4 Completing the Accounting Cycle

All accounts not on the balance sheet reset to zero at the end of a period, and update the capital balance.

SMART TOUCH LEARNING
Balance Sheet
May 31, 2013

Assets				Liabilities	
Current assets:				Current liabilities:	
Cash		$ 4,800		Accounts payable	$ 48,700
Accounts receivable		2,600		Salary payable	900
Inventory		30,500		Interest payable	100
Supplies		600		Unearned service revenue	400
Prepaid rent		2,000		Total current liabilities	50,100
Total current assets			$ 40,500	Long-term liabilities:	
Plant assets:				Notes payable	20,000
Furniture	$18,000			Total liabilities	70,100
Less: Accumulated depreciation—furniture	300	17,700			
Building	48,000				
Less: Accumulated depreciation—building	200	47,800		**Owner's Equity**	
Total plant assets			65,500	**Bright, capital**	**35,900**
Total assets			$106,000	Total liabilities and owner's equity	$106,000

Learning Objectives

1. Prepare an accounting worksheet
2. Use the worksheet to prepare financial statements
3. Close the revenue, expense, and drawing accounts
4. Prepare the post-closing trial balance
5. Classify assets and liabilities as current or long-term
6. Describe the effect of various transactions on the current ratio and the debt ratio
7. Understand reversing entries (see Appendix 4A, located at myaccountinglab.com)

What do football, baseball, basketball, hockey, soccer, and accounting have in common? They all have a player in each position and each game starts with a score of zero.

Sheena Bright and Greg Moore have operated Smart Touch Learning and Greg's Tunes, respectively, for a month. They took in revenue, incurred expenses, and earned net income during the first month. It is time to look ahead to the next period.

Should Smart Touch or Greg's Tunes start month 2 with the net income that the business earned last month? No, just like a game, both companies must start from zero

in order to measure their business performance in the second month. Therefore, they must set their accounting scoreboard back to zero.

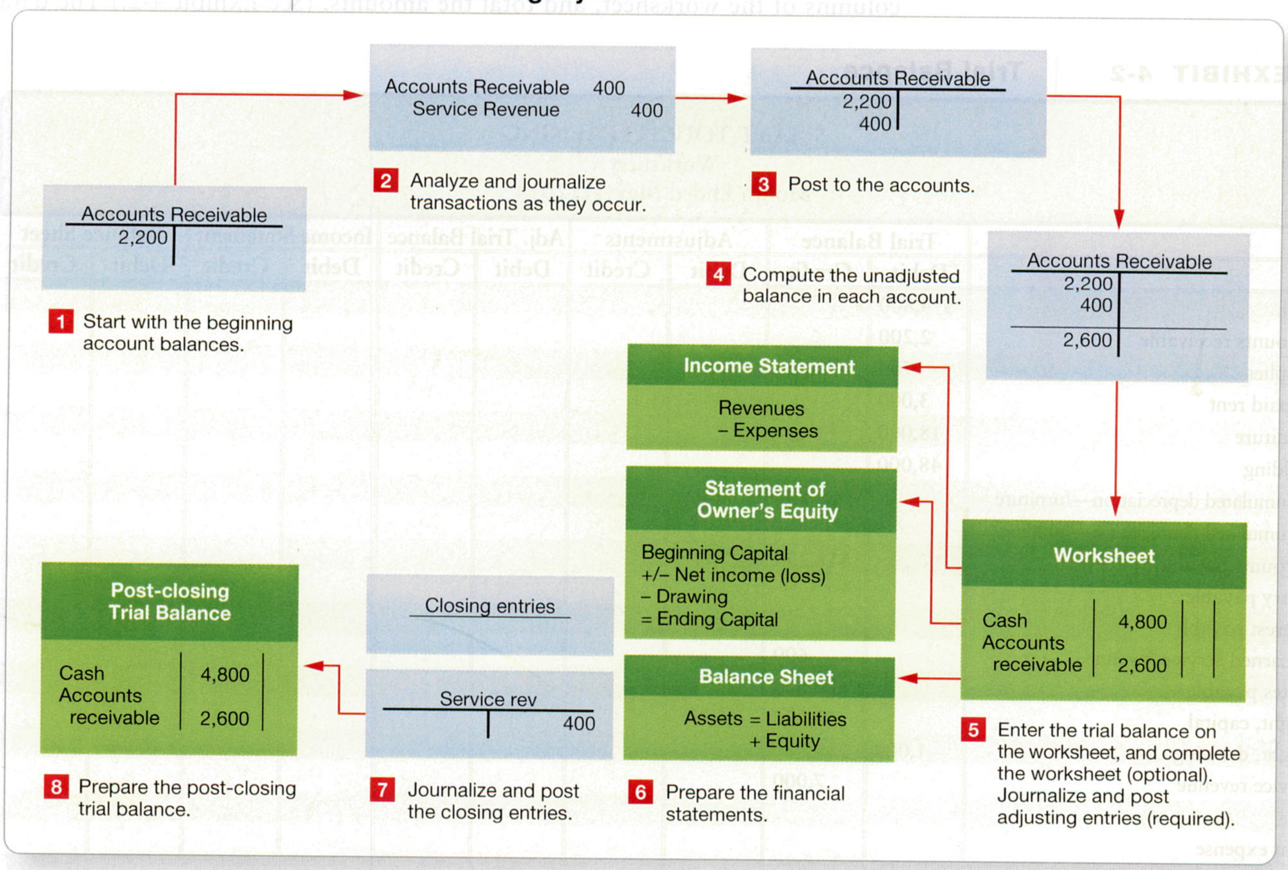
This process of getting back to zero is called *closing the books,* and it is the last step in the accounting cycle. The **accounting cycle** is the process by which companies produce their financial statements.

• • •

This chapter completes the accounting cycle by showing how to close the books. It begins with the *adjusted trial balance,* which you learned about in Chapter 3. In this chapter we'll learn how to prepare a more complete version of an adjusted trial balance document called the *worksheet.* Worksheets help by summarizing lots of data in one place.

The accounting cycle starts with the beginning asset, liability, and owner's equity account balances left over from the preceding period. Exhibit 4-1 outlines the complete accounting cycle of Smart Touch and every other business. Start with item 1 and move clockwise.

EXHIBIT 4-1 | The Accounting Cycle



Accounting takes place at two different times:

- During the period—Journalizing transactions, posting to the accounts
- End of the period—Adjusting the accounts, preparing the financial statements, and closing the accounts

The end-of-period work also readies the accounts for the next period. In Chapters 3 and 4, we cover the end-of-period accounting for service businesses such as Greg's Tunes and Smart Touch. Chapter 5 shows how a merchandising entity such as **Walmart** or **Sports Academy** adjusts and closes its books.

The Worksheet

1 Prepare an accounting worksheet

Accountants often use a **worksheet**—a document with several columns—to summarize data for the financial statements. The worksheet is not a journal, a ledger, or a financial statement. It is merely a summary device that helps identify the accounts that need adjustment. An Excel spreadsheet works well for preparing a worksheet. Note that the worksheet is an internal document. It is not meant to be given to outsiders.

Exhibits 4-2 though 4-6 illustrate the development of a typical worksheet for Smart Touch. The heading at the top displays the following information:

- Name of the business (Smart Touch Learning)
- Title of the document (Worksheet)
- Period covered by the worksheet (Month Ended May 31, 2013)

A step-by-step description of the worksheet follows, with all amounts given in Exhibits 4-2 though 4-6. Simply turn the acetate pages to follow from exhibit to exhibit.

1. **Enter the account titles and their unadjusted balances in the Trial Balance columns of the worksheet, and total the amounts.** (See Exhibit 4-2.) The data

EXHIBIT 4-2 **Trial Balance**

SMART TOUCH LEARNING
Worksheet
Month Ended May 31, 2013

	Trial Balance		Adjustments		Adj. Trial Balance		Income Statement		Balance Sheet	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
Cash	$ 4,800									
Accounts receivable	2,200									
Supplies	700									
Prepaid rent	3,000									
Furniture	18,000									
Building	48,000									
Accumulated depreciation—furniture										
Accumulated depreciation—building										
Accounts payable		$18,200								
Salary payable										
Interest payable										
Unearned service revenue		600								
Notes payable		20,000								
Bright, capital		33,200								
Bright, drawing	1,000									
Service revenue		7,000								
Rent expense										
Salary expense	900									
Supplies expense										
Depreciation expense—furniture										
Depreciation expense—building										
Interest expense										
Utilities expense	400									
	$79,000	$79,000								

		$ 4,800				$ 4,800	
(g)$ 400		2,600				2,600	
	(b)$ 100	600				600	
	(a) 1,000	2,000				2,000	
		18,000				18,000	
		48,000				48,000	
	(c) 300		$ 300				$ 300
	(d) 200		200				200
			18,200				18,200
	(e) 900		900				900
	(f) 100		100				100
(h) 200			400				400
			20,000				20,000
			33,200				33,200
		1,000				1,000	
	(g) 400		7,600		$7,600		
	(h) 200						
(a) 1,000		1,000		$1,000			
(e) 900		1,800		1,800			
(b) 100		100		100			
(c) 300		300		300			
(d) 200		200		200			
(f) 100		100		100			
		400		400			
$3,200	$3,200	$80,900	$80,900	$3,900	$7,600	$77,000	$73,300
			Net income	3,700			3,700
				$7,600	$7,600	$77,000	$77,000

come from the ledger accounts before any adjustments. Accounts are listed in proper order (Cash first, Accounts receivable second, and so on). Total debits must equal total credits. Note that these two columns of the worksheet are the same as the trial balance from Chapter 3.

2. **Enter the adjusting entries in the Adjustments columns, and total the amounts.** Exhibit 4-3 includes the May adjusting entries that we made in Chapter 3. The adjusting entries, letters a–h from Exhibit 3-8, are posted into the adjustments column of the worksheet.

3. **Compute each account's adjusted balance by combining the trial balance and adjustment figures. Enter each account's adjusted amount in the Adjusted Trial Balance columns.** Exhibit 4-4 shows the worksheet with the adjusted trial balance completed. For example, Cash is up-to-date, so it receives no adjustment. Accounts receivable's adjusted balance of $2,600 is computed by adding the $400 adjustment to the unadjusted amount of $2,200. For Supplies we subtract the $100 credit adjustment from the unadjusted debit balance of $700. Note that an account may receive more than one adjustment. For example, Service revenue has two adjustments. The adjusted balance of $7,600 is computed by taking the unadjusted balance of $7,000 and adding the adjustment credits of $400 and $200 to arrive at the $7,600 adjusted balance. As on the trial balance, total debits must equal total credits on the adjusted trial balance. Notice how the three completed column sets of Exhibit 4-4 look exactly like Exhibit 3-8.

4. **Draw an imaginary line above the first revenue account (in this case, Service revenue). Every account above that line (assets, liabilities, and equity accounts) is copied from the Adjusted Trial Balance to the Balance Sheet columns. Every account below the line (revenues and expenses) is copied from the Adjusted Trial Balance to the Income Statement columns.** Each account's balance should appear in only one column, as shown in Exhibit 4-5.

   First, total the *income statement columns*, as follows:

Income Statement

■ Debits (Dr.) ⟶ Total expenses = $3,900
■ Credits (Cr.) ⟶ Total revenues = $7,600

} Difference = $3,700, a net income because total credits (revenues) exceed total debits (expenses)

Then total the *balance sheet* columns:

Balance Sheet

■ Debits (Dr.) ⟶ Total assets and drawing = $77,000
■ Credits (Cr.) ⟶ Total liabilities, owner's equity, and accumulated depreciation = $73,300

} Difference = $3,700, a net income because total debits are greater

5. **On the income statement, compute net income or net loss as total revenues minus total expenses. Enter net income (loss) as the balancing amount on the income statement. Also enter net income (loss) as the balancing amount on the balance sheet. Then total the financial statement columns.** Exhibit 4-6 presents the completed worksheet.

Revenue (total **credits** on the income statement)	$ 7,600
Expenses (total **debits** on the income statement)	(3,900)
Net income	$ 3,700

Net Income

Net income of $3,700 is entered as the balancing amount in the debit column of the income statement. This brings total debits up to total credits on the income statement. Net income is also entered as the balancing amount in the credit column of the balance sheet. Net income brings the balance sheet into balance. Note that the difference in these columns is the same: Net income.

Key Takeaway

The worksheet is a tool that puts the whole accounting process in one place. Remember that debits = credits in the first three columns. Columns 4 and 5 (Income Statement and Balance Sheet) debits do not equal credits until you post the net income or net loss for the period.

Net Loss

If expenses exceed revenues, the result is a net loss. In that event, print Net loss on the worksheet next to the result. The net loss amount should be entered in the *credit* column of the income statement (to balance out) and in the *debit* column of the balance sheet (to balance out). After completion, total debits should equal total credits in both the Income Statement columns and in the Balance Sheet columns.

Now practice what you have learned by working Summary Problem 4-1.

Summary Problem 4-1

The trial balance of Super Employment Services, at December 31, 2014, follows.

