CHAPTER 4

COMPLETING THE ACCOUNTING CYCLE

LEARNING OBJECTIVES

1. PREPARE A WORKSHEET.

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.

*7. PREPARE REVERSING ENTRIES.
CHAPTER REVIEW

Preparing a Worksheet

1. (L.O. 1) The steps in preparing a worksheet are:
   a. Prepare a trial balance on the worksheet.
   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.
   e. Total the statement columns, compute the net income (or loss), and complete the worksheet.

2. A worksheet is a multiple-column form that may be used in the adjustment process and in preparing financial statements. The basic form of a worksheet consists of the following columns:

<table>
<thead>
<tr>
<th>Account Titles</th>
<th>Trial Balance</th>
<th>Adjustments</th>
<th>Adjusted Trial Balance</th>
<th>Income Statement</th>
<th>Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Dr.</td>
<td>Cr.</td>
<td>Dr.</td>
<td>Cr.</td>
<td>Cr.</td>
</tr>
</tbody>
</table>

3. For each account in the worksheet, the amount in the adjusted trial balance columns is equal to the account balance that will appear in the ledger after the adjusting entries have been journalized and posted.

4. After the worksheet has been completed the statement columns contain all data that are required for the preparation of financial statements. The income statement is prepared from the income statement columns, and the owner’s equity statement and balance sheet are prepared from the balance sheet columns.

5. Using a worksheet accountants can prepare financial statements before adjusting entries are journalized and posted.

6. A worksheet is not a journal and it cannot be used as a basis for posting to ledger accounts.

Closing Entries

7. (L.O. 2) Closing entries formally recognize in the ledger the transfer of net income (or loss) and owner’s drawings to owner’s capital as shown in the owner’s equity statement.

8. Journalizing and posting closing entries is a required step in the accounting cycle.

9. The drawing, revenue, and expense accounts are temporary (nominal) accounts. Asset accounts, liability accounts, and the owner’s capital account are permanent (real) accounts.

10. A temporary account, Income Summary, is used in closing revenue and expense accounts to minimize the amount of detail in the permanent owner’s capital account.

11. In closing the books of a proprietorship:
   a. Debit each revenue account for its balance, and credit Income Summary for total revenues.
   b. Debit Income Summary for total expenses, and credit each expense account for its balance.
   c. Debit Income Summary, and credit Owner’s Capital for the amount of net income; conversely, credit Income Summary and debit Owner’s Capital if a net loss exists.
   d. Debit Owner’s Capital for the balance in the Owner’s Drawings account and credit Owner’s Drawings for the same amount.
Post-Closing Trial Balance

12. (L.O. 3) After all closing entries have been journalized and posted, a post-closing trial balance is prepared. 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.

Steps in the Accounting Cycle

13. (L.O. 4) 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: Deferrals/Accruals.
   f. Prepare an adjusted trial balance.
   g. Prepare financial statements: Income statement, Owner’s equity statement, Balance sheet.
   h. Journalize and post closing entries.
   i. Prepare a post-closing trial balance.

14. A reversing entry is the exact opposite of an adjusting entry. The preparation of reversing entries is an optional bookkeeping procedure that is not a required step in the accounting cycle.

Correcting Entries

15. (L.O. 5) Errors that occur in recording transactions should be corrected as soon as they are discovered by preparing correcting entries. Correcting entries:
   a. are unnecessary if the records are free of errors.
   b. are journalized and posted whenever an error is discovered.
   c. may involve any combination of balance sheet and income statement accounts.

16. To determine the correcting entry, it is useful to compare the incorrect entry with the correct entry, and then make a correcting entry. Another approach is to reverse the incorrect entry and then prepare the correct entry.

Classified Balance Sheet

17. (L.O. 6) Financial statements become more useful when the elements are classified into significant subgroups. A classified balance sheet generally has the following standard classifications:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities and Owner’s Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>Current liabilities</td>
</tr>
<tr>
<td>Long-term investments</td>
<td>Long-term liabilities</td>
</tr>
<tr>
<td>Property, plant, and</td>
<td>Owner’s equity</td>
</tr>
<tr>
<td>equipment</td>
<td></td>
</tr>
<tr>
<td>Intangible assets</td>
<td></td>
</tr>
</tbody>
</table>

Assets

18. Current assets are assets that a company expects to convert to cash or use up within one year or its operating cycle, whichever is longer. Current assets are listed in the order of their liquidity.

19. The operating cycle of a company is the average time that it takes to purchase inventory, sell it on account, and then collect cash from customers.
20. **Long-term investments** are generally investments in stocks and bonds of other companies that are normally held for many years.

21. **Property, plant, and equipment** are assets with relatively long useful lives that a company is currently using in operating the business.

22. **Intangible assets** do not have physical substance yet often are very valuable.

**Liabilities**

23. **Current liabilities** are obligations that the company is to pay within the coming year.

24. **Long-term liabilities** are obligations that a company expects to pay after one year.

