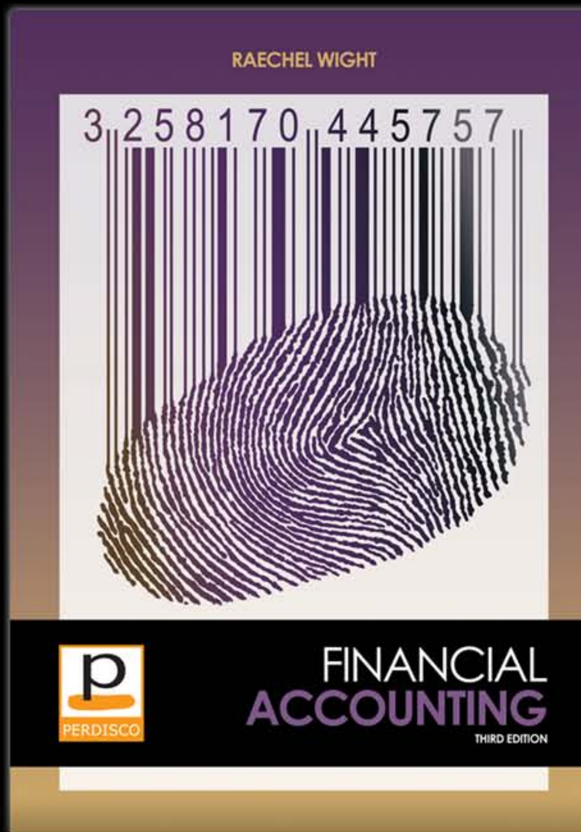

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Chapter 4

Completing the accounting cycle

Learning objectives

1. Prepare an accounting worksheet and describe its purpose
2. Prepare a classified balance sheet and explain the major headings
3. Explain why closing entries are recorded in the accounts
4. Prepare closing entries
5. Prepare a post-closing trial balance

Learning objectives

6. Explain the steps in the complete accounting cycle
7. Explain the differences in the accounting cycle for partnerships and corporations

Learning objective 1

Prepare an accounting worksheet and describe its purpose

Worksheet

- An **accounting worksheet** is a document used to help record adjusting entries and prepare the financial statements
- Used for internal management purposes only and exists outside the formal journals and ledger accounts
- Adjusting entries are still required to be journalized and posted to the general ledger as a separate step

Benefits of using a worksheet

- Contains information about the adjusting entries for the period in the one document
- Demonstrates the impact of adjusting entries on the financial statements
- Helps accountants prepare interim financial statements for internal use when adjusting entries are only journalized and posted to the general ledger accounts at the end of the financial year
- Can be used as a tool by management to demonstrate the effects of hypothetical transactions

Structure of a worksheet

- General structure is the same for all businesses
- Heading
  - states the name of the business, the name of the document (Worksheet) and the time period covered
- Lists the account numbers and account names on the left

Structure of a worksheet

Five columns labeled:

1. Unadjusted trial balance
2. Adjustments
3. Adjusted trial balance
4. Income statement
5. Balance sheet

- Each of these columns is split into a debit column and a credit column, resulting in ten columns in which to record the dollar amounts

Worksheet Example

Running Latte Worksheet For the month ended December 31, 2011											
		Unadjusted trial balance		Adjustments		Adjusted trial balance		Income Statement		Balance Sheet	
No.	**Account**	**Debit**	**Credit**	**Debit**	**Credit**	**Debit**	**Credit**	**Debit**	**Credit**	**Debit**	**Credit**
100	Cash	800				800				800	
110	Accounts Receivable	300		150		450				450	
210	Accounts Payable		200		50		250				250
300	Capital		500				500				500
350	Withdrawals	100				100				100	
400	Revenues		900		150		1,050		1,050		
500	Expenses	400		50		450		450			
	Totals	1,600	1,600	200	200	1,800	1,800	450	1,050	1,350	750
	Net Income							600			600
	Totals							1,050	1,050	1,350	1,350

Steps in constructing the worksheet

- After listing all of the account numbers and names of the accounts held by the business