SUPER EMPLOYMENT SERVICES
Trial Balance
December 31, 2014

Account Title	Balance Debit	Balance Credit
Cash	$ 6,000	
Accounts receivable	5,000	
Supplies	1,000	
Furniture	10,000	
Accumulated depreciation—furniture		$ 4,000
Building	50,000	
Accumulated depreciation—building		30,000
Accounts payable		2,000
Salary payable		
Unearned service revenue		8,000
Mudge, capital		12,000
Mudge, drawing	25,000	
Service revenue		60,000
Salary expense	16,000	
Supplies expense		
Depreciation expense—furniture		
Depreciation expense—building		
Advertising expense	3,000	
Total	$116,000	$116,000

Data needed for the adjusting entries include the following:

a. Supplies on hand at year-end, $200.
b. Depreciation on furniture, $2,000.
c. Depreciation on building, $1,000.
d. Salaries owed but not yet paid, $500.
e. Accrued service revenue, $1,300.
f. $3,000 of the unearned service revenue was earned during 2014.

Requirement

1. Prepare the worksheet of Super Employment Services for the year ended December 31, 2014. Key each adjusting entry by the letter corresponding to the data given.

Solution

SUPER EMPLOYMENT SERVICES
Worksheet
Year Ended December 31, 2014

	Trial Balance		Adjustments		Adjusted Trial Balance		Income Statement		Balance Sheet	
Account Title	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	$ 6,000				$ 6,000				$ 6,000	
Accounts receivable	5,000		(e) $1,300		6,300				6,300	
Supplies	1,000			(a) $ 800	200				200	
Furniture	10,000				10,000				10,000	
Accumulated depreciation—furniture		$ 4,000		(b) 2,000		$ 6,000				$ 6,000
Building	50,000				50,000				50,000	
Accumulated depreciation—building		30,000		(c) 1,000		31,000				31,000
Accounts payable		2,000				2,000				2,000
Salary payable				(d) 500		500				500
Unearned service revenue		8,000	(f) 3,000			5,000				5,000
Mudge, capital		12,000				12,000				12,000
Mudge, drawing	25,000				25,000				25,000	
Service revenue		60,000		(e) 1,300						
				(f) 3,000		64,300		$64,300		
Salary expense	16,000		(d) 500		16,500		$16,500			
Supplies expense			(a) 800		800		800			
Depreciation expense—furniture			(b) 2,000		2,000		2,000			
Depreciation expense—building			(c) 1,000		1,000		1,000			
Advertising expense	3,000				3,000		3,000			
	$116,000	$116,000	$8,600	$8,600	$120,800	$120,800	$23,300	$64,300	$97,500	$56,500
						Net income	41,000			41,000
							$64,300	$64,300	$97,500	$97,500

Completing the Accounting Cycle

2 Use the worksheet to prepare financial statements

The worksheet helps accountants make the adjusting entries, prepare the financial statements, and close the accounts. First, let's prepare the financial statements. We'll start by returning to the running example of Smart Touch Learning, whose financial statements are given in Exhibit 4-7 on the following page. Notice that these are identical to the financial statements prepared in Chapter 3 (Exhibits 3-9 though 3-11).

Preparing the Financial Statements from a Worksheet

The worksheet shows the amount of net income or net loss for the period, but it is an internal document. We still must prepare the financial statements for external decision makers. Exhibit 4-7 on the next page shows the May financial statements for Smart Touch (based on data from the worksheet in Exhibit 4-6). We can prepare the business's financial statements immediately after completing the worksheet.

Stop & Think...

Look at the formal financial statements in Exhibit 4-7 and the worksheet financial statement columns in Exhibit 4-6. The income number is the same on both sheets, so why do we need to do both a worksheet and a formal document, such as an income statement? The answer is the worksheet will be used mainly by internal decision makers, whereas the formal financial statements will be used by external decision makers.

Recording the Adjusting Entries from a Worksheet

Adjusting the accounts requires journalizing entries and posting to the accounts. We learned how to prepare adjusting journal entries in Chapter 3. The adjustments that are journalized after they are entered on the worksheet are *exactly* the same adjusting journal entries. Panel A of Exhibit 4-8 on page 206 repeats Smart Touch's adjusting entries that we journalized in Chapter 3. Panel B shows the revenue and the expense accounts after all adjustments have been posted. Only the revenue and expense accounts are presented here to focus on the closing process.

EXHIBIT 4-7 Financial Statements

SMART TOUCH LEARNING
Income Statement
Month Ended May 31, 2013

Revenue:		
Service revenue		$7,600
Expenses:		
Salary expense	$1,800	
Rent expense	1,000	
Utilities expense	400	
Depreciation expense—furniture	300	
Depreciation expense—building	200	
Interest expense	100	
Supplies expense	100	
Total expenses		3,900
Net income		$3,700

SMART TOUCH LEARNING
Statement of Owner's Equity
Month Ended May 31, 2013

Bright, capital, May 1, 2013	$ 33,200
Net income	3,700
	36,900
Drawing	(1,000)
Bright, capital, May 31, 2013	$ 35,900

SMART TOUCH LEARNING
Balance Sheet
May 31, 2013

Assets			Liabilities	
Cash		$ 4,800	Accounts payable	$18,200
Accounts receivable		2,600	Salary payable	900
Supplies		600	Interest payable	100
Prepaid rent		2,000	Unearned service revenue	400
Furniture	$18,000		Notes payable	20,000
Less: Accumulated depreciation—furniture	300	17,700	Total liabilities	39,600
Building	48,000			
Less: Accumulated depreciation—building	200	47,800	**Owner's Equity**	
			Bright, capital	35,900
Total assets		$75,500	Total liabilities and owner's equity	$75,500

EXHIBIT 4-8 **Journalizing and Posting the Adjusting Entries of Smart Touch Learning**

PANEL A—Adjusting Entries

a.		Rent expense (E+)	1,000	
		Prepaid rent (A–)		1,000
		To record rent expense.		
b.		Supplies expense (E+)	100	
		Supplies (A–)		100
		To record supplies used.		
c.		Depreciation expense—furniture (E+)	300	
		Accumulated depreciation—furniture (CA+)		300
		To record depreciation on furniture.		
d.		Depreciation expense—building (E+)	200	
		Accumulated depreciation—building (CA+)		200
		To record depreciation on building.		
e.		Salary expense (E+)	900	
		Salary payable (L+)		900
		To accrue salary expense.		
f.		Interest expense (E+)	100	
		Interest payable (L+)		100
		To accrue interest expense.		
g.		Accounts receivable (A+)	400	
		Service revenue (R+)		400
		To accrue service revenue.		
h.		Unearned service revenue (L–)	200	
		Service revenue (R+)		200
		To record service revenue that was collected in advance.		

PANEL B—Ledger Accounts

REVENUES

Service revenue

			7,000
		(g)	400
		(h)	200
		Bal	7,600

EXPENSES

Rent expense

(a)	1,000		
Bal	1,000		

Salary expense

	900		
(e)	900		
Bal	1,800		

Supplies expense

(b)	100		
Bal	100		

Depreciation expense—furniture

(c)	300		
Bal	300		

Depreciation expense—building

(d)	200		
Bal	200		

Interest expense

(f)	100		
Bal	100		

Utilities expense

Bal	400		

Accountants can use the worksheet to prepare monthly statements (as in Exhibit 4-7) without journalizing and posting the adjusting entries. A big advantage of the worksheet is that a small business can see the complete results of a period on one page. Many small companies journalize and post the adjusting entries only at the end of the year.

Now we are ready to move to the last step—closing the accounts.

Key Takeaway

The formal financial statements yield the same net income or loss that is shown on the worksheet.

Closing the Accounts

3 Close the revenue, expense, and drawing accounts

Closing the accounts occurs at the end of the period. Closing 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 the revenues and all the expenses in order to measure each period's net income separately from all other periods. It also updates the Capital account balance. The last step in the closing process zeroes out drawing.

Stop & Think...

Have you ever closed an account at a bank? How much was left in your account when you closed it? You needed to take all the money out, right? Well it's the same theory behind closing journal entries—after closing, we leave a zero balance in all revenue, expense, and drawing accounts.

Recall that the income statement reports net income for a specific period. For example, the business's net income for 2013 relates exclusively to 2013. At December 31, 2013, Smart Touch closes its revenue and expense accounts for the year. For this reason, revenues and expenses are called **temporary accounts** (also known as **nominal accounts**). For example, Smart Touch's balance of Service revenue at May 31, 2013, is $7,600. This balance relates exclusively to May and must be zeroed out before Smart Touch records revenue for June. Similarly, the various expense account balances are for May only and must also be zeroed out at the end of the month.

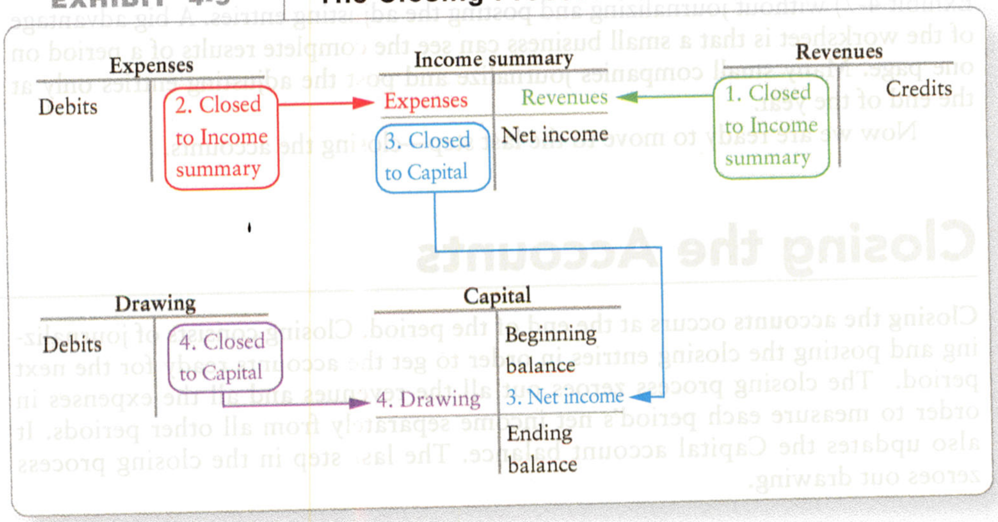
The Bright, drawing account is also temporary and must be closed at the end of the period because it measures the owner drawing for only that one period. All temporary accounts (drawing, revenues, and expenses) are closed (zeroed).

By contrast, the **permanent accounts** (also known as **real accounts**)—the assets, liabilities, and capital—are not closed at the end of the period. Another way to remember which accounts are permanent is to recall that all accounts on the balance sheet are permanent accounts because they are part of the accounting equation.

Closing entries transfer the revenue, expense, and drawing balances to the Capital account to ready the company's books for the next period.

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 balance—net income or net loss—is then transferred (closed) to the Capital account (the final account in the closing process). Exhibit 4-9 summarizes the closing process.

EXHIBIT 4-9 The Closing Process



Closing Temporary Accounts

As we stated previously, all temporary accounts are closed (zeroed out) during the closing process. **Temporary accounts are not permanent. Only the accounting equation accounts (the balance sheet accounts) are permanent.** The four steps in closing the books follow (and are illustrated in Exhibit 4-10).

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.

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.

The Income summary account now holds the net income or net loss of the period. The Income summary T-account is presented next:

Income summary

Closing Entry 2	Expenses	Closing Entry 1	Revenues
Expenses > Revenues	Net Loss	Revenues > Expenses	Net Income

STEP 3: Make the Income summary account equal zero via the Capital account. This closing entry transfers net income (or net loss) to the Capital account.

STEP 4: Make the Drawing account equal zero via the Capital account. This entry transfers the drawing to the *debit* side of the Capital account.

Key Takeaway

Closing the accounts is just like starting a new baseball game. The score is 0-0. All temporary account balances are zero after closing.

These steps are best illustrated with an example. Suppose Smart Touch closes its books at the end of May. Exhibit 4-10 on the following page shows the complete closing process for Smart Touch's training agency. Panel A gives the closing entries, and Panel B shows the accounts after posting. After the closing entries, Bright, capital ends with a balance of $35,900. Trace this balance to the statement of owner's equity and then to the balance sheet in Exhibit 4-7.

EXHIBIT 4-10 | **Journalizing and Posting the Closing Entries**

PANEL A—Journalizing

Closing Entries

	Date	Accounts	Debit	Credit
1	May 31	Service revenue (R–)	7,600	
		Income summary		7,600
2	31	Income summary	3,900	
		Rent expense (E–)		1,000
		Salary expense (E–)		1,800
		Supplies expense (E–)		100
		Depreciation expense—furniture (E–)		300
		Depreciation expense—building (E–)		200
		Interest expense (E–)		100
		Utilities expense (E–)		400
3	31	Income summary ($7,600 − $3,900)	3,700	
		Bright, capital (Q+)		3,700
4	31	Bright, capital (Q–)	1,000	
		Bright, drawing (D–)		1,000

PANEL B—Posting

Rent expense

Adj	1,000		
Bal	1,000	Clo 2	1,000
Bal	0		

Salary expense

	900		
Adj	900		
Bal	1,800	Clo 2	1,800
Bal	0		

Supplies expense

Adj	100		
Bal	100	Clo 2	100
Bal	0		

Depreciation expense—furniture

Adj	300		
Bal	300	Clo 2	300
Bal	0		

Depreciation expense—building

Adj	200		
Bal	200	Clo 2	200
Bal	0		

Interest expense

Adj	100		
Bal	100	Clo 2	100
Bal	0		

Utilities expense

Bal	400	Clo 2	400
Bal	0		

Income summary

Clo 2	3,900	Clo 1	7,600
Clo 3	3,700	Bal	3,700
		Bal	0

Service revenue

			7,000
		Adj	400
		Adj	200
Clo 1	7,600	Bal	7,600
		Bal	0

Bright, drawing

Bal	1,000	Clo 4	1,000
Bal	0		

Bright, capital

Clo 4	1,000		33,200
		Clo 3	3,700
		Bal	35,900

Adj = Amount posted from an adjusting entry
Clo = Amount posted from a closing entry
Bal = Balance

Post-Closing Trial Balance

4 Prepare the post-closing trial balance

The accounting cycle can end with a **post-closing trial balance** (see Exhibit 4-11). This optional step lists the accounts and their adjusted balances after closing.

