Chapter 4

# Completion of the Accounting Cycle

**THE NAVIGATOR ✓**

- Understand **Concepts for Review** ❑
- Read **Feature Story** ❑
- Scan **Study Objectives** ❑
- Read **Preview** ❑
- Read text and answer **Before You Go On** p. 147 ❑ p. 157 ❑ p. 164 ❑
- Work **Demonstration Problem** ❑
- Review **Summary of Study Objectives** ❑
- Answer **Self-Study Questions** ❑
- Complete **Assignments** ❑

## CONCEPTS FOR REVIEW

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

- How to apply the revenue recognition and matching principles. (Ch. 3, pp. 95–96)
- How to make adjusting entries. (Ch. 3, pp. 97–108)
- How to prepare an adjusted trial balance. (Ch. 3, p. 111)
- How to prepare a balance sheet, income statement, and retained earnings statement. (Ch. 3, pp. 112–113)

THE NAVIGATOR

ACCOUNTING MATTERS! 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. Employment has increased from 20 to 130 people, while both revenues and profits have grown dramatically.

THE NAVIGATOR

## 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 4

As was true at **Rhino Foods, Inc.**, financial statements can help employees understand what is happening in the business. In Chapter 3, 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, especially the closing process, again using Pioneer Advertising Agency Inc. as an example. Then we will consider (1) correcting entries and (2) classified balance sheets. The content and organization of Chapter 4 are as follows.

**COMPLETION OF THE ACCOUNTING CYCLE**

| Using a Work Sheet | Closing the Books | Summary of the Accounting Cycle | Classified Balance Sheet |
|---|---|---|---|
| • Steps in preparation<br>• Preparing financial statements<br>• Preparing adjusting entries from a work sheet | • Preparing closing entries<br>• Posting closing entries<br>• Preparing a post-closing trial balance | • Reversing entries—An optional step<br>• Correcting entries—An avoidable step | • Standard classifications<br>• Balance sheet illustration |

THE NAVIGATOR

## Using a Work Sheet

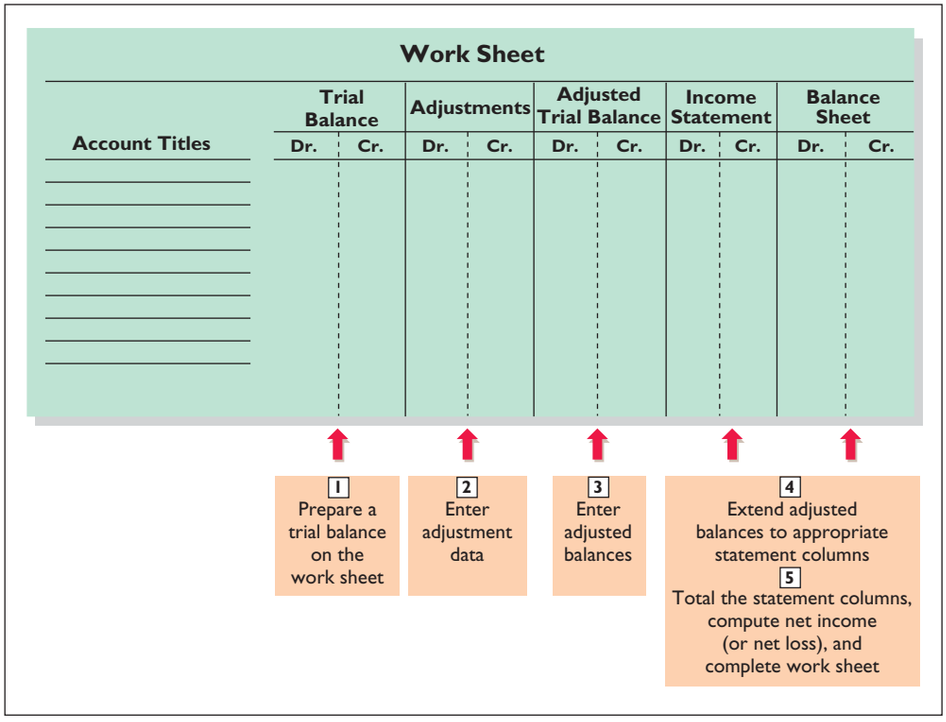
**STUDY OBJECTIVE 1**

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 4-1 (page 142). Each step must be performed in the prescribed sequence.

**Illustration 4-1**
Form and procedure for a work sheet




**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.

## Steps in Preparing a Work Sheet

We will use the October 31 trial balance and adjustment data of Pioneer Advertising in Chapter 3 to illustrate the preparation of a work sheet. Each step of the process is described below and demonstrated in Illustrations 4-2 and 4-3A, B, C, and D following page 143.

### *Step 1. Prepare a Trial Balance on the Work Sheet*

All ledger accounts with balances are entered in the account titles space. Debit and credit amounts from the ledger are entered in the trial balance columns. The work sheet trial balance for Pioneer Advertising Agency Inc. is shown in Illustration 4-2 on page 144.

### *Step 2. Enter the Adjustments in the Adjustments Columns*

**Turn over the first transparency, Illustration 4-3A.** When a work sheet is used, all adjustments are entered in the adjustments columns. In entering the adjustments, applicable trial balance accounts should be used. If additional accounts are needed, they are inserted on the lines immediately below the trial balance totals. Each adjustment is indexed and keyed; this practice facilitates the journalizing of the adjusting entry in the general journal. **The adjustments are not journalized until after the work sheet is completed and the financial statements have been prepared.**

The adjustments for Pioneer Advertising Agency Inc. are the same as the adjustments presented in Illustration 3-19 on page 109. They are keyed in the adjustments columns of the work sheet as follows.

**(a)** An additional account Advertising Supplies Expense is debited $1,500 for the cost of supplies used, and Advertising Supplies is credited $1,500.

**(b)** An additional account Insurance Expense is debited $50 for the insurance that has expired, and Prepaid Insurance is credited $50.

**(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 4-3B.** 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 3-21 (page 111).

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.

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

**HELPFUL HINT**

Every adjusted trial balance amount must be extended to one of the four statement columns.

**Turn over the third transparency, Illustration 4-3C.** 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 4-3C.

(**Note:** Text continues on page 145, following acetate overlays.)

**Illustration 4-3A**
Entering the adjustments in the adjustments columns

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

Add additional accounts as 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 adjustments columns and check for equality.

**Illustration 4-3B**
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 | |
| | 200 | |
| | 50 | |
| | | 50 |
| | | 1,200 |
| | 30,190 | 30,190 |

Combine trial balance amounts with adjustment amounts to obtain the adjusted trial balance.

Total adjusted trial balance columns and check for equality.

**Illustration 4-3C**
Extending the adjusted trial balance amounts to appropriate financial statement 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 | | | | |
| | | | 200 | |
| 50 | | | | |
| | | | | 50 |
| | | | | 1,200 |

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

Extend all asset and liability account balances, as well as common stock and dividends account balances, to the balance sheet columns.

**Illustration 4-3D**
Computing net income or net loss and completing the work sheet

| | | | | |
|---|---|---|---|---|
| | 7,740 | 10,600 | 22,450 | 19,590 |
| Net Income | 2,860 | | | 2,860 |
| Totals | 10,600 | 10,600 | 22,450 | 22,450 |

The difference between the totals of the two income statement columns determines net income or net loss.

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

**Illustration 4-2**
Preparing a trial balance

**PIONEER ADVERTISING AGENCY INC.**
Work Sheet
For the Month Ended October 31, 2006

| 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 | | | | | | | | | |
| Advertising 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 with balances from ledger.

Trial balance amounts are taken directly from ledger accounts.

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

**Turn over the fourth transparency, Illustration 4-3D.** 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 4-3D, 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 Pioneer Advertising Agency Inc. is shown in Illustration 4-3D.

**ACCOUNTING MATTERS!** **Business Insight**

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.

? What are the advantages of an electronic worksheet over a pencil-and-paper version?

## Preparing Financial Statements from a Work Sheet

Accounting Cycle Tutorial—Preparing Financial Statements and Closing the Books

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 Pioneer Advertising Agency Inc. are shown in Illustration 4-4 (page 146). 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 Pioneer'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.

**Illustration 4-4**
Financial statements from a work sheet

**PIONEER ADVERTISING AGENCY INC.**
Income Statement
For the Month Ended October 31, 2006

| | | |
|---|---|---|
| Revenues | | |
| Service revenue | | $10,600 |
| Expenses | | |
| Salaries expense | $5,200 | |
| Advertising supplies expense | 1,500 | |
| Rent expense | 900 | |
| Insurance expense | 50 | |
| Interest expense | 50 | |
| Depreciation expense | 40 | |
| Total expenses | | 7,740 |
| Net income | | $ 2,860 |

**PIONEER ADVERTISING AGENCY INC.**
Retained Earnings Statement
For the Month Ended October 31, 2006

| | |
|---|---|
| Retained earnings, October 1 | $ –0– |
| Add: Net income | 2,860 |
| | 2,860 |
| Less: Dividends | 500 |
| Retained earnings, October 31 | $2,360 |

**PIONEER ADVERTISING AGENCY INC.**
Balance Sheet
October 31, 2006

| | | |
|---|---|---|
| **Assets** | | |
| Cash | | $15,200 |
| Accounts receivable | | 200 |
| Advertising supplies | | 1,000 |
| Prepaid insurance | | 550 |
| Office equipment | $5,000 | |
| Less: Accumulated depreciation | 40 | 4,960 |
| Total assets | | $21,910 |
| **Liabilities and Stockholders' Equity** | | |
| Liabilities | | |
| Notes payable | | $ 5,000 |
| Accounts payable | | 2,500 |
| Interest payable | | 50 |
| Unearned revenue | | 800 |
| Salaries payable | | 1,200 |
| Total liabilities | | 9,550 |
| Stockholders' equity | | |
| Common stock | | 10,000 |
| Retained earnings | | 2,360 |
| Total liabilities and stockholders' equity | | $21,910 |

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.**

## 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 Pioneer Advertising Agency Inc. are the same as those shown in Illustration 3-19 (page 109).

### 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. 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 e-Business Insight box on page 145, the work sheet is an ideal application for electronic spreadsheet software like Microsoft Excel.

Related exercise material: *BE4-1, BE4-2, BE4-3, E4-1, E4-2, E4-4, and E4-5.*

THE NAVIGATOR

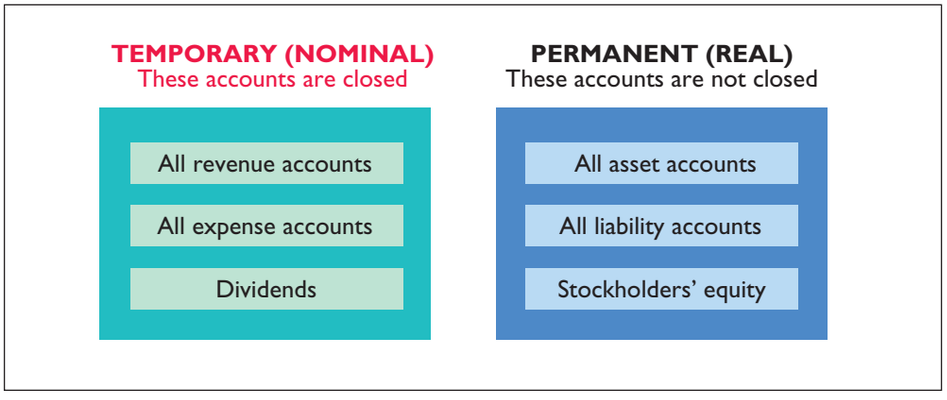
## Closing the Books

**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 4-5 identifies the accounts in each category.

**Illustration 4-5**
Temporary versus permanent accounts




**HELPFUL HINT**

A contra asset account, such as accumulated depreciation, is a permanent 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 4-12 on page 155.) 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.