1. Construct the unadjusted trial balance
2. Enter the adjustments
3. Construct the adjusted trial balance
4. Transfer the adjusted trial balance amounts to the appropriate financial statement column
5. Total the financial statements, calculate net income or loss, and calculate the final balance row

Steps in constructing the worksheet

- After each step you should check that total debits equals total credits in that column type to check no errors have been recorded

The purpose of using a worksheet

Three main reasons why a worksheet may be prepared:

1. To help record adjusting entries
   - Still need to journalize and post
2. To help prepare financial statements
   - Remember to adjust equity for the income or loss
3. To demonstrate the effects of hypothetical transactions
   - Reported in **pro-forma financial statements** that demonstrate the effects of proposed transactions and events

Learning objective 2

Prepare a classified balance sheet and explain the major headings

Classified balance sheet

- Until now we have been preparing the unclassified balance sheet that reports each line item under the heading of either assets, liabilities or equity
- The **classified balance sheet** presents assets and liabilities in **subcategories** that include current and long-term items

Classified balance sheet

- **Current items** are defined as items that are due to be received or paid within one year or the normal operating cycle of the business
- **Long-term items** are due to be received or paid over a time period that is longer than one year or longer than the operating cycle of the business

Asset subcategories

- **Current assets** are cash and other resources expected to be collected, sold or used up within one year or the operating cycle of the business, whichever is the longer
  - Cash
  - Short-term investments
  - Accounts receivable
  - Short-term notes receivable
  - Inventory
  - Prepaid expenses

Asset subcategories

- **Property, plant and equipment** is a category of long-term assets reported in the balance sheet that consists of tangible assets with long lives that are used by the business to produce and distribute its products or services
  - Equipment
  - Machinery
  - Furniture and fixtures
  - Buildings
  - Land (not depreciated)

Asset subcategories

- **Intangible assets** are long-term assets of the business that do not have a physical form
  - Patents
  - Copyrights
  - Trademarks
  - Franchises
  - Goodwill

Asset subcategories

- **Long-term investments** are assets held by the business that are expected to provide benefits to the business in the future
  - Long-term notes receivable
  - Investments in stocks
- Any portion that is due to be received within one year or the operating cycle of the business are classified and reported as current assets

Liability subcategories

- **Current liabilities** are obligations that are expected to be paid or settled within one year or the operating cycle of the business, whichever is the longer
  - Accounts payable
  - Wages and salaries payable
  - Interest payable
  - Taxes payable
  - Unearned revenues
  - Short-term debt
  - Short-term notes payable

Liability subcategories

- **Long-term liabilities** are obligations that are **not** expected to be paid or settled within the longer of one year or the operating cycle of the business
  - Bank loans
  - Mortgages payable
  - Notes payable
  - Other long-term debts payable
- Any portion of a long-term liability due to be paid within one year or the operating cycle of the business is classified and reported as a current liability

Learning objective 3

Explain why closing entries are recorded in the accounts

Closing entries

- After preparing the financial statements, the next step in the accounting cycle is to prepare closing entries

Step in the accounting cycle	Documentation
1. Analyze transactions	Source documents
2. Journalize transactions	General journal
3. Post transactions from the journal to the ledger	General ledger
4. Prepare an unadjusted trial balance	Unadjusted trial balance
5. Journalize adjusting entries	General journal
6. Post adjusting entries from the general journal to the ledger	General ledger
7. Prepare an adjusted trial balance	Adjusted trial balance
8. Prepare the financial statements	Financial statements
9. Prepare closing entries	**General journal and general ledger**

Closing process

- The **closing process** consists of the procedures performed at the end of the accounting period to prepare the temporary ledger accounts for recording the transactions of the next accounting period
- The closing process involves:
  - Identifying the temporary accounts to be closed
  - Recording the closing entries
  - Preparing a post-closing trial balance

Temporary and permanent accounts

- **Temporary (or nominal)** accounts are the revenue, expense or withdrawal accounts that are closed at the end of each accounting period
- **Permanent (or real)** accounts are the asset, liability or equity accounts that have their balances carried forward from one accounting period to the next