EXHIBIT 4-11 **Post-Closing Trial Balance**

SMART TOUCH LEARNING
Post-Closing Trial Balance
May 31, 2013

	Debit	Credit
Cash	$ 4,800	
Accounts receivable	2,600	
Supplies	600	
Prepaid rent	2,000	
Furniture	18,000	
Building	48,000	
Accumulated depreciation—furniture		$ 300
Accumulated depreciation—building		200
Accounts payable		18,200
Salary payable		900
Interest payable		100
Unearned service revenue		400
Notes payable		20,000
Bright, capital		35,900
Total	$ 76,000	$ 76,000

Key Takeaway

In summary, the post-closing trial balance contains the same accounts that the balance sheet contains—assets, liabilities, and capital.

Only assets, liabilities, and capital accounts appear on the post-closing trial balance. No temporary accounts—revenues, expenses, or drawing—are included because they have been closed (their balances are zero). The ledger is now up-to-date and ready for the next period.

Classifying Assets and Liabilities

5 Classify assets and liabilities as current or long-term

Assets and liabilities are classified as either *current* or *long-term* to show their relative liquidity. **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. Supplies are less liquid, and furniture and buildings are even less so because they take longer to convert to cash. A classified balance sheet lists assets in the order of their liquidity.

Assets

Owners need to know what they own. The balance sheet lists assets in liquidity order. Balance sheets report two asset categories: *current assets* and *long-term assets*.

Current 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. **Current assets are items that will be used up in a year, like your notebook paper for this class or the change in your pocket.** 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, and
3. the business collects cash from customers.

For most businesses, the operating cycle is a few months. Cash, Accounts receivable, Supplies, and Prepaid expenses are current assets. Merchandising entities such as Lowes and Coca-Cola have another current asset: inventory. Inventory shows the cost of the goods the company holds for sale to customers, like tools at Lowes or cans of soda for Coca-Cola.

Long-Term Assets

Long-term assets are all the assets that will not be converted to cash within the business's operating cycle. **Long-term assets can be used for more than a year, like your car or computer.** One category of long-term assets is plant assets (also called fixed assets or property, plant, and equipment). Land, Buildings, Furniture, and Equipment are plant assets. Of these, Smart Touch has Furniture and a Building.

Other categories of long-term assets include Long-Term Investments and Other Assets (a catchall category). We will discuss these categories in later chapters.

Liabilities

Owners need to know when they must pay each liability. The balance sheet lists liabilities in the order in which they must be paid. Balance sheets report two liability categories: *current liabilities* and *long-term liabilities*.

Current 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. **Your cell phone bill is a current liability because you have to pay it every month.** Accounts payable, Notes payable due within one year, Salary payable, Interest payable, and Unearned revenue are all current liabilities.

Long-Term Liabilities

All liabilities that do not need to be paid within the entity's operating cycle are classified as **long-term liabilities**. **When you buy a car, you often sign up for several years of car payments, making it a long-term liability.** Many notes payable are long-term, such as a mortgage on a building.

Connect To: Ethics

The classification of assets and liabilities as current or long-term affects many key ratios that outsiders use to evaluate the financial health of a company. Many times, the classification of a particular account is very clear—for example, a building is normally a long-term asset. But what if the company must demolish the existing building within six months due to some structural default? It would not be ethical to still show the building as a long-term asset.

The Classified Balance Sheet

So far we have presented the *unclassified* balance sheet of Smart Touch. We are now ready for the balance sheet that is actually used in practice—called a **classified balance sheet**. Exhibit 4-12 presents Smart Touch's classified balance sheet using the data from Exhibit 4-7 on page 205.

Smart Touch classifies each asset and each liability as either current or long-term. Notice that the Total assets of $75,500 is the same as the Total assets on the unclassified balance sheet in Exhibit 4-7.

EXHIBIT 4-12 | **Classified Balance Sheet in Account Form**

SMART TOUCH LEARNING
Balance Sheet
May 31, 2013

Assets				Liabilities	
Current assets:				Current liabilities:	
Cash		$ 4,800		Accounts payable	$18,200
Accounts receivable		2,600		Salary payable	900
Supplies		600		Interest payable	100
Prepaid rent		2,000		Unearned service revenue	400
Total current assets			$10,000	Total current liabilities	19,600
Plant assets:				Long-term liabilities:	
Furniture	$18,000			Notes payable	20,000
Less: Accumulated depreciation—furniture	300	17,700		Total liabilities	39,600
Building	48,000				
Less: Accumulated depreciation—building	200	47,800		**Owner's Equity**	
Total plant assets			65,500	Bright, capital	35,900
Total assets			$75,500	Total liabilities and owner's equity	$75,500

Balance Sheet Forms

Smart Touch's balance sheet in Exhibit 4-12 lists the assets on the left and the liabilities and the equity on the right in an arrangement known as the *account form*. The balance sheet of Smart Touch in Exhibit 4-13 lists the assets at the top and the liabilities and owner's equity below in an arrangement known as the *report form*. Although either form is acceptable, the report form is more popular.

Key Takeaway

Classification means dividing assets and liabilities between those that will last less than a year (current) and those that will last longer than a year (long-term). The classified balance sheet still represents the accounting equation and must balance (Assets = Liabilities + Equity).

EXHIBIT 4-13 | **Classified Balance Sheet in Report Form**

SMART TOUCH LEARNING
Balance Sheet
May 31, 2013

Assets			
Current assets:			
Cash		$ 4,800	
Accounts receivable		2,600	
Supplies		600	
Prepaid rent		2,000	
Total current assets			$10,000
Plant assets:			
Furniture	$18,000		
Less: Accumulated depreciation—furniture	300	17,700	
Building	48,000		
Less: Accumulated depreciation—building	200	47,800	
Total plant assets			65,500
Total assets			$75,500
Liabilities			
Current liabilities:			
Accounts payable			$18,200
Salary payable			900
Interest payable			100
Unearned service revenue			400
Total current liabilities			19,600
Long-term liabilities			
Notes payable			20,000
Total liabilities			39,600
Owner's Equity			
Bright, capital			35,900
Total owner's equity			35,900
Total liabilities and owner's equity			$75,500

Accounting Ratios

Accounting is designed to provide information that business owners, managers, and lenders then use to make decisions. A bank considering lending money to a business must predict whether that business can repay the loan. If Smart Touch already has a lot of debt, repayment is less certain than if it does not owe much money. To measure the business's financial position, decision makers use financial ratios that they compute from the company's financial statements. Two of the most widely used decision aids in business are the current ratio and the debt ratio.

6 Describe the effect of various transactions on the current ratio and the debt ratio

Current Ratio

The **current ratio** measures a company's ability to pay its current liabilities with its current assets. This ratio is computed as follows:

$$\text{Current ratio} = \frac{\text{Total current assets}}{\text{Total current liabilities}}$$

A company prefers to have a high current ratio because that means it has plenty of current assets to pay its current liabilities. A current ratio that has increased from the prior period indicates improvement in a company's ability to pay its current debts. A current ratio that has decreased from the prior period signals deterioration in the company's ability to pay its current liabilities. **Your personal current ratio is your checking account balance (your current assets) divided by your monthly bills (your current liabilities).**

A Rule of Thumb: A strong current ratio is 1.50, which indicates that the company has \$1.50 in current assets for every \$1.00 in current liabilities. A current ratio of 1.00 is considered low and somewhat risky.

Debt Ratio

The **debt ratio** measures an organization's overall ability to pay its total liabilities (debt). The debt ratio is computed as follows:

$$\text{Debt ratio} = \frac{\text{Total liabilities}}{\text{Total assets}}$$

Key Takeaway

The current ratio measures liquidity within one year by comparing current assets to current liabilities. The debt ratio measures the ability to pay liabilities in the long term by comparing all liabilities to all assets. The different ratios give different views of a company's financial health.

The debt ratio indicates the proportion of a company's assets that are financed with debt. A *low* debt ratio is safer than a high debt ratio. Why? Because a company with low liabilities usually has low required payments and is less likely to get into financial difficulty. **Your personal debt ratio is everything you owe divided by everything you own.**

A Rule of Thumb: A debt ratio below 0.60, or 60%, is considered safe for most businesses, as it indicates that the company owes only \$0.60 for every \$1.00 in total assets. A debt ratio above 0.80, or 80%, borders on high risk.

Now study the Decision Guidelines feature, which summarizes what you have learned in this chapter.

Decision Guidelines 4-1

COMPLETING THE ACCOUNTING CYCLE

Suppose you own Greg's Tunes or Smart Touch Learning. How can you measure the success of your business? The Decision Guidelines describe the accounting process you will use to provide the information for any accounting decisions you need to make.

Decision	Guidelines
• What document summarizes the effects of all the entity's transactions and adjustments throughout the period?	The *worksheet* with columns for • Trial balance • Adjustments • Adjusted trial balance • Income statement • Balance sheet
• What is the last *major* step in the accounting cycle?	*Closing entries for the temporary accounts:* • Revenues } Income statement accounts • Expenses • Drawing
• Why close out the revenues, expenses, and drawing accounts?	Because these *temporary accounts* have balances that relate only to one accounting period and *do not* carry over to the next period
• Which accounts do *not* get closed out?	*Permanent (balance sheet) accounts:* • Assets • Liabilities • Capital The balances of these accounts *do* carry over to the next period.
• How do businesses classify their assets and liabilities for reporting on the balance sheet?	*Current* (within one year, or the entity's operating cycle if longer than a year), or *Long-term* (not current)
• How do Greg Moore and Sheena Bright evaluate their companies?	There are many ways, such as the company's net income (or net loss) on the income statement and the trend of net income from year to year. Another way to evaluate a company is based on the company's *financial ratios*. Two key ratios are the current ratio and the debt ratio: $\text{Current ratio} = \dfrac{\text{Total current assets}}{\text{Total current liabilities}}$ The *current ratio* measures the company's ability to pay current liabilities with current assets. $\text{Debt ratio} = \dfrac{\text{Total liabilities}}{\text{Total assets}}$ The *debt ratio* measures the company's overall ability to pay liabilities. The debt ratio shows the proportion of the company's assets that are financed with debt.

Summary Problem 4-2

Refer to the data in Summary Problem 4-1 (Super Employment Services).

Requirements

1. Journalize and post the adjusting entries. (Before posting to the accounts, enter into each account its balance as shown in the trial balance. For example, enter the $5,000 balance in the Accounts receivable account before posting its adjusting entry.) Key adjusting entries by *letter*, as shown in the worksheet solution to Summary Problem 4-1. You can take the adjusting entries straight from the worksheet in the chapter.
2. Journalize and post the closing entries. (Each account should carry its balance as shown in the adjusted trial balance.) To distinguish closing entries from adjusting entries, key the closing entries by *number*. Draw arrows to illustrate the flow of data, as shown in Exhibit 4-10. Indicate the balance of the Mudge, capital account after the closing entries are posted.
3. Prepare the income statement for the year ended December 31, 2014.
4. Prepare the statement of owner's equity for the year ended December 31, 2014. Draw an arrow linking the income statement to the statement of owner's equity.
5. Prepare the classified balance sheet at December 31, 2014. Use the account form. All liabilities are current. Draw an arrow linking the statement of owner's equity to the balance sheet.