**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.

**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:

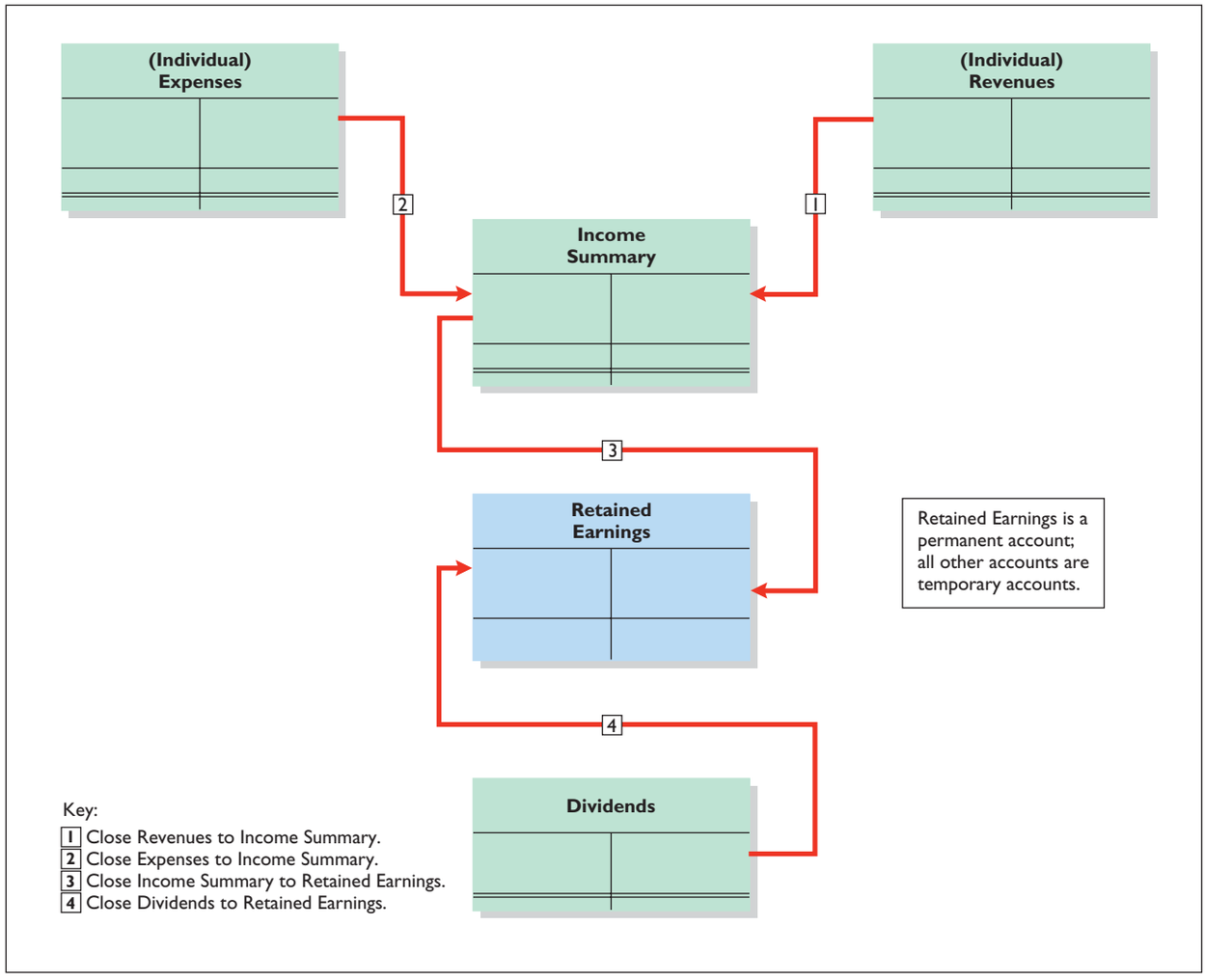
1. Debit each revenue account for its balance, and credit Income Summary for total revenues.
2. Debit Income Summary for total expenses, and credit each expense account for its balance.
3. Debit Income Summary and credit Retained Earnings for the amount of net income.
4. Debit Retained Earnings for the 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 4-6 and in the journal entries in Illustration 4-7 (page 150). The posting of closing entries is shown in Illustration 4-8 (page 151).

**HELPFUL HINT**

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

**Illustration 4-6**
Diagram of closing process—corporation




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

## ACCOUNTING MATTERS! 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.

? How did Sam Walton know the "books didn't balance"? In what circumstances today might the ESP method be acceptable?

## *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 Pioneer Advertising Agency Inc. closes its books monthly. The closing entries at October 31 are shown in Illustration 4-7.

**Illustration 4-7**
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.

| 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 | |
| | Advertising Supplies Expense | 631 | | 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) | | | |

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 Closing Entries

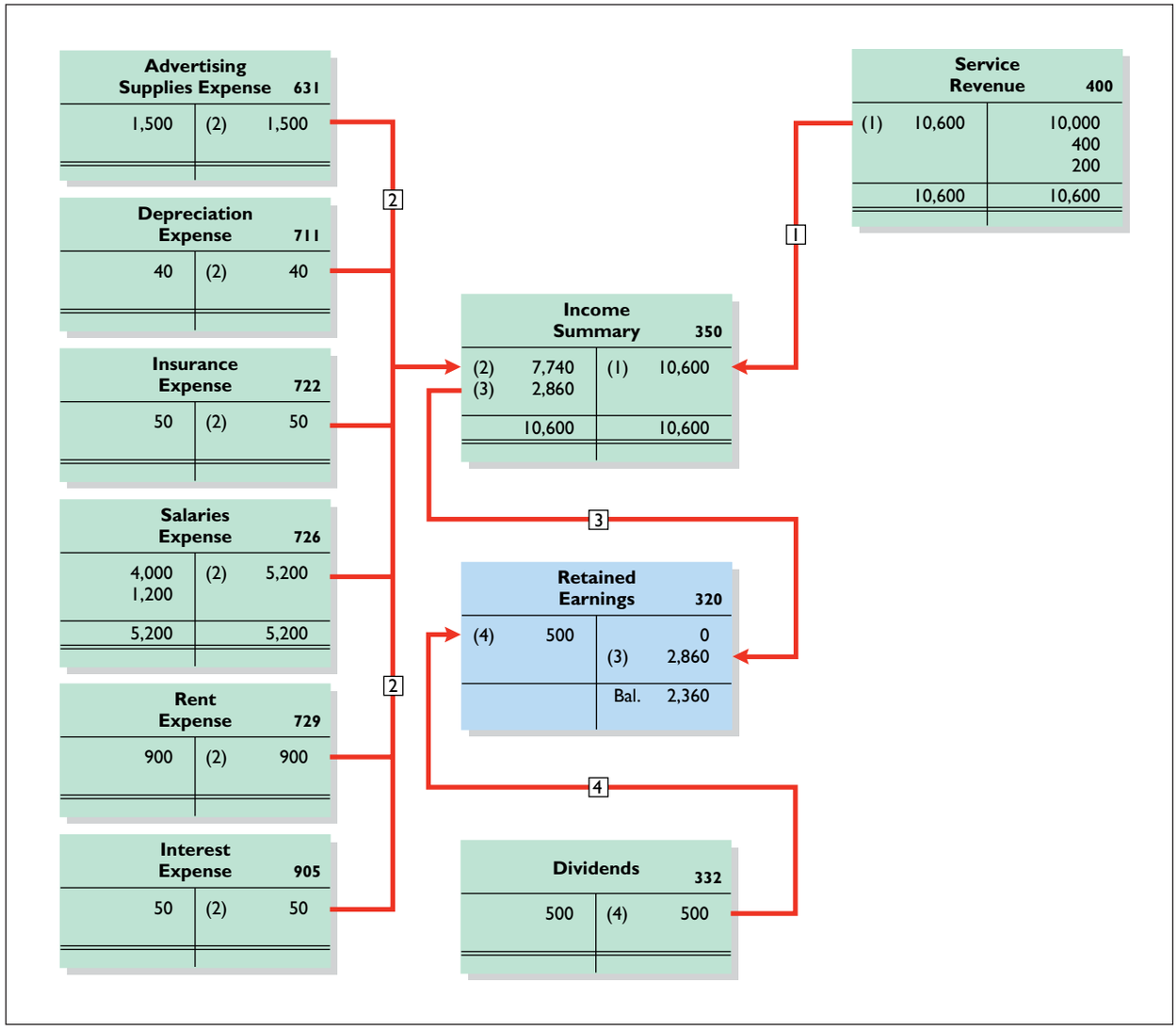
The posting of the closing entries and the ruling of the accounts are shown in Illustration 4-8. Note that all temporary accounts have zero balances after posting the closing entries. In addition, you should realize that the balance in Retained Earnings represents the accumulated undistributed earnings 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 4-4. **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 4-8. 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 4-8**
Posting of closing entries



## ACCOUNTING MATTERS! Business Insight

Technology has dramatically changed the accounting process. When Larry Carter became chief financial officer of **Cisco Systems**, closing the quarterly accounts would take up to ten days. Within four years he got it down to two days and halved the cost of finance, to 1 percent of sales. He since has made the "one-day virtual close"—closing within a day on any day in the quarter—a reality at Cisco.

This is not just showing off. Knowing exactly where you are all of the time, says Mr. Carter, allows you to respond faster than your competitors. But it also means that the 600 people who used to spend 10 days a quarter tracking transactions can now be more usefully employed on things such as mining data for business intelligence to find new business opportunities.

***Source:*** Excerpted from "Business and the Internet," *The Economist* (June 26, 1999), p. 12.

? If you do not have the IT resources to do a "virtual close," can the net income or net loss be known without "closing the books"?

## Preparing a Post-Closing Trial Balance

**STUDY OBJECTIVE 3**

Describe the content and purpose of 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 Pioneer Advertising Agency Inc. is shown in Illustration 4-9. These balances are the same as those reported in the company's balance sheet in Illustration 4-4.

The post-closing trial balance is prepared from the permanent accounts in the ledger. The permanent accounts of Pioneer Advertising are shown in the general

**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.

**Illustration 4-9**
Post-closing trial balance

**PIONEER ADVERTISING AGENCY INC.**
Post-Closing Trial Balance
October 31, 2006

| | Debit | Credit |
|---|---|---|
| Cash | $15,200 | |
| Accounts Receivable | 200 | |
| Advertising 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 |
| | $21,950 | $21,950 |

ledger in Illustration 4-10 below. 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 4-11 on page 154). After the closing entries are correctly posted, each temporary account has a zero balance. These accounts are double-ruled to finalize the closing process.

**Illustration 4-10**
General ledger, permanent accounts

**(Permanent Accounts Only)**

**GENERAL LEDGER**

**Cash** **No. 101**

| Date | Explanation | Ref. | Debit | Credit | Balance |
|---|---|---|---|---|---|
| 2006 | | | | | |
| Oct. 1 | | J1 | 10,000 | | 10,000 |
| 2 | | J1 | 1,200 | | 11,200 |
| 3 | | J1 | | 900 | 10,300 |
| 4 | | J1 | | 600 | 9,700 |
| 20 | | J1 | | 500 | 9,200 |
| 26 | | J1 | | 4,000 | 5,200 |
| 31 | | J1 | 10,000 | | **15,200** |

**Accounts Receivable** **No. 112**

| Date | Explanation | Ref. | Debit | Credit | Balance |
|---|---|---|---|---|---|
| 2006 | | | | | |
| Oct. 31 | Adj. entry | J2 | **200** | | **200** |

**Advertising Supplies** **No. 126**

| Date | Explanation | Ref. | Debit | Credit | Balance |
|---|---|---|---|---|---|
| 2006 | | | | | |
| Oct. 5 | | J1 | 2,500 | | 2,500 |
| 31 | Adj. entry | J2 | | **1,500** | **1,000** |

**Prepaid Insurance** **No. 130**

| Date | Explanation | Ref. | Debit | Credit | Balance |
|---|---|---|---|---|---|
| 2006 | | | | | |
| Oct. 4 | | J1 | 600 | | 600 |
| 31 | Adj. entry | J2 | | **50** | **550** |

**Office Equipment** **No. 157**

| Date | Explanation | Ref. | Debit | Credit | Balance |
|---|---|---|---|---|---|
| 2006 | | | | | |
| Oct. 1 | | J1 | 5,000 | | **5,000** |

**Accumulated Depreciation—Office Equipment** **No. 158**

| Date | Explanation | Ref. | Debit | Credit | Balance |
|---|---|---|---|---|---|
| 2006 | | | | | |
| Oct. 31 | Adj. entry | J2 | | **40** | **40** |

**Notes Payable** **No. 200**

| Date | Explanation | Ref. | Debit | Credit | Balance |
|---|---|---|---|---|---|
| 2006 | | | | | |
| Oct. 1 | | J1 | | 5,000 | **5,000** |

**Accounts Payable** **No. 201**

| Date | Explanation | Ref. | Debit | Credit | Balance |
|---|---|---|---|---|---|
| 2006 | | | | | |
| Oct. 5 | | J1 | | 2,500 | **2,500** |

**Unearned Revenue** **No. 209**

| Date | Explanation | Ref. | Debit | Credit | Balance |
|---|---|---|---|---|---|
| 2006 | | | | | |
| Oct. 2 | | J1 | | 1,200 | 1,200 |
| 31 | Adj. entry | J2 | 400 | | **800** |

**Salaries Payable** **No. 212**

| Date | Explanation | Ref. | Debit | Credit | Balance |
|---|---|---|---|---|---|
| 2006 | | | | | |
| Oct. 31 | Adj. entry | J2 | | **1,200** | **1,200** |

**Interest Payable** **No. 230**

| Date | Explanation | Ref. | Debit | Credit | Balance |
|---|---|---|---|---|---|
| 2006 | | | | | |
| Oct. 31 | Adj. entry | J2 | | **50** | **50** |

**Common Stock** **No. 311**

| Date | Explanation | Ref. | Debit | Credit | Balance |
|---|---|---|---|---|---|
| 2006 | | | | | |
| Oct. 1 | | J1 | | 10,000 | 10,000 |

**Retained Earnings** **No. 320**

| Date | Explanation | Ref. | Debit | Credit | Balance |
|---|---|---|---|---|---|
| 2006 | | | | | |
| Oct. 1 | | | | | –0– |
| **31** | **Closing entry** | **J3** | | **2,860** | **2,860** |
| **31** | **Closing entry** | **J3** | **500** | | **2,360** |

*Note:* The permanent accounts for Pioneer Advertising Agency Inc. are shown here; the temporary accounts are shown in Illustration 4-11. Both permanent and temporary accounts are part of the general ledger; they are segregated here to aid in learning.

