

Principles of Accounting

Lecture 7

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Subject code: MGM 227





Principles of Accounting

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Chapter 4: Completing the Accounting Cycle

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Now after we made the adjustments in last chapter, the accounts are up to date, the business is ready to take the next step in the accounting cycle which is: **preparing the financial statements.**

In this chapter, you review the financial statements that you have already learned about and learn how to prepare a more complete version of the balance sheet.

In addition, you complete the accounting cycle by learning how to **close the books.**

Learning objectives:

- 1) Prepare the financial statements including the classified balance sheet
- 2) Explain the purpose of, journalize, and post closing entries
- 3) Prepare the post-closing trial balance
- 4) Describe the accounting cycle
- 5) Use the current ratio to evaluate business performance



Prepare the financial statements including the classified balance sheet

HOW DO WE PREPARE FINANCIAL STATEMENTS?

As always, the financial statements should be prepared in the following order:

1. **Income statement**—reports revenues and expenses and calculates net income or net loss for the time period.
2. **Statement of retained earnings**—shows how retained earnings changed during the period due to net income (or net loss) and dividends.
3. **Balance sheet**—reports assets, liabilities, and stockholders' equity as of the last day of the period.



Following **IFRS**, companies must present a statement of profit or loss (income statement), statement of financial position (balance sheet), statement of changes in equity (similar to statement of retained earnings) and statement of cash flows—the same as U.S. companies. Yet the statements may look quite different. Revenue may be called *Turnover*, and Net Income may be called *Profit*. On the balance sheet, assets and liabilities are presented in a different order. Cash is often one of the last assets listed.

SMART TOUCH LEARNING
Adjusted Trial Balance
December 31, 2018

Account Title	Balance	
	Debit	Credit
Cash	\$ 12,200	
Accounts Receivable	1,800	
Office Supplies	100	
Prepaid Rent	2,000	
Land	20,000	
Building	60,000	
Accumulated Depreciation—Building		\$ 250
Furniture	18,000	
Accumulated Depreciation—Furniture		300
Accounts Payable		200
Utilities Payable		100
Salaries Payable		1,200
Interest Payable		100
Unearned Revenue		400
Notes Payable		60,000
Common Stock		48,000
Dividends	5,000	
Service Revenue		17,500
Rent Expense	3,000	
Salaries Expense	4,800	
Supplies Expense	400	
Utilities Expense	100	
Depreciation Expense—Building	250	
Depreciation Expense—Furniture	300	
Interest Expense	100	
Total	\$ 128,050	\$ 128,050

3. Balance Sheet
Accounts

2. Statement of Retained
Earnings Account

1. Income Statement
Accounts

The financial statements of Smart Touch Learning are prepared from the adjusted trial balance, which you learned in Chapter 3. Exhibit 4-1 shows the adjusted trial balance for Smart Touch Learning. In the right margin of the exhibit, we see how the accounts are distributed to the financial statements.

Relationships Among the Financial Statements

The arrows in Exhibit 4-2 (on the next page) show how the financial statements relate to each other.

1. Net income from the income statement increases Retained Earnings on the statement of retained earnings. A net loss decreases Retained Earnings.
2. Ending Retained Earnings from the statement of retained earnings goes to the balance sheet and makes total liabilities plus total stockholders' equity equal total assets, satisfying the accounting equation.

To solidify your understanding of these relationships, trace net income from the income statement to the statement of retained earnings. Then trace ending Retained Earnings to the balance sheet. Note that these are the three main financial statements you learned about in the first chapter. They are always prepared in the order described previously: income statement, then statement of retained earnings, and then balance sheet.

SMART TOUCH LEARNING
Income Statement
Two Months Ended December 31, 2018

Revenues:		
Service Revenue		\$ 17,500
Expenses:		
Salaries Expense	\$ 4,800	
Rent Expense	3,000	
Supplies Expense	400	
Depreciation Expense—Furniture	300	
Depreciation Expense—Building	250	
Utilities Expense	100	
Interest Expense	100	
Total Expenses	<u>8,950</u>	
Net Income		<u>\$ 8,550</u>

SMART TOUCH LEARNING
Statement of Retained Earnings
Two Months Ended December 31, 2018

Retained Earnings, November 1, 2018	\$ 0
Net income for the two months	8,550
	<u>8,550</u>
Dividends	(5,000)
Retained Earnings, December 31, 2018	<u>\$ 3,550</u>

Exhibit 4-2 | Smart Touch Learning Financial Statements

1

2

SMART TOUCH LEARNING
Balance Sheet
December 31, 2018

Assets		Liabilities	
Cash	\$ 12,200	Accounts Payable	\$ 200
Accounts Receivable	1,800	Utilities Payable	100
Office Supplies	100	Salaries Payable	1,200
Prepaid Rent	2,000	Interest Payable	100
Land	20,000	Unearned Revenue	400
Building	\$ 60,000	Notes Payable	60,000
Less: Acc. Depr.—Building	(250)	Total Liabilities	<u>62,000</u>
Furniture	18,000		
Less: Acc. Depr.—Furniture	(300)		
	17,700		
		Stockholders' Equity	
		Common Stock	48,000
		Retained Earnings	3,550
		Total Stockholders' Equity	<u>51,550</u>
Total Assets	<u>\$ 113,550</u>	Total Liabilities and Stockholders' Equity	<u>\$ 113,550</u>

Classified Balance Sheet

So far we have presented the unclassified balance sheet of Smart Touch Learning. We are now ready for the balance sheet that is actually used in practice—called a classified balance sheet.

