,000	
Notes receivable		1,000	
Inventory		3,000	
Supplies		2,100	
Prepaid insurance		400	
Total current assets			$22,100
Long-term investments			
Stock investments		5,200	
Investment in real estate		2,000	7,200
Property, plant, and equipment			
Land		10,000	
Equipment	$24,000		
Less: Accumulated depreciation—equipment	5,000	19,000	29,000
Intangible assets			
Patents			3,100
Total assets			$61,400

Liabilities and Stockholders' Equity

Current liabilities		
Notes payable	$11,000	
Accounts payable	2,100	
Unearned sales revenue	900	
Salaries and wages payable	1,600	
Interest payable	450	
Total current liabilities		$16,050
Long-term liabilities		
Mortgage payable	10,000	
Notes payable	1,300	
Total long-term liabilities		11,300
Total liabilities		27,350
Stockholders' equity		
Common stock	14,000	
Retained earnings	20,050	
Total stockholders' equity		34,050
Total liabilities and stockholders' equity		$61,400

*****Notice that Assets = Liabilities + Stockholders' Equity. Everything is balanced.**

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ACCOUNT CLASSIFICATION	EXAMPLES	DEFINITION
Current Assets	1. Cash 2. Accounts Receivable 3. Inventory 4. Prepaids 5. Supplies 6. Investments (short-term).	"Cash and other resources that are expected to be sold, collected, or used **WITHIN one year or company's operating cycle**, whichever is longer." Companies list current asset accounts in the order they expect to convert them into cash.
Long-Term Investments	1. Investments in stocks and bonds of other corporations that are held for more than one year. 2. Long-term assets such as land or buildings that a company is not currently using in its operating activities. 3. Long-term notes receivable.	"Notes receivable and investments in stocks and bonds that the company intends to hold onto for **MORE THAN** the longer of one year or operating cycle." Also, they **ARE NOT** used in the company's operating activities.
Plant Assets (Property, Plant, and Equipment)	1.Equipment 2. Machinery 3. Buildings 4. Land 5. Delivery Vehicles 6. Furniture.	"Tangible assets that are both long-lived and used in operating the business." All plant assets (EXCLUDING Land) depreciate over their useful lives. • **Depreciation**: allocating the cost of assets to a number of years. • **Accumulated Depreciation**: total amount of depreciation expensed thus far in the asset's life.
Intangible Assets	1. Trademarks 2. Patents 3. Copyrights 4. Franchises 5. Goodwill	"Long-term resources that lack a physical form (not touchable) and benefit business operations."
Current Liabilities	1. Accounts Payable 2. Salaries and Wages Payable 3. Income Taxes Payable 4. Interest Payable 5. Notes Payable (1 year or less). 6. Current maturities of long-term obligations	"Obligations due to be paid or settled **WITHIN one year or the operating cycle**, whichever is longer."
Long-Term Liabilities	1. Bonds Payable 2. Notes Payable (more than 1 year) 3. Mortgage Payable. 4. Lease Liabilities 5. Pension Liabilities	"Obligations **NOT DUE within one year or the operating cycle**, whichever is longer."
Equity	1. Common stock 2. Preferred Stock 3. Paid-in Capital 4. Retained Earnings (income retained for use in the business)	"The owner's claim on assets."