

COMPLETION OF THE ACCOUNTING CYCLE

THE NAVIGATOR ✓

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*C*ONCEPTS FOR REVIEW

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

- a. How to apply the revenue recognition and matching principles.
(Ch. 4, p. 114)
- b. How to make adjusting entries. (Ch. 4, pp. 115–126)
- c. How to prepare an adjusted trial balance. (Ch. 4, p. 130)
- d. How to prepare a balance sheet, income statement, and retained earnings statement. (Ch. 4, pp. 131–132)

FEATURE STORY

Everyone Likes to Win

When Ted Castle was a hockey coach at the University of Vermont, his players were self-motivated by their desire to win. Hockey was a game you either won or lost. But at **Rhino Foods, Inc.**, a specialty-bakery-foods company he founded in Burlington, Vermont, he discovered that manufacturing-line workers were not so self-motivated. Ted thought, what if he turned the food-making business into a game, with rules, strategies, and trophies?

Ted knew that in a game knowing the score is all-important. He felt that only if the employees know the score—know exactly how the business is doing daily, weekly, monthly—could he turn food-making into a game. But Rhino is a closely held, family-owned business, and its financial statements and profits were confidential. Should Ted open Rhino's books to the employees?

A consultant he was working with put Ted's concerns in perspective. The consultant said, "Imagine

you're playing touch football. You play for an hour or two, and the whole time I'm sitting there with a book, keeping score. All of a sudden I blow the whistle, and I say, 'OK, that's it. Everybody go home.' I close my book and walk away. How would you feel?" Ted opened his books and revealed the financial statements to his employees.

The next step was to teach employees the rules and strategies of how to win at making food. The first lesson: "Your opponent at Rhino is expenses. You must cut and control expenses." Ted and his staff distilled those lessons into daily scorecards (production reports and income statements) that keep Rhino's employees up to date on the game. At noon each day, Ted posts the previous day's results at the entrance to the production room. Everyone checks whether

they made or lost money on what they produced the day before. And it's not just an academic exercise; there's a bonus check for each employee at the end of every four-week "game" that meets profitability guidelines. Everyone can be a winner!

Rhino has flourished since the first game, three years ago. Employment has nearly tripled to 58, while both revenues and profits have grown by about 600 percent.



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STUDY OBJECTIVES

After studying this chapter, you should be able to

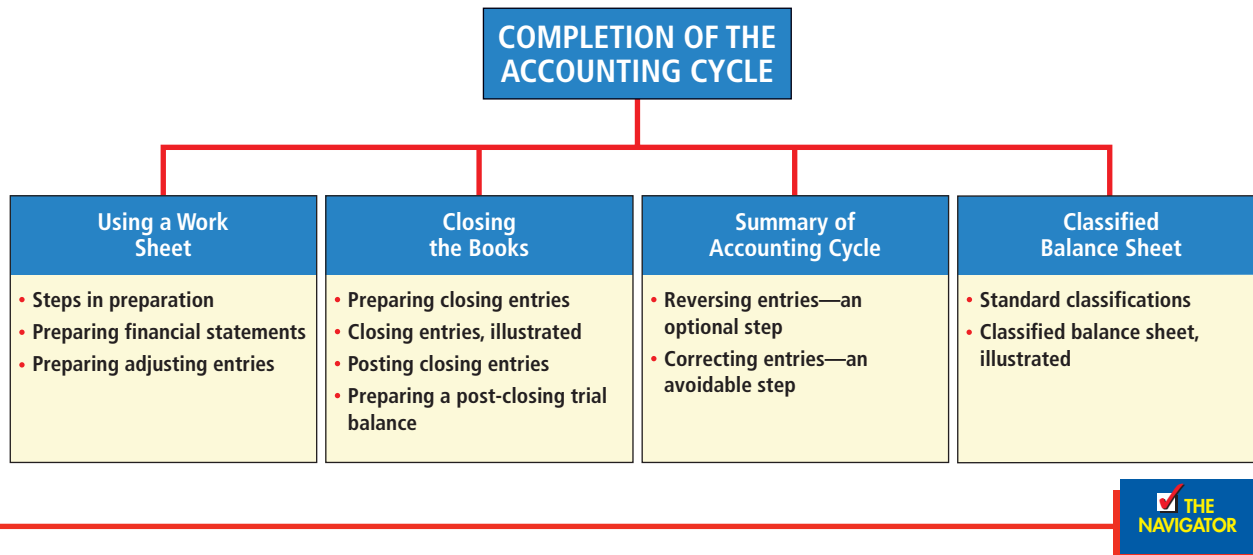
1. Prepare a work sheet.
2. Explain the process of closing the books.
3. Describe the content and purpose of a post-closing trial balance.
4. State the required steps in the accounting cycle.
5. Explain the approaches to preparing correcting entries.
6. Identify the sections of a classified balance sheet.

 **THE NAVIGATOR**

PREVIEW OF CHAPTER 5

As was true at **Rhino Foods, Inc.**, financial statements can help employees understand what is happening in the business. In Chapter 4, we prepared financial statements directly from the adjusted trial balance. However, with so many details involved in the end-of-period accounting procedures, it is easy to make errors. Locating and correcting errors can cost much time and effort. One way to minimize errors in the records and to simplify the end-of-period procedures is to use a work sheet.

In this chapter we will explain the role of the work sheet in accounting as well as the remaining steps in the accounting cycle, most especially, the closing process, again using Premier Staffing Agency as an example. Then we will consider (1) correcting entries and (2) classified balance sheets. The content and organization of Chapter 5 are as follows.



USING A WORK SHEET

STUDY OBJECTIVE 1

Prepare a work sheet.

A **work sheet** is a multiple-column form that may be used in the adjustment process and in preparing financial statements. As its name suggests, the work sheet is a working tool. **A work sheet is not a permanent accounting record**; it is neither a journal nor a part of the general ledger. The work sheet is merely a device used to make it easier to prepare adjusting entries and the financial statements. In small companies with relatively few accounts and adjustments, a work sheet may not be needed. In large companies with numerous accounts and many adjustments, it is almost indispensable.

The basic form of a work sheet and the procedure (five steps) for preparing it are shown in Illustration 5-1. Each step must be performed in the prescribed sequence.

The use of a work sheet is optional. When one is used, financial statements are prepared from the work sheet. The adjustments are entered in the work sheet columns and are then journalized and posted after the financial statements have been prepared. Thus, management and other interested parties can receive the financial statements at an earlier date when a work sheet is used.

- (c) Two additional depreciation accounts are needed. Depreciation Expense is debited \$40 for the month's depreciation, and Accumulated Depreciation—Office Equipment is credited \$40.
- (d) Unearned Revenue is debited \$400 for services provided, and Service Revenue is credited \$400.
- (e) An additional account Accounts Receivable is debited \$200 for services provided but not billed, and Service Revenue is credited \$200.
- (f) Two additional accounts relating to interest are needed. Interest Expense is debited \$50 for accrued interest, and Interest Payable is credited \$50.
- (g) Salaries Expense is debited \$1,200 for accrued salaries, and an additional account Salaries Payable is credited \$1,200.

Note in the illustration that after all the adjustments have been entered, the adjustments columns are totaled and the equality of the column totals is proved.

Step 3. Enter Adjusted Balances in the Adjusted Trial Balance Columns

Turn over the second transparency, Illustration 5-3B. The adjusted balance of an account is obtained by combining the amounts entered in the first four columns of the work sheet for each account. For example, the Prepaid Insurance account in the trial balance columns has a \$600 debit balance and a \$50 credit in the adjustments columns. The result is a \$550 debit balance recorded in the adjusted trial balance columns. **For each account on the work sheet, the amount in the adjusted trial balance columns is the account balance that will appear in the ledger after the adjusting entries have been journalized and posted.** The balances in these columns are the same as those in the adjusted trial balance in Illustration 4-19 (page 130).

After all account balances have been entered in the adjusted trial balance columns, the columns are totaled and their equality is proved. The agreement of the column totals facilitates the completion of the work sheet. If these columns are not in agreement, the financial statement columns will not balance and the financial statements will be incorrect.

HELPFUL HINT

Every adjusted trial balance amount must be extended to one of the four statement columns. Debit amounts go to debit columns and credit amounts go to credit columns.

Step 4. Extend Adjusted Trial Balance Amounts to Appropriate Financial Statement Columns

Turn over the third transparency, Illustration 5-3C. The fourth step is to extend adjusted trial balance amounts to the income statement and balance sheet columns of the work sheet. Balance sheet accounts are entered in the appropriate balance sheet debit and credit columns. For instance, Cash is entered in the balance sheet debit column, and Notes Payable is entered in the credit column. Accumulated Depreciation is extended to the balance sheet credit column. The reason is that accumulated depreciation is a contra-asset account with a credit balance.

Because the work sheet does not have columns for the retained earnings statement, the balances in Common Stock and Retained Earnings, if any, are extended to the balance sheet credit column. In addition, the balance in Dividends is extended to the balance sheet debit column because it is a stockholders' equity account with a debit balance.

The expense and revenue accounts such as Salaries Expense and Service Revenue are entered in the appropriate income statement columns.

All of these extensions are shown in Illustration 5-3C.

Step 5. Total the Statement Columns, Compute the Net Income (or Net Loss), and Complete the Work Sheet

Turn over the fourth transparency, Illustration 5-3D. Each of the financial statement columns must be totaled. The net income or loss for the period is then found

by computing the difference between the totals of the two income statement columns. If total credits exceed total debits, net income has resulted. In such a case, as shown in Illustration 5-3D, the words “Net Income” are inserted in the account titles space. The amount then is entered in the income statement debit column and the balance sheet credit column. **The debit amount balances the income statement columns, and the credit amount balances the balance sheet columns.** In addition, the credit in the balance sheet column indicates the increase in stockholders’ equity resulting from net income.

If, instead, total debits in the income statement columns exceed total credits, a net loss has occurred. The amount of the net loss is entered in the income statement credit column and the balance sheet debit column.

After the net income or net loss has been entered, new column totals are determined. The totals shown in the debit and credit income statement columns will match. The totals shown in the debit and credit balance sheet columns will also match. If either the income statement columns or the balance sheet columns are not equal after the net income or net loss has been entered, an error has been made in the work sheet. The completed work sheet for Premier Staffing Agency Inc. is shown in Illustration 5-3D.