Solution

Requirement 1

Adjusting Entries

a.	Dec 31	Supplies expense (E+)	800	
		Supplies (A–)		800
b.	31	Depreciation expense—furniture (E+)	2,000	
		Accumulated depreciation—furniture (CA+)		2,000
c.	31	Depreciation expense—building (E+)	1,000	
		Accumulated depreciation—building (CA+)		1,000
d.	31	Salary expense (E+)	500	
		Salary payable (L+)		500
e.	31	Accounts receivable (A+)	1,300	
		Service revenue (R+)		1,300
f.	31	Unearned service revenue (L–)	3,000	
		Service revenue (R+)		3,000

Accounts receivable

	5,000		
(e)	1,300		
Bal	6,300		

Supplies

	1,000	(a)	800
Bal	200		

Accumulated depreciation—furniture

			4,000
		(b)	2,000
		Bal	6,000

Accumulated depreciation—building

			30,000
		(c)	1,000
		Bal	31,000

Salary payable

		(d)	500
		Bal	500

Unearned service revenue

(f)	3,000		8,000
		Bal	5,000

Service revenue

			60,000
		(e)	1,300
		(f)	3,000
		Bal	64,300

Salary expense

	16,000		
(d)	500		
Bal	16,500		

Supplies expense

(a)	800		
Bal	800		

Depreciation expense—furniture

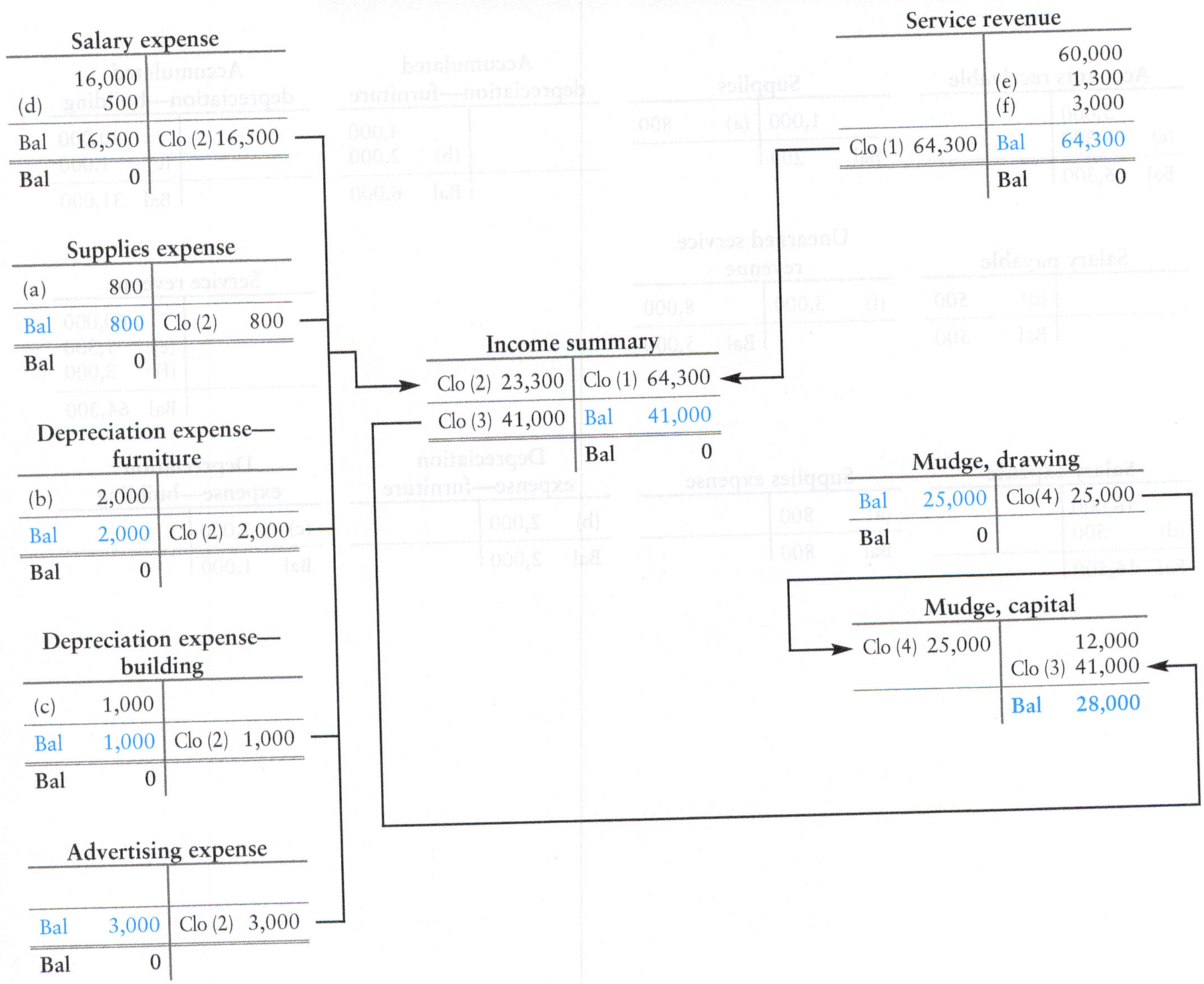
(b)	2,000		
Bal	2,000		

Depreciation expense—building

(c)	1,000		
Bal	1,000		

Requirement 2

Closing Entries				
1.	Dec 31	Service revenue (R–)	64,300	
		Income summary		64,300
2.	31	Income summary	23,300	
		Salary expense (E–)		16,500
		Supplies expense (E–)		800
		Depreciation expense—furniture (E–)		2,000
		Depreciation expense—building (E–)		1,000
		Advertising expense (E–)		3,000
3.	31	Income summary ($64,300 – $23,300)	41,000	
		Mudge, capital (Q+)		41,000
4.	31	Mudge, capital (Q–)	25,000	
		Mudge, drawing (D–)		25,000



Requirement 3

SUPER EMPLOYMENT SERVICES
Income Statement
Year Ended December 31, 2014

Revenue:		
Service revenue		$64,300
Expenses:		
Salary expense	$16,500	
Advertising expense	3,000	
Depreciation expense—furniture	2,000	
Depreciation expense—building	1,000	
Supplies expense	800	
Total expenses		23,300
Net income		$41,000

Requirement 4

SUPER EMPLOYMENT SERVICES
Statement of Owner's Equity
Year Ended December 31, 2014

Mudge, capital, January 1, 2014	$ 12,000
Net income	41,000
	53,000
Drawing	(25,000)
Mudge, capital, December 31, 2014	$ 28,000

Requirement 5

SUPER EMPLOYMENT SERVICES
Balance Sheet
December 31, 2014

Assets			Liabilities	
Current assets:			Current liabilities:	
Cash		$ 6,000	Accounts payable	$ 2,000
Accounts receivable		6,300	Salary payable	500
Supplies		200	Unearned service revenue	5,000
Total current assets		12,500	Total current liabilities	7,500
Long-term assets:				
Furniture	$10,000			
Less: Accumulated depreciation—furniture	6,000	4,000		
Building	50,000		**Owner's Equity**	
Less: Accumulated depreciation—building	31,000	19,000	Mudge, capital	28,000
Total assets		$35,500	Total liabilities and owner's equity	$35,500

Chapter 4: Demo Doc

Accounting Worksheets and Closing Entries

To make sure you understand this material, work through the following demonstration "demo doc" with detailed comments to help you see the concept within the framework of a worked-through problem.

1 2 3

This question continues on from the Cloud Break Consulting Demo Doc in Chapter 3.
Use the data from the adjusted trial balance of Cloud Break Consulting at June 30, 2014:

CLOUD BREAK CONSULTING
Adjusted Trial Balance
June 30, 2014

Account Title	Debit	Credit
Cash	$131,000	
Accounts receivable	119,000	
Supplies	1,000	
Prepaid rent	18,000	
Land	45,000	
Building	300,000	
Accumulated depreciation—building		$167,000
Accounts payable		159,000
Salary payable		1,000
Unearned service revenue		10,000
Moe, capital		102,000
Moe, drawing	7,000	
Service revenue		495,000
Salary expense	256,000	
Supplies expense	3,000	
Rent expense	34,000	
Depreciation expense—building	12,000	
Miscellaneous expense	8,000	
Totals	$934,000	$934,000

Requirements

1. **Prepare Cloud Break's accounting worksheet showing the adjusted trial balance, the income statement accounts, and the balance sheet accounts.**
2. **Journalize and post Cloud Break's closing entries.**

Chapter 4: Demo Doc Solution

Requirement 1

Prepare Cloud Break's accounting worksheet showing the adjusted trial balance, the income statement accounts, and the balance sheet accounts.

Part 1	Part 2	Part 3	Part 4	Part 5	Demo Doc Complete

The accounting worksheet is very similar to the adjusted trial balance; however, the worksheet has additional debit and credit columns for the income statement and balance sheet.

CLOUD BREAK CONSULTING
Worksheet
Month Ended June 30, 2014

	Adjusted Trial Balance		Income Statement		Balance Sheet	
Account Title	Debit	Credit	Debit	Credit	Debit	Credit
Cash	$131,000					
Accounts receivable	119,000					
Supplies	1,000					
Prepaid rent	18,000					
Land	45,000					
Building	300,000					
Accumulated depreciation—building		$167,000				
Accounts payable		159,000				
Salary payable		1,000				
Unearned service revenue		10,000				
Moe, capital		102,000				
Moe, drawing	7,000					
Service revenue		495,000				
Salary expense	256,000					
Supplies expense	3,000					
Rent expense	34,000					
Depreciation expense—building	12,000					
Miscellaneous expense	8,000					
	$934,000	$934,000				

The accounts that belong on the income statement are put into the income statement columns and all other accounts are put into the balance sheet columns.

The income statement lists revenues and expenses. So Cloud Break's revenues (Service revenue) and expenses (Salary expense, Supplies expense, Rent expense, Depreciation expense—building, and Miscellaneous expense) are copied over to the income statement columns.

CLOUD BREAK CONSULTING
Worksheet
Month Ended June 30, 2014

	Adjusted Trial Balance		Income Statement		Balance Sheet	
Account Title	Debit	Credit	Debit	Credit	Debit	Credit
Cash	$131,000					
Accounts receivable	119,000					
Supplies	1,000					
Prepaid rent	18,000					
Land	45,000					
Building	300,000					
Accumulated depreciation—building		$167,000				
Accounts payable		159,000				
Salary payable		1,000				
Unearned service revenue		10,000				
Moe, capital		102,000				
Moe, drawing	7,000					
Service revenue		495,000		$495,000		
Salary expense	256,000		$256,000			
Supplies expense	3,000		3,000			
Rent expense	34,000		34,000			
Depreciation expense—building	12,000		12,000			
Miscellaneous expense	8,000		8,000			
	$934,000	$934,000	$313,000	$495,000		
		Net income	182,000			
			$495,000	$495,000		

Net income is calculated by subtracting the expenses from the revenues, $495,000 – $313,000 = $182,000. Notice that this is the same as net income from the income statement prepared in the Chapter 3 Demo Doc.

The other accounts (assets, liabilities, equity, and drawing) are now copied over to the balance sheet columns.

CLOUD BREAK CONSULTING
Worksheet
Month Ended June 30, 2014

Account Title	Adjusted Trial Balance Debit	Adjusted Trial Balance Credit	Income Statement Debit	Income Statement Credit	Balance Sheet Debit	Balance Sheet Credit
Cash	$131,000				$131,000	
Accounts receivable	119,000				119,000	
Supplies	1,000				1,000	
Prepaid rent	18,000				18,000	
Land	45,000				45,000	
Building	300,000				300,000	
Accumulated depreciation—building		$167,000				$167,000
Accounts payable		159,000				159,000
Salary payable		1,000				1,000
Unearned service revenue		10,000				10,000
Moe, capital		102,000				102,000
Moe, drawing	7,000				7,000	
Service revenue		495,000		$495,000		
Salary expense	256,000		$256,000			
Supplies expense	3,000		3,000			
Rent expense	34,000		34,000			
Depreciation expense—building	12,000		12,000			
Miscellaneous expense	8,000		8,000			
	$934,000	$934,000	$313,000	$495,000	$621,000	$439,000
		Net income	182,000			182,000
			$495,000	$495,000	$621,000	$621,000

Net income is added to the credit side of the balance sheet to make total credits equal total debits. This is because net income increases Moe, capital (and therefore equity) as seen in Requirement 2 of this Demo Doc (where the closing entries are journalized).

Requirement 2

Journalize and post Cloud Break's closing entries.

Part 1	Part 2	Part 3	Part 4	Part 5	Demo Doc Complete

We prepare closing entries to (1) clear out the revenue, expense, and drawing accounts to a zero balance in order to get them ready for the next period—that is, they must begin the next period empty so that we can evaluate each period's earnings separately from other periods. We also need to (2) update the Moe, capital account by transferring net income (or net loss) and drawing into it.

The Capital balance is calculated each year using the following formula:

Beginning capital
+ Net income (or – Net loss)
– Drawing
= Ending capital

You can see this in the Capital T-account as well:

Capital	
	Beginning capital
	Net income
Drawing	
	Ending capital

This formula is the key to preparing the closing entries. We will use this formula, but we will do it *inside* the Capital T-account.

From the adjusted trial balance, we know that beginning Moe, capital is $102,000. The first component of the formula is already in the T-account.

The next component is net income, which is *not* yet in the Moe, capital account. There is no T-account with net income in it, but we can *create* one. We will create a new T-account called *Income summary*. We will place in the Income summary account all the components of net income and come out with the net income number at the bottom. Remember:

Revenues – Expenses = Net income (or Net loss)

This means that we need to get all of the revenues and expenses into the Income summary account.

Look at the Service revenue T-account:

Service revenue	
	Bal 495,000

In order to clear out all the income statement accounts so that they are empty to begin the next year, the first step is to debit each revenue account for the amount of its credit balance. Service revenue has a *credit* balance of $495,000, so to bring that to zero, we need to *debit* Service revenue for $495,000.