In a classified balance sheet, each asset and each liability are placed into a specific category or classification.

In a classified balance sheet, assets are shown in order of liquidity and liabilities are classified by the order in which they must be paid, either *current* (within one year) or *long-term* (more than one year).

Liquidity measures how quickly and easily an account can be converted to cash (because cash is the most liquid asset). Accounts Receivable are relatively liquid because receivables are collected quickly. Office Supplies are less liquid, and Buildings and Furniture are even less so because they take longer to convert to cash or to be used up.

Liquidity

A measure of how quickly an item can be converted to cash.

Classified Balance Sheet

A balance sheet that places each asset and each liability into a specific category.

Assets

The balance sheet lists assets in the order of liquidity. A classified balance sheet reports two asset categories: *current assets* and *long-term assets*.

Current assets will be converted to cash, sold, or used up during the next 12 months or within the business's operating cycle if the cycle is longer than a year. The **operating cycle** is the time span when

1. Cash is used to acquire goods and services.
2. These goods and services are sold to customers.
3. The business collects cash from customers.

For most businesses, the operating cycle is a few months. Cash, Accounts Receivable, Office Supplies, and Prepaid Expenses are examples of current assets.

Long-term assets are all the assets that will not be converted to cash or used up within the business's operating cycle or one year, whichever is greater. Long-term assets are typically made up of three categories: long-term investments; property, plant, and equipment; and intangible assets.

Current Asset

An asset that is expected to be converted to cash, sold, or used up during the next 12 months or within the business's normal operating cycle if the cycle is longer than a year.

Operating Cycle

The time span during which cash is paid for goods and services, which are then sold to customers from whom the business collects cash.

Long-term Asset

An asset that will not be converted to cash or used up within the business's operating cycle or one year, whichever is greater.

Long-term Investments Notes Receivable and other investments that are held long-term are considered **long-term investments** and include investments in bonds or stocks in which the company intends to hold for longer than one year.

Property, Plant, and Equipment Another category of long-term assets is **property, plant, and equipment** (also called *fixed assets* or *plant assets*). Land, Buildings, Furniture, and Equipment used in operations are plant assets. Property, plant, and equipment are presented in order of the category name, with Land (property) being presented first and then Buildings (plant) and Equipment, Furniture, and other accounts presented last.

Intangible Assets Assets with no physical form are **intangible assets**. Examples of intangible assets include patents, copyrights, and trademarks. Intangible assets are long term assets that convey special rights, such as the exclusive right to produce or sell an invention (patent) or book (copyright), or the symbol or image of a distinctive brand (trademark)

Long-term Investment

Investments in bonds (debt securities) or stocks (equity securities) in which the company intends to hold the investment for longer than one year.

Property, Plant, and Equipment

Long-lived, tangible assets, such as land, buildings, and equipment, used in the operation of a business.

Intangible Asset

An asset with no physical form that is valuable because of the special rights it carries.

Liabilities

The balance sheet lists liabilities in the order in which they must be paid. The two liability categories reported on the balance sheet are *current liabilities* and *long-term liabilities*.

Current liabilities must be paid either with cash or with goods and services within one year or within the entity's operating cycle if the cycle is longer than a year. Accounts Payable, Notes Payable due within one year, Salaries Payable, Interest Payable, and Unearned Revenue are all current liabilities. Any portion of a long-term liability that is due within the next year is also reported as a current liability. Current liabilities are listed in the order that they are due.

Long-term liabilities are all liabilities that do not need to be paid within one year or within the entity's operating cycle, whichever is longer. Many Notes Payable are long-term, such as a Smart Touch Learning's mortgage on its building.

Current Liability

A liability that must be paid with cash or with goods and services within one year or within the entity's operating cycle if the cycle is longer than a year.

Long-term Liability

A liability that does not need to be paid within one year or within the entity's operating cycle, whichever is longer.

Stockholders' Equity

Stockholders' equity represents the stockholders' claims to the assets of the business. The stockholders' equity section reported on the balance sheet is in part transferred from the ending Retained Earnings balance on the statement of retained earnings. The equity balance also reflects the stockholders' contributions through common stock. It represents the amount of assets that is left over after the corporation has paid its liabilities.

Exhibit 4-3 presents Smart Touch Learning's classified balance sheet. Notice that the company classifies each asset and each liability into specific categories, and that the total assets of \$113,550 is the same as the total assets on the unclassified balance sheet in Exhibit 4-2.

This classified balance sheet contains both current assets and long-term assets, but there is only one category of long-term assets: Property, Plant, and Equipment. Other categories of long-term assets that could be included are Long-term Investments and Intangible Assets.

SMART TOUCH LEARNING Balance Sheet December 31, 2018				
Assets				
Current Assets:				
Cash			\$ 12,200	
Accounts Receivable			1,800	
Office Supplies			100	
Prepaid Rent			2,000	
Total Current Assets				\$ 16,100
Property, Plant, and Equipment:				
Land			20,000	
Building	\$ 60,000			
Less: Accumulated Depreciation—Building	(250)		59,750	
Furniture	18,000			
Less: Accumulated Depreciation—Furniture	(300)		17,700	
Total Property, Plant, and Equipment				97,450
Total Assets				<u>\$ 113,550</u>
Liabilities				
Current Liabilities:				
Accounts Payable		\$ 200		
Utilities Payable		100		
Salaries Payable		1,200		
Interest Payable		100		
Unearned Revenue		400		
Total Current Liabilities				\$ 2,000
Long-term Liabilities:				
Notes Payable				60,000
Total Liabilities				<u>62,000</u>
Stockholders' Equity				
Common Stock		48,000		
Retained Earnings		3,550		
Total Stockholders' Equity				51,550
Total Liabilities and Stockholders' Equity				<u>\$ 113,550</u>