HELPFUL HINT

All pairs of columns must balance for a work sheet to be complete.

TECHNOLOGY IN ACTION



The work sheet can be computerized using an electronic spreadsheet program. The Excel supplement for this textbook is one of the most popular versions of such spreadsheet packages. With a program like Excel, you can produce any type of work sheet (accounting or otherwise) that you could produce with paper and pencil on a columnar pad. The tremendous advantage of an electronic work sheet over the paper-and-pencil version is the ability to change selected data easily. When data are changed, the computer updates the balance of your computations instantly. More specific applications of electronic spreadsheets will be noted as we proceed.



PREPARING FINANCIAL STATEMENTS FROM A WORK SHEET

After a work sheet has been completed, all the data that are required for the preparation of financial statements are at hand. The income statement is prepared from the income statement columns. The balance sheet and retained earnings statement are prepared from the balance sheet columns. The financial statements prepared from the work sheet for Premier Staffing Agency Inc. are shown in Illustration 5-4. At this point, adjusting entries have not been journalized and posted. Therefore, the ledger does not support all financial statement amounts.

The amount shown for common stock on the work sheet does not change from the beginning to the end of the period unless additional stock is issued by the company during the period. Because there was no balance in Premier’s retained earnings, the account is not listed on the work sheet. Only after dividends and net income (or loss) are posted to retained earnings does this account have a balance at the end of the first year of the business.

Using a work sheet, financial statements can be prepared before adjusting entries are journalized and posted. **However, the completed work sheet is not a substitute for formal financial statements.** Data in the financial statement columns of the work sheet are not properly arranged for statement purposes. Also, as noted above, the financial statement presentation for some accounts differs from their statement columns on the work sheet. **A work sheet is essentially a working tool of the accountant; it is not distributed to management and other parties.**

(Note: Text continues on page 149, following acetate overlays.)

Illustration 5-2

Preparing a trial balance

PREMIER STAFFING AGENCY INC.										
Work Sheet										
For the Month Ended October 31, 2004										
Account Titles	Trial Balance		Adjustments		Adjusted Trial Balance		Income Statement		Balance Sheet	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	15,200									
Supplies	2,500									
Prepaid Insurance	600									
Office Equipment	5,000									
Notes Payable		5,000								
Accounts Payable		2,500								
Unearned Revenue		1,200								
Common Stock		10,000								
Dividends	500									
Service Revenue		10,000								
Salaries Expense	4,000									
Rent Expense	900									
Totals	28,700	28,700								

↑
Include all accounts from
ledger with balances.

↑
Trial balance amounts are
taken directly from ledger
accounts.

Illustration 5-3A

Entering the adjustments in the adjustment columns

		(a) 1,500	
		(b) 50	
	(d) 400		
		(d) 400	
		(e) 200	
	(g) 1,200		
Supplies Expense	(a) 1,500		
Insurance Expense	(b) 50		
Accum. Depreciation—Office Equipment		(c) 40	
Depreciation Expense	(c) 40		
Interest Expense	(f) 50		
Accounts Receivable	(e) 200		
Interest Payable		(f) 50	
Salaries Payable		(g) 1,200	
Totals	<u>3,440</u>	<u>3,440</u>	

↑
Add additional accounts as are needed to complete the adjustments:

- (a) Supplies Used
- (b) Insurance Expired
- (c) Depreciation Expensed
- (d) Service Revenue Earned
- (e) Service Revenue Accrued
- (f) Interest Accrued
- (g) Salaries Accrued

↑
Enter adjustment amounts in appropriate columns, and use letters to cross-reference the debit and credit adjustments.

Total adjustment columns and check for equality.

*Entering adjusted balances
in the adjusted trial balance
columns*

15,200	
1,000	
550	
5,000	
	5,000
	2,500
	800
	10,000
500	
	10,600
5,200	
900	
1,500	
50	
	40
40	
50	
200	
	50
	1,200
<u>30,190</u>	<u>30,190</u>

Total adjusted trial balance columns and check for equality.

Extending the adjusted trial balance amounts to appropriate financial statement columns

Extend all revenue and expense account balances to the income statement columns.

Extend all asset and liability account balances, as well as owner's capital and drawing account balances, to the balance sheet columns.

Computing net income or net loss and completing the work sheet

<u>7,740</u>	<u>10,600</u>	<u>22,450</u>	<u>19,590</u>
→ <u>2,860</u>			<u>2,860</u>
<u><u>10,600</u></u>	<u><u>10,600</u></u>	<u><u>22,450</u></u>	<u><u>22,450</u></u>

Net income is extended to the credit column of the balance sheet columns. (Net loss would be extended to the debit column.)

PREMIER STAFFING AGENCY INC. Income Statement For the Month Ended October 31, 2004		
Revenues		
Service revenue		\$10,600
Expenses		
Salaries expense	\$5,200	
Supplies expense	1,500	
Rent expense	900	
Insurance expense	50	
Interest expense	50	
Depreciation expense	40	
Total expenses		<u>7,740</u>
Net income		<u>\$ 2,860</u>

Illustration 5-4

Financial statements from a work sheet

PREMIER STAFFING AGENCY INC. Retained Earnings Statement For the Month Ended October 31, 2004	
Retained earnings, October 1	\$ -0-
Add: Net income	<u>2,860</u>
	2,860
Less: Dividends	<u>500</u>
Retained earnings, October 31	<u>\$2,360</u>

PREMIER STAFFING AGENCY INC. Balance Sheet October 31, 2004		
Assets		
Cash		\$15,200
Accounts receivable		200
Supplies		1,000
Prepaid insurance		550
Office equipment	\$5,000	
Less: Accumulated depreciation	<u>40</u>	<u>4,960</u>
Total assets		<u>\$21,910</u>
Liabilities and Stockholders' Equity		
Liabilities		
Notes payable		\$ 5,000
Accounts payable		2,500
Interest payable		50
Unearned revenue		800
Salaries payable		<u>1,200</u>
Total liabilities		9,550
Stockholders' equity		
Common stock		10,000
Retained earnings		<u>2,360</u>
Total liabilities and stockholders' equity		<u>\$21,910</u>

PREPARING ADJUSTING ENTRIES FROM A WORK SHEET

A work sheet is not a journal, and it cannot be used as a basis for posting to ledger accounts. To adjust the accounts, it is necessary to journalize the adjustments and post them to the ledger. **The adjusting entries are prepared from the adjustments columns of the work sheet.** The reference letters in the adjustments columns and the explanations of the adjustments at the bottom of the work sheet help identify the adjusting entries. However, writing the explanation to the adjustments at the bottom of the work sheet is not required. As indicated previously, the journalizing and posting of adjusting entries follows the preparation of financial statements when a work sheet is used. The adjusting entries on October 31 for Premier Staffing Agency Inc. are the same as those shown in Illustration 4-17 (page 128).

BEFORE YOU GO ON...

▶ REVIEW IT

1. What are the five steps in preparing a work sheet?
2. How is net income or net loss shown in a work sheet?
3. How does a work sheet relate to preparing financial statements and adjusting entries?

▶ DO IT

Susan Elbe is preparing a work sheet for her travel agency. Explain to Susan how the following adjusted trial balance accounts should be extended to the financial statement columns of the work sheet: Cash; Accumulated Depreciation; Accounts Payable; Dividends; Service Revenue; and Salaries Expense.

ACTION PLAN

- Extend asset balances to the balance sheet debit column. Extend liability balances to the balance sheet credit column. Extend accumulated depreciation to the balance sheet credit column.
- Extend the Dividends account to the balance sheet debit column.
- Extend expenses to the income statement debit column.
- Extend revenue accounts to the income statement credit column.

SOLUTION

Income statement debit column—Salaries Expense

Income statement credit column—Service Revenue

Balance sheet debit column—Cash; Dividends

Balance sheet credit column—Accumulated Depreciation; Accounts Payable

As indicated in the Technology in Action box on page 147, the work sheet is an ideal application for electronic spreadsheet software like Microsoft Excel and LOTUS 1–2–3.

Related exercise material: 5-1, 5-2, and 5-8.



CLOSING THE BOOKS

STUDY OBJECTIVE 2

Explain the process of closing the books.

At the end of the accounting period, the accounts are made ready for the next period. This is called **closing the books**. In closing the books, it is necessary to distinguish between temporary and permanent accounts. **Temporary** or **nominal accounts** relate only to a given accounting period. They include all income statement accounts and dividends. All temporary accounts are closed. In contrast, **permanent** or **real accounts** relate to one or more future accounting periods. They consist of all balance sheet accounts, including common stock and retained earnings. Permanent accounts are not closed. Instead, their balances are carried forward into the next accounting period. Illustration 5-5 identifies the accounts in each category.

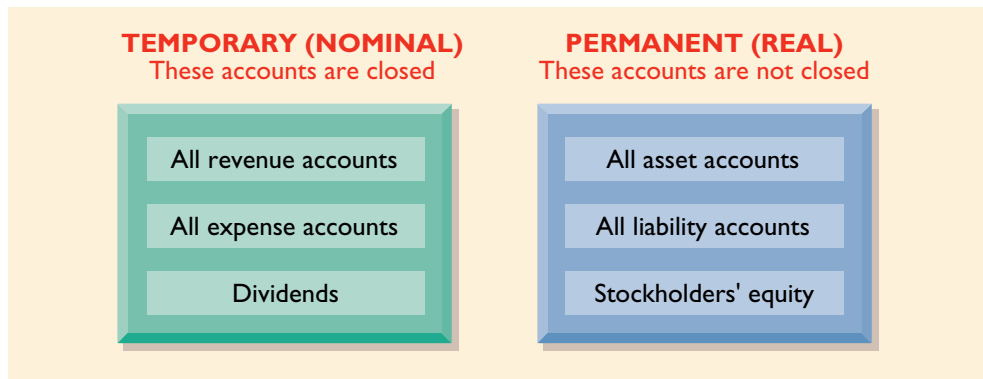


Illustration 5-5

Temporary versus permanent accounts

HELPFUL HINT

A contra-asset account, such as accumulated depreciation, is a real account also.