**Illustration 4-11**
General ledger, temporary accounts

**(Temporary Accounts Only)**

**GENERAL LEDGER**

**Dividends** — **No. 332**

| Date | Explanation | Ref. | Debit | Credit | Balance |
|---|---|---|---|---|---|
| 2006 | | | | | |
| Oct. 20 | | J1 | 500 | | 500 |
| 31 | Closing entry | J3 | | 500 | –0– |

**Income Summary** — **No. 350**

| Date | Explanation | Ref. | Debit | Credit | Balance |
|---|---|---|---|---|---|
| 2006 | | | | | |
| Oct. 31 | Closing entry | J3 | | 10,600 | 10,600 |
| 31 | Closing entry | J3 | 7,740 | | 2,860 |
| 31 | Closing entry | J3 | 2,860 | | –0– |

**Service Revenue** — **No. 400**

| Date | Explanation | Ref. | Debit | Credit | Balance |
|---|---|---|---|---|---|
| 2006 | | | | | |
| Oct. 31 | | J1 | | 10,000 | 10,000 |
| 31 | Adj. entry | J2 | | **400** | 10,400 |
| 31 | Adj. entry | J2 | | **200** | 10,600 |
| 31 | Closing entry | J3 | 10,600 | | –0– |

**Advertising Supplies Expense** — **No. 631**

| Date | Explanation | Ref. | Debit | Credit | Balance |
|---|---|---|---|---|---|
| 2006 | | | | | |
| Oct. 31 | Adj. entry | J2 | **1,500** | | 1,500 |
| 31 | Closing entry | J3 | | 1,500 | –0– |

**Depreciation Expense** — **No. 711**

| Date | Explanation | Ref. | Debit | Credit | Balance |
|---|---|---|---|---|---|
| 2006 | | | | | |
| Oct. 31 | Adj. entry | J2 | **40** | | 40 |
| 31 | Closing entry | J3 | | 40 | –0– |

**Insurance Expense** — **No. 722**

| Date | Explanation | Ref. | Debit | Credit | Balance |
|---|---|---|---|---|---|
| 2006 | | | | | |
| Oct. 31 | Adj. entry | J2 | **50** | | 50 |
| 31 | Closing entry | J3 | | 50 | –0– |

**Salaries Expense** — **No. 726**

| Date | Explanation | Ref. | Debit | Credit | Balance |
|---|---|---|---|---|---|
| 2006 | | | | | |
| Oct. 26 | | J1 | 4,000 | | 4,000 |
| 31 | Adj. entry | J2 | **1,200** | | 5,200 |
| 31 | Closing entry | J3 | | 5,200 | –0– |

**Rent Expense** — **No. 729**

| Date | Explanation | Ref. | Debit | Credit | Balance |
|---|---|---|---|---|---|
| 2006 | | | | | |
| Oct. 3 | | J1 | 900 | | 900 |
| 31 | Closing entry | J3 | | 900 | –0– |

**Interest Expense** — **No. 905**

| Date | Explanation | Ref. | Debit | Credit | Balance |
|---|---|---|---|---|---|
| 2006 | | | | | |
| Oct. 31 | Adj. entry | J2 | **50** | | 50 |
| 31 | Closing entry | J3 | | 50 | –0– |

*Note:* The temporary accounts for Pioneer Advertising Agency Inc. are shown here; the permanent accounts are shown in Illustration 4-10. Both permanent and temporary accounts are part of the general ledger; they are segregated here to aid in learning.

## 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 4-12 on page 155. 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.

Steps 1–3 may occur daily during the accounting period, as explained in Chapter 2. 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.

There are also two optional steps in the accounting cycle. As you have seen, a work sheet may be used in preparing adjusting entries and financial statements. In addition, reversing entries may be used, as explained in the following section.

### Reversing Entries—An Optional Step

Some accountants prefer to reverse certain adjusting entries at the beginning of a new accounting period. A **reversing entry** is made at the beginning of the next

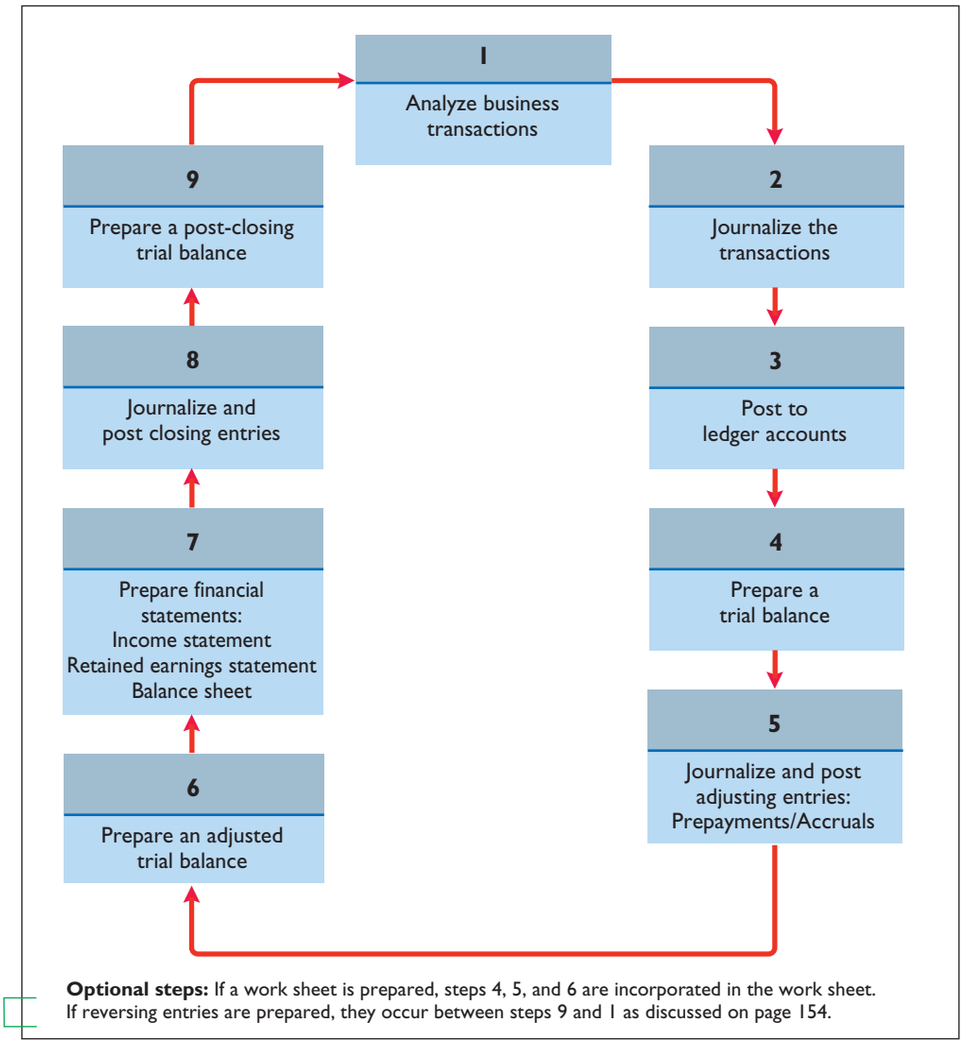



**Illustration 4-12**
Steps in the accounting cycle

**STUDY OBJECTIVE 5**

Explain the approaches to preparing correcting entries.

accounting period. It is the exact opposite of the adjusting entry made in the previous period. **The preparation of reversing entries is an optional bookkeeping procedure that is not a required step in the accounting cycle.** Therefore, we have chosen to cover this topic in an appendix at the end of the chapter.

## Correcting Entries—An Avoidable Step

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 several differences between correcting entries and adjusting entries. First, 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. Second, **adjustments are journalized and posted only at the end of an accounting period**. **In contrast, correcting entries are made whenever an error is discovered.** Finally, 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.**

**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.

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.

**Illustration 4-13**
Comparison of entries

| 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.

**Illustration 4-14**
Correcting entry

| A | = | L | + | SE |
|---|---|---|---|---|
| −50 | | | | −50 Rev |

**Cash Flows**
no effect

**Correcting Entry**

| | | | |
|---|---|---|---|
| May 20 | Service Revenue | 50 | |
| | Accounts Receivable | | 50 |
| | (To correct entry of May 10) | | |

## *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.

**Illustration 4-15**
Comparison of entries

| 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:

**Illustration 4-16**
Correcting entry

| A | = | L | + | SE |
|---|---|---|---|---|
| +450 | | | | |
| −45 | | +405 | | |

**Cash Flows**
no effect

**Correcting Entry**

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

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.

## ACCOUNTING MATTERS! Business Insight

**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 cutoff 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.

On the other hand, **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!

? What might Yale Express's vice president have done to produce more accurate financial statements without waiting months for Republic's outstanding transportation bills?

## 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 Corporation 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: *BE4-4, BE4-5, BE4-6, BE4-8, E4-3, E4-6, E4-8, and E4-9.*

THE NAVIGATOR

## Classified Balance Sheet

**STUDY OBJECTIVE 6**

Identify the sections of a 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 5. 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:

**Illustration 4-17**
Standard balance sheet classifications

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

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 **GM**, **Ford**, and **DaimlerChrysler** in the automobile industry. Each of the sections is explained next.

A complete set of specimen financial statements for **PepsiCo, Inc.** is shown in Appendix A 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 since 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, (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 below in the presentation of **UAL, Inc.** (**United Airlines**).

**Illustration 4-18**
Current assets section

| UAL, INC, (UNITED AIRLINES) Balance Sheet (partial) (in millions) | |
|---|---|
| **Current assets** | |
| Cash | $1,348 |
| Short-term investments | 388 |
| Receivables | 788 |
| Aircraft fuel, spare parts, and supplies | 310 |
| Prepaid expenses | 219 |
| Other current assets | 326 |
| Total current assets | $3,379 |

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

**HELPFUL HINT**

Long-term investments are investments made *by* the business—not investments by the owner or stockholders *in* the business.

## *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. **Yahoo! Inc.** reported the following in its balance sheet.

**Illustration 4-19**
Long-term investments section

| YAHOO! INC. Balance Sheet (partial) | |
|---|---|
| **Long-term investments** | |
| Long-term investments in marketable securities | $763,408 |

**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 furniture and fixtures. Assets subject to depreciation should be reported at cost less accumulated

depreciation. This practice is illustrated in the following presentation of **Delta Air Lines**.

**DELTA AIR LINES, INC.**
Balance Sheet (partial)
(in millions)

| | | | |
|---|---|---|---|
| **Property, plant, and equipment** | | | |
| Flight equipment | $20,295 | | |
| Less: Accumulated depreciation | 6,109 | $14,186 | |
| Ground property and equipment | 4,841 | | |
| Less: Accumulated depreciation | 2,503 | 2,338 | $16,524 |

**Illustration 4-20**
Property, plant, and equipment section

## *Intangible Assets*

**Intangible assets** are noncurrent resources that do not have physical substance. They are recorded at cost, and this cost is expensed over the useful life of the intangible asset. 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.

In its balance sheet, **The Walt Disney Company** reported the following.

**THE WALT DISNEY COMPANY**
Balance Sheet (partial)
(in millions)

| | | |
|---|---|---|
| **Intangible assets** | | |
| Patents, trademarks, and other intangibles | $ 2,776 | |
| Goodwill | 17,083 | 19,859 |

**Illustration 4-21**
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).

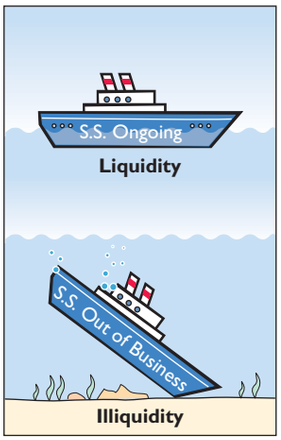
The arrangement of items within the current liabilities section has evolved through custom rather than from a prescribed rule. Notes payable is usually listed first, followed by accounts payable. Other items are then listed in any order. The current liabilities section adapted from the balance sheet of **Deckers Outdoor Corporation** is as follows.

**DECKERS** outdoor corporation

**DECKERS OUTDOOR CORPORATION**
Balance Sheet (partial)

| | |
|---|---|
| **Current liabilities** | |
| Notes payable | $ 3,951,000 |
| Accounts payable | 12,916,000 |
| Allowance for returns | 1,255,000 |
| Salaries and commissions payable | 2,342,000 |
| Taxes payable | 732,000 |
| Other current liabilities | 912,000 |
| Total current liabilities | $22,108,000 |

**Illustration 4-22**
Current liabilities section




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*

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, **Brunswick Corporation** reported the following.

**ALTERNATIVE TERMINOLOGY**

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

**BRUNSWICK CORPORATION**
Balance Sheet (partial)
(in millions)

| | |
|---|---|
| **Long-term liabilities** | |
| Notes payable | $437.2 |
| Bonds payable | 124.4 |
| Guaranteed debt | 15.5 |
| Other long-term debt | 12.4 |
| Total long-term liabilities | $589.5 |

**Illustration 4-23**
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' (stockholders') 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, **Dell Computer Corporation** recently reported its stockholders' equity section as follows.

**Illustration 4-24**
Stockholders' equity section

**DELL INC.**
(in millions)

| | |
|---|---|
| **Stockholders' equity** | |
| Common stock, 2,681,000,000 shares | $1,479 |
| Retained earnings | 3,394 |
| Total stockholders' equity | $4,873 |

## Classified Balance Sheet Illustrated

An unclassified, report form balance sheet of Pioneer Advertising Agency Inc. was presented in Illustration 4-4 on page 146. Using the same adjusted trial balance accounts at October 31, 2006, we can prepare the classified balance sheet shown in Illustration 4-25. 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 4-25.

**Illustration 4-25**
Classified balance sheet in account form

**PIONEER ADVERTISING AGENCY INC.**
Balance Sheet
October 31, 2006

| Assets | | | Liabilities and Stockholders' Equity | | |
|---|---|---|---|---|---|
| Current assets | | | Current liabilities | | |
| Cash | | $15,200 | Notes payable | | $ 1,000 |
| Accounts receivable | | 200 | Accounts payable | | 2,500 |
| Advertising 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 | 4,960 | Notes payable | | 4,000 |
| Total assets | | $21,910 | Total liabilities | | 9,550 |
| | | | Stockholders' equity | | |
| | | | Common stock | $10,000 | |
| | | | Retained earnings | 2,360 | |
| | | | Total stockholders' equity | | 12,360 |
| | | | Total liabilities and stockholders' equity | | $21,910 |

Another, more complete example of a classified balance sheet is presented in report form in Illustration 4-26.