Exhibit 4-3 | Classified Balance Sheet

Compare the balance sheet in Exhibit 4-3 with the balance sheet in Exhibit 4-2. You'll notice two differences. Exhibit 4-3 is a classified balance sheet, but it is also in a different format than Exhibit 4-2. The balance sheet in Exhibit 4-3 is being presented in the *report form*, which lists the assets at the top and liabilities and stockholders' equity below. Smart Touch Learning's balance sheet in Exhibit 4-2 lists the assets on the left and the liabilities and the stockholders' equity on the right in an arrangement known as the *account form*. Although either form is acceptable, the *report form* is more popular.

Try It!

For each account listed, identify the category in which it would appear on a classified balance sheet.

- | | |
|---|---|
| 1. Patents | 5. Unearned Revenue |
| 2. Mortgage Payable (due in five years) | 6. Investments in stock of another company held long-term |
| 3. Land | 7. Accumulated Depreciation—Furniture |
| 4. Office Supplies | |

Preparing an income statement

Dalton Hair Stylists's adjusted trial balance follows. Prepare Dalton's income statement for the year ended December 31, 2018.

DALTON HAIR STYLISTS Adjusted Trial Balance December 31, 2018

Account Title	Balance	
	Debit	Credit
Cash	\$ 1,300	
Accounts Receivable	1,500	
Office Supplies	1,800	
Equipment	20,900	
Accumulated Depreciation—Equipment		\$ 2,200
Accounts Payable		400
Interest Payable		500
Notes Payable		3,100
Common Stock		16,150
Dividends	1,400	
Service Revenue		13,800
Rent Expense	3,900	
Supplies Expense	850	
Depreciation Expense—Equipment	2,200	
Interest Expense	2,300	
Total	<u>\$ 36,150</u>	<u>\$ 36,150</u>

S4-1

DALTON HAIR STYLISTS Income Statement Year Ended December 31, 2018

Revenues:		
Service Revenue		\$ 13,800
Expenses:		
Rent Expense	\$ 3,900	
Interest Expense	2,300	
Depreciation Expense—Equipment	2,200	
Supplies Expense	850	
Total Expenses	<u>9,250</u>	
Net Income		<u>\$ 4,550</u>

Preparing a statement of retained earnings

Refer to the data in Short Exercise S4-1. Prepare Dalton's statement of retained earnings for the year ended December 31, 2018.

DALTON HAIR STYLISTS	
Statement of Retained Earnings	
Year Ended December 31, 2018	
Retained Earnings, January 1, 2018	\$ 0
Net income for the year	4,550
	<u>4,550</u>
Dividends	(1,400)
Retained Earnings, December 31, 2018	<u>\$ 3,150</u>

Preparing a balance sheet (unclassified, account form)

Refer to the data in Short Exercise S4-1. Prepare Dalton's *unclassified* balance sheet at December 31, 2018. Use the account form.

DALTON HAIR STYLISTS

Balance Sheet

December 31, 2018

Assets		Liabilities	
Cash	\$ 1,300	Accounts Payable	\$ 400
Accounts Receivable	1,500	Interest Payable	500
Office Supplies	1,800	Notes Payable	3,100
Equipment	\$ 20,900	Total Liabilities	4,000
Less: Acc. Depr.—Equip.	<u>(2,200)</u>		
	18,700		
		Stockholders' Equity	
		Common Stock	16,150
		Retained Earnings	3,150
		Total Stockholders' Equity	19,300
Total Assets	<u>\$ 23,300</u>	Total Liabilities and Stockholders' Equity	<u>\$ 23,300</u>

Preparing a balance sheet (classified, report form)

Refer to the data in Short Exercise S4-1. Prepare Dalton's classified balance sheet at December 31, 2018. Assume the Notes Payable is due on December 1, 2025. Use the report form.

DALTON HAIR STYLISTS

Balance Sheet

December 31, 2018

Assets		
Current Assets:		
Cash	\$ 1,300	
Accounts Receivable	1,500	
Office Supplies	1,800	
Total Current Assets		\$ 4,600
Property, Plant, and Equipment:		
Equipment	\$ 20,900	
Less: Accumulated Depreciation—Equipment	(2,200)	
Total Property, Plant, and Equipment		18,700
Total Assets		<u>\$ 23,300</u>
Liabilities		
Current Liabilities:		
Accounts Payable	\$ 400	
Interest Payable	500	
Total Current Liabilities		\$ 900
Long-term Liabilities:		
Notes Payable (long-term)		3,100
Total Liabilities		<u>4,000</u>
Stockholders' Equity		
Common Stock	\$ 16,150	
Retained Earnings	3,150	
Total Stockholders' Equity		19,300
Total Liabilities and Stockholders' Equity		<u>\$ 23,300</u>

Classifying balance sheet accounts

For each account listed, identify the category in which it would appear on a classified balance sheet.