Closing entries

- **Closing entries** are entries recorded at the end of the accounting period to transfer the balance of the temporary accounts (including revenues, expenses and withdrawals) to an owner's equity account
- Closing the temporary accounts involves resetting their balances to zero so they are ready to record the information for the following accounting period
- The **Income Summary** account is a temporary account used in the closing process to avoid excessive detail in the permanent equity accounts

Purpose of closing entries

The purpose of closing entries is to:

- Reset the balance of the temporary revenue, expense and withdrawals accounts to zero so they are ready to measure the transactions for the next accounting period
- Summarize the net income or net loss for the period
- Update equity to include the net income, net loss and withdrawals of the period

Learning objective 4

Prepare closing entries

Preparing closing entries

Preparing closing entries involves four steps:

1. Close all revenue accounts to the Income Summary account
2. Close all expense accounts to the Income Summary account
3. Close the Income Summary account to equity
4. Close the Withdrawals account to equity

But what is this Income Summary account?

Income Summary account

- The **Income Summary** account is a temporary account used in the closing process to avoid excessive detail in the permanent equity accounts
- After the revenues and expenses have been closed to the income summary account, the balance summarizes the income or loss for the period
- Net income = credit balance
- Net loss = debit balance
- Lets now use this account in recording closing entries

Step 1: Close all revenue accounts

- Each revenue account is debited to the value of their ending balance
- The sum of all revenue accounts debited is credited to the Income Summary account

Journal entry to close all revenue accounts to the Income Summary account:

Dec.	31	Revenues	8,000	
		Income Summary		8,000
		(To close revenue accounts.)		

Step 2: Close all expense accounts

- Each expense account is credited to the value of their ending balance
- The sum of all expense accounts credited is debited to the Income Summary account

Journal entry to close all expense accounts to the Income Summary account:				
Dec.	31	Income Summary	4,500	
		Wages Expense		3,000
		Supplies Expense		500
		Depreciation Expense - Equipment		1,000
		(To close expense accounts.)		

Step 3: Close the Income Summary account

- The Income Summary account is closed to an equity account
- The equity account used in recording closing entries differs depending on whether the business is structured as a sole proprietorship, partnership or corporation

Step 3: Close the Income Summary account

- This section illustrates the closing entries of a sole proprietorship
- Sole proprietorship closes the Income Summary account and the Withdrawals account to the owner's Capital account
- Closing entries of partnerships and corporations use slightly different equity accounts and are illustrated later

Step 3: Close the Income Summary account

- Before closing the balance of the Income Summary account, we first need to work out its ending balance from its ledger account

Income Summary				No. 310
Date	**Description**	**Debit**	**Credit**	**Bal.**
Dec. 31	Closing entry to close revenue accounts		8,000	8,000 Cr
31	Closing entry to close expense accounts	4,500		**3,500 Cr**

- A credit balance means that the business has earned a net income

Step 3: Close the Income Summary account

- We can now close the Income Summary account to the Capital account

Journal entry to close the Income Summary account to equity (net income):				
Dec.	31	Income Summary	3,500	
		Capital		3,500
		(To close the Income Summary account to equity.)		

- If a net loss had occurred (a debit balance in the Income Summary account), the journal entry would debit the Capital account and credit the Income Summary account

Step 4: Close the Withdrawals account

- Finally, the Withdrawals account is closed to the Capital account

Journal entry to close Withdrawals account to equity:				
Dec.	31	Capital	1,500	
		Withdrawals		1,500
		(To close the Withdrawals account to equity.)		