**Illustration 4-26**
Classified balance sheet in report form

**FRANKLIN CORPORATION**
Balance Sheet
October 31, 2006

| | | | |
|---|---|---|---|
| **Assets** | | | |
| **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. | | 5,200 | |
| Investment in real estate | | 2,000 | 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 | | | $61,400 |
| **Liabilities and Stockholders' Equity** | | | |
| **Current liabilities** | | | |
| Notes payable | | $11,000 | |
| Accounts payable | | 2,100 | |
| Salaries payable | | 1,600 | |
| Unearned revenue | | 900 | |
| 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 | | | $61,400 |

## BEFORE YOU GO ON...

### Review It

1. What are the major sections in a classified balance sheet?
2. Using the **PepsiCo, Inc.** annual report, determine its current liabilities at December 27, 2003, and December 28, 2002. Were current liabilities higher or lower than current assets in these two years? The answer to this question is provided on page 188.
3. What is the difference between the report form and the account form of the classified balance sheet?

THE NAVIGATOR

## DEMONSTRATION PROBLEM

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

**WATSON ANSWERING SERVICE, INC.**
August 31, 2006
Trial Balance

| | Debit | Credit |
|---|---|---|
| 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 | |
| | $83,300 | $83,300 |

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 ANSWERING SERVICE, INC.
Work Sheet
For the Month Ended August 31, 2006

| | Trial Balance | | Adjustments | | Adjusted Trial Balance | | Income Statement | | Balance Sheet | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Account Titles** | **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 | 83,300 | 83,300 | | | | | | | | |
| 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 | | | 1,900 | 1,900 | 84,700 | 84,700 | 6,300 | 10,900 | 78,400 | 73,800 |
| Net Income | | | | | | | 4,600 | | | 4,600 |
| Totals | | | | | | | 10,900 | 10,900 | 78,400 | 78,400 |

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

**(b)**

### WATSON ANSWERING SERVICE, INC.
Balance Sheet
August 31, 2006

**Assets**

| | | |
|---|---|---|
| Current assets | | |
| Cash | | $ 5,400 |
| Accounts receivable | | 8,800 |
| Prepaid insurance | | 2,200 |
| Supplies | | 1,000 |
| Total current assets | | 17,400 |
| Property, plant, and equipment | | |
| Equipment | $60,000 | |
| Less: Accumulated depreciation—equipment | 900 | 59,100 |
| Total assets | | $76,500 |

**Liabilities and Stockholders' Equity**

| | | |
|---|---|---|
| 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 stockholders' equity | | 33,600 |
| 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) | | |

THE NAVIGATOR

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 adjustments 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; and 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 NAVIGATOR

## GLOSSARY

**Classified balance sheet** A balance sheet that contains a number of standard classifications or sections. (p. 158).

**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. 148).

**Correcting entries** Entries to correct errors made in recording transactions. (p. 155).

**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. 158).

**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. 160).

**Income Summary** A temporary account used in closing revenue and expense accounts. (p. 148).

**Intangible assets** Noncurrent resources that do not have physical substance. (p. 160).

**Liquidity** The ability of a company to pay obligations that are expected to become due within the next year or operating cycle. (p. 161).

**Long-term investments** Resources not expected to be realized in cash within the next year or operating cycle. (p. 159).

**Long-term liabilities** Obligations expected to be paid after one year. (p. 161).

**Operating cycle** The average time required to go from cash to cash in producing revenues. (p. 158).

**Permanent (real) accounts** Balance sheet accounts whose balances are carried forward to the next accounting period. (p. 148).

**Post-closing trial balance** A list of permanent accounts and their balances after closing entries have been journalized and posted. (p. 152).

**Property, plant, and equipment** Assets of a relatively permanent nature that are being used in the business and not intended for sale. (p. 159).

**Reversing entry** An entry made at the beginning of the next accounting period that is the exact opposite of the adjusting entry made in the previous period. (p. 154).

**Stockholders' equity** The ownership claim of shareholders on total assets as represented by common stock and retained earnings. (p. 162).

**Temporary (nominal) accounts** Revenue, expense, and Dividends accounts whose balances are transferred to Retained Earnings at the end of an accounting period. (p. 148).

**Work sheet** A multiple-column form that may be used in the adjustment process and in preparing financial statements. (p. 141).

# APPENDIX REVERSING ENTRIES

STUDY OBJECTIVE 7

Prepare reversing entries.

After the financial statements are prepared and the books are closed, it is often helpful to reverse some of the adjusting entries before recording the regular transactions of the next period. Such entries are called reversing entries. **A reversing entry is made at the beginning of the next accounting period and is the exact opposite of the adjusting entry made in the previous period.** The recording of reversing entries is an **optional** step in the accounting cycle.

The purpose of reversing entries is to simplify the recording of a subsequent transaction related to an adjusting entry. In Chapter 3, you may recall, the payment of salaries after an adjusting entry resulted in two debits: one to Salaries Payable and the other to Salaries Expense. With reversing entries, the entire subsequent payment can be debited to Salaries Expense. **The use of reversing entries does not change the amounts reported in the financial statements. What it does is simplify the recording of subsequent transactions.**

## Illustration of Reversing Entries

Reversing entries are most often used to reverse two types of adjusting entries: accrued revenues and accrued expenses. They are seldom made for prepaid expenses and unearned revenues. To illustrate the optional use of reversing entries for accrued expenses, we will use the salaries expense transactions for Pioneer Advertising Agency Inc. The transaction and adjustment data are as follows.

1. October 26 (initial salary entry): $4,000 of salaries earned between October 15 and October 26 are paid.
2. October 31 (adjusting entry): Salaries earned between October 29 and October 31 are $1,200. These will be paid in the November 9 payroll.
3. November 9 (subsequent salary entry): Salaries paid are $4,000. Of this amount, $1,200 applied to accrued wages payable and $2,800 was earned between November 1 and November 9.

The comparative entries with and without reversing entries are shown in Illustration 4A-1.

**Illustration 4A-1**
Comparative entries—not reversing vs. reversing

| When Reversing Entries Are Not Used (per chapter) | | | | When Reversing Entries Are Used (per appendix) | | | |
|---|---|---|---|---|---|---|---|
| | Initial Salary Entry | | | | Initial Salary Entry | | |
| Oct. 26 | Salaries Expense | 4,000 | | **Oct. 26** | **Salaries Expense** | **4,000** | |
| | Cash | | 4,000 | | **Cash** | | **4,000** |
| | Adjusting Entry | | | | Adjusting Entry | | |
| Oct. 31 | Salaries Expense | 1,200 | | **Oct. 31** | **Salaries Expense** | **1,200** | |
| | Salaries Payable | | 1,200 | | **Salaries Payable** | | **1,200** |
| | Closing Entry | | | | Closing Entry | | |
| Oct. 31 | Income Summary | 5,200 | | **Oct. 31** | **Income Summary** | **5,200** | |
| | Salaries Expense | | 5,200 | | **Salaries Expense** | | **5,200** |
| | Reversing Entry | | | | Reversing Entry | | |
| Nov. 1 | No reversing entry is made. | | | **Nov. 1** | **Salaries Payable** | **1,200** | |
| | | | | | **Salaries Expense** | | **1,200** |
| | Subsequent Salary Entry | | | | Subsequent Salary Entry | | |
| Nov. 9 | Salaries Payable | 1,200 | | **Nov. 9** | **Salaries Expense** | **4,000** | |
| | Salaries Expense | 2,800 | | | | | |
| | Cash | | 4,000 | | **Cash** | | **4,000** |

The first three entries are the same whether or not reversing entries are used. The last two entries are different. The November 1 **reversing entry** eliminates the $1,200 balance in Salaries Payable that was created by the October 31 adjusting entry. The reversing entry also creates a $1,200 credit balance in the Salaries Expense account. As you know, it is unusual for an expense account to have a credit balance. The balance is correct in this instance, though, because it anticipates that the entire amount of the first salary payment in the new accounting period will be debited to Salaries Expense. This debit will eliminate the credit balance, and the resulting debit balance in the expense account will equal the salaries expense incurred in the new accounting period ($2,800 in this example).

When reversing entries are made, all cash payments of expenses can be debited to the expense account. This means that on November 9 (and every payday) Salaries Expense can be debited for the amount paid without regard to any accrued salaries payable. Being able to make the same entry each time simplifies the recording process: Subsequent transactions can be recorded as if the related adjusting entry had never been made.

The posting of the entries with reversing entries is shown in Illustration 4A-2.

**Illustration 4A-2**
Postings with reversing entries

| Salaries Expense | | | |
|---|---|---|---|
| 10/26 Paid | 4,000 | 10/31 Closing | 5,200 |
| 31 Adjusting | 1,200 | | |
| | 5,200 | | 5,200 |
| 11/9 Paid | 4,000 | **11/1 Reversing** | **1,200** |

| Salaries Payable | | | |
|---|---|---|---|
| **11/1 Reversing** | **1,200** | 10/31 Adjusting | 1,200 |

Reversing entries may also be made for accrued revenue adjusting entries. For Pioneer Advertising, the adjusting entry was: Accounts Receivable (Dr.) $200 and Service Revenue (Cr.) $200. Thus, the reversing entry on November 1 is:

| | | | |
|---|---|---|---|
| Nov. 1 | Service Revenue | 200 | |
| | Accounts Receivable | | 200 |
| | (To reverse October 31 adjusting entry) | | |

| A | = | L | + | SE |
|---|---|---|---|---|
| −200 | | | | −200 Rev |

**Cash Flows**
no effect

When the accrued fees are collected, Cash is debited and Service Revenue is credited.

**7. Prepare reversing entries.** Reversing entries are the opposite of the adjusting entries made in the preceding period. They are made at the beginning of a new accounting period to simplify the recording of later transactions related to the adjusting entries. In most cases, only accrued adjusting entries are reversed.

***Note:** All asterisked Questions, Exercises, and Problems relate to material in the appendix to the chapter.

Self-Study/Self-Test

Answers are at the end of the chapter.

(SO 1) **1.** Which of the following statements is *incorrect* concerning the work sheet?
**a.** The work sheet is essentially a working tool of the accountant.
**b.** The work sheet cannot be used as a basis for posting to ledger accounts.
**c.** The work sheet is distributed to management and other interested parties.
**d.** Financial statements can be prepared directly from the work sheet before journalizing and posting the adjusting entries.

**2.** In a work sheet, net income is entered in the following columns: (SO 1)
**a.** income statement (Dr) and balance sheet (Dr).
**b.** income statement (Dr) and balance sheet (Cr).
**c.** income statement (Cr) and balance sheet (Dr).
**d.** income statement (Cr) and balance sheet (Cr).

**3.** An account that will have a zero balance after closing entries have been journalized and posted is: (SO 2)
**a.** Unearned Revenue.
**b.** Advertising Supplies.
**c.** Prepaid Insurance.
**d.** Rent Expense.

(SO 2) **4.** When a net loss has occurred, Income Summary is:
**a.** credited and retained earnings is debited.
**b.** debited and retained earnings is credited.
**c.** debited and common stock is credited.
**d.** credited and common stock is debited.

(SO 2) **5.** The closing process involves separate entries to close (1) expenses, (2) dividends, (3) revenues, and (4) net income (or loss). The correct sequencing of the entries is:
**a.** (4), (3), (2), (1)
**b.** (1), (2), (3), (4)
**c.** (3), (2), (1), (4)
**d.** (3), (1), (4), (2)

(SO 3) **6.** Which type of accounts will appear in the post-closing trial balance?
**a.** Temporary (nominal) accounts.
**b.** Permanent (real) accounts.
**c.** Accounts shown in the income statement columns of a work sheet.
**d.** None of the above.

(SO 4) **7.** All of the following are required steps in the accounting cycle *except*:
**a.** preparing a work sheet.
**b.** journalizing and posting closing entries.
**c.** preparing an adjusted trial balance.
**d.** preparing a post-closing trial balance.

(SO 5) **8.** Cash of $100 received at the time the service was rendered was journalized and posted as a debit to Cash $100 and a credit to Accounts Receivable $100. Assuming the incorrect entry is not reversed, the correcting entry is:
**a.** debit Service Revenue $100 and credit Accounts Receivable $100.
**b.** debit Cash $100 and credit Service Revenue $100.
**c.** debit Accounts Receivable $100 and credit Service Revenue $100.
**d.** debit Accounts Receivable $100 and credit Cash $100.

**9.** In a classified balance sheet, assets are usually classified using the following categories: (SO 6)
**a.** current assets; long-term assets; property, plant, and equipment; and intangible assets.
**b.** current assets; long-term investments; property, plant, and equipment; and other assets.
**c.** current assets; long-term investments; property, plant, and equipment; and intangible assets.
**d.** current assets; long-term investments; tangible assets; and intangible assets.

**10.** Current assets are listed: (SO 6)
**a.** by importance.
**b.** by liquidity.
**c.** by longevity.
**d.** alphabetically.

***11.** On December 31, Sondgeroth Corporation correctly made an adjusting entry to recognize $2,000 of accrued salaries payable. On January 8 of the next year, total salaries of $3,500 were paid. Assuming the correct reversing entry was made on January 1, the entry on January 8 will result in a credit to Cash $3,500, and the following debit(s): (SO 7)
**a.** Salaries Payable $3,500.
**b.** Salaries Expense $3,500.
**c.** Salaries Payable $2,000 and Salaries Expense $1,500.
**d.** Salaries Payable $1,500 and Salaries Expense $2,000.