- | | |
|----------------------|--|
| a. Office Supplies | f. Accumulated Depreciation—Furniture |
| b. Interest Payable | g. Land (held for long-term investment purposes) |
| c. Retained Earnings | h. Unearned Revenue |
| d. Copyrights | i. Notes Payable (due in six years) |
| e. Land | |

- a. current assets
- b. current liabilities
- c. stockholders' equity
- d. intangible assets
- e. property, plant and equipment
- f. property, plant, and equipment
- g. long-term investments
- h. current liabilities
- i. long-term liabilities

1. What type of normal balance does the Retained Earnings account have—debit or credit?
2. Which type of income statement account has the same type of balance as the Retained Earnings account?
3. Which type of income statement account has the opposite type of balance as the Retained Earnings account?
4. What do we call the difference between total debits and total credits on the income statement section of the worksheet?

1. Credit
2. Revenue
3. Expense
4. Net Income or Net Loss



WHAT IS THE CLOSING PROCESS, AND HOW DO WE CLOSE THE ACCOUNTS?

At the end of the accounting cycle, after the financial statements have been prepared, Smart Touch Learning is ready to close the books. Often referred to as the closing process, this consists of journalizing and posting the closing entries in order to get the accounts ready for the next period. The **closing process** zeroes out all revenue accounts and all expense accounts in order to measure each period's net income separately from all other periods. It also updates the Retained Earnings account balance for net income or loss during the period and any dividends paid to the stockholders. The closing process prepares the accounts for the next time period by setting the balances of revenues, expenses, and dividends to zero. By completing the closing process, the business is following the time period concept in that it is slicing its activities into small time segments and preparing financial statements for only those specific periods.

Recall that the income statement reports net income for a specific period. For example, Smart Touch Learning's net income for the two months ended December 31, 2018, relates exclusively to November and December, 2018. At December 31, 2018, Smart Touch Learning closes its revenue and expense accounts for the last two months of the year. For this reason, revenues and expenses are called **temporary accounts** (also known as *nominal accounts*). For example, Smart Touch Learning's balance of Service Revenue at December 31, 2018, is \$17,500. This balance relates exclusively to the last two months of 2018 and must be zeroed out before the company records revenue for the next year. Similarly, the various expense account balances are for the last two months of 2018 only and must also be zeroed out at the end of the year.

Closing Process

A step in the accounting cycle that occurs at the end of the period. The closing process consists of journalizing and posting the closing entries to set the balances of the revenues, expenses, Income Summary, and Dividends accounts to zero for the next period.

Temporary Account

An account that relates to a particular accounting period and is closed at the end of that period—the revenues, expenses, Income Summary, and Dividends accounts.

The Dividends account is also temporary and must be closed at the end of the period because it measures the payments to stockholders for only that one period. All temporary accounts (revenues, expenses, and dividends) are closed (zeroed). The balances of temporary accounts do not carry forward into the next time period. Instead, the business starts the new time period with a zero beginning balance in the temporary accounts.

By contrast, the **permanent accounts** (also known as *real accounts*)—the assets, liabilities, Common Stock, and Retained Earnings—are not closed at the end of the period. Permanent account balances are carried forward into the next time period. All accounts on the balance sheet are permanent accounts.

Permanent Account

An account that is not closed at the end of the period—the asset, liability, Common Stock, and Retained Earnings accounts.

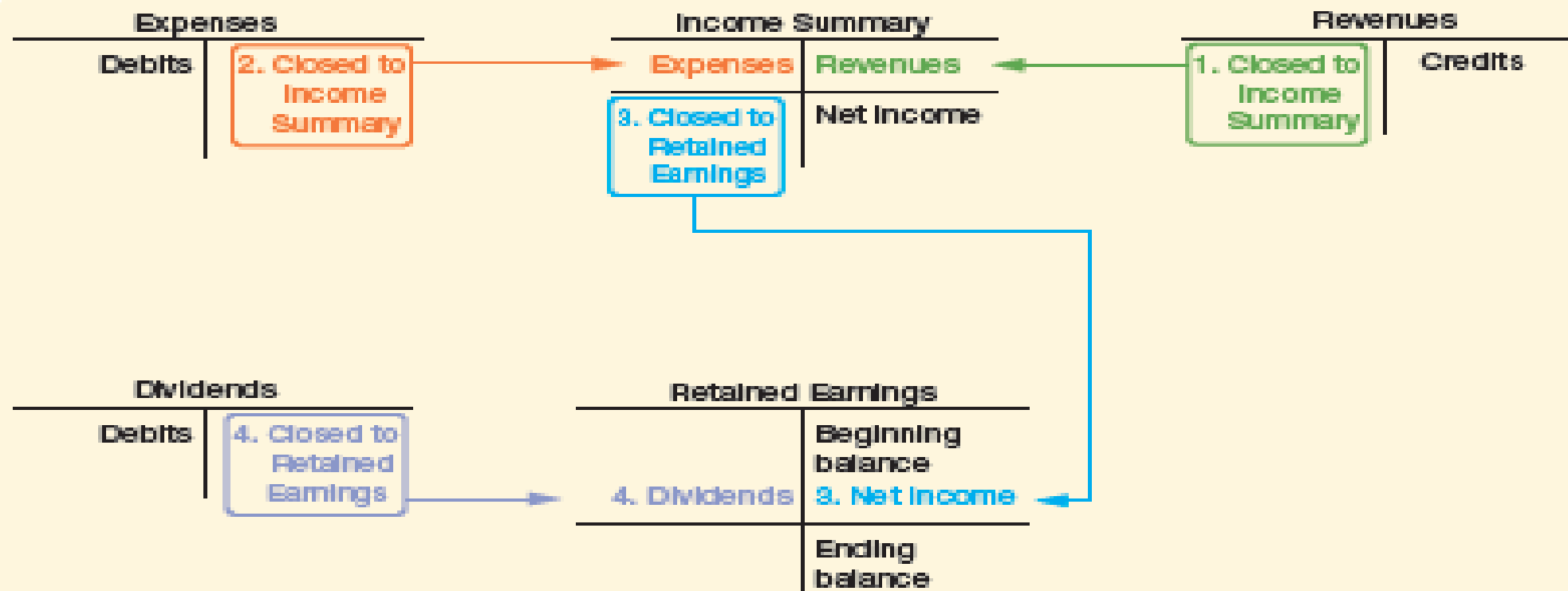
Closing entries transfer the revenues, expenses, and Dividends balances to the Retained Earnings account to prepare the company's books for the next period. This transfer to Retained Earnings also causes the Retained Earnings ledger account to now equal its balance reported on the balance sheet. As an intermediate step, the revenues and the expenses may be transferred first to an account titled **Income Summary**. The Income Summary account *summarizes* the net income (or net loss) for the period by collecting the sum of all the expenses (a debit) and the sum of all the revenues (a credit). The Income Summary account is like a temporary "holding tank" that shows the amount of net income or net loss of the current period. Its ending balance—net income or net loss—is then transferred (closed) to the Retained Earnings account (the final account in the closing process). Exhibit 4-5 summarizes the closing process.