PREPARING CLOSING ENTRIES

At the end of the accounting period, the temporary account balances are transferred to the permanent stockholders' equity account, Retained Earnings, through the preparation of closing entries. **Closing entries** formally recognize in the ledger the transfer of net income (or net loss) and Dividends to Retained Earnings as shown in the retained earnings statement. **These entries also produce a zero balance in each temporary account. These accounts are then ready to be used to accumulate data in the next accounting period separate from the data of prior periods.** Permanent accounts are not closed.

Journalizing and posting closing entries is a required step in the accounting cycle. (See Illustration 5-12 on page 158.) This step is performed after financial statements have been prepared. In contrast to the steps in the cycle that you have already studied, closing entries are generally journalized and posted **only at the end of a company's annual accounting period**. This practice facilitates the preparation of annual financial statements because all temporary accounts will contain data for the entire year.

In preparing closing entries, each income statement account could be closed directly to Retained Earnings. However, to do so would result in excessive detail in the Retained Earnings account. Instead, the revenue and expense accounts are closed to another temporary account, **Income Summary**; only the net income or net loss is transferred from this account to Retained Earnings.

Closing entries are journalized in the general journal. A center caption entitled Closing Entries, inserted in the journal between the last adjusting entry and the first closing entry, identifies these entries. Then the closing entries are posted to the ledger accounts.

Closing entries may be prepared directly from the adjusted balances in the ledger, from the income statement and balance sheet columns of the work sheet, or from the income and retained earnings statements. Separate closing entries could be prepared for each nominal account, but the following four entries accomplish the desired result more efficiently:

1. Debit each revenue account for its balance, and credit Income Summary for total revenues.
2. Debit Income Summary for total expenses, and credit each expense account for its balance.
3. Debit Income Summary and credit Retained Earnings for the amount of net income.
4. Debit Retained Earnings for the balance in the Dividends account, and credit Dividends for the same amount.

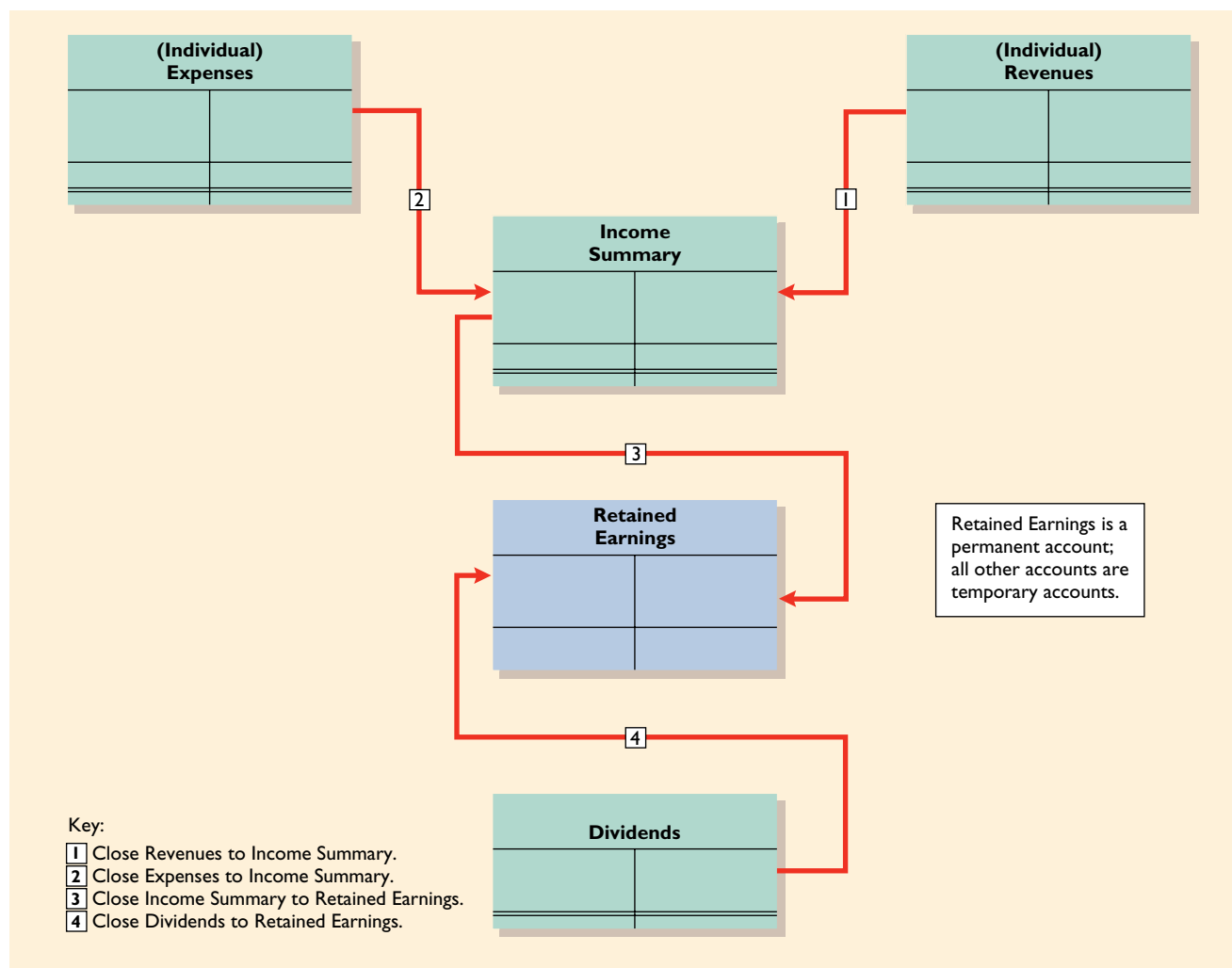
The four entries are referenced in the diagram of the closing process shown in Illustration 5-6 and in the journal entries in Illustration 5-7. The posting of closing entries is shown in Illustration 5-8.

HELPFUL HINT

When the work sheet is used, revenue and expense account data are found in the income statement columns, and Dividends is in the balance sheet debit column.

Illustration 5-6

Diagram of closing process—corporation



HELPFUL HINT

Dividends is closed directly to Retained Earnings and *not* to Income Summary because Dividends is not an expense.

If a net loss has occurred, entry (3) credits Income Summary and debits Retained Earnings.

ACCOUNTING IN ACTION *Business Insight*



Until Sam Walton had opened twenty Wal-Mart stores, he used what he called the “ESP method” of closing the books. ESP was a pretty basic method: If the books didn’t balance, Walton calculated the amount by which they were off and entered that amount under the heading ESP—which stood for “Error Some Place.” As Walton noted, “It really sped things along when it came time to close those books.”

SOURCE: Sam Walton, *Made in America* (New York: Doubleday, 1992), p. 53.

CLOSING ENTRIES, ILLUSTRATED

In practice, closing entries are generally prepared only at the end of a company’s annual accounting period. However, to illustrate the journalizing and posting of

closing entries, we will assume that Premier Staffing Agency Inc. closes its books monthly. The closing entries at October 31 are shown in Illustration 5-7.

GENERAL JOURNAL				J3
Date	Account Titles and Explanation	Ref.	Debit	Credit
	Closing Entries			
	(1)			
Oct. 31	Service Revenue	400	10,600	
	Income Summary	350		10,600
	(To close revenue account)			
	(2)			
31	Income Summary	350	7,740	
	Supplies Expense	611		1,500
	Depreciation Expense	711		40
	Insurance Expense	722		50
	Salaries Expense	726		5,200
	Rent Expense	729		900
	Interest Expense	905		50
	(To close expense accounts)			
	(3)			
31	Income Summary	350	2,860	
	Retained Earnings	320		2,860
	(To close net income to retained earnings)			
	(4)			
31	Retained Earnings	320	500	
	Dividends	332		500
	(To close dividends to retained earnings)			

Illustration 5-7

Closing entries journalized

HELPFUL HINT

Income Summary is a very descriptive title: total revenues are closed to Income Summary, total expenses are closed to Income Summary, and the balance in the Income Summary is a net income or net loss.

Note that the amounts for Income Summary in entries (1) and (2) are the totals of the income statement credit and debit columns, respectively, in the work sheet.

A couple of cautions in preparing closing entries: (1) Avoid unintentionally doubling the revenue and expense balances rather than zeroing them. (2) Do not close Dividends through the Income Summary account. **Dividends are not expenses, and they are not a factor in determining net income.**

POSTING OF CLOSING ENTRIES

The posting of the closing entries and the ruling of the accounts are shown in Illustration 5-8. Note that all temporary accounts have zero balances after posting the closing entries. In addition, you should realize that the balance in Retained Earnings represents the accumulated undistributed earnings of the corporation at the end of the accounting period. This balance is shown on the balance sheet and is the ending amount reported on the retained earnings statement, as shown in Illustration 5-4. **The Income Summary account is used only in closing.** No entries are journalized and posted to this account during the year.