THE NAVIGATOR

---

**1.** "A work sheet is a permanent accounting record and its use is required in the accounting cycle." Do you agree? Explain.

**2.** Explain the purpose of the work sheet.

**3.** What is the relationship, if any, between the amount shown in the adjusted trial balance column for an account and that account's ledger balance?

**4.** If a company's revenues are $125,000 and its expenses are $113,000, in which financial statement columns of the work sheet will the net income of $12,000 appear? When expenses exceed revenues, in which columns will the difference appear?

**5.** Why is it necessary to prepare formal financial statements if all of the data are in the statement columns of the work sheet?

**6.** Identify the account(s) debited and credited in each of the four closing entries, assuming the company has net income for the year.

**7.** Describe the nature of the Income Summary account and identify the types of summary data that may be posted to this account.

**8.** What are the content and purpose of a post-closing trial balance?

**9.** Which of the following accounts would not appear in the post-closing trial balance? Interest Payable; Equipment; Depreciation Expense; Dividends, Unearned Revenue; Accumulated Depreciation—Equipment; and Service Revenue.

**10.** Distinguish between a reversing entry and an adjusting entry. Are reversing entries required?

**11.** Indicate, in the sequence in which they are made, the three required steps in the accounting cycle that involve journalizing.

**12.** Identify, in the sequence in which they are prepared, the three trial balances that are often used to report financial information about a company.

**13.** How do correcting entries differ from adjusting entries?

**14.** What standard classifications are used in preparing a classified balance sheet?

**15.** What is meant by the term "operating cycle?"

**16.** Define current assets. What basis is used for arranging individual items within the current assets section?

**17.** Distinguish between long-term investments and property, plant, and equipment.

**18.** How do current liabilities differ from long-term liabilities?

**19.** (a) What is the term used to describe the owner's equity section of a corporation? (b) Identify the two owner's equity accounts in a corporation and indicate the purpose of each.

**20.** How does a report form balance sheet differ from an account form balance sheet?

***21.** Sang Nam Company prepares reversing entries. If the adjusting entry for interest payable is reversed, what type of an account balance, if any, will there be in Interest Payable and Interest Expense after the reversing entry is posted?

***22.** At December 31, accrued salaries payable totaled $4,500. On January 10, total salaries of $8,000 are paid. (a) Assume that reversing entries are made at January 1. Give the January 10 entry, and indicate the Salaries Expense account balance after the entry is posted. (b) Repeat part (a) assuming reversing entries are not made.

## BRIEF EXERCISES

**BE4-1** 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.

*List the steps in preparing a work sheet.* (SO 1)

**(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.

**BE4-2** The ledger of Keo 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 $1,100, 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.

*Prepare partial work sheet.* (SO 1)

**BE4-3** The following selected accounts appear in the adjusted trial balance columns of the work sheet for Cesar Company: Accumulated Depreciation, Depreciation Expense, Common Stock, Dividends, Service Revenue, Supplies, and Accounts Payable. Indicate the financial statement column (income statement Dr., balance sheet Cr., etc.) to which each balance should be extended.

*Identify work sheet columns for selected accounts.* (SO 1)

**BE4-4** The ledger of Rowen Company contains the following balances: Common Stock $30,000; Dividends $2,000; Service Revenue $50,000; Salaries Expense $23,000; and Supplies Expense $4,000. Prepare the closing entries at December 31.

*Prepare closing entries from ledger balances.* (SO 2)

**BE4-5** Using the data in BE4-4, enter the balances in T accounts, post the closing entries, and rule and balance the accounts.

*Post closing entries; rule and balance T accounts.* (SO 2)

**BE4-6** The income statement for Mosquera Golf Club for the month ending July 31 shows Green Fee Revenue $14,600, Salaries Expense $8,200, Maintenance Expense $2,500, and Net Income $3,900. 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.

*Journalize and post closing entries using the three-column form of account.* (SO 2)

**BE4-7** Using the data in BE4-3, identify the accounts that would be included in a post-closing trial balance.

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

**BE4-8** 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.
**(b)** _____ Journalize the transactions.
**(c)** _____ Journalize and post closing entries.
**(d)** _____ Prepare financial statements.
**(e)** _____ Journalize and post adjusting entries.
**(f)** _____ Post to ledger accounts.
**(g)** _____ Prepare a post-closing trial balance.
**(h)** _____ Prepare an adjusted trial balance.
**(i)** _____ Analyze business transactions.

*Prepare correcting entries.*
(SO 5)

**BE4-9** At Rafeul Huda Company, the following errors were discovered after the transactions had been journalized and posted. Prepare the correcting entries.

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 $1,580 was recorded as a debit to Store Supplies $1,850 and a credit to Accounts Payable $1,850.

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

**BE4-10** The balance sheet debit column of the work sheet for Kren Company includes the following accounts: Accounts Receivable $12,500; Prepaid Insurance $3,600; Cash $18,400; Supplies $5,200, and Short-term Investments $6,700. Prepare the current assets section of the balance sheet, listing the accounts in proper sequence.

*Prepare reversing entries.*
(SO 7)

***BE4-11** At October 31, Prasad Company made an accrued expense adjusting entry of $1,200 for salaries. Prepare the reversing entry on November 1, and indicate the balances in Salaries Payable and Salaries Expense after posting the reversing entry.

## EXERCISES

*Complete work sheet*
(SO 1)

**E4-1** The adjusted trial balance columns of the work sheet for Cajon Company are as follows.

**CAJON COMPANY**
Work Sheet (partial)
For the Month Ended April 30, 2006

| | Adjusted Trial Balance | | Income Statement | | Balance Sheet | |
|---|---|---|---|---|---|---|
| **Account Titles** | **Dr.** | **Cr.** | **Dr.** | **Cr.** | **Dr.** | **Cr.** |
| Cash | 14,752 | | | | | |
| Accounts Receivable | 7,840 | | | | | |
| Prepaid Rent | 2,280 | | | | | |
| Equipment | 23,050 | | | | | |
| Accumulated Depreciation | | 4,921 | | | | |
| Notes Payable | | 5,700 | | | | |
| Accounts Payable | | 5,672 | | | | |
| Common Stock | | 25,000 | | | | |
| Retained Earnings | | 8,960 | | | | |
| Dividends | 3,650 | | | | | |
| Service Revenue | | 12,590 | | | | |
| Salaries Expense | 9,840 | | | | | |
| Rent Expense | 760 | | | | | |
| Depreciation Expense | 671 | | | | | |
| Interest Expense | 57 | | | | | |
| Interest Payable | | 57 | | | | |
| Totals | 62,900 | 62,900 | | | | |

**Instructions**
Complete the work sheet.

*Prepare financial statements from work sheet.*
(SO 1, 6)

**E4-2** Work sheet data for Cajon Company are presented in E4-1. No common stock was issued during April.

**Instructions**
Prepare an income statement, a retained earnings statement, and a classified balance sheet.

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

**E4-3** Work sheet data for Cajon Company are presented in E4-1.

**Instructions**
**(a)** Journalize the closing entries at April 30.
**(b)** Post the closing entries to Income Summary and Retained Earnings. Use T accounts.
**(c)** Prepare a post-closing trial balance at April 30.

**E4-4** The adjustments columns of the work sheet for Munoz Company are shown below.

*Prepare adjusting entries from a work sheet and extend balance to work sheet columns.*

(SO 1)

| Account Titles | Adjustments Debit | Adjustments Credit |
|---|---|---|
| Accounts Receivable | 600 | |
| Prepaid Insurance | | 400 |
| Accumulated Depreciation | | 900 |
| Salaries Payable | | 500 |
| Service Revenue | | 600 |
| Salaries Expense | 500 | |
| Insurance Expense | 400 | |
| Depreciation Expense | 900 | |
| | 2,400 | 2,400 |

**Instructions**

**(a)** Prepare the adjusting entries.

**(b)** Assuming the adjusted trial balance amount for each account is normal, indicate the financial statement column to which each balance should be extended.

**E4-5** Selected work sheet data for Jane Freeman Company are presented below.

*Derive adjusting entries from work sheet data.*

(SO 1)

| Account Titles | Trial Balance Dr. | Trial Balance Cr. | Adjusted Trial Balance Dr. | Adjusted Trial Balance Cr. |
|---|---|---|---|---|
| Accounts Receivable | ? | | 34,000 | |
| Prepaid Insurance | 26,000 | | 18,000 | |
| Supplies | 7,000 | | ? | |
| Accumulated Depreciation | | 12,000 | | ? |
| Salaries Payable | | ? | | 5,000 |
| Service Revenue | | 88,000 | | 95,000 |
| Insurance Expense | | | ? | |
| Depreciation Expense | | | 10,000 | |
| Supplies Expense | | | 4,000 | |
| Salaries Expense | ? | | 49,000 | |

**Instructions**

**(a)** Fill in the missing amounts.

**(b)** Prepare the adjusting entries that were made.

**E4-6** The adjusted trial balance of Lanza Company at the end of its fiscal year is:

*Journalize and post closing entries and prepare a post-closing trial balance.*

(SO 2, 3)

**LANZA COMPANY**
Adjusted Trial Balance
July 31, 2006

| No. | Account Titles | Debits | Credits |
|---|---|---|---|
| 101 | Cash | $ 14,840 | |
| 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 | 16,000 | |
| 404 | Commission Revenue | | 67,000 |
| 429 | Rent Revenue | | 6,500 |
| 711 | Depreciation Expense | 4,000 | |
| 720 | Salaries Expense | 55,700 | |
| 732 | Utilities Expense | 14,900 | |
| | | $130,120 | $130,120 |

**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.

*Prepare financial statements.* (SO 6)

**E4-7** The adjusted trial balance for Lanza Company is presented in E4-6.

**Instructions**

**(a)** Prepare an income statement and a retained earnings statement for the year. There were no issuances of stock during the year.
**(b)** Prepare a classified balance sheet at July 31.

*Prepare closing entries.* (SO 2)

**E4-8** Selected accounts for Roth Salon are presented below. All June 30 postings are from closing entries.

| Salaries Expense | | | |
|---|---|---|---|
| 6/10 | 3,200 | 6/30 | 8,800 |
| 6/28 | 5,600 | | |

| Service Revenue | | | |
|---|---|---|---|
| 6/30 | 16,100 | 6/15 | 7,700 |
| | | 6/24 | 8,400 |

| Dividends | | | |
|---|---|---|---|
| 6/15 | 2,500 | 6/30 | 2,500 |

| Supplies Expense | | | |
|---|---|---|---|
| 6/12 | 600 | 6/30 | 1,300 |
| 6/24 | 700 | | |

| Rent Expense | | | |
|---|---|---|---|
| 6/1 | 3,000 | 6/30 | 3,000 |

| Retained Earnings | | | |
|---|---|---|---|
| 6/30 | 2,500 | 6/30 | 3,000 |
| | | Bal. | 500 |

**Instructions**

**(a)** Prepare the closing entries that were made.
**(b)** Post the closing entries to Income Summary.

*Prepare correcting entries.* (SO 5)

**E4-9** Kogan Company has an inexperienced accountant. During the first 2 weeks on the job, the accountant made the following errors in journalizing transactions. All entries were posted as made.

1. A payment on account of $830 to a creditor was debited to Accounts Payable $380 and credited to Cash $380.
2. The purchase of supplies on account for $560 was debited to Equipment $56 and credited to Accounts Payable $56.
3. A $400 cash dividend was debited to Salaries Expense $400 and credited to Cash $400.

**Instructions**

Prepare the correcting entries.

*Prepare a classified balance sheet.* (SO 6)

**E4-10** The adjusted trial balance for Rego Bowling Alley Inc. at December 31, 2006, contains the following accounts.

| Debits | | Credits | |
|---|---|---|---|
| Building | $128,800 | Common Stock | $100,000 |
| Accounts Receivable | 14,520 | Retained Earnings | 15,000 |
| Prepaid Insurance | 4,680 | Accumulated Depreciation—Building | 45,600 |
| Cash | 18,040 | Accounts Payable | 12,300 |
| Equipment | 62,400 | Mortgage Payable | 94,780 |
| Land | 64,000 | Accumulated Depreciation—Equipment | 18,720 |
| Insurance Expense | 780 | Interest Payable | 2,600 |
| Depreciation Expense | 7,360 | Bowling Revenues | 14,180 |
| Interest Expense | 2,600 | | $303,180 |
| | $303,180 | | |

**Instructions**

**(a)** Prepare a classified balance sheet; assume that $13,600 of the mortgage payable will be paid in 2007.

**(b)** Comment on the liquidity of the company.

*Prepare closing and reversing entries.*

(SO 2, 4, 7)

***E4-11** On December 31, the adjusted trial balance of Garg Employment Agency shows the following selected data.

| | | | |
|---|---|---|---|
| Accounts Receivable | $24,000 | Commission Revenue | $92,000 |
| Interest Expense | 7,800 | Interest Payable | 1,500 |

Analysis shows that adjusting entries were made to (1) accrue $4,200 of commission revenue and (2) accrue $1,500 interest expense.

**Instructions**

**(a)** Prepare the closing entries for the temporary accounts at December 31.
**(b)** Prepare the reversing entries on January 1.
**(c)** Post the entries in (a) and (b). Rule and balance the accounts. (Use T accounts.)
**(d)** Prepare the entries to record (1) the collection of the accrued commissions on January 10 and (2) the payment of all interest due ($2,700) on January 15.
**(e)** Post the entries in (d) to the temporary accounts.