This means that we have part of our first closing entry:

1.		Service revenue (R–)	495,000	
		???		495,000

What is the credit side of this entry? The reason we were looking at Service revenue to begin with was to help calculate net income using the Income summary account. So the other side of the entry must go to the Income summary account:

1.	Service revenue (R–)	495,000	
	Income summary		495,000

Part 1 | Part 2 | **Part 3** | Part 4 | Part 5 | Demo Doc Complete

The second step is to *credit* each expense account for the amount of its *debit* balance to bring each expense account to zero. In this case, we have five different expenses:

Salary expense

Bal	256,000	

Supplies expense

Bal	3,000	

Rent expense

Bal	34,000	

Depreciation expense—building

Bal	12,000	

Miscellaneous expense

Bal	8,000	

The sum of all the expenses will go to the debit side of the Income summary account:

2.	Income summary	313,000	
	Salary expense (E–)		256,000
	Supplies expense (E–)		3,000
	Rent expense (E–)		34,000
	Depreciation expense—building (E–)		12,000
	Miscellaneous expense (E–)		8,000

Part 1 | Part 2 | Part 3 | **Part 4** | Part 5 | Demo Doc Complete

Now look at the Income summary account:

Income summary

		1.	495,000
2.	313,000		
		Bal	182,000

Remember that the credit of $495,000 is from the first closing entry prepared at the beginning of this requirement.

The purpose of creating the Income summary was to get the net income number into a single account. Notice that the Income summary balance is the same net income number that appears on the income statement and in the accounting worksheet in Requirement 1.

Income summary now has a *credit* balance of $182,000. The third step in the closing process is to transfer net income to the Moe, capital account. To zero out the Income summary account, we must *debit* the Income summary for $182,000:

3.	Income summary	182,000	
	???		182,000

What is the credit side of this entry? It is the Moe, capital account. The reason we created the (temporary) Income summary account was to help calculate the net income or net loss for the Moe, capital account. So the credit side of the entry must go to Moe, capital:

3.	Income summary	182,000	
	Moe, capital (Q+)		182,000

This entry adds the net income to Moe, capital. Notice that it also brings the Income summary account to a zero balance.

Part 1	Part 2	Part 3	Part 4	**Part 5**	Demo Doc Complete

The last component of the capital formula is drawing. There is already a Moe, drawing account:

Moe, drawing		
Bal	7,000	

The final step in the closing process is to transfer Moe, drawing to the debit side of the Moe, capital account. The Moe, drawing account has a *debit* balance of $7,000, so to bring that to zero, we need to *credit* Moe, drawing by $7,000. The balancing debit will go to Moe, capital:

4.	Moe, capital (Q–)	7,000	
	Moe, drawing (D–)		7,000

This entry subtracts Moe, drawing from the Moe, capital account. Moe, capital now holds the following data:

Moe, capital				
			102,000	**Beginning capital**
		3.	182,000	**Net income**
Drawing 4.	7,000			
		Bal	277,000	**Ending capital**

The formula to update Moe, capital has now been re-created inside the Moe, capital T-account.

The following accounts are included in the closing process:

Service revenue

			495,000
1.	495,000		
		Bal	0

Income summary

		1.	495,000
2.	313,000		
		Bal	182,000
3.	182,000		
		Bal	0

Salary expense

	256,000		
		2.	256,000
Bal	0		

Moe, drawing

	7,000		
		4.	7,000
Bal	0		

Supplies expense

	3,000		
		2.	3,000
Bal	0		

Moe, capital

			102,000
		3.	182,000
4.	7,000		
		Bal	277,000

Rent expense

	34,000		
		2.	34,000
Bal	0		

Depreciation expense—building

	12,000		
		2.	12,000
Bal	0		

Miscellaneous expense

	8,000		
		2.	8,000
Bal	0		

Notice that all the temporary accounts (the revenues, the expenses, Drawing, and Income summary) now have a zero balance.

Part 1 | Part 2 | Part 3 | Part 4 | Part 5 | **Demo Doc Complete**

Review Completing the Accounting Cycle

Accounting Vocabulary

Accounting Cycle (p. 199)
Process by which companies produce their financial statements for a specific period.

Classified Balance Sheet (p. 211)
A balance sheet that classifies each asset and each liability as either current or long-term.

Closing the Accounts (p. 207)
Step in the accounting cycle at the end of the period. Closing the accounts consists of journalizing and posting the closing entries to set the balances of the revenue, expense, and drawing accounts to zero for the next period.

Closing Entries (p. 207)
Entries that transfer the revenue, expense, and drawing balances to the Capital account.

Current Assets (p. 211)
Assets that are 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.

Current Liabilities (p. 211)
Debts due to 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.

Current Ratio (p. 214)
Current assets divided by current liabilities. This ratio measures the company's ability to pay current liabilities from current assets.

Debt Ratio (p. 214)
Total liabilities divided by total assets. This ratio reveals the proportion of a company's assets that it has financed with debt.

Income Summary (p. 207)
A temporary "holding tank" account into which revenues and expenses are transferred prior to their final transfer to the Capital account.

Liquidity (p. 210)
Measure of how quickly an item can be converted to cash.

Long-Term Assets (p. 211)
Any 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 Liabilities (p. 211)
Liabilities that are not current.

Nominal Accounts (p. 207)
The revenue and expense accounts that relate to a particular accounting period and are closed at the end of that period. For a company, the Drawing account is also temporary. Also called **temporary accounts**.

Operating Cycle (p. 211)
Time span during which cash is paid for goods and services, which are then sold to customers from whom the business collects cash.

Permanent Accounts (p. 207)
Accounts that are *not* closed at the end of the period—the asset, liability, and capital accounts. Also called **real accounts**.

Post-Closing Trial Balance (p. 210)
List of the accounts and their balances at the end of the period after journalizing and posting the closing entries. This last step of the accounting cycle ensures that the ledger is in balance to start the next accounting period. It should include only balance sheet accounts.

Real Accounts (p. 207)
Accounts that are not closed at the end of the period—the assets, liabilities, and capital accounts. Also called **permanent accounts**.

Reversing Entries (online Appendix 4A)
Special journal entries that ease the burden of accounting for transactions in the next period.

Temporary Accounts (p. 207)
The revenue and expense accounts that relate to a particular accounting period and are closed at the end of that period. For a company, the Drawing account is also temporary. Also called **nominal accounts**.

Worksheet (p. 200)
An internal columnar document designed to help move data from the trial balance to their financial statements.

Destination: Student Success

Student Success Tips

The following are hints on some common trouble areas for students in this chapter:

- Be sure you remember the four closing entries, paying special attention to which accounts are closed. (TIP: Make temporary accounts = zero.)
- Practice the 5-column worksheets. Remember that debits = credits in the first 3 columns. Debits from columns 4 and 5 (Income Statement and Balance Sheet) do not equal credits until you post the net income or net loss for the period. (TIP: Total Debits from Column 3 = Column 4 Debits + Column 5 Debits.)
- Recall the classification difference between current (normally, 1 year or less) and long term (more than a year). (TIP: If it lasts more than a year, it's long term.)

Getting Help

If there's a learning objective from the chapter you aren't confident about, try using one or more of the following resources:

- Practice additional exercises or problems at the end of Chapter 4 that cover the specific learning objective that is challenging you.
- Watch the white board tips and/or videos for Chapter 4 located at myaccountinglab.com under the Chapter Resources button.
- Review the Chapter 4 Demo Doc located on page 220 of the textbook.
- Go to myaccountinglab.com and select the Study Plan button. Choose Chapter 4 and work the questions covering that specific learning objective until you've mastered it.

Destination: Student Success *(Continued)*

Student Success Tips

- Remember the formulas for the current ratio and debt ratio. (TIP: The current ratio usually should be greater than 1; the debt ratio should be less than 1.)

Getting Help

- Work the Chapter 4 pre/post tests in myaccountinglab.com.
- Consult the Check Figures for End of Chapter starters, exercises, and problems—located at myaccountinglab.com.
- Visit the learning resource center on your campus for tutoring.

Quick Check

Experience the Power of Practice!

As denoted by the logo, all of these questions, as well as additional practice materials, can be found in MyAccountingLab.

Please visit myaccountinglab.com

1. Consider the steps in the accounting cycle in Exhibit 4-1. Which part of the accounting cycle provides information to help a business decide whether to expand its operations?
   a. Post-closing trial balance
   b. Adjusting entries
   c. Closing entries
   d. Financial statements
2. Which columns of the accounting worksheet show unadjusted amounts?
   a. Adjustments
   b. Trial Balance
   c. Income Statement
   d. Balance Sheet
3. Which of the following accounts may appear on a post-closing trial balance?
   a. Cash, Salary payable, and Capital
   b. Cash, Salary payable, and Service revenue
   c. Cash, Service revenue, and Salary expense
   d. Cash, Salary payable, and Salary expense
4. Which situation indicates a net loss within the Income Statement columns of the worksheet?
   a. Total credits exceed total debits
   b. Total debits exceed total credits
   c. Total debits equal total credits
   d. None of the above
5. Supplies has a $10,000 unadjusted balance on your trial balance. At year-end you count supplies of $6,000. What adjustment will appear on your worksheet?

a.

Supplies	4,000	
Supplies expense		4,000

b.

Supplies expense	6,000	
Supplies		6,000

c.

Supplies expense	4,000	
Supplies		4,000

d. No adjustment is needed because the Supplies account already has a correct balance.

6. Which of the following accounts is *not* closed?
   a. Depreciation expense
   b. Drawing
   c. Service revenue
   d. Accumulated depreciation
7. What do closing entries accomplish?
   a. Zero out the revenues, expenses, and drawing
   b. Transfer revenues, expenses, and drawing to the Capital account
   c. Bring the Capital account to its correct ending balance
   d. All of the above

8. Which of the following is *not* a closing entry?

a.

Capital	XXX	
Drawing		XXX

b.

Service revenue	XXX	
Income summary		XXX

c.

Salary payable	XXX	
Income summary		XXX

d.

Income summary	XXX	
Rent expense		XXX

9. Assets and liabilities are listed on the balance sheet in order of their
   a. purchase date. c. liquidity.
   b. adjustments. d. balance.

10. Clean Water Softener Systems has cash of $600, receivables of $900, and supplies of $400. Clean owes $500 on accounts payable and salary payable of $200. Clean's current ratio is
    a. 2.71 c. 0.63
    b. 2.50 d. 0.37

Answers are given after Apply Your Knowledge (p. 253).

Assess Your Progress

• Short Exercises

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S4-1 **1 Explaining worksheet items [10 min]**

Link Back to Chapter 3 (Adjusting Entries). Consider the following adjusting entries:

	Journal Entry				
	Date		Accounts and Explanations	Debit	Credit
a.	Apr	30	Rent expense	900	
			Prepaid rent		900
b.		30	Unearned service revenue	350	
			Service revenue		350
c.		30	Supplies expense	200	
			Supplies		200
d.		30	Salary expense	850	
			Salary payable		850
e.		30	Depreciation expense—furniture	450	
			Accumulated depreciation—furniture		450

Requirement

1. State one reason why each of the previous adjusting entries were made.
   Example: The explanation for journal entry a could be some of the Prepaid rent has expired. Another correct explanation would be the asset account Prepaid rent was overstated. A third correct explanation would be that Rent expense incurred was understated.

S4-2 **1 Explaining worksheet items [10–15 min]**

Link Back to Chapters 2 and 3 (Definitions of Accounts). Consider the following list of accounts:

a. Accounts receivable
b. Supplies
c. Prepaid rent
d. Furniture
e. Accumulated depreciation—furniture
f. Accounts payable
g. Unearned service revenue
h. Service revenue
i. Rent expense

Requirement

1. Explain what a normal balance in each account means. For example, if the account is "Cash," the explanation would be "the balance of cash on a specific date."

S4-3 **2 Using the worksheet to prepare financial statements [5–10 min]**

Answer the following questions:

Requirements

1. What type of normal balance does the Capital account have—debit or credit?
2. Which type of income statement account has the same type of balance as the Capital account?
3. Which type of income statement account has the opposite type of balance as the Capital account?
4. What do we call the difference between total debits and total credits on the income statement? Into what account is the difference figure closed at the end of the period?

S4-4 **3 Journalizing closing entries [10–15 min]**

It is December 31 and time for you to close the books for Brett Tilman Enterprises.

Requirement

1. Journalize the closing entries for Brett Tilman Enterprises:

a. Service revenue, $20,600.
b. Make a single closing entry for all the expenses: Salary, $7,200; Rent, $4,500; Advertising, $3,400.
c. Income summary.
d. Drawing, $3,800.

S4-5 **3 Posting closing entries directly to T-accounts [5 min]**

It is December 31 and time for your business to close the books. The following balances appear on the books of Sarah Simon Enterprises:

a. Drawing, $8,500.
b. Service revenue, $23,700.
c. Expense account balances: Salary, $6,100; Rent, $4,000; Advertising, $3,300.

Requirements

1. Set up each T-account given and insert its adjusted balance as given (denote as *Bal*) at December 31. Also set up a T-account for Simon, capital, $26,100, and for Income summary.
2. Post the closing entries to the accounts, denoting posted amounts as *Clo.*
3. Compute the ending balance of Simon, capital.