**Owner's Equity**

25. The content of the owner’s equity section varies with the form of business organization. In a proprietorship, there is one capital account. In a partnership, there are separate capital accounts for each partner. For a corporation, owners’ equity is called stockholders’ equity and it consists of two accounts: Capital Stock and Retained Earnings.

**Form of Balance Sheet**

26. A balance sheet is most often presented in **report form** with the assets shown above the liabilities and owner’s equity. It may also be presented in **account form** with the assets section placed on the left and the liabilities and owner’s equity section on the right.

**Reversing Entries**

*27. (L.O. 7) A reversing entry is made at the beginning of the next accounting period. The **purpose** of reversing entries is to simplify the recording of a subsequent transaction related to an adjusting entry.

*28. Reversing entries are most often used to reverse two types of adjusting entries: **accrued revenues** and **accrued expenses**.
LECTURE OUTLINE

A. Using a Worksheet.

1. A worksheet is a multiple-column form used in the adjustment process and in preparing financial statements.

   Emphasize that the major purpose of a worksheet is to facilitate the preparation of financial statements.

2. The steps in the preparation of a worksheet:
   a. Step 1: Prepare a trial balance on the worksheet.
   b. Step 2: Enter the adjustments in the adjustments columns.
   c. Step 3: Enter adjusted balances in the adjusted trial balance columns.
   d. Step 4: Extend adjusted trial balance amounts to the appropriate financial statement columns.
   e. Step 5: Total the statement columns, compute the net income (or net loss), and complete the worksheet.

3. A worksheet facilitates the preparation of financial statements because it organizes the account balances and the statements can be prepared before the adjusting entries are journalized and posted.

4. The use of a worksheet is optional and it is essentially a working tool of the accountant.

5. A worksheet is not a journal, and it cannot be used as a basis for posting to ledger accounts. The company must record adjusting entries in the journal, and then post them to the ledger.
B. Preparing Closing Entries.

1. Closing entries formally recognize in the ledger the transfer of net income (or net loss) and owner’s drawings to owner’s capital. Journalizing and posting closing entries is a required step in the accounting cycle.

2. Closing entries produce a zero balance in each temporary account (revenue and expense accounts and the Owner’s Drawings account) so that each temporary account may be used to accumulate data in the next accounting period separate from the data of prior periods.

3. There are four closing entries:
   
a. Debit each revenue account for its balance, and credit Income Summary for total revenues.

b. Debit Income Summary for total expenses, and credit each expense account for its balance.

c. Debit Income Summary and credit Owner’s Capital for the amount of net income (assuming the company had net income).

d. Debit Owner’s Capital for the balance in the Owner’s Drawings account, and credit Owner’s Drawings for the same amount.

Point out that the information for closing entries can be obtained from the adjusted trial balance columns or the income statement columns of the worksheet.

ACCOUNTING ACROSS THE ORGANIZATION

Recent surveys have reported that the average company now takes only six to seven days to close, rather than 20 days. Knowing exactly where you are financially all the time allows the company to respond faster than competitors.

Who else benefits from a shorter closing process?
Answer: Investors benefit from a shorter closing process. The shorter the closing, the sooner the company can report its financial results. This means that the financial information is more timely, and therefore more relevant to investors.

C. Preparing a Post-Closing Trial Balance.

1. The purpose of the post-closing trial balance is to prove the equality of the permanent account balances carried forward into the next accounting period.

2. The post-closing trial balance will contain only permanent—balance sheet—accounts since all temporary accounts will have zero balances.

D. Summary of the Accounting Cycle.

Emphasize that the cycle is repeated each accounting period.

1. Analyze business transactions.
2. Journalize the transactions.
3. Post to ledger accounts.
4. Prepare a trial balance.
5. Journalize and post adjusting entries: Deferrals/Accruals.
6. Prepare an adjusted trial balance.
7. Prepare financial statements.
E. Correcting Entries.

1. Companies should correct errors, as soon as they discover them, by journalizing and posting correcting entries.

2. Companies make correcting entries whenever they discover an error, not only at the end of an accounting period.

3. To determine the correcting entry, it is useful to compare the incorrect entry with the correct entry in order to identify the accounts and amounts that should—or should not—be corrected.

4. Errors may also be corrected by reversing the incorrect entry and then preparing the correct entry.

ACCOUNTING ACROSS THE ORGANIZATION

Yale Express, a short-haul trucking firm, turned over much of its cargo to local truckers to complete deliveries and waited 20 days to receive the local truckers’ bills. However, Republic Carloading, a nationwide, long-distance freight forwarder whom Yale merged with, frequently did not receive bills from truckers until months after the year-end.

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

**Answer:** 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 using past experience and the current volume of business.)

F. The Classified Balance Sheet.

1. Current assets are assets that a company expects to convert to cash or use up within one year or its operating cycle, whichever is longer. On the balance sheet, companies usually list current assets in the order in which they expect to convert them into cash (order of liquidity).
2. Long-term investments are generally investments in stocks and bonds of other companies that are normally held for many years. This category also includes long-term assets (land, buildings) not currently being used in operations, and long-term notes receivable.