## PROBLEMS: SET A

*Prepare a work sheet, financial statements, and adjusting and closing entries.*

(SO 1, 2, 3, 6)

**P4-1A** The trial balance columns of the work sheet for Undercover Roofing Inc. at March 31, 2006, are as follows.

### UNDERCOVER ROOFING INC.
Work Sheet
For the Month Ended March 31, 2006

| Account Titles | Trial Balance Dr. | Trial Balance Cr. |
|---|---|---|
| Cash | 2,500 | |
| Accounts Receivable | 1,800 | |
| Roofing Supplies | 1,100 | |
| Equipment | 6,000 | |
| Accumulated Depreciation—Equipment | | 1,200 |
| Accounts Payable | | 1,400 |
| Unearned Revenue | | 300 |
| Common Stock | | 5,000 |
| Retained Earnings | | 2,000 |
| Dividends | 600 | |
| Service Revenue | | 3,000 |
| Salaries Expense | 700 | |
| Miscellaneous Expense | 200 | |
| | 12,900 | 12,900 |

Other data:

1. A physical count reveals only $140 of roofing supplies on hand.
2. Depreciation for March is $200.
3. Unearned revenue amounted to $130 after adjustment on March 31.
4. Accrued salaries are $350.

**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 month of March and a classified balance sheet at March 31. No additional issuances of stock occured in March.
**(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.

(a) Adjusted trial balance $13,450
(b) Net income $ 760
Total assets $9,040

*Complete work sheet; prepare financial statements, closing entries, and post-closing trial balance.*

(SO 1, 2, 3, 6)

**P4-2A** The adjusted trial balance columns of the work sheet for Eagle Company, owned by Alfred Eagle, are as follows.

**EAGLE COMPANY**
Work Sheet
For the Year Ended December 31, 2006

| Account No. | Account Titles | Adjusted Trial Balance Dr. | Adjusted Trial Balance Cr. |
|---|---|---|---|
| 101 | Cash | 13,600 | |
| 112 | Accounts Receivable | 15,400 | |
| 126 | Supplies | 2,000 | |
| 130 | Prepaid Insurance | 2,800 | |
| 151 | Office Equipment | 34,000 | |
| 152 | Accumulated Depreciation—Office Equipment | | 8,000 |
| 200 | Notes Payable | | 20,000 |
| 201 | Accounts Payable | | 6,000 |
| 212 | Salaries Payable | | 3,500 |
| 230 | Interest Payable | | 800 |
| 311 | Common Stock | | 20,000 |
| 320 | Retained Earnings | | 5,000 |
| 332 | Dividends | 10,000 | |
| 400 | Service Revenue | | 88,000 |
| 610 | Advertising Expense | 12,000 | |
| 631 | Supplies Expense | 5,700 | |
| 711 | Depreciation Expense | 8,000 | |
| 722 | Insurance Expense | 5,000 | |
| 726 | Salaries Expense | 42,000 | |
| 905 | Interest Expense | 800 | |
| | Totals | 151,300 | 151,300 |

**Instructions**

(a) Net income $14,500
(b) Current assets $33,800; Current liabilities $20,300

(e) Post-closing trial balance $67,800

**(a)** Complete the work sheet by extending the balances to the financial statement columns.
**(b)** Prepare an income statement, a retained earnings statement, and a classified balance sheet. (*Note:* $10,000 of the notes payable become due in 2007.) No additional issuances of stock occured during 2006.
**(c)** Prepare the closing entries. Use J14 for the journal page.
**(d)** Post the closing entries. Use the three-column form of account. Income Summary is No. 350.
**(e)** Prepare a post-closing trial balance.

*Prepare financial statements, closing entries, and post-closing trial balance.*

(SO 1, 2, 3, 6)

**P4-3A** The completed financial statement columns of the work sheet for Lathrop Company are shown below and on the next page.

**LATHROP COMPANY**
Work Sheet
For the Year Ended December 31, 2006

| Account No. | Account Titles | Income Statement Dr. | Income Statement Cr. | Balance Sheet Dr. | Balance Sheet Cr. |
|---|---|---|---|---|---|
| 101 | Cash | | | 17,400 | |
| 112 | Accounts Receivable | | | 13,500 | |
| 130 | Prepaid Insurance | | | 3,500 | |
| 157 | Equipment | | | 26,000 | |
| 167 | Accumulated Depreciation | | | | 5,600 |
| 201 | Accounts Payable | | | | 11,300 |
| 212 | Salaries Payable | | | | 3,000 |
| 311 | Common Stock | | | | 20,000 |
| 320 | Retained Earnings | | | | 16,000 |
| 332 | Dividends | | | 14,000 | |
| 400 | Service Revenue | | 64,000 | | |
| 622 | Repair Expense | 2,000 | | | |
| 711 | Depreciation Expense | 2,600 | | | |
| 722 | Insurance Expense | 2,200 | | | |

| Account No. | Account Titles | Income Statement Dr. | Income Statement Cr. | Balance Sheet Dr. | Balance Sheet Cr. |
|---|---|---|---|---|---|
| 726 | Salaries Expense | 37,000 | | | |
| 732 | Utilities Expense | 1,700 | | | |
| | Totals | 45,500 | 64,000 | 74,400 | 55,900 |
| | Net Income | 18,500 | | | 18,500 |
| | | 64,000 | 64,000 | 74,400 | 74,400 |

**Instructions**

**(a)** Prepare an income statement, a retained earnings statement, and a classified balance sheet.
**(b)** Prepare the closing entries. No additional shares of stock were issued during the year.
**(c)** Post the closing entries and rule and balance the accounts. Use T accounts. Income Summary is account No. 350.
**(d)** Prepare a post-closing trial balance.

(a) Ending retained earnings $20,500
Total current assets $34,400
(d) Post-closing trial balance $60,400

**P4-4A** Nish Kumar Management Services Inc. began business on January 1, 2006, with a capital investment of $120,000. The company manages condominiums for owners (Service Revenue) and rents space in its own office building (Rent Revenue). The trial balance and adjusted trial balance columns of the work sheet at the end of the first year are as follows.

*Complete work sheet; prepare classified balance sheet, entries, and post-closing trial balance.*
(SO 1, 2, 3, 6)

Peachtree

**NISH KUMAR MANAGEMENT SERVICES INC.**
Work Sheet
For the Year Ended December 31, 2006

| Account Titles | Trial Balance Dr. | Trial Balance Cr. | Adjusted Trial Balance Dr. | Adjusted Trial Balance Cr. |
|---|---|---|---|---|
| Cash | 14,500 | | 14,500 | |
| Accounts Receivable | 23,600 | | 23,600 | |
| Prepaid Insurance | 3,100 | | 1,400 | |
| Land | 56,000 | | 56,000 | |
| Building | 106,000 | | 106,000 | |
| Equipment | 49,000 | | 49,000 | |
| Accounts Payable | | 10,400 | | 10,400 |
| Unearned Rent Revenue | | 5,000 | | 2,800 |
| Mortgage Payable | | 100,000 | | 100,000 |
| Common Stock | | 120,000 | | 120,000 |
| Retained Earnings | | –0– | | –0– |
| Dividends | 20,000 | | 20,000 | |
| Service Revenue | | 75,600 | | 75,600 |
| Rent Revenue | | 24,000 | | 26,200 |
| Salaries Expense | 30,000 | | 30,000 | |
| Advertising Expense | 17,000 | | 17,000 | |
| Utilities Expense | 15,800 | | 15,800 | |
| Totals | 335,000 | 335,000 | | |
| Insurance Expense | | | 1,700 | |
| Depreciation Expense—Building | | | 2,500 | |
| Accumulated Depreciation—Building | | | | 2,500 |
| Depreciation Expense—Equipment | | | 3,900 | |
| Accumulated Depreciation—Equipment | | | | 3,900 |
| Interest Expense | | | 9,000 | |
| Interest Payable | | | | 9,000 |
| Totals | | | 350,400 | 350,400 |

**Instructions**

**(a)** Prepare a complete work sheet.
**(b)** Prepare a classified balance sheet. (*Note*: $10,000 of the mortgage payable is due for payment next year.)
**(c)** Journalize the adjusting entries.
**(d)** Journalize the closing entries.
**(e)** Prepare a post-closing trial balance.

(a) Net income $21,900
(b) Total current assets $39,500

(e) Post-closing trial balance $250,500

*Complete all steps in accounting cycle.*

(SO 1, 2, 3, 4, 6)

**P4-5A** Eve Tsai opened Tsai's Window Washing Corp. on July 1, 2006. During July the following transactions were completed.

July 1 Issued $12,000 of common stock for $12,000 cash.
1 Purchased used truck for $6,000, paying $3,000 cash and the balance on account.
3 Purchased cleaning supplies for $1,300 on account.
5 Paid $1,200 cash on one-year insurance policy effective July 1.
12 Billed customers $2,500 for cleaning services.
18 Paid $1,000 cash on amount owed on truck and $800 on amount owed on cleaning supplies.
20 Paid $1,200 cash for employee salaries.
21 Collected $1,400 cash from customers billed on July 12.
25 Billed customers $3,000 for cleaning services.
31 Paid gas and oil for month on truck $200.
31 Declared and paid $900 cash dividend.

The chart of accounts for Tsai's Window Washing Corp. contains the following accounts: No. 101 Cash, No. 112 Accounts Receivable, No. 128 Cleaning Supplies, No. 130 Prepaid Insurance, No. 157 Equipment, No. 158 Accumulated Depreciation—Equipment, No. 201 Accounts Payable, No. 212 Salaries Payable, No. 311 Common Stock, No. 320 Retained Earnings, No. 332 Dividends, No. 350 Income Summary, No. 400 Service Revenue, No. 633 Gas & Oil Expense, No. 634 Cleaning Supplies Expense, No. 711 Depreciation Expense, No. 722 Insurance Expense, and No. 726 Salaries Expense.

**Instructions**

**(a)** Journalize and post the July transactions. Use page J1 for the journal and the three-column form of account.

(b) Trial balance $20,000

**(b)** Prepare a trial balance at July 31 on a work sheet.

(c) Adjusted trial balance $22,300

**(c)** Enter the following adjustments on the work sheet and complete the work sheet.
**(1)** Services provided but unbilled and uncollected at July 31 were $1,500.
**(2)** Depreciation on equipment for the month was $200.
**(3)** One-twelfth of the insurance expired.
**(4)** An inventory count shows $600 of cleaning supplies on hand at July 31.
**(5)** Accrued but unpaid employee salaries were $600.

**(d)** Journalize and post adjusting entries. Use page J2 for the journal.

(e) Net income $4,000; Total assets $18,200

**(e)** Prepare the income statement and a retained earnings statement for July and a classified balance sheet at July 31.

**(f)** Journalize and post closing entries and complete the closing process. Use page J3 for the journal.

(g) Post-closing trial balance $18,400

**(g)** Prepare a post-closing trial balance at July 31.

*Analyze errors and prepare correcting entries and trial balance.*

(SO 5)

**P4-6A** Tom Brennan, CPA, was retained by 24/7 Cable Inc. to prepare financial statements for April 2006. Brennan accumulated all the ledger balances per 24/7's records and found the following.

**24/7 CABLE INC.**
Trial Balance
April 30, 2006

| | Debit | Credit |
|---|---|---|
| Cash | $ 4,100 | |
| Accounts Receivable | 3,200 | |
| Supplies | 800 | |
| Equipment | 10,600 | |
| Accumulated Depreciation | | $ 1,350 |
| Accounts Payable | | 2,100 |
| Salaries Payable | | 500 |
| Unearned Revenue | | 890 |
| Common Stock | | 10,000 |
| Retained Earnings | | 2,900 |
| Service Revenue | | 5,450 |
| Salaries Expense | 3,300 | |
| Advertising Expense | 400 | |
| Miscellaneous Expense | 290 | |
| Depreciation Expense | 500 | |
| | $23,190 | $23,190 |

Tom Brennan reviewed the records and found the following errors.

1. Cash received from a customer on account was recorded as $870 instead of $780.
2. A payment of $65 for advertising expense was entered as a debit to Miscellaneous Expense $65 and a credit to Cash $65.
3. The first salary payment this month was for $1,900, which included $500 of salaries payable on March 31. The payment was recorded as a debit to Salaries Expense $1,900 and a credit to Cash $1,900. (No reversing entries were made on April 1.)
4. The purchase on account of a printer costing $290 was recorded as a debit to Supplies and a credit to Accounts Payable for $290.
5. A cash payment of repair expense on equipment for $95 was recorded as a debit to Equipment $59 and a credit to Cash $59.

**Instructions**

**(a)** Prepare an analysis of each error showing (1) the incorrect entry, (2) the correct entry, and (3) the correcting entry. Items 4 and 5 occurred on April 30, 2006.

**(b)** Prepare a correct trial balance. Trial balance $22,690

## PROBLEMS: SET B

**P4-1B** Sherlock Holmes began operations as a private investigator on January 1, 2006. The trial balance columns of the work sheet for Sherlock Holmes P.I. at March 31 are as follows.

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

**SHERLOCK HOLMES P.I.**
Work Sheet
For the Quarter Ended March 31, 2006

| Account Titles | Trial Balance Dr. | Trial Balance 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 | |
| | 55,970 | 55,970 |

Other data:

1. Supplies on hand total $680.
2. Depreciation is $1,000 per quarter.
3. Interest accrued on 6-month note payable, issued January 1, $300.
4. Insurance expires at the rate of $200 per month.
5. Services provided but unbilled at March 31 total $830.