S4-6 ❸ **Making closing entries [5 min]**
Brown Insurance Agency reported the following items at November 30, 2012:

Sales and marketing expense	$2,100	Cash	$1,100
Other assets	700	Service revenue	5,500
Depreciation expense	800	Accounts payable	500
Long-term liabilities	600	Accounts receivable	900

Requirement

1. Journalize Brown's closing entries, as needed for these accounts.

S4-7 ❸ **Posting closing entries [5 min]**
Patel Insurance Agency reported the following items at September 30:

Sales and marketing expense	$1,600	Cash	$1,300
Other assets	700	Service revenue	4,000
Depreciation expense	900	Patel, capital	500
Long-term liabilities	600	Accounts receivable	900

Requirement

1. Prepare T-accounts for Patel Insurance Agency. Insert the account balances prior to closing. Post the closing entries to the affected T-accounts, and show each account's ending balance after closing. Also show the Income summary T-account. Denote a balance as *Bal* and a closing entry amount as *Clo*.

S4-8 ❹ **Preparing a post-closing trial balance [10 min]**
After closing its accounts at July 31, 2012, Goodrow Electric Company had the following account balances:

Long-term liabilities	$ 800	Equipment	$ 4,500
Land	1,200	Cash	100
Accounts receivable	1,600	Service revenue	0
Total expenses	0	Goodrow, capital	3,000
Accounts payable	1,100	Supplies	200
Unearned service revenue	1,400	Accumulated depreciation	1,300
Goodrow, drawing	0		

Requirement

1. Prepare Goodrow's post-closing trial balance at July 31, 2012.

S4-9 ❺ **Classifying assets and liabilities as current or long-term [5 min]**
Jet Fast Printing reported the following:

Buildings	$4,200	Service revenue	$1,115
Accounts payable	600	Cash	400
Total expenses	1,200	Receivables	700
Accumulated depreciation	3,000	Interest expense	110
Accrued liabilities (such as Salary payable)	400	Equipment	1,100
Prepaid expenses	300		

Requirements

1. Identify the assets (including contra assets) and liabilities.
2. Classify each asset and each liability as current or long-term.

S4-10 **5 Classifying assets and liabilities as current or long-term [10 min]**
Link Back to Chapter 3 (Book Value). Examine Jet Fast Printing's account balances in Short Exercise 4-9.

Requirement

1. Identify or compute the following amounts for Jet Fast Printing:
   a. Total current assets
   b. Total current liabilities
   c. Book value of plant assets
   d. Total long-term liabilities

S4-11 **6 Computing the current and debt ratios [10–15 min]**
Heart of Texas Telecom has these account balances at December 31, 2012:

Note payable, long-term	$ 7,800	Accounts payable	$ 3,700
Prepaid rent	2,300	Accounts receivable	5,700
Salary payable	3,000	Cash	3,500
Service revenue	29,400	Depreciation expense	6,000
Supplies	500	Equipment	15,000

Requirements

1. Compute Heart of Texas Telecom's current ratio and debt ratio.
2. How much in *current* assets does Heart of Texas Telecom have for every dollar of *current* liabilities that it owes?

• Exercises

E4-12 **1 Preparing a worksheet [30–40 min]**
Data for the unadjusted trial balance of Mexican Riviera Tanning Salon at March 31, 2012, follow.

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Cash	$ 13,000	Service revenue	$ 89,900
Equipment	66,500	Salary expense	42,200
Accumulated depreciation	18,500	Depreciation expense	
Accounts payable	3,200	Supplies expense	
Supplies	1,400	Neeland, drawing	
Neeland, capital	11,500		

Adjusting data for March 2012 are:

a. Accrued service revenue, $2,600.
b. Supplies used in operations, $400.
c. Accrued salary expense, $1,700.
d. Depreciation expense, $4,100.

Les Neeland, the owner, has received an offer to sell the company. He needs to know the net income for the month covered by these data.

Requirements

1. Prepare the worksheet for Mexican Riviera Tanning Salon.
2. How much was the net income/net loss for March?

E4-13 **1 Preparing a worksheet and using it to calculate net income [20–30 min]**

The trial balance of Telegraphic Link at November 30, follows:

TELEGRAPHIC LINK
Trial Balance
November 30, 2012

	Balance	
Account	Debit	Credit
Cash	$ 4,000	
Accounts receivable	3,200	
Prepaid rent	1,900	
Supplies	3,000	
Equipment	34,800	
Accumulated depreciation		$ 1,600
Accounts payable		5,400
Salary payable		
Thomas, capital		35,700
Thomas, drawing	2,100	
Service revenue		8,600
Depreciation expense		
Salary expense	1,700	
Rent expense		
Utilities expense	600	
Supplies expense		
Total	$51,300	$51,300

Additional information at November 30, 2012:

a. Accrued service revenue, $600.
b. Depreciation, $300.
c. Accrued salary expense, $800.
d. Prepaid rent expired, $500.
e. Supplies used, $100.

Requirements

1. Complete Telegraphic Link's worksheet for the month ended November 30, 2012.
2. How much was net income for November?

Note: Exercise 4-14 should be used only after completing Exercise 4-13.

E4-14 **2 Preparing financial statements from the completed worksheet [15–20 min]**

Use your answer from E4-13.

Requirement

1. Prepare Telegraphic Link's balance sheet as of November 30, 2012.

Note: Exercise 4-15 should be used only after completing Exercise 4-13.

E4-15 **3 Journalizing adjusting and closing entries [15–20 min]**

Use your answer from E4-13.

Requirement

1. Journalize Telegraphic Link's adjusting and closing entries at November 30, 2012.

Note: Exercise 4-16 should be used only after completing Exercise 4-13 and 4-15.

E4-16 3 **Using the worksheet, and posting adjusting and closing entries [20–30 min]**
Consider the entries prepared in Exercise 4-15.

Requirements

1. Set up T-accounts for those accounts affected by the adjusting and closing entries in Exercise 4-15.
2. Post the adjusting and closing entries to the accounts; denote adjustment amounts by *Adj*, closing amounts by *Clo*, and balances by *Bal*. Double underline the accounts with zero balances after you close them, and show the ending balance in each account.

E4-17 3 **Preparing adjusting and closing entries [20 min]**
Link Back to Chapter 3 (Adjusting Entries). Todd McKinney Magic Show's accounting records include the following account balances as of December 31:

	2011	2012
Prepaid rent	$ 200	$ 3,100
Unearned service revenue	1,000	500

During 2012, the business recorded the following:

a. Prepaid annual rent of $8,000.
b. Made the year-end adjustment to record rent expense of $5,100 for the year.
c. Collected $4,400 cash in advance for service revenue to be earned later.
d. Made the year-end adjustment to record the earning of $4,900 service revenue that had been collected in advance.

Requirements

1. Set up T-accounts for Prepaid rent, Rent expense, Unearned service revenue, and Service revenue. Insert beginning and ending balances for Prepaid rent and Unearned service revenue.
2. Journalize the adjusting entries a–d, and post to the accounts. Explanations are not required.
3. What is the balance in Service revenue after adjusting?
4. What is the balance in Rent expense after adjusting?
5. Journalize any required closing entries.

E4-18 **3 Preparing closing entries from a partial worksheet [15–25 min]**
The adjusted trial balance from the January worksheet of Silver Sign Company follows:

SILVER SIGN COMPANY
Partial Worksheet
Month Ended January 31, 2012

Account	Adjusted Trial Balance Debit	Adjusted Trial Balance Credit
Cash	$14,300	
Supplies	2,400	
Prepaid rent	1,400	
Equipment	45,000	
Accumulated depreciation		$ 6,100
Accounts payable		4,500
Salary payable		300
Unearned service revenue		4,500
Note payable, long-term		5,300
Silver, capital		32,600
Silver, drawing	800	
Service revenue		16,800
Salary expense	3,600	
Rent expense	1,400	
Depreciation expense	400	
Supplies expense	200	
Utilities expense	600	
Total	$70,100	$70,100

Requirements

1. Journalize Silver's closing entries at January 31.
2. How much net income or net loss did Silver earn for January? How can you tell?

E4-19 **3 Preparing a statement of owner's equity [5–10 min]**
Selected accounts of Guitars by Peter for the year ended December 31, 2012, follow:

Peter, capital

Clo	31,000	Jan 1	152,000
		Clo	120,000
		Bal	241,000

Peter, drawing

Mar 31	10,000		
Jun 30	7,000		
Sep 30	8,000		
Dec 31	6,000		
Bal	31,000	Clo	31,000

Income summary

Clo	100,000	Clo	220,000
Clo	120,000	Bal	120,000

Requirement

1. Prepare the company's statement of owner's equity for the year.

E4-20 **3 Identifying and journalizing closing entries [15 min]**

Gunther recorded the following transactions and year-end adjustments during 2012:

Journal Entry		
Accounts and Explanations	**Debit**	**Credit**
Prepaid rent	8,000	
Cash		8,000
Prepaid the annual rent.		
Rent expense	5,100	
Prepaid rent		5,100
Adjustment to record rent expense for the year.		
Cash	4,200	
Unearned service revenue		4,200
Collected cash in advance of service revenue to be earned.		
Unearned service revenue	4,700	
Service revenue		4,700
Adjustment to record revenue earned.		

Requirements

1. Assuming that there were no other service revenue and rent expense transactions during 2012, journalize Gunther's closing entries at the end of 2012.
2. Open T-accounts for Service revenue and Rent expense. Post the closing entries to these accounts. What are their balances after closing?

E4-21 **3 Identifying and journalizing closing entries [10–15 min]**

The accountant for Klein Photography has posted adjusting entries (a)–(e) to the following selected accounts at December 31, 2012.

Accounts receivable

	Debit		Credit
	46,000		
(a)	2,000		

Supplies

	Debit		Credit
	5,000	(b)	2,400

Accumulated depr.—furniture

	Debit		Credit
			8,000
		(c)	800

Accumulated depr.—building

	Debit		Credit
			30,000
		(d)	6,200

Salary payable

	Debit		Credit
		(e)	700

Klein, capital

	Debit		Credit
			47,000

Klein, drawing

	Debit		Credit
	57,000		

Service revenue

	Debit		Credit
			108,000
		(a)	2,000

Salary expense

	Debit		Credit
	25,400		
(e)	700		

Supplies expense

	Debit		Credit
(b)	2,400		

Depreciation expense—furniture

	Debit		Credit
(c)	800		

Depreciation expense—building

	Debit		Credit
(d)	6,200		

Requirements

1. Journalize Klein Photography's closing entries at December 31, 2012.
2. Determine Klein Photography's ending Klein, capital balance at December 31, 2012.

Note: Exercise 4-22 should be prepared only after completing Exercises 4-13 through 4-16.

E4-22 ④ **Preparing a post-closing trial balance [10–15 min]**
Review your answers from Exercises 4-13 through 4-16.

Requirement

1. Prepare the post-closing trial balance of Telegraphic Link at November 30, 2012.

E4-23 ⑤ ⑥ **Preparing a classified balance sheet, and calculating the current and debt ratios [15–20 min]**
The adjusted trial balance amounts from the August worksheet of Brian O'Brion Dance Studio Company follow:

BRIAN O'BRION DANCE STUDIO COMPANY
Partial Worksheet
Month Ended August 31, 2012

Account	Adjusted Trial Balance Debit	Adjusted Trial Balance Credit
Cash	$15,800	
Supplies	2,000	
Prepaid rent	900	
Equipment	49,000	
Accumulated depreciation		$ 5,500
Accounts payable		4,500
Salary payable		500
Unearned service revenue		5,100
Long-term note payable		4,400
O'Brion, capital		36,500
O'Brion, drawing	1,100	
Service revenue		18,100
Salary expense	3,000	
Rent expense	1,500	
Depreciation expense	300	
Supplies expense	400	
Utilities expense	600	
Total	$74,600	$74,600

Requirements

1. Prepare the classified balance sheet of Brian O'Brion Dance Studio Company at August 31, 2012. Use the report form. You must compute the ending balance of O'Brion, capital.
2. Compute O'Brion's current ratio and debt ratio at August 31, 2012. One year ago, the current ratio was 1.49 and the debt ratio was 0.29. Indicate whether O'Brion's ability to pay current and total debts has improved, deteriorated, or remained the same during the current year.

• Problems (Group A)

P4-24A ① ② **Preparing a worksheet and the financial statements [40–50 min]**

The trial balance and adjustment data of Myla's Motors at November 30, 2012, follow:

MYLA'S MOTORS Trial Balance November 30, 2012		
	Balance	
Account	Debit	Credit
Cash	$ 4,300	
Accounts receivable	26,600	
Supplies	500	
Prepaid insurance	1,700	
Equipment	53,500	
Accumulated depreciation		$36,400
Accounts payable		13,400
Wages payable		
Unearned service revenue		8,000
Myla, capital		19,700
Myla, drawing	3,800	
Service revenue		16,000
Depreciation expense		
Wage expense	1,600	
Insurance expense		
Utilities expense	1,500	
Supplies expense		
Total	$93,500	$93,500

Additional data at November 30, 2012:

a. Depreciation on equipment, $1,100.
b. Accrued wage expense, $600.
c. Supplies on hand, $200.
d. Prepaid insurance expired during November, $200.
e. Unearned service revenue earned during November, $4,000.
f. Accrued service revenue, $800.