Closing Entries

Entries that transfer the revenues, expenses, and Dividends balances to the Retained Earnings account to prepare the company's books for the next period.

Income Summary

A temporary account into which revenues and expenses are transferred prior to their final transfer into the Retained Earnings account. Summarizes net income (or net loss) for the period.



When thinking about which accounts to close, consider your grades in this class as an example. If you made a failing grade on an exam in this class, would you want your exam grade for this class to carry forward to your next accounting class? Your answer would probably be no, because your exam grade in this class does not necessarily represent your knowledge in your next class. In this example, your exam grades are temporary and should not carry forward to your next accounting class. In the same sense, a business's revenues, expenses, and dividends for a specific time period should not be carried forward to the next time period because doing so does not accurately reflect that future period.

Closing Temporary Accounts—Net Income for the Period

As stated previously, all temporary accounts are closed (zeroed out) during the closing process.

Revenue, expenses, and dividends accounts are not permanent. Only the balance sheet accounts are permanent. The four steps in closing the books follow (and are illustrated in Exhibit 4-6).

Step 1: Make the revenue accounts equal zero via the Income Summary account. This Closing entry transfers total revenues to the *credit* side of the Income Summary account.

For example, Smart Touch Learning has a \$17,500 credit balance in Service Revenue.

To close this account (make it zero), we *debit* Service Revenue and *credit* Income Summary.

Service Revenue		Income Summary	
	17,500 Adj. Bal.	17,500 Clos. 1	
Clos. 1 17,500			
	0 Bal.		

Date	Accounts and Explanation	Debit	Credit
Dec. 31	Service Revenue	17,500	
	Income Summary		17,500
	To close revenue.		

A	-	L	+	E↑
				Service Revenue↓
				Income Summary↑

Step 2: Make expense accounts equal zero via the Income Summary account. This closing entry transfers total expenses to the *debit* side of the Income Summary account.

As an example, we will review the Rent Expense account for Smart Touch Learning, which has a \$3,000 debit balance. This account will be closed with a *credit* to Rent Expense.

Rent Expense	
Adj. Bal. 3,000	
	3,000 Clos. 2
Bal. 0	

Smart Touch Learning will close all expense accounts in the same manner. This will most likely be done with a compound closing entry. Each individual expense account will be *credited* and the Income Summary account will be *debited* for the total amount of expenses.

Date	Accounts and Explanation	Debit	Credit
Dec. 31	Income Summary	8,950	
	Rent Expense		3,000
	Salaries Expense		4,800
	Supplies Expense		400
	Utilities Expense		100
	Depreciation Expense—Building		250
	Depreciation Expense—Furniture		300
	Interest Expense		100
	To close expenses.		

$$\begin{array}{c} \underline{A} \\ \left. \vphantom{\begin{array}{c} A \\ L \\ E \end{array}} \right\} - \left\{ \begin{array}{c} L \\ + \\ E \updownarrow \\ \text{Income} \\ \text{Summary} \downarrow \\ \text{Expenses} \downarrow \end{array} \right. \end{array}$$

The Income Summary account now holds the net income of \$8,550 for the period. The Income Summary T-account after closing revenues and expenses is:

Income Summary			
Clos. 2	8,950	17,500	Clos. 1
		8,550	Bal.

Step 3: Make the Income Summary account equal zero via the Retained Earnings account. This closing entry transfers net income (or net loss) to the Retained Earnings account. Smart Touch Learning has an \$8,550 credit balance in the Income Summary account. This represents net income for the period. Net income will now be transferred to the Retained Earnings account. We will *debit* Income Summary and *credit* Retained Earnings. Notice that this closing entry, in effect, increases the Retained Earnings account for the net income of the period.

Income Summary			
Clos. 2	8,950	17,500	Clos. 1
		8,550	Bal.
Clos. 3	8,550		
		0	Bal.

Retained Earnings	
0	Adj. Bal.
8,550	Clos. 3

Net Income

A		L	+	E↑↓
				Income Summary↓
				Retained Earnings↑

Date	Accounts and Explanation	Debit	Credit
Dec. 31	Income Summary	8,550	
	Retained Earnings		8,550
	To close Income Summary.		

Step 4: Make the Dividends account equal zero via the Retained Earnings account. This entry transfers the dividends to the *debit* side of the Retained Earnings account.