**Instructions**

**(a)** Enter the trial balance on a work sheet and complete the work sheet. (a) Adjusted trial balance $58,100

**(b)** Prepare an income statement and a retained earnings statement for the quarter and a classified balance sheet at March 31. Stockholders purchased $20,000 of common stock for cash at the beginning of the quarter ended March 31, 2006. (b) Net income $ 7,280 Total assets $49,330

**(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.

*Complete work sheet; prepare financial statements, closing entries, and post-closing trial balance.*

(SO 1, 2, 3, 6)

**P4-2B** The adjusted trial balance columns of the work sheet for Mr. Watson Company are as follows.

**MR. WATSON COMPANY**
Work Sheet
For the Year Ended December 31, 2006

| Account No. | Account Titles | Adjusted Trial Balance Dr. | Adjusted Trial Balance Cr. |
|---|---|---|---|
| 101 | Cash | 20,800 | |
| 112 | Accounts Receivable | 16,200 | |
| 126 | Supplies | 2,300 | |
| 130 | Prepaid Insurance | 4,400 | |
| 151 | Office Equipment | 44,000 | |
| 152 | Accumulated Depreciation—Office Equipment | | 18,000 |
| 200 | Notes Payable | | 20,000 |
| 201 | Accounts Payable | | 8,000 |
| 212 | Salaries Payable | | 2,600 |
| 230 | Interest Payable | | 1,000 |
| 311 | Common Stock | | 20,000 |
| 320 | Retained Earnings | | 16,000 |
| 332 | Dividends | 12,000 | |
| 400 | Service Revenue | | 79,800 |
| 610 | Advertising Expense | 12,000 | |
| 631 | Supplies Expense | 3,700 | |
| 711 | Depreciation Expense | 6,000 | |
| 722 | Insurance Expense | 4,000 | |
| 726 | Salaries Expense | 39,000 | |
| 905 | Interest Expense | 1,000 | |
| | Totals | 165,400 | 165,400 |

**Instructions**

(a) Net income $14,100
(b) Current assets $43,700
Current liabilities $21,600

**(a)** Complete the work sheet by extending the balances to the financial statement columns.
**(b)** Prepare an income statement, a retained earnings statement, and a classified balance sheet. $10,000 of the notes payable become due in 2007. No additional issuances of stock occured during 2006.
**(c)** Prepare the closing entries. Use J14 for the journal page.
**(d)** Post the closing entries. Use the three-column form of account. Income Summary is account No. 350.

(e) Post-closing trial balance $87,700

**(e)** Prepare a post-closing trial balance.

*Prepare financial statements, closing entries, and post-closing trial balance.*

(SO 1, 2, 3, 6)

**P4-3B** The completed financial statement columns of the work sheet for Hubbs Company are shown below and on page 181.

**HUBBS COMPANY**
Work Sheet
For the Year Ended December 31, 2006

| Account No. | Account Titles | Income Statement Dr. | Income Statement Cr. | Balance Sheet Dr. | Balance Sheet Cr. |
|---|---|---|---|---|---|
| 101 | Cash | | | 10,200 | |
| 112 | Accounts Receivable | | | 7,500 | |
| 130 | Prepaid Insurance | | | 1,800 | |
| 157 | Equipment | | | 28,000 | |
| 167 | Accumulated Depreciation | | | | 8,600 |
| 201 | Accounts Payable | | | | 11,700 |
| 212 | Salaries Payable | | | | 3,000 |
| 311 | Common Stock | | | | 20,000 |
| 320 | Retained Earnings | | | | 14,000 |

| Account No. | Account Titles | Income Statement Dr. | Income Statement Cr. | Balance Sheet Dr. | Balance Sheet Cr. |
|---|---|---|---|---|---|
| 332 | Dividends | | | 7,200 | |
| 400 | Service Revenue | | 44,000 | | |
| 622 | Repair Expense | 3,400 | | | |
| 711 | Depreciation Expense | 2,800 | | | |
| 722 | Insurance Expense | 1,200 | | | |
| 726 | Salaries Expense | 35,200 | | | |
| 732 | Utilities Expense | 4,000 | | | |
| | Totals | 46,600 | 44,000 | 54,700 | 57,300 |
| | Net Loss | | 2,600 | 2,600 | |
| | | 46,600 | 46,600 | 57,300 | 57,300 |

**Instructions**

**(a)** Prepare an income statement, a retained earnings statement, and a classified balance sheet. Stockholders made additional purchases of common stock of $4,000 during 2006.

(a) Net loss $2,600
Total assets $38,900

**(b)** Prepare the closing entries.

**(c)** Post the closing entries and rule and balance the accounts. Use T accounts. Income Summary is account No. 350.

**(d)** Prepare a post-closing trial balance.

(d) Post-closing trial balance $47,500

**P4-4B** London Amusement Park Inc. has a fiscal year ending on September 30. Selected data from the September 30 work sheet are presented below.

*Complete work sheet; prepare classified balance sheet, entries, and post-closing trial balance.*
(SO 1, 2, 3, 6)

**LONDON AMUSEMENT PARK INC.**
Work Sheet
For the Year Ended September 30, 2006

| | Trial Balance Dr. | Trial Balance Cr. | Adjusted Trial Balance Dr. | Adjusted Trial Balance Cr. |
|---|---|---|---|---|
| Cash | 41,400 | | 41,400 | |
| Supplies | 18,600 | | 1,200 | |
| Prepaid Insurance | 31,900 | | 3,900 | |
| Land | 80,000 | | 80,000 | |
| Equipment | 120,000 | | 120,000 | |
| Accumulated Depreciation | | 36,200 | | 42,200 |
| Accounts Payable | | 14,600 | | 14,600 |
| Unearned Admissions Revenue | | 3,700 | | 1,000 |
| Mortgage Payable | | 50,000 | | 50,000 |
| Common Stock | | 100,000 | | 100,000 |
| Retained Earnings | | 9,700 | | 9,700 |
| Dividends | 14,000 | | 14,000 | |
| Admissions Revenue | | 277,500 | | 280,200 |
| Salaries Expense | 105,000 | | 105,000 | |
| Repair Expense | 30,500 | | 30,500 | |
| Advertising Expense | 9,400 | | 9,400 | |
| Utilities Expense | 16,900 | | 16,900 | |
| Property Taxes Expense | 18,000 | | 21,000 | |
| Interest Expense | 6,000 | | 10,000 | |
| Totals | 491,700 | 491,700 | | |
| Insurance Expense | | | 28,000 | |
| Supplies Expense | | | 17,400 | |
| Interest Payable | | | | 4,000 |
| Depreciation Expense | | | 6,000 | |
| Property Taxes Payable | | | | 3,000 |
| Totals | | | 504,700 | 504,700 |

(a) Net income $36,000
(b) Total current assets $46,500

(e) Post-closing trial balance $246,500

**Instructions**

**(a)** Prepare a complete work sheet.
**(b)** Prepare a classified balance sheet. (*Note*: $10,000 of the mortgage payable is due for payment in the next fiscal year.)
**(c)** Journalize the adjusting entries using the work sheet as a basis.
**(d)** Journalize the closing entries using the work sheet as a basis.
**(e)** Prepare a post-closing trial balance.

*Complete all steps in accounting cycle.*

(SO 1, 2, 3, 4, 6)

**P4-5B** Mike Young opened Young's Carpet Cleaners Inc. on March 1. During March, the following transactions were completed.

Mar. 1 Issued $10,000 of common stock for $10,000 cash.
1 Purchased used truck for $6,000, paying $3,000 cash and the balance on account.
3 Purchased cleaning supplies for $1,200 on account.
5 Paid $1,800 cash on one-year insurance policy effective March 1.
14 Billed customers $2,800 for cleaning services.
18 Paid $1,500 cash on amount owed on truck and $500 on amount owed on cleaning supplies.
20 Paid $1,800 cash for employee salaries.
21 Collected $1,400 cash from customers billed on March 14.
28 Billed customers $2,500 for cleaning services.
31 Paid gas and oil for month on truck $200.
31 Declared and paid $700 cash dividend.

The chart of accounts for Young's Carpet Cleaners Inc. contains the following accounts: No. 101 Cash, No. 112 Accounts Receivable, No. 128 Cleaning Supplies, No. 130 Prepaid Insurance, No. 157 Equipment, No. 158 Accumulated Depreciation—Equipment, No. 201 Accounts Payable, No. 212 Salaries Payable, No. 311 Common Stock, No. 320 Retained Earnings, No. 332 Dividends, No. 350 Income Summary, No. 400 Service Revenue, No. 633 Gas & Oil Expense, No. 634 Cleaning Supplies Expense, No. 711 Depreciation Expense, No. 722 Insurance Expense, and No. 726 Salaries Expense.

(b) Trial balance $17,500
(c) Adjusted trial balance $18,950

(e) Net income $ 2,500
Total assets $14,500

(g) Post-closing trial balance $14,750

**Instructions**

**(a)** Journalize and post the March transactions. Use page J1 for the journal and the three-column form of account.
**(b)** Prepare a trial balance at March 31 on a work sheet.
**(c)** Enter the following adjustments on the work sheet and complete the work sheet.
**(1)** Earned but unbilled revenue at March 31 was $700.
**(2)** Depreciation on equipment for the month was $250.
**(3)** One-twelfth of the insurance expired.
**(4)** An inventory count shows $600 of cleaning supplies on hand at March 31.
**(5)** Accrued but unpaid employee salaries were $500.
**(d)** Journalize and post adjusting entries. Use page J2 for the journal.
**(e)** Prepare the income statement and a retained earnings statement for March and a classified balance sheet at March 31.
**(f)** Journalize and post closing entries and complete the closing process. Use page J3 for the journal.
**(g)** Prepare a post-closing trial balance at March 31.

Mary Coleman opened Mary's Maids Cleaning Service Inc. on July 1, 2006. During July, the following transactions were completed.

July 1 Issued $14,000 of common stock for $14,000 cash.
1 Purchased a used truck for $10,000, paying $3,000 cash and the balance on account.
3 Purchased cleaning supplies for $800 on account.
5 Paid $2,400 on a one-year insurance policy, effective July 1.
12 Billed customers $3,800 for cleaning services.
18 Paid $1,000 of amount owed on truck, and $400 of amount owed on cleaning supplies.
20 Paid $1,600 for employee salaries.

21 Collected $1,400 from customers billed on July 12.
25 Billed customers $2,500 for cleaning services.
31 Paid gas and oil for the month on the truck, $400.
31 Declared and paid a $600 cash dividend.

The chart of accounts for Mary's Maids Cleaning Service Inc. contains the following accounts: No. 101 Cash, No. 112 Accounts Receivable, No. 128 Cleaning Supplies, No. 130 Prepaid Insurance, No. 157 Equipment, No. 158 Accumulated Depreciation—Equipment, No. 201 Accounts Payable, No. 212 Salaries Payable, No. 311 Common Stock, No. 320 Retained Earnings, No. 332 Dividends, No. 350 Income Summary, No. 400 Service Revenue, No. 633 Gas & Oil Expense, No. 634 Cleaning Supplies Expense, No. 711 Depreciation Expense, No. 722 Insurance Expense, and No. 726 Salaries Expense.

**Instructions**

**(a)** Journalize and post the July transactions. Use page J1 for the journal.
**(b)** Prepare a trial balance at July 31 on a work sheet. (b) Trial balance totals $26,700
**(c)** Enter the following adjustments on the work sheet, and complete the work sheet.
  **(1)** Earned but unbilled fees at July 31 were $1,300.
  **(2)** Depreciation on equipment for the month was $200.
  **(3)** One-twelfth of the insurance expired.
  **(4)** An inventory count shows $300 of cleaning supplies on hand at July 31.
  **(5)** Accrued but unpaid employee salaries were $500.
**(d)** Journalize and post the adjusting entries. Use page J2 for the journal.
**(e)** Prepare the income statement and a retained earnings statement for July, and a classified balance sheet at July 31, 2006. (e) Net income $4,200 Total assets $24,500
**(f)** Journalize and post the closing entries, and complete the closing process. Use page J3 for the journal.
**(g)** Prepare a post-closing trial balance at July 31. (g) Trial balance totals $24,700

# BROADENING YOUR PERSPECTIVE

## Financial Reporting and Analysis

### ■ FINANCIAL REPORTING PROBLEM: PepsiCo

**BYP4-1** The financial statements of **PepsiCo, Inc.** are presented in Appendix A at the end of this textbook.

**Instructions**

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

**(a)** What were PepsiCo's total current assets at December 27, 2003 and December 28, 2002?
**(b)** Are assets that PepsiCo included under current assets listed in proper order? Explain.
**(c)** How are PepsiCo's assets classified?
**(d)** What are "cash equivalents"?
**(e)** What were PepsiCo's total current liabilities at December 27, 2003 and December 28, 2002?

### ■ COMPARATIVE ANALYSIS PROBLEM: PepsiCo vs. Coca-Cola

**BYP4-2** **PepsiCo**'s financial statements are presented in Appendix A. **Coca-Cola**'s financial statements are presented in Appendix B.

**Instructions**

**(a)** Based on the information contained in these financial statements, determine each of the following for PepsiCo at December 27, 2003, and for Coca-Cola at December 31, 2003.
  **(1)** Total current assets.
  **(2)** Net amount of property, plant, and equipment (land, buildings, and equipment).
  **(3)** Total current liabilities.
  **(4)** Total stockholders' (shareholders') equity.
**(b)** What conclusions concerning the companies' respective financial positions can be drawn?

## RESEARCH CASE

**BYP4-3** The February 21, 2002, issue of the *Wall Street Journal* includes an article by Ken Brown titled "Creative Accounting: Four Areas to Buff Up a Company's Picture."

**Instructions**

Read the article and do the following.

Although the title says "four areas," it actually describes five ways that companies inappropriately manipulate their financial statements. Describe each of these five methods. For each method, give an example of a company that has been accused of using the method, and describe what that specific company was accused of.