Requirements

1. Complete Myla's worksheet for November. Key adjusting entries by letter.
2. Prepare the income statement, the statement of owner's equity, and the classified balance sheet in account form for the month ended November 30, 2012.

P4-25A ❶❷❸ **Preparing a worksheet, financial statements, and closing entries [50–60 min]**

The trial balance of Fugazy Investment Advisers at December 31, 2012, follows:

FUGAZY INVESTMENT ADVISERS
Trial Balance
December 31, 2012

Account	Balance Debit	Balance Credit
Cash	$ 32,000	
Accounts receivable	46,000	
Supplies	3,000	
Equipment	25,000	
Accumulated depreciation		$ 11,000
Accounts payable		15,000
Salary payable		
Unearned service revenue		2,000
Note payable, long-term		39,000
Fugazy, capital		38,000
Fugazy, drawing	50,000	
Service revenue		97,000
Salary expense	32,000	
Supplies expense		
Depreciation expense		
Interest expense	3,000	
Rent expense	9,000	
Insurance expense	2,000	
Total	$202,000	$202,000

Adjustment data at December 31, 2012:

a. Unearned service revenue earned during the year, $500.
b. Supplies on hand, $1,000.
c. Depreciation for the year, $6,000.
d. Accrued salary expense, $1,000.
e. Accrued service revenue, $4,000.

Requirements

1. Enter the account data in the Trial Balance columns of a worksheet, and complete the worksheet through the Adjusted Trial Balance. Key each adjusting entry by the letter corresponding to the data given. Leave a blank line under Service revenue.
2. Prepare the income statement, the statement of owner's equity, and the classified balance sheet in account format.
3. Prepare closing journal entries from the worksheet.
4. Did the company have a good or a bad year during 2012? Give the reason for your answer.

P4-26A 1 2 3 4 5 6 **Completing the accounting cycle [120–150 min]**
The trial balance of Wolfe Anvils at October 31, 2012, and the data for the month-end adjustments follow:

WOLFE ANVILS
Trial Balance
October 31, 2012

Account	Balance Debit	Balance Credit
Cash	$ 4,300	
Accounts receivable	15,000	
Prepaid rent	2,700	
Supplies	1,600	
Equipment	31,200	
Accumulated depreciation		$ 3,000
Accounts payable		6,900
Salary payable		
Unearned service revenue		5,400
Wolfe, capital		26,600
Wolfe, drawing	3,500	
Service revenue		18,900
Salary expense	2,500	
Rent expense		
Depreciation expense		
Supplies expense		
Total	$60,800	$60,800

Adjustment data:

a. Unearned service revenue still unearned at October 31, $1,200.
b. Prepaid rent still in force at October 31, $2,500.
c. Supplies used during the month, $1,000.
d. Depreciation for the month, $300.
e. Accrued salary expense at October 31, $200.

Requirements

1. Prepare adjusting journal entries.
2. Enter the trial balance on a worksheet and complete the worksheet through the Adjusted Trial Balance of Wolfe Anvils for the month ended October 31, 2012.
3. Prepare the income statement, the statement of owner's equity, and the classified balance sheet in report form.
4. Using the worksheet data that you prepared, journalize the closing entries and post the adjusting and closing entries to T-accounts. Use dates and show the ending balance of each account.
5. Prepare a post-closing trial balance.
6. Calculate the current and debt ratios for the company.

P4-27A 1 2 3 4 5 6 **Completing the accounting cycle [120–150 min]**

The trial balance of Racer Internet at March 31, 2012, follows:

RACER INTERNET Trial Balance March 31, 2012		
	Balance	
Account	Debit	Credit
Cash	$ 4,300	
Accounts receivable	15,100	
Prepaid rent	2,300	
Supplies	1,000	
Equipment	30,600	
Accumulated depreciation		$ 3,900
Accounts payable		6,400
Salary payable		
Unearned service revenue		9,800
Racer, capital		23,000
Racer, drawing	4,100	
Service revenue		17,300
Salary expense	3,000	
Rent expense		
Depreciation expense		
Supplies expense		
Total	$60,400	$60,400

Adjusting data at March 31, 2012:

a. Unearned service revenue still unearned, $500.
b. Prepaid rent still in force, $2,000.
c. Supplies used during the month, $800.
d. Depreciation for the month, $400.
e. Accrued salary expense, $600.

Requirements

1. Journalize adjusting journal entries.
2. Enter the trial balance on a worksheet and complete the worksheet of Racer Internet.
3. Prepare the income statement, statement of owner's equity, and classified balance sheet in report form.
4. Using the worksheet data that you prepared, journalize the closing entries, and post the adjusting and closing entries to T-accounts. Use dates and show the ending balance of each account.
5. Prepare a post-closing trial balance.
6. Calculate the current and debt ratios for the company.

P4-28A **3** **Journalizing adjusting and closing entries [45–60 min]**
The *unadjusted* trial balance and adjustment data of Elias Real Estate Appraisal Company at June 30, 2012, follow:

ELIAS REAL ESTATE APPRAISAL COMPANY
Unadjusted Trial Balance
June 30, 2012

Account Title	Debit	Credit
Cash	$ 4,900	
Accounts receivable	4,000	
Supplies	3,000	
Prepaid insurance	2,200	
Building	74,400	
Accumulated depreciation		$ 18,800
Land	13,600	
Accounts payable		19,500
Interest payable		8,800
Salary payable		1,300
Elias, capital		30,800
Elias, drawing	27,900	
Service revenue		97,900
Salary expense	32,400	
Depreciation expense	0	
Insurance expense	4,200	
Utilities expense	4,000	
Supplies expense	6,500	
Total	$ 177,100	$ 177,100

Adjustment data at June 30, 2012:

a. Prepaid insurance expired, $300.
b. Accrued service revenue, $1,300.
c. Accrued salary expense, $900.
d. Depreciation for the year, $8,500.
e. Supplies used during the year, $600.

Requirements

1. Open T-accounts for Elias, capital and all the accounts that follow on the trial balance. Insert their unadjusted balances. Also open a T-account for Income summary, which has a zero balance.
2. Journalize the adjusting entries and post to the accounts that you opened. Show the balance of each revenue account and each expense account.
3. Journalize the closing entries and post to the accounts that you opened. Draw double underlines under each account balance that you close to zero.
4. Compute the ending balance of Elias, capital.

P4-29A 5 6 **Preparing a classified balance sheet in report form, and using the current and debt ratios to evaluate a company [30–40 min]**

Selected accounts of Blume Irrigation System at December 31, 2012, follow:

Insurance expense	$ 900	Accounts payable	$24,700
Note payable, long-term	2,800	Accounts receivable	43,100
Other assets	2,200	Accumulated depreciation—building	24,000
Building	55,800	Blume, capital, December 31, 2011	52,000
Prepaid insurance	4,000	Accumulated depreciation—equipment	7,900
Salary expense	16,300	Cash	11,000
Salary payable	3,900	Interest payable	400
Service revenue	74,800	Blume, drawing	2,000
Supplies	3,300	Equipment	23,000
Unearned service revenue	1,600	Depreciation expense	30,500

Requirements

1. Prepare the company's classified balance sheet in report form at December 31, 2012.
2. Compute the company's current ratio and debt ratio at December 31, 2012. At December 31, 2011, the current ratio was 1.81 and the debt ratio was 0.34. Did the company's ability to pay debts improve or deteriorate, or did it remain the same during 2012?

• Problems (Group B)

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P4-30B 1 2 **Preparing a worksheet and the financial statements [40–50 min]**

The trial balance and adjustment data of Brooke's Motors at September 30, 2012, follow:

BROOKE'S MOTORS
Trial Balance
September 30, 2012

Account	Balance Debit	Balance Credit
Cash	$ 4,200	
Accounts receivable	26,500	
Supplies	800	
Prepaid insurance	1,800	
Equipment	53,500	
Accumulated depreciation		$36,300
Accounts payable		13,300
Wages payable		
Unearned service revenue		8,500
Brooke, capital		19,000
Brooke, drawing	3,500	
Service revenue		16,500
Depreciation expense		
Wage expense	2,100	
Insurance expense		
Utilities expense	1,200	
Supplies expense		
Total	$93,600	$93,600

Additional data at September 30, 2012:

a. Depreciation on equipment, $1,100.
b. Accrued wage expense, $500.
c. Supplies on hand, $700.
d. Prepaid insurance expired during September, $200.
e. Unearned service revenue earned during September, $4,500.
f. Accrued service revenue, $900.

Requirements

1. Complete Brooke's worksheet for September. Key adjusting entries by letter.
2. Prepare the income statement, the statement of owner's equity, and the classified balance sheet in account form for the month ended September 30, 2012.

P4-31B **1 2 3 Preparing a worksheet, financial statements, and closing entries [50–60 min]**

The trial balance of Giambi Investment Advisers at December 31, 2012, follows:

GIAMBI INVESTMENT ADVISERS
Trial Balance
December 31, 2012

	Balance	
Account	Debit	Credit
Cash	$ 28,000	
Accounts receivable	50,000	
Supplies	8,000	
Equipment	26,000	
Accumulated depreciation		$ 16,000
Accounts payable		14,000
Salary payable		
Unearned service revenue		1,000
Note payable, long-term		44,000
Giambi, capital		40,000
Giambi, drawing	50,000	
Service revenue		97,000
Salary expense	32,000	
Supplies expense		
Depreciation expense		
Interest expense	7,000	
Rent expense	7,000	
Insurance expense	4,000	
Total	$212,000	$212,000

Adjustment data at December 31, 2012:

a. Unearned service revenue earned during the year, $500.
b. Supplies on hand, $5,000.
c. Depreciation for the year, $8,000.
d. Accrued salary expense, $1,000.
e. Accrued service revenue, $3,000.

Requirements

1. Enter the account data in the Trial Balance columns of a worksheet, and complete the worksheet through the Adjusted Trial Balance. Key each adjusting entry by the letter corresponding to the data given. Leave a blank line under Service revenue.
2. Prepare the income statement, the statement of owner's equity, and the classified balance sheet in account format.
3. Prepare closing journal entries from the worksheet.
4. Did the company have a good or a bad year during 2012? Give the reason for your answer.

P4-32B 1 2 3 4 5 6 **Completing the accounting cycle [120–150 min]**

The trial balance of Leopard Anvils at January 31, 2012, and the data for the month-end adjustments follow:

LEOPARD ANVILS
Trial Balance
January 31, 2012

Account	Balance Debit	Balance Credit
Cash	$ 4,400	
Accounts receivable	14,800	
Prepaid rent	2,300	
Supplies	1,200	
Equipment	30,100	
Accumulated depreciation		$ 4,600
Accounts payable		7,500
Salary payable		
Unearned service revenue		4,900
Leopard, capital		25,700
Leopard, drawing	4,800	
Service revenue		17,400
Salary expense	2,500	
Rent expense		
Depreciation expense		
Supplies expense		
Total	$60,100	$60,100

Adjustment data:

a. Unearned service revenue still unearned at January 31, $400.
b. Prepaid rent still in force at January 31, $1,800.
c. Supplies used during the month, $1,100.
d. Depreciation for the month, $400.
e. Accrued salary expense at January 31, $500.

Requirements

1. Prepare adjusting journal entries.
2. Enter the trial balance on a worksheet and complete the worksheet through the Adjusted Trial Balance of Leopard Anvils for the month ended January 31, 2012.
3. Prepare the income statement, the statement of owner's equity, and the classified balance sheet in report form.

4. Using the worksheet data that you prepared, journalize and post the adjusting and closing entries to T-accounts. Use dates and show the ending balance of each account.
5. Prepare a post-closing trial balance.
6. Calculate the current and debt ratios for the company.

P4-33B 1 2 3 4 5 6 **Completing the accounting cycle [120–150 min]**
The trial balance of Road Runner Internet at July 31, 2012, follows:

ROAD RUNNER INTERNET
Trial Balance
July 31, 2012

	Balance	
Account	Debit	Credit
Cash	$ 4,200	
Accounts receivable	14,600	
Prepaid rent	2,000	
Supplies	1,600	
Equipment	30,900	
Accumulated depreciation		$ 3,900
Accounts payable		6,700
Salary payable		
Unearned service revenue		5,400
Runner, capital		25,800
Runner, drawing	3,200	
Service revenue		17,700
Salary expense	3,000	
Rent expense		
Depreciation expense		
Supplies expense		
Total	$59,500	$59,500

Adjusting data at July 31, 2012:

a. Unearned service revenue still unearned, $1,200.
b. Prepaid rent still in force at July 31, $1,900.
c. Supplies used during the month, $800.
d. Depreciation for the month, $300.
e. Accrued salary expense at July 31, $500.

Requirements

1. Journalize adjusting journal entries.
2. Enter the trial balance on a worksheet and complete the worksheet for Road Runner Internet.
3. Prepare the income statement, statement of owner's equity, and classified balance sheet in report form.
4. Using the worksheet data that you prepared, journalize the closing entries and post the adjusting and closing entries to T-accounts. Use dates and show the ending balance of each account.
5. Prepare a post-closing trial balance.
6. Calculate the current and debt ratios for the company.