3. Property, plant, and equipment are assets with relatively long useful lives that a company is currently using in operating the business.

4. Intangible assets are assets that do not have physical substance yet often are very valuable.

5. Current liabilities are obligations that the company is to pay within the coming year or its operating cycle, whichever is longer.

6. Long-term liabilities are obligations that a company expects to pay after one year.

7. The content of the owner’s equity section varies with the form of business organization. In a proprietorship, there is one capital account but corporations divide owner’s equity into Common Stock and Retained Earnings.

*G. Reversing Entries.

1. Companies make reversing entries at the beginning of the next accounting period. Each reversing entry is the exact opposite of the adjusting entry made in the previous period.

2. The recording of reversing entries is an optional step in the accounting cycle.

3. The use of reversing entries does not change the amounts reported in the financial statements.
A Look at IFRS

The classified balance sheet, although generally required internationally, contains certain variations in format when reporting under IFRS.

KEY POINTS

- The procedures of the closing process are applicable to all companies, whether they are using IFRS or GAAP.
- IFRS recommends but does not require the use of the title “statement of financial position” rather than balance sheet.
- The format of statement of financial position information is often presented differently under IFRS. Although no specific format is required, most companies that follow IFRS present statement of financial position information in this order:
  - Noncurrent assets
  - Current assets
  - Equity
  - Noncurrent liabilities
  - Current liabilities
- IFRS requires a classified statement of financial position except in very limited situations. IFRS follows the same guidelines as this textbook for distinguishing between current and noncurrent assets and liabilities.
- Under IFRS, current assets are usually listed in the reverse order of liquidity. For example, under GAAP cash is listed first, but under IFRS it is listed last.
- Some companies report the subtotal net assets, which equals total assets minus total liabilities. See, for example, the statement of financial position of Zetar plc in Appendix F.

- IFRS has many differences in terminology from what are shown in your textbook. For example, in the investment category stock is called shares.
Both IFRS and GAAP require disclosures about (1) accounting policies followed, (2) judgments that management has made in the process of applying the entity's accounting policies, and (3) the key assumptions and estimation uncertainty that could result in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

Comparative prior-period information must be presented and financial statements must be prepared annually.

Both GAAP and IFRS are increasing the use of fair value to report assets. However, at this point IFRS has adopted it more broadly. As examples, under IFRS companies can apply fair value to property, plant, and equipment; natural resources; and in some cases intangible assets.
20 MINUTE QUIZ

Circle the correct answer.

**True/False**

1. An important purpose of closing entries is to set permanent account balances to zero in order to begin the next period.
   
   True  False

2. The preparation of reversing entries is a required step in the accounting cycle.
   
   True  False

3. A worksheet can be used as a basis for posting the adjustments to the ledger.
   
   True  False

4. The content of the owner’s equity section of a proprietorship is the same as the content of the owners’ equity section of a corporation.
   
   True  False

5. Adjustments are journalized and posted only at the end of an accounting period, whereas correcting entries are journalized and posted whenever an error is discovered.
   
   True  False

6. Current assets are resources that can be converted into cash, but are not expected to be converted within one year.
   
   True  False

7. Long-term liabilities such as lease liabilities, mortgages payable, and bonds payable are expected to be paid from existing current assets.
   
   True  False

8. The balance of Accumulated Depreciation will appear in the credit side of the worksheet’s Balance Sheet column.
   
   True  False

9. The relationship between current assets and current liabilities is important in evaluating a company’s liquidity.
   
   True  False

10. Intangible assets are not listed on the balance sheet because they do not have physical substance.
    
    True  False
Multiple Choice

1. The worksheet is a type of
   a. financial statement.
   b. permanent accounting record.
   c. working paper.
   d. journal.

2. In preparing closing entries, which of the following columns of the worksheet are the most helpful?
   a. The Adjustments column
   b. The Adjusted Trial Balance columns
   c. The Income Statement columns
   d. The Balance Sheet columns

3. The proper sequence for the accounting cycle is
   a. analyze, journalize, post, adjust, prepare statements, close.
   b. post, journalize, analyze, prepare statements, close, adjust.
   c. prepare statements, journalize, post, adjust, close, analyze.
   d. journalize, post, close, prepare statements, adjust, analyze.

4. After all the closing entries have been posted, the balance of the income summary will be
   a. a debit if a net income has occurred.
   b. a debit if a net loss has occurred.
   c. a credit if a net loss has occurred.
   d. zero.

5. The post-closing trial balance will
   a. be prepared before closing entries are posted to the ledger.
   b. contain both income statement and balance sheet accounts.
   c. contain only balance sheet accounts.
   d. contain only income statement accounts.
ANSWERS TO QUIZ

True/False

1. False 6. False
2. False 7. False
3. False 8. True
4. False 9. True
5. True 10. False

Multiple Choice

1. c.
2. c.
3. a.
4. d.
5. c.