## INTERPRETING FINANCIAL STATEMENTS

**BYP4-4** **Laser Recording Systems**, founded in 1981, produces disks for use in the home market. The following is an excerpt from Laser Recording Systems financial statements (all dollars in thousands).

**LASER RECORDING SYSTEMS**
Management Discussion

Accrued liabilities increased to $1,642 at January 31, from $138 at the end of the previous fiscal year. Compensation and related accruals increased $195 due primarily to increases in accruals for severance, vacation, commissions, and relocation expenses. Accrued professional services increased by $137 primarily as a result of legal expenses related to several outstanding contractual disputes. Other expenses increased $35, of which $18 was for interest payable.

**Instructions**

**(a)** Can you tell from the discussion whether Laser Recording Systems has prepaid its legal expenses and is now making an adjustment to the asset account Prepaid Legal Expenses, or whether the company is handling the legal expense via an accrued expense adjustment?

**(b)** Identify each of the adjustments Laser Recording Systems is discussing as one of the four types of possible adjustments discussed in Chapter 3. How is net income ultimately affected by each of the adjustments?

**(c)** What journal entry did Laser Recording make to record the accrued interest?

## A GLOBAL FOCUS

**BYP4-5** **Lign Multiwood** is a Swedish forest products company. Its statements conform with the standards of the Swedish Standards Board. Its financial statements are presented to have minimal difference in methods with member countries of the European Union. The balance sheet presented on page 185 is from its 2000 annual report.

**Instructions**

List all differences that you notice between Lign Multiwood's balance sheet presentation (format and terminology) and the presentation of U.S. companies shown in the chapter: For differences in terminology, list the corresponding terminology used by U.S. companies.

## EXPLORING THE WEB

**BYP4-6** Numerous companies have established home pages on the Internet, e.g., **Boston Beer Company (www.samadams.com)** and **Kodak (www.kodak.com).**

**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?

## LIGN MULTIWOOD
Balance Sheet
at December 31
(Swedish kronor)

| ASSETS | 2000 | 1999 |
|---|---|---|
| **Fixed assets** | | |
| ***Intangible fixed assets*** | | |
| Balanced expenses for development work | 28 407 064 | 12 056 864 |
| Licence rights | 1 200 000 | 600 000 |
| | 29 607 064 | 12 656 864 |
| ***Material fixed assets*** | | |
| Machinery and other technical plant | 33 608 189 | 34 606 812 |
| Fittings & fixtures, tools and installations | 564 952 | 163 020 |
| | 34 173 141 | 34 769 832 |
| ***Financial fixed assets*** | | |
| Other long-term securities holdings | 165 000 | 165 000 |
| Deferred tax claim | 3 042 000 | 1 129 000 |
| | 3 207 000 | 1 294 000 |
| **Total fixed assets** | 66 987 205 | 48 720 696 |
| **Current assets** | | |
| ***Stocks held, etc.*** | | |
| Stocks of test materials | 554 000 | 116 924 |
| | 554 000 | 116 924 |
| ***Short-term receivables*** | | |
| Customer receivables | 727 159 | 652 662 |
| Other receivables | 1 099 197 | 711 979 |
| Prepaid costs and accrued income | 2 479 411 | 1 620 467 |
| | 4 305 767 | 2 985 108 |
| ***Cash in hand and on deposit*** | 17 965 269 | 40 755 806 |
| **Total current assets** | 22 825 036 | 43 857 838 |
| **TOTAL ASSETS** | 89 812 241 | 92 578 534 |
| **EQUITY CAPITAL AND LIABILITIES** | | |
| ***Equity capital*** | | |
| *Tied equity capital* | | |
| Share capital | 2 825 740 | 2 825 740 |
| Tied reserves | 56 745 410 | 56 745 410 |
| | 59 571 150 | 59 571 150 |
| *Accumulated loss* | | |
| Balanced loss | −2 801 000 | − 598 000 |
| Year's profit/loss | −4 933 000 | −2 203 000 |
| | −7 734 000 | −2 801 000 |
| | 51 837 150 | 56 770 150 |
| ***Minority interest*** | 40 000 | 40 000 |
| ***Long-term liabilities*** | | |
| Other liabilities | 33 619 451 | 34 162 457 |
| | 33 619 451 | 34 162 457 |
| ***Short-term liabilities*** | | |
| Accounts payable | 2 151 435 | 1 232 505 |
| Other liabilities | 959 044 | 64 099 |
| Accrued costs and prepaid income | 1 205 161 | 309 323 |
| | 4 315 640 | 1 605 927 |
| **TOTAL EQUITY CAPITAL AND LIABILITIES** | 89 812 241 | 92 578 534 |

# Critical Thinking

## GROUP DECISION CASE

**BYP4-7** Everclean Janitorial Service Inc. was started 2 years ago by Laurie Merar. Because business has been exceptionally good, Laurie decided on July 1, 2006, to expand operations by acquiring an additional truck and hiring two more assistants. To finance the expansion, Laurie obtained on July 1, 2006, a $25,000, 10% bank loan, payable $10,000 on July 1, 2007, and the balance on July 1, 2008. The terms of the loan require the borrower to have $10,000 more current assets than current liabilities at December 31, 2006. If these terms are not met, the bank loan will be refinanced at 15% interest. At December 31, 2006, the accountant for Everclean Janitorial Service Inc. prepared the balance sheet shown below.

Laurie presented the balance sheet to the bank's loan officer on January 2, 2007, confident that the company had met the terms of the loan. The loan officer was not impressed. She said, "We need financial statements audited by a CPA." A CPA was hired and immediately realized that the balance sheet had been prepared from a trial balance and not from an adjusted trial balance. The adjustment data at the balance sheet date consisted of the following.

**(1)** Earned but unbilled janitorial services were $5,700.
**(2)** Janitorial supplies on hand were $2,800.
**(3)** Prepaid insurance was a 3-year policy dated January 1, 2006.
**(4)** December expenses incurred but unpaid at December 31, $700.
**(5)** Interest on the bank loan was not recorded.
**(6)** The amounts for property, plant, and equipment in the balance sheet were reported net of accumulated depreciation (cost less accumulated depreciation). These amounts were $4,000 for cleaning equipment and $5,000 for delivery trucks as of January 1, 2006. Depreciation for 2006 was $2,000 for cleaning equipment and $5,000 for delivery trucks.

**EVERCLEAN JANITORIAL SERVICE INC.**
Balance Sheet
December 31, 2006

| Assets | | Liabilities and Stockholders' Equity | | |
|---|---|---|---|---|
| Current assets | | Current liabilities | | |
| Cash | $ 6,500 | Notes payable | | $10,000 |
| Accounts receivable | 9,000 | Accounts payable | | 2,500 |
| Janitorial supplies | 5,200 | Total current liabilities | | 12,500 |
| Prepaid insurance | 4,800 | Long-term liability | | |
| Total current assets | 25,500 | Notes payable | | 15,000 |
| Property, plant, and equipment | | Total liabilities | | 27,500 |
| Cleaning equipment (net) | 22,000 | Stockholders' equity | | |
| Delivery trucks (net) | 34,000 | Common stock | $40,000 | |
| Total property, plant, and equipment | 56,000 | Retained earnings | 14,000 | 54,000 |
| Total assets | $81,500 | Total liabilities and stockholders' equity | | $81,500 |

### Instructions

With the class divided into groups, answer the following.

**(a)** Prepare a correct balance sheet.
**(b)** Were the terms of the bank loan met? Explain.

## COMMUNICATION ACTIVITY

**BYP4-8** The accounting cycle is important in understanding the accounting process.

### Instructions

Write a memo to your instructor that lists the steps of the accounting cycle in the order they should be completed. End with a paragraph that explains the optional steps in the cycle.

## ETHICS CASE

Accounting Matters!

**BYP4-9** As the controller of Take No Prisoners Perfume Company, you discover a misstatement that 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, Rocky Balboa, about this misstatement, you gather your courage to inform him. Rocky 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 a controller in this situation?

## CONTINUING COOKIE CHRONICLE

Accounting Matters!

(Note: The Continuing Cookie Chronicle was started in Chapter 1 and continued in Chapters 2 and 3.)

**BYP4-10** Natalie is gearing up for the holiday season. During the month of December, the following transactions happen.

| | | |
|---|---|---|
| Dec. | 1 | Natalie hires an assistant to help with cookie making and to do some administrative duties. Natalie and her assistant agree on an hourly rate of $8. |
| | 4 | Natalie teaches the class that was booked on November 25 and receives the balance outstanding. |
| | 8 | She collects the amount due from the neighborhood school that was accrued at the end of November, 2005. |
| | 10 | She receives $625 in advance from the local school board for five classes that are to be given during December and January. |
| | 15 | She pays for the cell phone bill accrued in the adjusting journal entries in November 2005. |
| | 16 | Natalie issues a check to her brother for payment of the Web site he set up in November 2005. |
| | 18 | She receives a deposit of $50 on a cookie class that is scheduled for early January. |
| | 24 | Natalie adds up all of the additional revenue for the classes taught during the month. She has not had time to account for each class individually. She determines that during the period December 1 to 24 she taught $3,500 worth of cookie-making classes. For these classes, she has collected $3,000 in cash and sent out invoices for $500. (This is in addition to the December 4 and the December 10 transactions.) |
| | 24 | Natalie adds up all of the sugar, flour, and chocolate chips she purchased during the month. In total she paid $1,250 for these baking supplies. |
| | 24 | Natalie issues a check to her assistant for $800. Her assistant worked approximately 100 hours from the time she started working for Natalie until December 24. |
| | 24 | Because Natalie has had such a busy December doing school work and giving lessons, she decides to take the rest of the month off. |
| | 24 | Cash dividends on $500 are paid. |

As at December 31, the following adjusting entry data are available:

1. A count reveals that $50 of brochures and posters remain at the end of December.
2. Another month's worth of depreciation needs to be recorded on the baking equipment purchased in November. (The baking equipment has a useful life of 5 years or 60 months.)
3. One month's worth of amortization needs to be recorded for the Web site. (Recall that the Web site has a useful life of 2 years or 24 months.)
4. An additional month's worth of interest on her grandmother's loan needs to be accrued. (Recall that the interest rate is 6%.)
5. One month's worth of insurance has expired.
6. Natalie is unexpectedly telephoned on December 28 to give a cookie class at the neighborhood community center. In January, she invoices the center for $375. The invoice will be paid some time in early January.

7. A count on December 31 reveals that $1,000 of baking supplies were used during December.
8. Natalie receives her cell phone bill, $75. The bill is for services provided during the month of December and is due January 15. (Recall that the cell phone is only used for business.)
9. Because the cookie-making class on December 28 is for such a large group of children, Natalie's assistant helps out. Her assistant works 7 hours at a rate of $8 per hour.
10. An analysis of the unearned revenue account reveals that two of the five classes paid for by the local school board on December 10 have still not been taught by the end of December. The $50 deposit received on December 18 for another class also remains unearned.

**Instructions**

Using the information that you have gathered through Chapter 3, the general ledger accounts already prepared, and the new information above, do the following.

**(a)** Prepare and post the December 2005 transactions. (Use the general ledger accounts that you prepared in Chapter 3.)
**(b)** Prepare a trial balance as at December 31, 2005.
**(c)** Prepare and post adjusting journal entries for the month of December.
**(d)** Prepare an adjusted trial balance as at December 31, 2005.
**(e)** Prepare an income statement and a retained earnings for the 2 months ended December 31, 2005, and a classified balance sheet as at December 31, 2005.
**(f)** Prepare and post closing entries as at December 31, 2005.
**(g)** Prepare a post-closing trial balance.

**Accounting Matters!**

**Answers to Accounting Matters! Questions**

**p. 145**

**Q:** What are the advantages of an electronic worksheet over a pencil-and-paper version?

**A:** Preparation of an electronic worksheet on a computer is faster and easier, and also generally more accurate and flexible, than a manually produced pencil-and-paper version. Ability to prepare electronic worksheets is a competency that is expected of today's accountants.

**p. 150**

**Q:** How did Sam Walton know the "books didn't balance"?

**A:** Using the trial balance and the adjusted trial balance, Sam could see that the debits and credits either balanced or did not balance. Also, the accounting equation did not balance (Assets ≠ Liabilities + Common Stock + Retained Earnings − Dividends + Revenues − Expenses).

**p. 150**

**Q:** In what circumstances today might the ESP method be acceptable?

**A:** The ESP method might be acceptable today in looking at interim (e.g., month's end) results. It might also be used by sole proprietors who determine that they do not want to "spend dollars looking for pennies." However, the ESP method cannot be used by companies who must report the results of operations to regulators or the public.

**p. 152**

**Q:** If you do not have the IT resources to do a "virtual close," can the net income or net loss be known without "closing the books"?

**A:** The net income or net loss can be determined by preparing an income statement from the adjusted trial balance without formally closing the books—that is, without closing (balancing and ruling) every revenue and expense account.

**p. 157**

**Q:** What might Yale Express's vice president have done to produce more accurate financial statements without waiting months for Republic's outstanding transportation bills?

**A:** Yale's vice president could have engaged his accountants and auditors to prepare an adjusting entry based on an estimate of the outstanding transportation bills. (The estimate could have been made considering past experience and the current volume of business.)

**Answers to PepsiCo Review It Question 2, p. 164**

PepsiCo's current liabilities in 2003 were $6,415 million. Current liabilities in 2002 were $6,052 million. In both 2003 and 2002, current liabilities were less than current assets.

**Answers to Self-Study Questions**

**1.** c **2.** b **3.** d **4.** a **5.** d **6.** b **7.** a **8.** c **9.** c **10.** b **11.** b

**REMEMBER** to go back to the Navigator box on the chapter-opening page and check off your completed work.