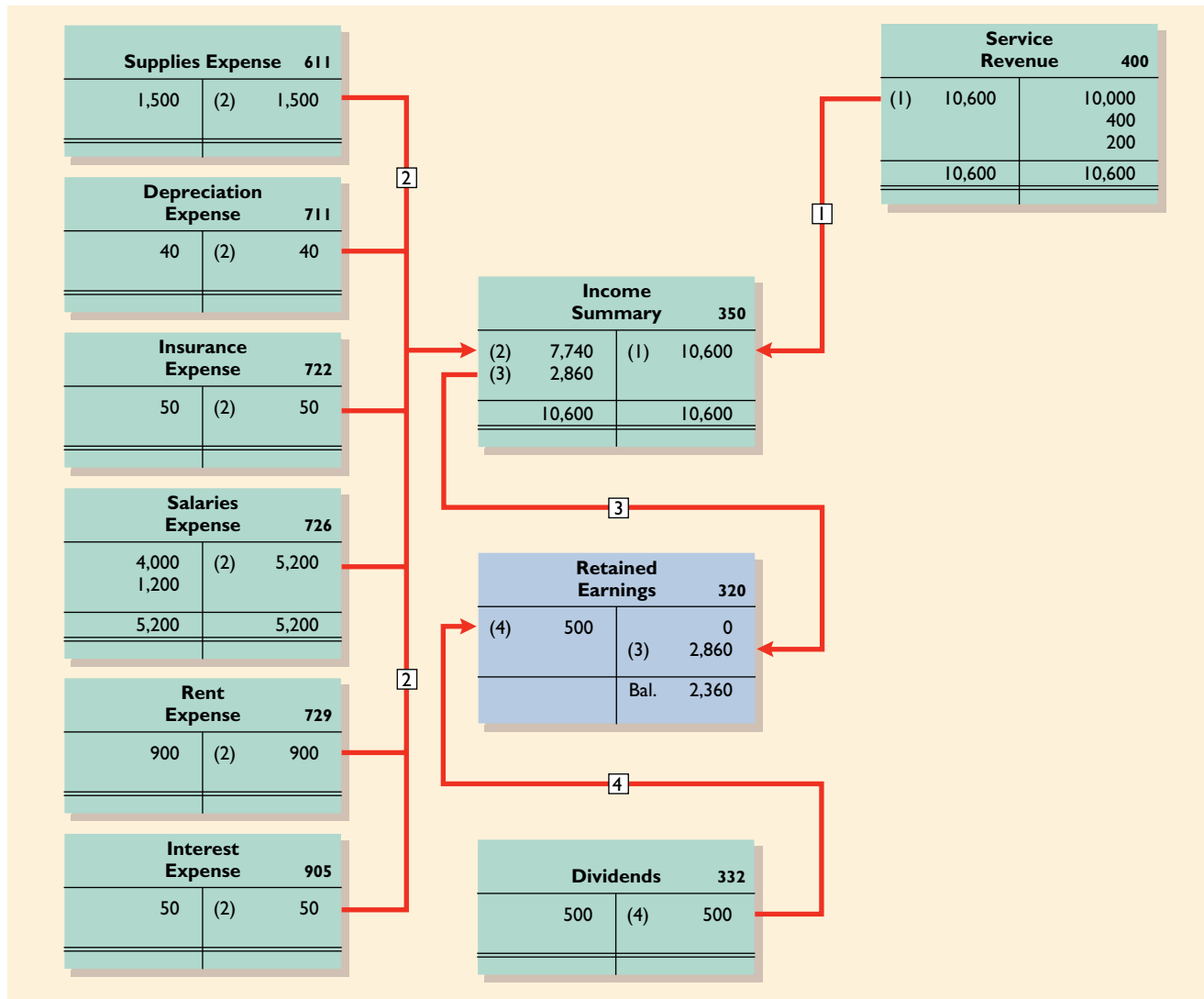
As part of the closing process, the **temporary accounts**—revenues, expenses, and Dividends—in T-account form are totaled, balanced, and double-ruled, as shown in Illustration 5-8. The **permanent accounts**—assets, liabilities, and stockholders' equity (Common Stock and Retained Earnings)—are not closed. A single rule is drawn beneath the current-period entries, and the account balance carried forward to the next period is entered below the single rule. (For example, see Retained Earnings.)

HELPFUL HINT

The balance in Income Summary before it is closed must equal the net income or net loss for the period.

Illustration 5-8

Posting of closing entries



ACCOUNTING IN ACTION Business Insight



The **River Oaks Country Club** is an exclusive private club in the Houston metropolitan area. It has more than 1,500 members, and monthly billing can be a big project without the use of computers. Mel Samuelson, chief financial officer of the club, comments that he could not imagine how cumbersome the system would be if month-end closing and billing had to be done manually. "It only takes us one day to do our month-end closing with computers," said Samuelson. "If every transaction for all 1,530 members has to be done by hand, it may take at least a week just for the closing." Mr. Samuelson also adds that with the use of computers, all postings are updated on a daily basis, making information accessible and real-time.

As Mr. Samuelson suggests, computers do provide more accurate and updated information. More important, this also means the associates in the accounting office can now use the time saved to do other, more meaningful, analysis of data, thereby providing better information to management and better service to its members.



PREPARING A POST-CLOSING TRIAL BALANCE

After all closing entries have been journalized and posted, another trial balance, called a **post-closing trial balance**, is prepared from the ledger. The post-closing trial balance lists permanent accounts and their balances after closing entries have been journalized and posted. **The purpose of this trial balance is to prove the equality of the permanent account balances that are carried forward into the next accounting period.** Since all temporary accounts will have zero balances, the post-closing trial balance will contain only permanent—that is, *balance sheet*—accounts.

The procedure for preparing a post-closing trial balance again consists entirely of listing the accounts and their balances. The post-closing trial balance for Premier Staffing Agency Inc. is shown in Illustration 5-9. These balances are the same as those reported in the company's balance sheet in Illustration 5-4.

STUDY OBJECTIVE 3

Describe the content and purpose of a post-closing trial balance.

PREMIER STAFFING AGENCY INC. Post-Closing Trial Balance October 31, 2004		
	<u>Debit</u>	<u>Credit</u>
Cash	\$15,200	
Accounts Receivable	200	
Supplies	1,000	
Prepaid Insurance	550	
Office Equipment	5,000	
Accumulated Depreciation—Office Equipment		\$ 40
Notes Payable		5,000
Accounts Payable		2,500
Unearned Revenue		800
Salaries Payable		1,200
Interest Payable		50
Common Stock		10,000
Retained Earnings		2,360
	<u>\$21,950</u>	<u>\$21,950</u>

Illustration 5-9

Post-closing trial balance

HELPFUL HINT

Will total debits in a post-closing trial balance equal total assets on the balance sheet? Answer: No. Accumulated depreciation is deducted from assets on the balance sheet but added to the credit balance total in a post-closing trial balance.

The post-closing trial balance is prepared from the permanent accounts in the ledger. The permanent accounts of Premier Staffing are shown in the general ledger in Illustration 5-10 on page 156. Remember that the balance of each permanent account is computed after every posting. Therefore, no additional work on these accounts is needed as part of the closing process.

A post-closing trial balance provides evidence that the journalizing and posting of closing entries have been properly completed. It also shows that the accounting equation is in balance at the end of the accounting period. However, like the trial balance, it does not prove that all transactions have been recorded or that the ledger is correct. For example, the post-closing trial balance will balance if a transaction is not journalized and posted or if a transaction is journalized and posted twice.

The remaining accounts in the general ledger are temporary accounts (shown in Illustration 5-11 on page 157). After the closing entries are correctly posted, each temporary account has a zero balance. These accounts are double-ruled to finalize the closing process.

(Permanent Accounts Only)

GENERAL LEDGER											
Cash No. 101						Accounts Payable No. 201					
Date	Explanation	Ref.	Debit	Credit	Balance	Date	Explanation	Ref.	Debit	Credit	Balance
2004						2004					
Oct. 1		J1	10,000		10,000	Oct. 5		J1		2,500	2,500
2		J1	1,200		11,200	Unearned Revenue No. 209					
3		J1		900	10,300	Date	Explanation	Ref.	Debit	Credit	Balance
4		J1		600	9,700	2004					
20		J1		500	9,200	Oct. 2		J1		1,200	1,200
26		J1		4,000	5,200	Oct. 31	Adj. entry	J2	400		800
31		J1	10,000		15,200	Salaries Payable No. 212					
Accounts Receivable No. 112						Date	Explanation	Ref.	Debit	Credit	Balance
Date	Explanation	Ref.	Debit	Credit	Balance	2004					
2004						Oct. 31	Adj. entry	J2		1,200	1,200
Oct. 31	Adj. entry	J2	200		200	Interest Payable No. 230					
Supplies No. 129						Date	Explanation	Ref.	Debit	Credit	Balance
Date	Explanation	Ref.	Debit	Credit	Balance	2004					
2004						Oct. 31	Adj. entry	J2		50	50
Oct. 5		J1	2,500		2,500	Common Stock No. 311					
31	Adj. entry	J2		1,500	1,000	Date	Explanation	Ref.	Debit	Credit	Balance
Prepaid Insurance No. 130						2004					
Date	Explanation	Ref.	Debit	Credit	Balance	Oct. 1		J1		10,000	10,000
2004						Retained Earnings No. 320					
Oct. 4		J1	600		600	Date	Explanation	Ref.	Debit	Credit	Balance
31	Adj. entry	J2		50	550	2004					
Office Equipment No. 157						Oct. 1					-0-
Date	Explanation	Ref.	Debit	Credit	Balance	31	Closing entry	J3		2,860	2,860
2004						31	Closing entry	J3	500		2,360
Oct. 1		J1	5,000		5,000	<div>Note: The permanent accounts for Premier Staffing Agency Inc. are shown here; the temporary accounts are shown in Illustration 5-11. Both permanent and temporary accounts are part of the general ledger; they are segregated here to aid in learning.</div>					
Accumulated Depreciation—Office Equipment No. 158											
Date	Explanation	Ref.	Debit	Credit	Balance						
2004											
Oct. 31	Adj. entry	J2		40	40						
Notes Payable No. 200											
Date	Explanation	Ref.	Debit	Credit	Balance						
2004											
Oct. 1		J1		5,000	5,000						

Illustration 5-10

General ledger, permanent accounts

SUMMARY OF THE ACCOUNTING CYCLE

STUDY OBJECTIVE 4

State the required steps in the accounting cycle.

The required steps in the accounting cycle are shown in Illustration 5-12 on page 158. From the graphic you can see that the cycle begins with the analysis of business transactions and ends with the preparation of a post-closing trial balance. The steps in the cycle are performed in sequence and are repeated in each accounting period.