P4-34B ③ **Journalizing adjusting and closing entries [45–60 min]**
The *unadjusted* trial balance and adjustment data of Smith Real Estate Appraisal Company at June 30, 2012, follow:

SMITH REAL ESTATE APPRAISAL COMPANY Unadjusted Trial Balance June 30, 2012		
Account Title	Debit	Credit
Cash	$ 4,600	
Accounts receivable	3,500	
Supplies	3,000	
Prepaid insurance	2,100	
Building	74,700	
Accumulated depreciation		$ 18,600
Land	14,000	
Accounts payable		18,900
Interest payable		8,000
Salary payable		600
Smith, capital		33,000
Smith, drawing	27,000	
Service revenue		97,500
Salary expense	32,100	
Depreciation expense	0	
Insurance expense	5,100	
Utilities expense	3,600	
Supplies expense	6,900	
Total	$ 176,600	$ 176,600

Adjustment data at June 30, 2012:

a. Prepaid insurance expired, $400.
b. Accrued service revenue, $1,100.
c. Accrued salary expense, $700.
d. Depreciation for the year, $8,500.
e. Supplies used during the year, $100.

Requirements

1. Open T-accounts for Smith, capital and all the accounts that follow on the trial balance. Insert their unadjusted balances. Also open a T-account for Income summary, which has a zero balance.
2. Journalize the adjusting entries and post to the accounts that you opened. Show the balance of each revenue account and each expense account.
3. Journalize the closing entries and post to the accounts that you opened. Draw double underlines under each account balance that you close to zero.
4. Compute the ending balance of Smith, capital.

P4-35B 5 6 **Preparing a classified balance sheet in report form, and using the current and debt ratios to evaluate a company [30–40 min]**

Selected accounts of Browne Irrigation Systems at December 31, 2012, follow:

Insurance expense	$ 500	Accounts payable	$22,300
Note payable, long-term	4,200	Accounts receivable	43,600
Other assets	2,000	Accumulated depreciation—building	24,200
Building	58,200	Browne, capital, December 31, 2011	54,000
Prepaid insurance	4,800	Accumulated depreciation—equipment	6,900
Salary expense	17,700	Cash	6,500
Salary payable	2,800	Interest payable	400
Service revenue	73,000	Browne, drawing	5,000
Supplies	3,300	Equipment	23,000
Unearned service revenue	1,800	Depreciation expense	25,000

Requirements

1. Prepare the company's classified balance sheet in report form at December 31, 2012.
2. Compute the company's current ratio and debt ratio at December 31, 2012. At December 31, 2011, the current ratio was 1.83 and the debt ratio was 0.39. Did the company's ability to pay debts improve or deteriorate, or did it remain the same during 2012?

• Continuing Exercise

E4-36 1 3 **Preparing a worksheet and closing entries [30–45 min]**

This exercise continues the Lawlor Lawn Service situation from Exercise 3-48 of Chapter 3. Start from the posted T-accounts and the *adjusted* trial balance for Lawlor Lawn Service prepared for the company at May 31, 2012:

Requirements

1. Complete the accounting worksheet at May 31, 2012.
2. Journalize and post the closing entries at May 31, 2012. Denote each closing amount as *Clo* and an account balance as *Bal.*

• Continuing Problem

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This problem continues the Draper Consulting situation from Problem 3-49 of Chapter 3.

P4-37 **1 3 5 Preparing a worksheet, preparing closing entries, and preparing a classified balence sheet [45–60 min]**

Start from the posted T-accounts and the *adjusted* trial balance that Draper Consulting prepared for the company at December 31:

DRAPER CONSULTING
Adjusted Trial Balance
December 31, 2012

	Balance	
Account Title	Debit	Credit
Cash	$16,350	
Accounts receivable	1,750	
Supplies	200	
Equipment	1,800	
Accumulated depreciation—equipment		$ 30
Furniture	4,200	
Accumulated depreciation—furniture		70
Accounts payable		4,650
Salary payable		685
Unearned service revenue		700
Draper, capital		18,000
Draper, drawing	1,400	
Service revenue		3,850
Rent expense	550	
Utilities expense	250	
Salary expense	685	
Depreciation expense—equipment	30	
Depreciation expense—furniture	70	
Supplies expense	700	
Total	$27,985	$27,985

Requirements

1. Complete the accounting worksheet at December 31.
2. Journalize and post the closing entries at December 31. Denote each closing amount as *Clo* and an account balance as *Bal*.
3. Prepare a classified balance sheet at December 31.

• Practice Set

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1 2 3 4 Preparing a worksheet, preparing financial statements, preparing closing entries, and preparing a post-closing trial balance [60–75 min]

Refer to the Practice Set data provided in Chapters 1, 2, and 3.

Requirements

1. Prepare an accounting worksheet.
2. Prepare an income statement, statement of owner's equity, and balance sheet using the report format.
3. Prepare closing entries for the month.
4. Prepare a post-closing trial balance.

Apply Your Knowledge

Decision Case 4-1

One year ago, Ralph Collins founded Collins Consignment Sales Company, and the business has prospered. Collins comes to you for advice. He wishes to know how much net income the business earned during the past year. The accounting records consist of the T-accounts in the ledger, which were prepared by an accountant who has moved. The accounts at December 31 follow:

Account	Debit	Credit
Cash	Dec 31 Bal 5,800	
Accounts receivable	Dec 31 Bal 12,300	
Prepaid rent	Jan 2 2,800	
Supplies	Jan 2 2,600	
Equipment	Jan 2 52,000	
Accumulated depreciation		
Accounts payable		Dec 31 Bal 18,500
Salary payable		
Unearned service revenue		Dec 31 Bal 4,100
Collins, capital		Jan 2 40,000
Collins, drawing	Dec 31 Bal 50,000	
Service revenue		Dec 31 Bal 80,700
Salary expense	Dec 31 Bal 17,000	
Depreciation expense		
Advertising expense		
Utilities expense	Dec 31 Bal 800	
Supplies expense		

Collins indicates that, at year-end, customers owe him $1,000 accrued service revenue, which he expects to collect early next year. These revenues have not been recorded. During the year, he collected $4,100 service revenue in advance from customers, but the business has earned only $800 of that amount. During the year he has incurred $2,400 of advertising expense, but he has not yet paid for it. In addition, he has used up $2,100 of the supplies. Collins determines that depreciation on equipment was $7,000 for the year. At December 31, he owes his employee $1,200 accrued salary. The owner made no capital investments during the year.

Collins expresses concern that drawing during the year might have exceeded the business's net income. To get a loan to expand the business, Collins must show the bank that the business's owner's equity has grown from its original $40,000 balance. Has it? You and Collins agree that you will meet again in one week.

Requirement

1. Prepare the financial statement that helps address the first issue concerning Collins. Can he expect to get the loan? Give your reason(s).

Ethical Issue 4-1

Link Back to Chapter 3 (Revenue Principle). Grant Film Productions wishes to expand and has borrowed $100,000. As a condition for making this loan, the bank requires that the business maintain a current ratio of at least 1.50.

Business has been good but not great. Expansion costs have brought the current ratio down to 1.40 on December 15. Rita Grant, owner of the business, is considering what might happen if she reports a current ratio of 1.40 to the bank. One course of action for Grant is to record in December $10,000 of revenue that the business will earn in January of next year. The contract for this job has been signed.

Requirements

1. Journalize the revenue transaction, and indicate how recording this revenue in December would affect the current ratio.
2. Discuss whether it is ethical to record the revenue transaction in December. Identify the accounting principle relevant to this situation, and give the reasons underlying your conclusion.

• Fraud Case 4-1

Arthur Chen, a newly minted CPA, was on his second audit job in the Midwest with a new client called Parson Farm Products. He was looking through the last four years of financials, and doing a few ratios, when he noticed something odd. The current ratio went from 1.9 in 2007 down to 0.3 in 2008, despite the fact that 2008 had record income. He decided to sample a few transactions from December 2008. He found that many of Parson's customers had returned products to the company because of substandard quality. Chen discovered that the company was clearing the receivables (i.e., crediting accounts receivable) but "stashing" the debits in an obscure long-term asset account called "grain reserves" to keep the company's income "in the black" (i.e., positive income).

Requirements

1. How did the fraudulent accounting just described affect the current ratio? (Hint: Think about Cash.)
2. Can you think of any reasons why someone in the company would want to take this kind of action?

• Financial Statement Case 4-1

This case, based on the balance sheet of **Amazon.com** in Appendix A at the end of the book, will familiarize you with some of the assets and liabilities of that company. Use the **Amazon.com** balance sheet to answer the following questions.

Requirements

1. Which balance sheet format does **Amazon.com** use?
2. Name the company's largest current asset and largest current liability at December 31, 2009.
3. Compute **Amazon's** current ratios at December 31, 2009 and 2008. Did the current ratio improve, worsen, or hold steady during 2009?
4. Under what category does **Amazon** report furniture, fixtures, and equipment?
5. What was the cost of the company's fixed assets at December 31, 2009? What was the amount of accumulated depreciation? What was the book value of the fixed assets? See Note 3 for the data.

• Team Project 4-1

Kathy Wintz formed a lawn service business as a summer job. To start the business on May 1, she deposited $1,000 in a new bank account in the name of the business. The $1,000 consisted of a $600 loan from Bank One to her company, Wintz Lawn Service, and $400 of her own money. The company gave $400 of capital to Wintz. Wintz rented lawn equipment, purchased supplies, and hired other students to mow and trim customers' lawns.

At the end of each month, Wintz mailed bills to the customers. On August 31, she was ready to dissolve the business and return to college. Because she was so busy, she kept few records other than the checkbook and a list of receivables from customers.

At August 31, the business's checkbook shows a balance of $2,000, and customers still owe $750. During the summer, the business collected $5,500 from customers. The business checkbook lists payments for supplies totaling $400, and it still has gasoline, weed eater cord, and other supplies that cost a total of $50. The business paid employees $1,800 and still owes them $300 for the final week of the summer.

Wintz rented some equipment from Ludwig's Machine Shop. On May 1, the business signed a six-month rental agreement on mowers and paid $600 for the full rental period in advance. Ludwig's will refund the unused portion of the prepayment if the equipment is returned in good shape. In order to get the refund, Wintz has kept the mowers in excellent condition. In fact, the business had to pay $300 to repair a mower.

To transport employees and equipment to jobs, Wintz used a trailer that the business bought for $300. The business estimates that the summer's work used up one-third of the trailer's service potential. The business checkbook lists a payment of $500 for cash withdrawals during the summer. The business paid the loan back during August. (For simplicity, ignore any interest expense associated with the loan.)

Requirements

1. Prepare the income statement and the statement of owner's equity of Wintz Lawn Service for the four months May through August.
2. Prepare the classified balance sheet of Wintz Lawn Service at August 31.
3. Was Wintz's summer work successful? Give the reason for your answer.

• Communication Activity 4-1

In 25 words or fewer, explain the rationale for closing the temporary accounts.

Quick Check Answers

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

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Comprehensive Problem for Chapters 1–4

Journalizing, Posting, Worksheet, Adjusting, Closing, and the Financial Statements

Matthews Delivery Service completed the following transactions during its first month of operations for January 2012:

a. Matthews Delivery Service began operations by receiving $6,000 cash and a truck valued at $11,000. The business gave Matthews capital to aquire these assets.

b. Paid $300 cash for supplies.

c. Prepaid insurance, $700.

d. Performed delivery services for a customer and received $800 cash.

e. Completed a large delivery job, billed the customer $1,500, and received a promise to collect the $1,500 within one week.
f. Paid employee salary, $700.
g. Received $12,000 cash for performing delivery services.
h. Collected $600 in advance for delivery service to be performed later.
i. Collected $1,500 cash from a customer on account.
j. Purchased fuel for the truck, paying $200 with a company credit card. (Credit Accounts payable)
k. Performed delivery services on account, $900.
l. Paid office rent, $600. This rent is not paid in advance.
m. Paid $200 on account.
n. Owner withdrew cash of $2,100.

Requirements

1. Record each transaction in the journal. Key each transaction by its letter. Explanations are not required.
2. Post the transactions that you recorded in Requirement 1 in the T-accounts.

Cash	Service revenue
Accounts receivable	Salary expense
Supplies	Depreciation expense
Prepaid insurance	Insurance expense
Delivery truck	Fuel expense
Accumulated depreciation	Rent expense
Accounts payable	Supplies expense
Salary payable	
Unearned service revenue	
Matthews, capital	
Matthews, drawing	
Income summary	

3. Enter the trial balance in the worksheet for the month ended January 31, 2012. Complete the worksheet using the adjustment data given at January 31.
   a. Accrued salary expense, $700.
   b. Depreciation expense, $60.
   c. Prepaid insurance expired, $250.
   d. Supplies on hand, $200.
   e. Unearned service revenue earned during January, $500.
4. Prepare Matthews Delivery Service's income statement and statement of owner's equity for the month ended January 31, 2012, and the classified balance sheet on that date. On the income statement, list expenses in decreasing order by amount—that is, the largest expense first, the smallest expense last.
5. Journalize and post the adjusting entries beginning with a.
6. Journalize and post the closing entries.
7. Prepare a post-closing trial balance at January 31, 2012.