Closing entries

- After the closing entries have been recorded the balance of all the temporary accounts have been reset to zero
  - Revenue
  - Expense
  - Withdrawal
- They are then ready to start recording the transactions for the next accounting period
- Equity has been updated to include the earnings for the period

Learning objective 5

Prepare a post-closing trial balance

Post closing trial balance

- After the closing entries have been recorded in the accounts a post-closing trial balance is prepared
- The **post-closing trial balance** is a list of all of the permanent accounts of the business and their ending balances after closing entries have been journalized and posted

Post closing trial balance

- The purpose of the post-closing trial balance is to verify that total debits equals total credits in the permanent accounts at the end of the accounting period
- When preparing the post-closing trial balance you should also check that all temporary revenue, expense and withdrawals accounts have been closed and have zero balances

Post-closing trial balance - example

Running Latte
Post-closing Trial Balance
December 31, 2011

No.	Account	Debit $	Credit $
100	Cash	6,900	
110	Accounts Receivable	4,000	
130	Supplies	600	
142	Prepaid Insurance	1,200	
160	Equipment	15,000	
161	Accumulated Depreciation - Equipment		1,000
210	Accounts Payable		900
220	Wages Payable		3,000
230	Unearned Revenue		800
250	Loan Payable		20,000
300	Capital		2,000
	Totals	**27,700**	**27,700**

Learning objective 6

Explain the steps in the complete accounting cycle

The complete accounting cycle

Step in the accounting cycle	**Documentation**
1. Analyze transactions	Source documents
2. Journalize transactions	General journal
3. Post transactions from the journal to the ledger	General ledger
4. Prepare an unadjusted trial balance	Unadjusted trial balance
5. Journalize adjusting entries	General journal
6. Post adjusting entries from the general journal to the ledger	General ledger
7. Prepare an adjusted trial balance	Adjusted trial balance
8. Prepare the financial statements	Financial statements
9. Prepare closing entries	General journal and general ledger
10. Prepare a post-closing trial balance	Post-closing trial balance
11. Reversing entries (optional)	General journal and general ledger

Learning objective 7

Explain the differences in the accounting cycle for partnerships and corporations

Partnership

- A partnership differs from a sole proprietorship in that a partnership has more than one owner of the business
- Separate capital and withdrawals accounts are held for each partner

Capital contribution to a partnership

- Each partner's Capital account is separately credited with the amount of their contribution
- For example, Stan contributed $300 and Francine contributed $700 to a partnership

Capital contribution to a partnership:				
Jan.	1	Cash	1,000	
		Stan, Capital		300
		Francine, Capital		700
		(To record the capital contribution to a partnership.)		

Partnership withdrawals

- Each partner has their own withdrawals account to record any withdrawals from the partnership
- For example, Francine withdrew $200 from the partnership

Partnership withdrawals:				
Aug.	28	Withdrawals, Francine	200	
		Cash		200
		(Cash withdrawal by a partner.)		

Closing entries in a partnership

- The first two steps in preparing closing entries are the same as for sole proprietorships

1. Close all revenue accounts to the Income Summary account
2. Close all expense accounts to the Income Summary account

(Not illustrated here because they are the same journal entries as previously illustrated)

Closing entries in a partnership

- The final two steps are slightly different

3. Close the Income Summary account to equity
   – Income summary account is closed to each partner's capital account
4. Close the Withdrawals account to equity
   – Withdrawals account of each partner is closed to that partner's capital account

Close the Income Summary account

- The Income Summary account is closed to each partner's Capital account
- The amount of net income (or net loss) allocated to each partner is determined by the ratio specified in the partnership agreement

Close the Income Summary account

Example:

- Partnership agreement stated income is to be allocated to 20% to Stan and 80% to Francine
- The business earned a net income of $2,000
- Stan is allocated 20% x $2,000 = $400
- Francine is allocated 80% x $2,000 = $1,600

Close the Income Summary account

Closing the Income Summary account of a partnership:				
Dec.	31	Income Summary	2,000	
		Stan, Capital		400
		Francine, Capital		1,600
		(To close the Income Summary account to each partner's equity account.)		

Close the Withdrawals account

- Withdrawals are recorded in a separate account for each partner
- The Withdrawals account of each partner is closed to that partner's capital account

Example:

- Recall that Francine withdrew $200 from the partnership

Close the Withdrawals account

Closing the Withdrawals account in a partnership:				
Dec.	31	Francine, Capital	200	
		Francine, Withdrawals		200
		(To close the Withdrawals account in a partnership.)		