(Temporary Accounts Only)

GENERAL LEDGER											
Dividends No. 332						Insurance Expense No. 722					
Date	Explanation	Ref.	Debit	Credit	Balance	Date	Explanation	Ref.	Debit	Credit	Balance
2004						2004					
Oct. 31		J1	500		500	Oct. 31	Adj. entry	J2	50		50
31	Closing entry	J3		500	<u>-0-</u>	31	Closing entry	J3		50	<u>-0-</u>
Income Summary No. 350						Salaries Expense No. 726					
Date	Explanation	Ref.	Debit	Credit	Balance	Date	Explanation	Ref.	Debit	Credit	Balance
2004						2004					
Oct. 31	Closing entry	J3		10,600	10,600	Oct. 26		J1	4,000		4,000
31	Closing entry	J3	7,740		2,860	31	Adj. entry	J2	1,200		5,200
31	Closing entry	J3	2,860		<u>-0-</u>	31	Closing entry	J3		5,200	<u>-0-</u>
Service Revenue No. 400						Rent Expense No. 729					
Date	Explanation	Ref.	Debit	Credit	Balance	Date	Explanation	Ref.	Debit	Credit	Balance
2004						2004					
Oct. 31		J1		10,000	10,000	Oct. 3		J1	900		900
31	Adj. entry	J2		400	10,400	31	Closing entry	J3		900	<u>-0-</u>
31	Adj. entry	J2		200	10,600						
31	Closing entry	J3	10,600		<u>-0-</u>						
Supplies Expense No. 611						Interest Expense No. 905					
Date	Explanation	Ref.	Debit	Credit	Balance	Date	Explanation	Ref.	Debit	Credit	Balance
2004						2004					
Oct. 31	Adj. entry	J2	1,500		1,500	Oct. 31	Adj. entry	J2	50		50
31	Closing entry	J3		1,500	<u>-0-</u>	31	Closing entry	J3		50	<u>-0-</u>
Depreciation Expense No. 711						<p><i>Note:</i> The temporary accounts for Premier Staffing Agency Inc. are shown here; the permanent accounts are shown in Illustration 5-10. Both permanent and temporary accounts are part of the general ledger; they are segregated here to aid in learning.</p>					
Date	Explanation	Ref.	Debit	Credit	Balance						
2004											
Oct. 31	Adj. entry	J2	40		40						
31	Closing entry	J3		40	<u>-0-</u>						

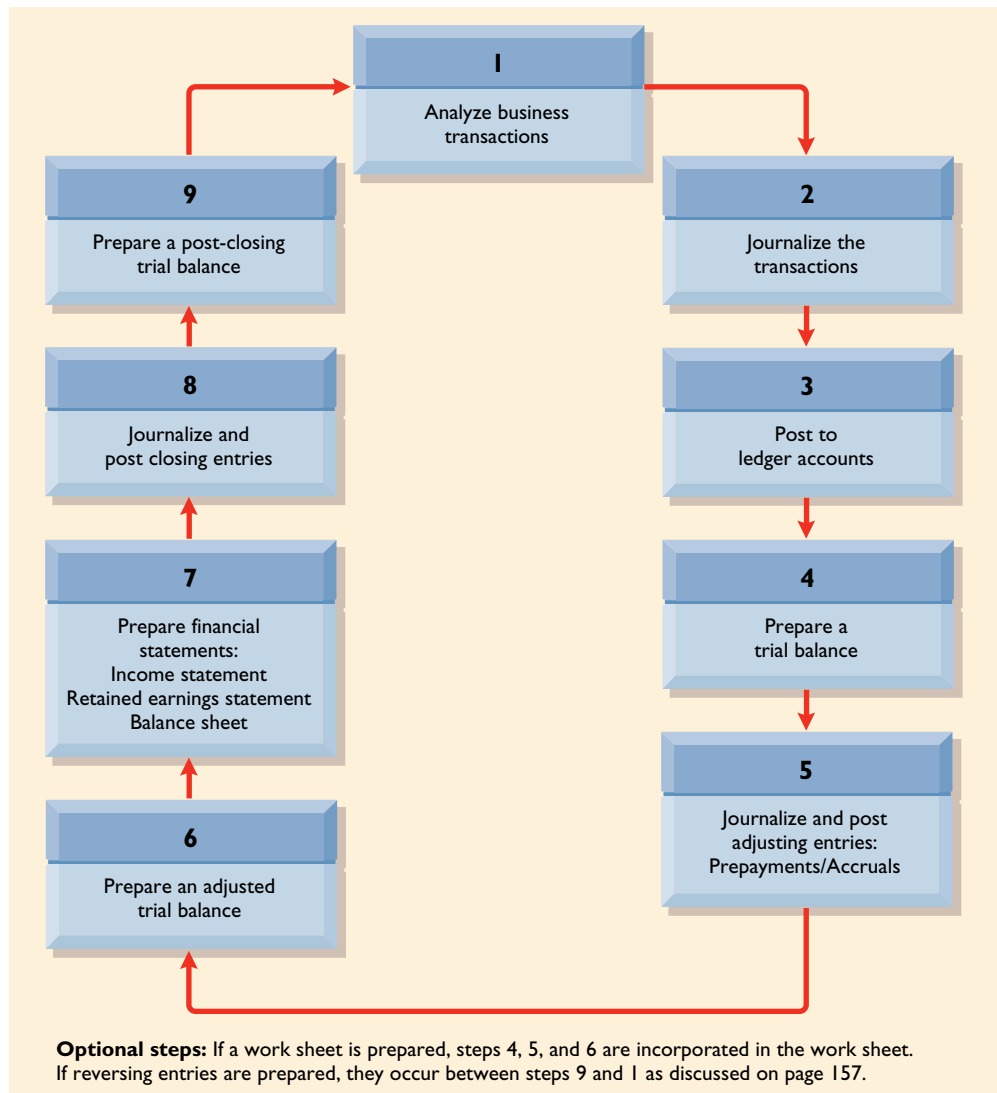
Illustration 5-11

General ledger, temporary accounts

Steps 1–3 may occur daily during the accounting period, as explained in Chapter 3. Steps 4–7 are performed on a periodic basis, such as monthly, quarterly, or annually. Steps 8 and 9, closing entries, and a post-closing trial balance, are usually prepared only at the end of a company's *annual* accounting period. As you have seen, a work sheet may also be used in preparing adjusting entries and financial statements.

Illustration 5-12

Steps in the accounting cycle



CORRECTING ENTRIES—AN AVOIDABLE STEP

STUDY OBJECTIVE 5

Explain the approaches to preparing correcting entries.

Unfortunately, errors may occur in the recording process. Errors should be corrected **as soon as they are discovered** by journalizing and posting **correcting entries**. If the accounting records are free of errors, no correcting entries are necessary.

You should recognize three differences between correcting entries and adjusting entries:

1. Adjusting entries are an integral part of the accounting cycle. Correcting entries, on the other hand, are unnecessary if the records are free of errors.
2. Adjustments are journalized and posted only at the end of an accounting period. In contrast, correcting entries are made whenever an error is discovered.
3. 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, it is useful to compare the incorrect entry with the correct entry. Doing so helps identify the accounts and amounts that should—and should not—be corrected. After comparison, a correcting entry is made to correct the accounts. This approach is illustrated in the following two cases.

CASE 1 On May 10, a \$50 cash collection on account from a customer is journalized and posted as a debit to Cash \$50 and a credit to Service Revenue \$50. The error is discovered on May 20, when the customer pays the remaining balance in full.

Incorrect Entry (May 10)			Correct Entry (May 10)		
Cash	50		Cash	50	
Service Revenue		50	Accounts Receivable		50

A comparison of the incorrect entry with the correct entry reveals that the debit to Cash \$50 is correct. However, the \$50 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. The following correcting entry is required.

Correcting Entry		
May 20	Service Revenue	50
	Accounts Receivable	
	(To correct entry of May 10)	50

CASE 2 On May 18, office equipment costing \$450 is purchased on account. The transaction is journalized and posted as a debit to Delivery Equipment \$45 and a credit to Accounts Payable \$45. The error is discovered on June 3, when the monthly statement for May is received from the creditor.

Incorrect Entry (May 18)			Correct Entry (May 18)		
Delivery Equipment	45		Office Equipment	450	
Accounts Payable		45	Accounts Payable		450

A comparison of the two entries shows that three accounts are incorrect. Delivery Equipment is overstated \$45; Office Equipment is understated \$450; and Accounts Payable is understated \$405. The correcting entry is shown in Illustration 5-16:

Correcting Entry		
June 3	Office Equipment	450
	Delivery Equipment	
	Accounts Payable	45
	(To correct entry of May 18)	405

Instead of preparing a correcting entry, **it is possible to reverse the incorrect entry and then prepare the correct entry.** This approach will result in more entries and postings than a correcting entry, but it will accomplish the desired result.

ETHICS NOTE

Citigroup once reported a correcting entry reducing reported revenue by \$23 million, while firing 11 employees. Company officials did not specify why the employees had apparently intentionally inflated the revenue figures, although it was noted that their bonuses were tied to their unit's performance.

Illustration 5-13

Comparison of entries

Illustration 5-14

Correcting entry

A	=	L	+	SE
-50				-50

Illustration 5-15

Comparison of entries

Illustration 5-16

Correcting entry

A	=	L	+	SE
+450				
-45		+405		

ACCOUNTING IN ACTION *Business Insight*



In the hospitality industry, much work is done behind the scenes so that guests can enjoy their experience, whether they are on a cruise, staying in a hotel for business, at a resort for their vacation, playing tennis at their country club, or dining out with good friends. All the products that make the ultimate service a reality have to be transported and shipped by various carriers. The produce may be grown in California and freighted to Texas; the grill in the kitchen may be manufactured in Ohio and shipped to Florida. Consider the following events with two freight companies.

Yale Express, a short-haul trucking firm, turned over much of its cargo to local truckers for delivery completion. Yale collected the entire delivery charge and, when billed by the local trucker, sent payment for the final phase to the local trucker. Yale used a cut-off period of 20 days into the next accounting period in making its adjusting entries for accrued liabilities. That is, it waited 20 days to receive the local truckers' bills to determine the amount of the unpaid but incurred delivery charges as of the balance sheet date.

In contrast, **Republic Carloading**, a nationwide, long-distance freight forwarder, frequently did not receive transportation bills from truckers to whom it passed on cargo until months after the year-end. In making its year-end adjusting entries, Republic waited for months in order to include all of these outstanding transportation bills.

When Yale Express merged with Republic Carloading, Yale's vice president employed the 20-day cutoff procedure for both firms. As a result, millions of dollars of Republic's accrued transportation bills went unrecorded. When the erroneous procedure was detected and correcting entries were made, these and other errors changed a reported profit of \$1.14 million into a loss of \$1.88 million!

BEFORE YOU GO ON...

► REVIEW IT

1. How do permanent accounts differ from temporary accounts?
2. What four different types of entries are required in closing the books?
3. What is the content and purpose of a post-closing trial balance?
4. What are the required and optional steps in the accounting cycle?

► DO IT

The work sheet for Hancock Health and Exercise Club shows the following in the financial statement columns: Common Stock \$98,000, Dividends \$15,000, Retained Earnings \$42,000, and Net Income \$18,000. Prepare the closing entries at December 31 that affect stockholders' equity.