Smart Touch Learning has a \$5,000 debit balance in the Dividends account. This account will be closed with a *debit* to Retained Earnings and a *credit* to Dividends.

Retained Earnings				Dividends			
			0 Adj. Bal.	Adj. Bal. 5,000			
Clos. 4	5,000	8,550	Clos. 3		5,000	Clos. 4	
		3,550	Bal.	Bal.	0		

Balance of Retained Earnings on the balance sheet

A		L	+	E↑↓
				Retained Earnings↓
				Dividends↓

Date	Accounts and Explanation	Debit	Credit
Dec. 31	Retained Earnings	5,000	
	Dividends		5,000
	To close Dividends.		

Closing Temporary Accounts—Net Loss for the Period

If a business had a net loss for the period, closing entries 1, 2, and 4 would be similar to those completed for net income. However, the closing entry to close the Income Summary account would be different. Consider this example. Suppose a business had a net loss of \$2,000. The Income Summary T-account would hold a *debit* balance instead of a *credit* balance. Therefore, the closing entry to close Income Summary would be a *debit* to Retained Earnings and a *credit* to Income Summary.

Income Summary				Retained Earnings			
Clos. 2	5,000	3,000	Clos. 1	Clos. 3	2,000	0	Adj. Bal.
Bal.	2,000						
		2,000	Clos. 3				
		0	Bal.				

Net Loss

Date	Accounts and Explanation	Debit	Credit
Dec. 31	Retained Earnings	2,000	
	Income Summary		2,000
	To close Income Summary.		

A	+	L	+	E↑↓
				Retained Earnings↓
				Income Summary↑

Notice that the effect of this closing entry decreases Retained Earnings. This is because a net loss decreases the Retained Earnings account.

Closing Temporary Accounts—Summary

Exhibit 4-6 (on the next page) shows the complete closing process for Smart Touch Learning. Panel A gives the closing entries, and Panel B shows the accounts after posting. After the closing entries, Retained Earnings ends with a balance of \$3,550. Trace this balance to the statement of retained earnings and then to the balance sheet in Exhibit 4-2.

Exhibit 4-6 | Journalizing and Posting Closing Entries

Panel A: Journalizing

Date	Accounts and Explanation	Debit	Credit
Dec. 31	Service Revenue	17,500	
	Income Summary		17,500
	<i>To close revenue.</i>		
31	Income Summary	8,950	
	Rent Expense		3,000
	Salaries Expense		4,800
	Supplies Expense		400
	Utilities Expense		100
	Depreciation Expense—Building		250
	Depreciation Expense—Furniture		300
	Interest Expense		100
	<i>To close expenses.</i>		
31	Income Summary	8,550	
	Retained Earnings		8,550
	<i>To close Income Summary.</i>		
31	Retained Earnings	5,000	
	Dividends		5,000
	<i>To close Dividends.</i>		

When a business uses a computerized accounting system, the software automatically closes the books. The software identifies the temporary accounts, records the closing entries, and posts to the ledger accounts. The closing entries are completed in a matter of seconds.

Panel B: Posting

Retained Earnings			Dividends			Service Revenue			Rent Expense		
→ Clos. 4	5,000	0 Adj. Bal.	Adj. Bal.	5,000	5,000 Clos. 4	← Clos. 1	17,500	17,500 Adj. Bal.	Adj. Bal.	3,000	3,000 Clos. 2
		8,550 Clos. 3	Bal.	0				0 Bal.	Bal.	0	
		3,550 Bal.									
Income Summary			Salaries Expense			Supplies Expense			Utilities Expense		
→ Clos. 2	8,950	17,500 Clos. 1	Adj. Bal.	4,800	4,800 Clos. 2	Adj. Bal.	400	400 Clos. 2	Adj. Bal.	100	100 Clos. 2
		8,550 Bal.	Bal.	0		Bal.	0		Bal.	0	
← Clos. 3	8,550										
		0 Bal.									
Depreciation Expense—Building			Depreciation Expense—Furniture			Interest Expense					
Adj. Bal.	250	250 Clos. 2	Adj. Bal.	300	300 Clos. 2	Adj. Bal.	100	100 Clos. 2			
Bal.	0		Bal.	0		Bal.	0				

Try It!

Benson Auto Repair had the following account balances after adjustments. Assume all accounts had normal balances.

Cash	\$ 4,000	Common Stock	\$ 20,000
Accounts Receivable	3,200	Retained Earnings, January 1	15,700
Prepaid Rent	1,900	Dividends	2,100
Office Supplies	3,000	Service Revenue	1,600
Equipment	34,800	Depreciation Expense—Equipment	300
Accumulated Depreciation—Equipment	1,600	Salaries Expense	800
Accounts Payable	5,400	Rent Expense	500
Notes Payable (long-term)	7,000	Utilities Expense	600
		Supplies Expense	100

14. Prepare the closing entries for Benson at December 31.
15. What is the balance of Retained Earnings after closing entries have been recorded? (Use a T-account to determine the balance.)

Identifying temporary and permanent accounts

For each account listed, identify whether the account is a temporary account (T) or a permanent account (P).

- | | |
|---------------------|---------------------|
| a. Rent Expense | f. Dividends |
| b. Prepaid Rent | g. Service Revenue |
| c. Equipment | h. Supplies Expense |
| d. Common Stock | i. Office Supplies |
| e. Salaries Payable | |

- | | |
|----|---|
| a. | T |
| b. | P |
| c. | P |
| d. | P |
| e. | P |
| f. | T |
| g. | T |
| h. | T |
| i. | P |

0 Journalizing closing entries

Brett Teddy Enterprises had the following accounts and normal balances listed on its December 31st adjusted trial balance: Service Revenue, \$21,900; Salaries Expense, \$6,000; Rent Expense, \$4,400; Advertising Expense, \$3,100; and Dividends, \$6,900. Journalize the closing entries for Teddy Enterprises.