- Stan did not make any withdrawals, so no closing entry is necessary
- If Stan did make some withdrawals, the closing entry would be the same as for Francine, except that Stan's Capital and Withdrawal accounts are used

Balance sheet of a partnership

- Equity section in the balance sheet of a partnership reports the equity of each partner as a separate line
- The ending balance of each partner's capital account reported on the balance sheet reflects:
  - Contributions of capital
  - Withdrawals of capital
  - Net income or loss allocated to that partner

Capital account balances of partnership

Stan:

Stan, Capital					No. 300
Date		**Description**	**Debit**	**Credit**	**Bal.**
Jan.	1	Contribution of capital		300	300 Cr
Dec.	31	Net income allocated		400	**700 Cr**

Francine:

Francine, Capital					No. 301
Date		**Description**	**Debit**	**Credit**	**Bal.**
Jan.	1	Contribution of capital		700	700 Cr
Dec.	31	Net income allocated		1,600	2,300 Cr
	31	Withdrawals	200		**2,100 Cr**

Partnership balance sheet

Stan and Francine Balance Sheet December 31, 2011	
	$
Total Liabilities	300
Equity	
Stan, Capital	700
Francine, Capital	2,100
Total liabilities and equity	3,100

Corporation

- A corporation is a business structure that may have many owners
- Ownership of a corporation is divided into units called shares, collectively known as stock
- A separate account is **not** held for each owner
- Instead, contributions of common equity from all owners is recorded in the **Common Stock** account

Capital contribution to a corporation

- Journal entry to issue stock in a corporation is similar to the contribution of capital in a sole proprietorship, except the corporation uses the Common Stock account
- For example, a corporation issues $30,000 of common stock:

To issue stock in a corporation:				
Jan.	1	Cash	30,000	
		Common Stock		30,000
		(Issued stock for cash.)		

Closing entries in a corporation

- Like sole proprietorships and partnerships the first two steps in preparing closing entries for a corporation are the same

1. Close all revenue accounts to the Income Summary account
2. Close all expense accounts to the Income Summary account

(Not illustrated here because they are the same journal entries as previously illustrated)

Closing entries in a corporation

- The final two steps are slightly different

3. Close the Income Summary account to equity
   - Income summary account is closed to the Retained Earnings account
4. Close the Withdrawals account to equity
   - This step is not necessary because the journal entry to record owners' withdrawals from the business is different in a corporation (explained shortly)

Retained Earnings account

- The accumulated net income or losses of a corporation are recorded in the **Retained Earnings** account
- This separates the owners' contributions of equity from the earnings of the business

Close the Income Summary account

- The Income Summary account is closed to the Retained Earnings account

Closing the Income Summary account of a corporation:				
Dec.	31	Income Summary	10,000	
		Retained Earnings		10,000
		(To close the Income Summary account to equity.)		

Withdrawals in a corporation

- Distributions of earnings from a corporation are called **dividends**
- Dividends are to be paid out of the retained earnings of the business
- Two stage process:

1. Declare the dividend
2. Pay the dividend

Declare the dividend

- The directors of the company announce that a dividend is to be paid and what amount it will be
- Creates a liability to pay the stockholders the dividend

To declare a dividend:				
Feb.	4	Retained Earnings	7,000	
		Dividend Payable		7,000
		(Declared cash dividend.)		

Pay the dividend

- The payment of the dividend is recorded in the same way as any liability payment

To pay a dividend:				
Mar.	7	Dividend Payable	7,000	
		Cash		7,000
		(Paid cash dividend.)		

Dividend payment

- Since the dividend was taken straight from the Retained Earnings account, there is no separate closing entry for dividends
- Be aware there are other ways to account for dividend payments that do require closing entries

Balance sheet of a corporation

- Balance sheet reports the balance of both the Common Stock account and the Retained Earnings account

Corporation balance sheet

Hyper Global Mega Tech Corporation Balance Sheet March 31, 2011		
	$	$
Total liabilities		10,000
Stockholders' equity		
Common stock	30,000	
Retained earnings	3,000	
Total stockholders' equity		33,000
Total liabilities and equity		43,000