ACTION PLAN

- Remember to make closing entries in the correct sequence.
- Make the first two entries to close revenues and expenses.
- Make the third entry to close net income to retained earnings.
- Make the final entry to close dividends to retained earnings.

SOLUTION

Dec. 31	Income Summary	18,000	
	Retained Earnings		18,000
	(To close net income to retained earnings)		
31	Retained Earnings	15,000	
	Dividends		15,000
	(To close dividends to retained earnings)		

Related exercise material: 5-3, 5-5, and 5-9.



CLASSIFIED BALANCE SHEET

The financial statements illustrated up to this point were purposely kept simple. We classified items as assets, liabilities, and stockholders' equity in the balance sheet, and as revenues and expenses in the income statement. **Financial statements, however, become more useful to management, creditors, and potential investors when the elements are classified into significant subgroups.** In the remainder of this chapter we will introduce you to the primary balance sheet classifications. The classified income statement will be presented in Chapter 6. The classified financial statements are what Ted Castle, owner of **Rhino Foods, Inc.** gave to his employees to understand what was happening in the business.

STANDARD CLASSIFICATIONS

A **classified balance sheet** usually contains these standard classifications:

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

Illustration 5-17

Standard balance sheet classifications

These sections help the financial statement user determine such matters as (1) the availability of assets to meet debts as they come due and (2) the claims of short- and long-term creditors on total assets. A classified balance sheet also makes it easier to compare companies in the same industry, such as **Four Seasons, Forte Hotels**, and **John Q. Hammons Hotels** in the hotel industry. Each of the sections is explained below.

A complete set of specimen financial statements for **Hilton Hotels Corporation** is shown in the Appendix at the back of the book.

Current Assets

Current assets are cash and other resources that are reasonably expected to be realized in cash or sold or consumed in the business within one year of the balance sheet date or the company's operating cycle, whichever is longer. For example, accounts receivable are current assets because they will be realized in cash through collection within one year. A prepayment such as supplies is a current asset because of its expected use or consumption in the business within one year.

The **operating cycle** of a company is the average time that is required to go from cash to cash in producing revenues. The term *cycle* suggests a circular flow, which in this case, starts and ends with cash. For example, in municipal transit companies, the operating cycle would tend to be short because services are provided entirely on a cash basis. On the other hand, the operating cycle in manufacturing companies is longer: they purchase goods and materials, manufacture and sell products, bill customers, and collect cash. This is a cash-to-cash cycle that may extend for several months. Most companies have operating cycles of less than one year. More will be said about operating cycles in later chapters.

In a service enterprise, it is customary to recognize four types of current assets: (1) cash, (2) short-term investments such as U.S. government bonds,

INTERNATIONAL NOTE

Other countries use a different format for the balance sheet. In Great Britain, for example, property, plant, and equipment are reported first on the balance sheet; assets and liabilities are netted and grouped into net current and net total assets.

(3) receivables (notes receivable, accounts receivable, and interest receivable), and (4) prepaid expenses (insurance and supplies). **These items are listed in the order of liquidity.** That is, they are listed in the order in which they are expected to be converted into cash. This arrangement is illustrated in Illustration 5-18 in the presentation of **UAL, Inc. (United Airlines)**.

Illustration 5-18

Current assets section

UAL, INC. (UNITED AIRLINES) Balance Sheet (partial) (in millions)		
Current assets		
Cash		\$ 310
Short-term investments		379
Receivables		1,284
Aircraft fuel, spare parts, and supplies		340
Prepaid expenses		368
Other current assets		254
Total current assets		<u>\$2,935</u>

A company's current assets are important in assessing the company's short-term debt-paying ability, as explained later in the chapter.

Long-Term Investments

Like current assets, **long-term investments** are resources that can be realized in cash. However, the conversion into cash is not expected within one year or the operating cycle, whichever is longer. In addition, long-term investments are not intended for use or consumption within the business. This category, often just called *investments*, normally includes stocks and bonds of other corporations. **Deluxe Corporation** reported the balance sheet shown in Illustration 5-19.

HELPFUL HINT

Long-term investments are investments *made by* the business—not investments by the stockholders *in* the business. Investments by the stockholders in the business are reported as part of stockholders' equity (see pp. 164–165).

Illustration 5-19

Long-term investments section

DELUXE CORPORATION Balance Sheet (partial)		
Long-term investments		
Investment in stock of Data Card Corporation	\$20,468,000	
Other long-term investments	<u>16,961,000</u>	\$37,429,000

ALTERNATIVE TERMINOLOGY

Property, plant, and equipment are sometimes referred to as *plant assets* or *fixed assets*.

Property, Plant, and Equipment

Property, plant, and equipment are tangible resources of a relatively permanent nature that are used in the business and not intended for sale. This category includes land, buildings, machinery and equipment, delivery equipment, and furni-

ture and fixtures. Assets subject to depreciation should be reported at cost less accumulated depreciation. Illustration 5-20 shows this practice for **Delta Air Lines**.

DELTA AIR LINES, INC. Balance Sheet (partial) (in millions)			
Property, plant, and equipment			
Flight equipment	\$9,619		
Less: Accumulated depreciation	<u>3,510</u>	\$6,109	
Ground property and equipment	3,032		
Less: Accumulated depreciation	<u>1,758</u>	<u>1,274</u>	\$7,383

Illustration 5-20

Property, plant, and equipment section

Intangible Assets

Intangible assets are noncurrent resources that do not have physical substance. Intangible assets include patents, copyrights, and trademarks or trade names that give the holder **exclusive right** of use for a specified period of time. Their value to a company is generally derived from the rights or privileges granted by governmental authority (such as the U.S. Patent Office and the Copyright Office). Intangibles are recorded at cost, and this cost is expensed (amortized) over the useful life of the intangible. Intangibles with indefinite lives are not amortized.

In its balance sheet, **Brunswick Corporation** reported the following.

BRUNSWICK CORPORATION Balance Sheet (partial)	
Intangible assets	
Patents, trademarks, and other intangibles	\$10,460,000

Illustration 5-21

Intangible assets section

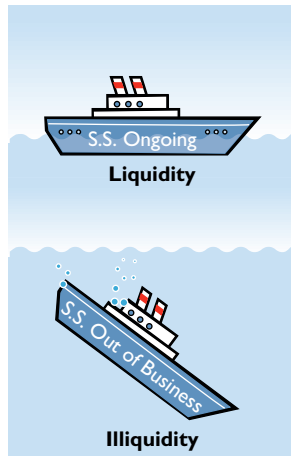
Current Liabilities

Listed first in the liabilities and stockholders' equity section of the balance sheet are current liabilities. **Current liabilities** are obligations that are reasonably expected to be paid from existing current assets or through the creation of other current liabilities. As in the case of current assets, the time period for payment is one year or the operating cycle, whichever is longer. Current liabilities include (1) debts related to the operating cycle, such as accounts payable and wages and salaries payable, and (2) other short-term debts, such as bank loans payable, interest payable, taxes payable, and current maturities of long-term obligations (payments to be made within the next year on long-term obligations).

The arrangement of items within the current liabilities section has evolved through custom rather than from a prescribed rule. Notes payable is usually listed first, followed by accounts payable. Other items are then listed in any order. The current liabilities section adapted from the balance sheet of **UAL, Inc. (United Airlines)** is shown in Illustration 5-22.

Illustration 5-22

Current liabilities section



UAL, INC. (UNITED AIRLINES) Balance Sheet (partial) (in thousands)	
Current liabilities	
Notes payable	\$ 297,518
Accounts payable	382,967
Current maturities of long-term obligations	81,525
Unearned ticket revenue	432,979
Salaries and wages payable	435,622
Taxes payable	80,390
Other current liabilities	240,652
Total current liabilities	\$1,951,653

Users of financial statements look closely at the relationship between current assets and current liabilities. This relationship is important in evaluating a company's **liquidity**—its ability to pay obligations that are expected to become due within the next year or operating cycle. When current assets exceed current liabilities at the balance sheet date, the likelihood for paying the liabilities is favorable. When the reverse is true, short-term creditors may not be paid, and the company may ultimately be forced into bankruptcy.

Long-Term Liabilities**ALTERNATIVE TERMINOLOGY**

Long-term liabilities are also called *long-term debt* or *noncurrent liabilities*.

Obligations expected to be paid after one year or an operating cycle, whichever is longer, are classified as **long-term liabilities**. Liabilities in this category include bonds payable, mortgages payable, long-term notes payable, lease liabilities, and obligations under employee pension plans. Many companies report long-term debt maturing after one year as a single amount in the balance sheet. They then show the details of the debt in the notes that accompany the financial statements. Others list the various sources of long-term liabilities. In its balance sheet, **Consolidated Freightways, Inc.** reported the following.

CONSOLIDATED FREIGHTWAYS, INC. Balance Sheet (partial) (in thousands)	
Long-term liabilities	
Bank notes payable	\$10,000
Mortgage payable	2,900
Bonds payable	53,422
Other long-term debt	9,597
Total long-term liabilities	\$75,919

Illustration 5-23

Long-term liabilities section

Stockholders' (Owners') Equity

The content of the owners' equity section varies with the form of business organization. In a proprietorship, there is one capital account. In a partnership, there is a capital account for each partner. For a corporation, owners' (stock-

holders') equity is divided into two accounts—Common Stock and Retained Earnings. As previously indicated, investments of capital in the business by the stockholders are recorded in the Common Stock account. Income retained for use in the business is recorded in the Retained Earnings account. These two accounts are combined and reported as **stockholders' equity** on the balance sheet.

In its balance sheet, **Round Top Tours** recently reported its stockholders' equity section as follows.

ROUND TOP TOURS	
Stockholders' equity	
Common stock, 1,000,000 shares	\$1,781,000
Retained earnings	540,000
Total stockholders' equity	<u>\$2,321,000</u>

Illustration 5-24

Stockholders' equity section

CLASSIFIED BALANCE SHEET, ILLUSTRATED

An unclassified, report form balance sheet of Premier Staffing Agency Inc. was presented in Illustration 4-21 on page 132. Using the same adjusted trial balance accounts at October 31, 2004, we can prepare the classified balance sheet shown in Illustration 5-25. For illustrative purposes, assume that \$1,000 of the notes payable is due currently and \$4,000 is long term.