Date	Accounts and Explanation	Debit	Credit
Dec. 31	Service Revenue Income Summary <i>To close revenue.</i>	21,900	21,900
31	Income Summary Salaries Expense Rent Expense Advertising Expense <i>To close expenses.</i>	13,500	6,000 4,400 3,100
31	Income Summary Retained Earnings <i>To close Income Summary.</i>	8,400	8,400
31	Retained Earnings Dividends <i>To close dividends.</i>	6,900	6,900

1 Posting closing entries directly to T-accounts

The following balances appear on the books of Sarah Simmons Enterprises: Retained Earnings, \$29,600; Dividends, \$10,500; Income Summary, \$0; Service Revenue, \$24,500; Salaries Expense, \$6,200; Rent Expense, \$3,500; and Advertising Expense, \$2,000. All accounts have normal balances.

Requirements

1. Open a T-account for each account, and insert its adjusted balance as given (denote as *Adj. Bal.*) at December 31.
2. Post the closing entries to the accounts, denoting posted amounts as *Clos.*
3. Compute the ending balance of Retained Earnings.

Retained Earnings			
		29,600	Adj. Bal.
Clos.	10,500	12,800	Clos.
		31,900	Bal.

Dividends			
Adj. Bal.	10,500		
		10,500	Clos.
Bal.		0	

Service Revenue			
		24,500	Adj. Bal.
Clos.	24,500		
		0	Bal.

Salaries Expense			
Adj. Bal.	6,200		
		6,200	Clos.
Bal.		0	

Rent Expense			
Adj. Bal.	3,500		
		3,500	Clos.
Bal.		0	

Advertising Expense			
Adj. Bal.	2,000		
		2,000	Clos.
Bal.		0	

Income Summary			
Clos.	11,700	24,500	Clos.
		12,800	Bal.
Clos.	12,800		
		0	Bal.

Requirement 3

Ending balance of Retained Earnings: \$31,900



Prepare the post-closing trial
balance

HOW DO WE PREPARE A POST-CLOSING TRIAL BALANCE?

After closing entries are recorded and posted, the accounting cycle ends with a **post-closing trial balance** (see Exhibit 4-7). This step lists the accounts and their balances after closing.

Only assets, liabilities, Common Stock, and Retained Earnings accounts (permanent accounts) appear on the post-closing trial balance. No temporary accounts—revenues, expenses, Income Summary, or Dividends—are included because they have been closed (their balances are zero). Also notice that the Retained Earnings account has been updated to reflect the period's net income (or net loss) and any dividends. The ledger is now up to date and ready for the next period.

Post-Closing Trial Balance

A list of the accounts and their balances at the end of the period after journalizing and posting the closing entries. It should include only permanent accounts.

Notice that the Adjusted Trial Balance for Smart Touch Learning (Exhibit 4-1) and the Post-Closing Trial Balance (Exhibit 4-7) are similar. An easy way to make sure that you didn't make an error in the closing process is to compare the Adjusted Trial Balance to the Post-Closing Trial Balance to ensure that: (1) account balances above Retained Earnings are the same; (2) account balances below Retained Earnings are zero and, therefore, not included; and (3) the Retained Earnings account balance matches Retained Earnings on the balance sheet.

Exhibit 4-7 | Post-Closing Trial Balance

SMART TOUCH LEARNING Post-Closing Trial Balance December 31, 2018		
Account Title	Balance	
	Debit	Credit
Cash	\$ 12,200	
Accounts Receivable	1,800	
Office Supplies	100	
Prepaid Rent	2,000	
Land	20,000	
Building	60,000	
Accumulated Depreciation—Building		\$ 250
Furniture	18,000	
Accumulated Depreciation—Furniture		300
Accounts Payable		200
Utilities Payable		100
Salaries Payable		1,200
Interest Payable		100
Unearned Revenue		400
Notes Payable		60,000
Common Stock		48,000
Retained Earnings		3,550
Total	<u>\$ 114,100</u>	<u>\$ 114,100</u>

Permanent
Accounts

For each account listed, identify whether the account would appear on the post-closing trial balance. Indicate either yes or no.

16. Dividends
17. Service Revenue
18. Cash
19. Advertising Expense
20. Retained Earnings

2 Identifying accounts included on a post-closing trial balance

For each account listed, identify whether the account would be included on a post-closing trial balance. Signify either Yes (Y) or No (N).

- | | |
|----------------------|---------------------------------------|
| a. Office Supplies | f. Accumulated Depreciation—Furniture |
| b. Interest Expense | g. Rent Expense |
| c. Retained Earnings | h. Unearned Revenue |
| d. Dividends | i. Accounts Payable |
| e. Service Revenue | |

- a. Y
- b. N
- c. Y
- d. N
- e. N
- f. Y
- g. N
- h. Y
- i. Y



Describe the accounting cycle

WHAT IS THE ACCOUNTING CYCLE?

We have now completed the accounting cycle for Smart Touch Learning. The **accounting cycle** is the process by which companies produce their financial statements for a specific period.

It is the steps that are followed throughout the time period. The accounting cycle starts with the beginning asset, liability, and stockholders' equity account balances left over from the preceding period. Exhibit 4-8 (on the next page) outlines the complete accounting cycle of Smart Touch Learning and every other business. Start with Step 1 and move clockwise.

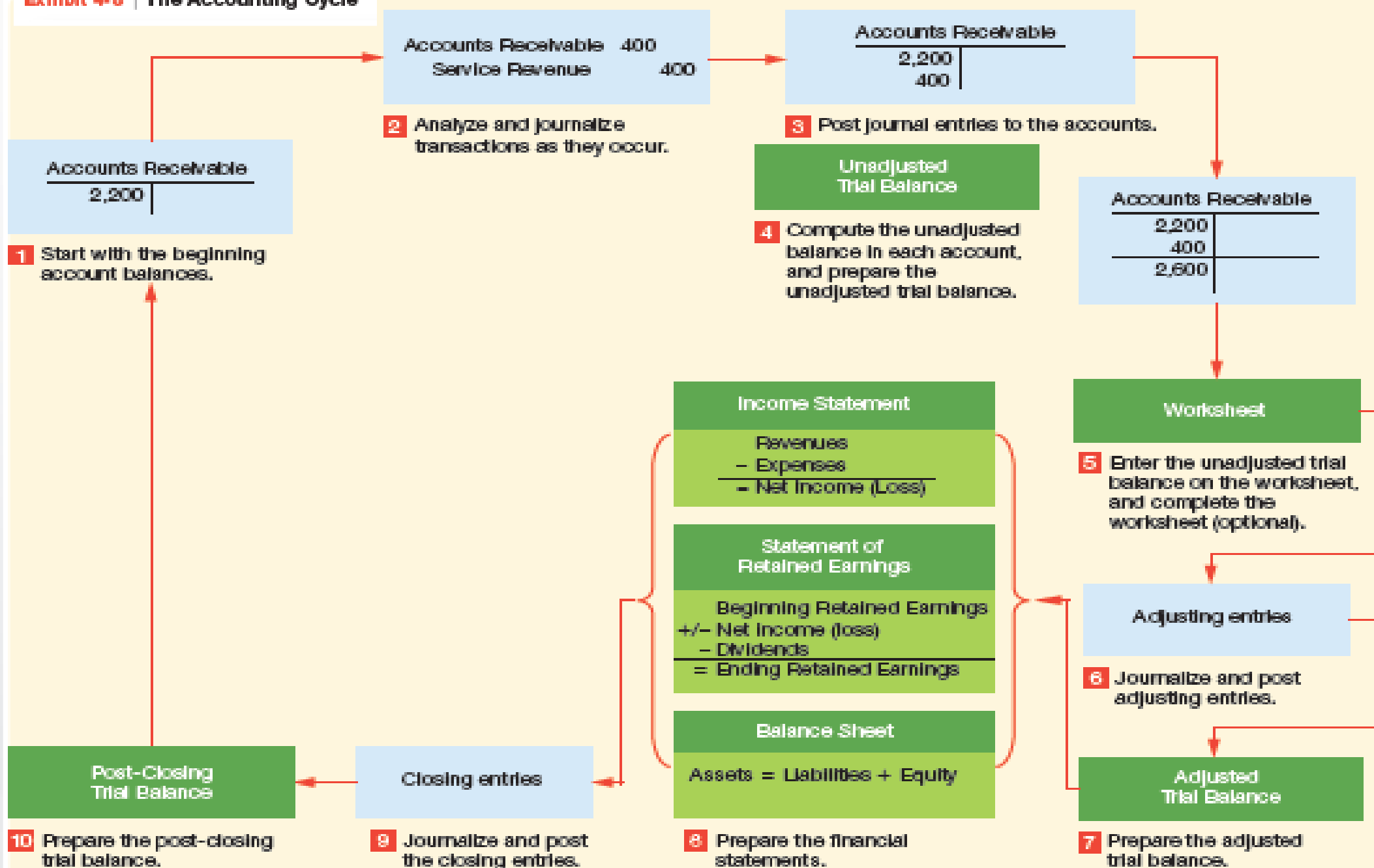
Accounting takes place at two different times:

- During the period (Steps 1 through 3)—Journalizing transactions and posting to the accounts
- End of the period (Steps 4 through 10)—Adjusting the accounts, preparing the financial statements, and closing the accounts

Accounting Cycle

The process by which companies produce their financial statements for a specific period.

Exhibit 4-8 The Accounting Cycle



Try It!

21. The steps of the accounting cycle are presented below. Identify the correct order of the steps.

- a. Journalize and post the closing entries.
- b. Start with the beginning account balances.
- c. Prepare the financial statements.
- d. Compute the unadjusted balance in each account, and prepare the unadjusted trial balance.
- e. Journalize and post adjusting entries.
- f. Enter the unadjusted trial balance on the worksheet, and complete the worksheet (optional).
- g. Prepare the adjusted trial balance.
- h. Analyze and journalize transactions as they occur.
- i. Post journal entries to the accounts.
- j. Prepare the post-closing trial balance.

3 Identifying steps in the accounting cycle

Review the steps in the accounting cycle, and answer the following questions:

1. What is the first step?
 2. Are any steps optional?
 3. Which steps are completed throughout the period?
 4. Which steps are completed only at the end of the period?
 5. What is the last step in the accounting cycle?
1. Start with beginning account balances.
 2. Yes, completing the worksheet is optional.
 3. Journalizing the transactions and posting to the accounts.
 4. Preparing worksheet (optional), adjusting the accounts, preparing the financial statements, and closing the accounts.
 5. Prepare the post-closing trial balance.



Thank You