The balance sheet is most often presented in **report form**, with assets listed above liabilities and stockholders' equity. The balance sheet may also be presented in **account form**: the assets section is placed on the left and the liabilities and stockholders' equity sections on the right, as shown in Illustration 5-25.

Illustration 5-25

Classified balance sheet in account form

PREMIER STAFFING AGENCY INC. Balance Sheet October 31, 2004			
<u>Assets</u>		<u>Liabilities and Stockholders' Equity</u>	
Current assets		Current liabilities	
Cash	\$15,200	Notes payable	\$ 1,000
Accounts receivable	200	Accounts payable	2,500
Supplies	1,000	Unearned revenue	800
Prepaid insurance	550	Salaries payable	1,200
Total current assets	16,950	Interest payable	50
Property, plant, and equipment		Total current liabilities	5,550
Office equipment	\$5,000	Long-term liabilities	
Less: Accumulated depreciation	40	Notes payable	4,000
Total assets	<u>\$21,910</u>	Total liabilities	9,550
		Stockholders' equity	
		Common stock	\$10,000
		Retained earnings	2,360
		Total stockholders' equity	12,360
		Total liabilities and stockholders' equity	<u>\$21,910</u>

Another, more complete example of a classified balance sheet is presented in report form in Illustration 5-26.

Illustration 5-26

Classified balance sheet in report form

FRANKLIN CORPORATION Balance Sheet October 31, 2004			
<u>Assets</u>			
Current assets			
Cash		\$ 6,600	
Short-term investments		2,000	
Accounts receivable		7,000	
Inventories		4,000	
Supplies		2,100	
Prepaid insurance		400	
Total current assets			\$22,100
Long-term investments			
Investment in stock of Walters Corp.			7,200
Property, plant, and equipment			
Land		10,000	
Office equipment	\$24,000		
Less: Accumulated depreciation	5,000	19,000	29,000
Intangible assets			
Patents			3,100
Total assets			<u>\$61,400</u>
<u>Liabilities and Stockholders' Equity</u>			
Current liabilities			
Notes payable		\$11,000	
Accounts payable		2,100	
Unearned revenue		900	
Salaries payable		1,600	
Interest payable		450	
Total current liabilities			\$16,050
Long-term liabilities			
Notes payable		1,300	
Mortgage payable		10,000	
Total long-term liabilities			11,300
Total liabilities			27,350
Stockholders' equity			
Common stock		20,000	
Retained earnings		14,050	
Total stockholders' equity			34,050
Total liabilities and stockholders' equity			<u>\$61,400</u>

BEFORE YOU GO ON...**REVIEW IT**

1. What are the major sections in a classified balance sheet?
2. Using the **Hilton** annual report, determine its current liabilities at December 31, 2001, and December 31, 2000. Were current liabilities higher or lower than current assets in these two years? The answer to this question is provided on page 173.
3. What is the difference between the report form and the account form of the classified balance sheet?

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LOOK BACK AT OUR FEATURE STORY

Refer back to the Feature Story about **Rhino Foods, Inc.** at the beginning of the chapter, and answer the following questions.

1. What is the lesson of the Rhino Foods story and Ted Castle's innovations?
2. How did Rhino's employees' knowledge of financial statements, especially production reports and the income statement, contribute to their effectiveness as employees?

SOLUTION

1. If you give employees equity in the company and provide them with the training and the information to understand the financial consequences of their decisions and actions, they will act more responsibly and make a greater contribution to the sales and income of the company. In other words, they begin to think like owners.
2. By understanding the income statement, they now recognize the impact of revenues and expenses in arriving at net income—as well as how productivity and expenses affect their bonuses.



DEMONSTRATION PROBLEM

At the end of its first month of operations, Watson Island Tour Service, Inc. has the following unadjusted trial balance.

WATSON ISLAND TOUR SERVICE, INC. August 31, 2004 Trial Balance

	<u>Debit</u>	<u>Credit</u>
Cash	\$ 5,400	
Accounts Receivable	8,800	
Prepaid Insurance	2,400	
Supplies	1,300	
Equipment	60,000	
Notes Payable		\$40,000
Accounts Payable		2,400
Common Stock		30,000
Dividends	1,000	
Service Revenue		10,900
Salaries Expense	3,200	
Utilities Expense	800	
Advertising Expense	400	
	<u>\$83,300</u>	<u>\$83,300</u>

Other data consist of the following:

1. Insurance expires at the rate of \$200 per month.
2. There are \$1,000 of supplies on hand at August 31.
3. Monthly depreciation on the equipment is \$900.
4. Interest of \$500 on the notes payable has accrued during August.

Instructions

- (a) Prepare a work sheet.
- (b) Prepare a classified balance sheet assuming \$35,000 of the notes payable are long term.
- (c) Journalize the closing entries.

ACTION PLAN

- In completing the work sheet, be sure to (a) key the adjustments, (b) start at the top of the adjusted trial balance columns and extend adjusted balances to the correct statement columns, and (c) enter net income (or net loss) in the proper columns.
- In preparing a classified balance sheet, know the contents of each of the sections.
- In journalizing closing entries, remember that there are only four entries and that dividends are closed to retained earnings.

SOLUTION TO DEMONSTRATION PROBLEM

(a) **WATSON ISLAND TOUR SERVICE, INC.**
Work Sheet
For the Month Ended August 31, 2004

Account Titles	Trial Balance		Adjustments		Adjusted Trial Balance		Income Statement		Balance Sheet	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	5,400				5,400				5,400	
Accounts Receivable	8,800				8,800				8,800	
Prepaid Insurance	2,400			(a) 200	2,200				2,200	
Supplies	1,300			(b) 300	1,000				1,000	
Equipment	60,000				60,000				60,000	
Notes Payable		40,000				40,000				40,000
Accounts Payable		2,400				2,400				2,400
Common Stock		30,000				30,000				30,000
Dividends	1,000				1,000				1,000	
Service Revenue		10,900				10,900	10,900			
Salaries Expense	3,200				3,200		3,200			
Utilities Expense	800				800		800			
Advertising Expense	400				400		400			
Totals	<u>83,300</u>	<u>83,300</u>								
Insurance Expense			(a) 200		200		200			
Supplies Expense			(b) 300		300		300			
Depreciation Expense			(c) 900		900		900			
Accumulated Depreciation— Equipment				(c) 900		900				900
Interest Expense			(d) 500		500		500			
Interest Payable				(d) 500		500				500
Totals			<u>1,900</u>	<u>1,900</u>	<u>84,700</u>	<u>84,700</u>	<u>6,300</u>	<u>10,900</u>	<u>78,400</u>	<u>73,800</u>
Net Income							<u>4,600</u>			<u>4,600</u>
Totals							<u>10,900</u>	<u>10,900</u>	<u>78,400</u>	<u>78,400</u>

Explanation: (a) Insurance expired, (b) Supplies used, (c) Depreciation expensed, (d) Interest accrued.

(b) **WATSON ISLAND TOUR SERVICE, INC.**
Balance Sheet
August 31, 2004

Assets

Current assets	
Cash	\$ 5,400
Accounts receivable	8,800
Prepaid insurance	2,200
Supplies	<u>1,000</u>
Total current assets	17,400
Property, plant, and equipment	
Equipment	\$60,000
Less: Accumulated depreciation—equipment	<u>900</u>
Total assets	<u>\$76,500</u>

<u>Liabilities and Stockholders' Equity</u>	
Current liabilities	
Notes payable	\$ 5,000
Accounts payable	2,400
Interest payable	500
Total current liabilities	7,900
Long-term liabilities	
Notes payable	35,000
Total liabilities	42,900
Stockholders' equity	
Common stock	30,000
Retained earnings	3,600*
Total liabilities and stockholders' equity	\$76,500

*Net income of \$4,600 less dividends of \$1,000.

(c)

Aug. 31	Service Revenue	10,900	
	Income Summary		10,900
	(To close revenue account)		
31	Income Summary	6,300	
	Salaries Expense		3,200
	Depreciation Expense		900
	Utilities Expense		800
	Interest Expense		500
	Advertising Expense		400
	Supplies Expense		300
	Insurance Expense		200
	(To close expense accounts)		
31	Income Summary	4,600	
	Retained Earnings		4,600
	(To close net income to retained earnings)		
31	Retained Earnings	1,000	
	Dividends		1,000
	(To close dividends to retained earnings)		



SUMMARY OF STUDY OBJECTIVES

1. Prepare a work sheet. The steps in preparing a work sheet are: (a) prepare a trial balance on the work sheet, (b) enter the adjustments in the adjustment columns, (c) enter adjusted balances in the adjusted trial balance columns, (d) extend adjusted trial balance amounts to appropriate financial statement columns, and (e) total the statement columns, compute net income (or net loss), and complete the work sheet.

2. Explain the process of closing the books. Closing the books occurs at the end of an accounting period. The process is to journalize and post closing entries and then rule and balance all accounts. In closing the books, separate entries are made to close revenues and expenses to Income Summary, Income Summary to Retained Earnings, and Dividends to Retained Earnings. Only temporary accounts are closed.

3. Describe the content and purpose of a post-closing trial balance. A post-closing trial balance contains the balances in

permanent accounts that are carried forward to the next accounting period. The purpose of this trial balance is to prove the equality of these balances.

4. State the required steps in the accounting cycle. The required steps in the accounting cycle are: (a) analyze business transactions, (b) journalize the transactions, (c) post to ledger accounts, (d) prepare a trial balance, (e) journalize and post adjusting entries, (f) prepare an adjusted trial balance, (g) prepare financial statements, (h) journalize and post closing entries, and (i) prepare a post-closing trial balance.

5. Explain the approaches to preparing correcting entries. One approach for determining the correcting entry is to compare the incorrect entry with the correct entry. After comparison, a correcting entry is made to correct the accounts. An alternative to a correcting entry is to reverse the incorrect entry and then prepare the correct entry.

6. Identify the sections of a classified balance sheet. In a classified balance sheet, assets are classified as current assets; long-term investments; property, plant, and equipment; or intangibles. Liabilities are classified as either current or long-term.

There is also an owners' equity section, which varies with the form of business organization. The classified balance sheet can be presented in either report form or account form.



GLOSSARY

Classified balance sheet A balance sheet that contains a number of standard classifications or sections (p. 161).

Closing entries Entries made at the end of an accounting period to transfer the balances of temporary accounts to a permanent stockholders' equity account, Retained Earnings (p. 151).

Correcting entries Entries to correct errors made in recording transactions (p. 158).

Current assets Cash and other resources that are reasonably expected to be realized in cash or sold or consumed in the business within one year or the operating cycle, whichever is longer (p. 161).

Current liabilities Obligations reasonably expected to be paid from existing current assets or through the creation of other current liabilities within the next year or operating cycle, whichever is longer (p. 162).

Income Summary A temporary account used in closing revenue and expense accounts (p. 151).

Intangible assets Noncurrent resources that do not have physical substance (p. 163).

Liquidity The ability of a company to pay obligations that are expected to become due within the next year or operating cycle (p. 164).

Long-term investments Resources not expected to be realized in cash within the next year or operating cycle (p. 162).

Long-term liabilities (Long-term debt) Obligations expected to be paid after one year (p. 164).

Operating cycle The average time required to go from cash to cash in producing revenues (p. 161).

Permanent (real) accounts Balance sheet accounts whose balances are carried forward to the next accounting period (p. 150).

Post-closing trial balance A list of permanent accounts and their balances after closing entries have been journalized and posted (p. 155).

Property, plant, and equipment Assets of a relatively permanent nature that are being used in the business and not intended for resale (p. 162).

Stockholders' equity The ownership claim of shareholders on total assets (p. 165).

Temporary (nominal) accounts Revenue, expense, and Dividends accounts whose balances are transferred to Retained Earnings at the end of an accounting period (p. 150).

Work sheet A multiple-column form that may be used in the adjustment process and in preparing financial statements (p. 144).

EXERCISES

List the steps in preparing a work sheet.

(SO 1)

5-1 The steps in using a work sheet are presented in random order below. List the steps in the proper order by placing numbers 1–5 in the blank spaces.

- (a) _____ Prepare a trial balance on the work sheet.
- (b) _____ Enter adjusted balances.
- (c) _____ Extend adjusted balances to appropriate statement columns.
- (d) _____ Total the statement columns, compute net income (loss), and complete the work sheet.
- (e) _____ Enter adjustment data.

Prepare partial work sheet.

(SO 1)

5-2 The ledger of Giovanni Party Decorations Company includes the following unadjusted balances: Prepaid Insurance \$4,000, Service Revenue \$58,000, and Salaries Expense \$25,000. Adjusting entries are required for (a) expired insurance \$1,200; (b) services provided \$900, but unbilled and uncollected; and (c) accrued salaries payable \$800. Enter the unadjusted balances and adjustments into a work sheet and complete the work sheet for all accounts. (Note: You will need to add the following accounts: Accounts Receivable, Salaries Payable, and Insurance Expense.)

Journalize and post closing entries using the three-column form of account.

(SO 2)

5-3 The income statement for Edgebrook Golf Club for the month ending July 31 shows Green Fee Revenue \$14,000, Salaries Expense \$8,200, Maintenance Expense \$2,500, and Net Income \$3,300. Prepare the entries to close the revenue and expense accounts. Post the entries to the revenue and expense accounts, and complete the closing process for these accounts using the three-column form of account.

5-4 Using the data in 5-3, identify the accounts that would be included in a post-closing trial balance.

Identify post-closing trial balance accounts.
(SO 3)

5-5 The steps in the accounting cycle are listed in random order below. List the steps in proper sequence, assuming no work sheet is prepared, by placing numbers 1–9 in the blank spaces.

List the required steps in the accounting cycle in sequence.
(SO 4)

- | | |
|--|---|
| (a) _____ Prepare a trial balance. | (f) _____ Post to ledger accounts. |
| (b) _____ Journalize the transactions. | (g) _____ Prepare a post-closing trial balance. |
| (c) _____ Journalize and post closing entries. | (h) _____ Prepare an adjusted trial balance. |
| (d) _____ Prepare financial statements. | (i) _____ Analyze business transactions. |
| (e) _____ Journalize and post adjusting entries. | |

5-6 At Piccola Pasta Sauce, the following errors were discovered after the transactions had been journalized and posted. Prepare the correcting entries.

Prepare correcting entries.
(SO 5)

1. A collection on account from a customer for \$780 was recorded as a debit to Cash \$780 and a credit to Service Revenue \$780.
2. The purchase of store supplies on account for \$1,730 was recorded as a debit to Store Supplies \$1,370 and a credit to Accounts Payable \$1,370.

5-7 The balance sheet debit column of the work sheet for Salsa Picante includes the following accounts: Accounts Receivable \$12,500; Prepaid Insurance \$3,600; Cash \$18,400; Supplies \$5,200, and Short-term Investments \$8,200. Prepare the current assets section of the balance sheet, listing the accounts in proper sequence.

Prepare the current assets section of a balance sheet.
(SO 6)

5-8 The adjusted trial balance columns of the work sheet for Jose Tortilla Company are as follows:

Complete work sheet.
(SO 1)

JOSE TORTILLA COMPANY
Work Sheet (partial)
For the Month Ended April 30, 2004

Account Titles	Adjusted Trial Balance		Income Statement		Balance Sheet	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	15,052					
Accounts Receivable	7,840					
Prepaid Rent	2,280					
Equipment	23,050					
Accumulated Depreciation		4,921				
Notes Payable		5,700				
Accounts Payable		5,972				
Common Stock		30,000				
Retained Earnings		3,960				
Dividends	3,650					
Service Revenue		12,590				
Salaries Expense	9,840					
Rent Expense	760					
Depreciation Expense	671					
Interest Expense	57					
Interest Payable		57				
Totals	63,200	63,200				

Instructions

Complete the work sheet.

Journalize and post closing entries and prepare a post-closing trial balance.
(SO 2, 3, 6)

5-9 The adjusted trial balance of Mozart D.J., Inc. at the end of its fiscal year is as follows.

MOZART D.J., INC.
Adjusted Trial Balance
July 31, 2004

No.	Account Titles	Debits	Credits
101	Cash	\$ 14,940	
112	Accounts Receivable	8,780	
157	Equipment	15,900	
167	Accumulated Depreciation		\$ 5,400
201	Accounts Payable		4,220
208	Unearned Rent Revenue		1,800
311	Common Stock		20,000
320	Retained Earnings		25,200
332	Dividends	14,000	
404	Commission Revenue		65,100
429	Rent Revenue		6,500
711	Depreciation Expense	4,000	
720	Salaries Expense	55,700	
732	Utilities Expense	14,900	
		<u>\$128,220</u>	<u>\$128,220</u>

Instructions

- (a) Prepare the closing entries using page J15.
- (b) Post to Retained Earnings and No. 350 Income Summary accounts. (Use the three-column form.)
- (c) Prepare a post-closing trial balance at July 31.
- (d) Prepare an income statement and a retained earnings statement for the year ended July 31, 2004. There were no issuances of stock during the year.
- (e) Prepare a classified balance sheet at July 31.

Prepare work sheet, financial statements, and adjusting and closing entries.
(SO 1, 2, 3, 6)

5-10 Susanne Perfect began operations as a mystery shopper on January 1, 2004. The trial balance columns of the work sheet for Susanne Perfect, Inc. at March 31 are as follows.

SUSANNE PERFECT, INC.
Work Sheet
For the Quarter Ended March 31, 2004

Account Titles	Trial Balance	
	Dr.	Cr.
Cash	11,400	
Accounts Receivable	5,620	
Supplies	1,050	
Prepaid Insurance	2,400	
Equipment	30,000	
Notes Payable		10,000
Accounts Payable		12,350
Common Stock		20,000
Dividends	600	
Service Revenue		13,620
Salaries Expense	2,200	
Travel Expense	1,300	
Rent Expense	1,200	
Miscellaneous Expense	200	
	<u>55,970</u>	<u>55,970</u>

Other data:

1. Supplies on hand total \$750.
2. Depreciation is \$500 per quarter.
3. Interest accrued on 6-month note payable, issued January 1, \$300.

4. Insurance expires at the rate of \$150 per month.
5. Services provided but unbilled at March 31 total \$750.

Instructions

- (a) Enter the trial balance on a work sheet and complete the work sheet.
- (b) Prepare an income statement and a retained earnings statement for the quarter and a classified balance sheet at March 31.
- (c) Journalize the adjusting entries from the adjustments columns of the work sheet.
- (d) Journalize the closing entries from the financial statement columns of the work sheet.

FINANCIAL REPORTING PROBLEM: Hilton Hotels Corporation

5-11 The financial statements of **Hilton** are presented in the Appendix at the end of this textbook.

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Instructions

Answer the following questions using the Consolidated Balance Sheet and the Notes to Consolidated Financial Statements section.

- (a) What were Hilton's total current assets at December 31, 2001, and December 31, 2000?
- (b) Are assets that Hilton's included under current assets listed in proper order? Explain.
- (c) How are Hilton's assets classified?
- (d) What are "cash equivalents"?
- (e) What were Hilton's total current liabilities at December 31, 2001, and December 31, 2000?

EXPLORING THE WEB

5-12 Numerous companies have established home pages on the Internet, e.g., **Hyatt Corporation** (www.hyatt.com/corporate) and **Four Seasons Hotels and Resorts** (www.fourseasons.com). You may have noticed company Internet addresses in television commercials or magazine advertisements.

Instructions

Examine the home pages of any two companies and answer the following questions.

- (a) What type of information is available?
- (b) Is any accounting-related information presented?
- (c) Would you describe the home page as informative, promotional, or both? Why?

ETHICS CASE

5-13 As the controller of TellTale Ice Cream Company, you discover a misstatement that significantly overstated net income in the prior year's financial statements. The misleading financial statements appear in the company's annual report which was issued to banks and other creditors less than a month ago. After much thought about the consequences of telling the president, Eddie Lieman, about this misstatement, you gather your courage to inform him. Eddie says, "Hey! What they don't know won't hurt them. But, just so we set the record straight, we'll adjust this year's financial statements for last year's misstatement. We can absorb that misstatement better in this year than in last year anyway! Just don't make such a mistake again."

Instructions

- (a) Who are the stakeholders in this situation?
- (b) What are the ethical issues in this situation?
- (c) What would you do as the controller in this situation?

Answers to Hilton Review It Question 2, p. 166

Current liabilities in 2001 were \$996 million. Current liabilities in 2000 were \$840 million. In both 2001 and 2000, current liabilities were considerably less than current assets.

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