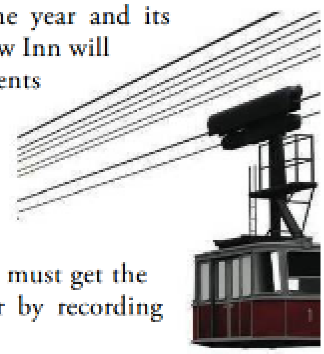
Completing the Accounting Cycle

4

It's the End of the Year, Now What?

The Bear Paw Inn just celebrated its one-year anniversary. Christina Merthieu, owner, is excited that she has one year of experience running a successful business. Although her previous job of working as a resort manager has helped her in dealing with customers, she has had to learn a lot about the accounting side of the business. Christina attributes her first-year success to always offering exceptional quality and personal service to her customers. In addition, Christina found a great accountant who has been helping her with the books.

From the beginning, Christina relied on her accountant to provide advice about recording transactions throughout the year. Now that the first year of business has been completed, she is ready to perform the final accounting tasks of the year. Christina's accountant has told her that she can now prepare financial statements to help her evaluate the inn's profit for the year and its financial position. Bear Paw Inn will use those financial statements to assess the business's performance over the past year. The business is also ready to start the next year of business, and in order to do this, Christina must get the books ready for next year by recording closing entries.



What Happens at Year-End?

As we saw with Christina and the Bear Paw Inn, businesses have special tasks that have to be completed at the end of the accounting cycle. These tasks help the business in evaluating the past year's operations and also prepare the business to start a new year. For example, Four Seasons Hotels and Resorts must prepare annual financial statements that report on the business's profit or loss for the year and its financial position at the end of the year. In addition, Four Seasons must prepare its books for next year—a process that is called closing the books, which consists of journalizing closing entries and updating the equity accounts for the year. These final tasks in the accounting cycle are what you learn about in this chapter.

In Chapter 3, our fictitious company, Smart Touch Learning, had completed the adjusting entries necessary to properly measure net income on the income statement and assets and liabilities on the balance sheet. Now that its accounts are up to date, Smart Touch Learning is ready to take the next step in the accounting cycle—preparing the financial statements. In this chapter, you review the financial statements that you have already learned about and learn how to prepare a more complete version of the balance sheet. In addition, you complete the accounting cycle by learning how to close the books.

HOW DO WE PREPARE FINANCIAL STATEMENTS?

Learning Objective 1
Prepare the financial statements including the classified balance sheet

IFRS

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

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

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

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

Exhibit 4-1 | **Adjusted Trial Balance**

SMART TOUCH LEARNING Adjusted Trial Balance December 31, 2016			
	Balance		
Account Title	**Debit**	**Credit**	
Cash	$ 12,200		
Accounts Receivable	1,800		
Office Supplies	100		
Prepaid Rent	2,000		
Furniture	18,000		
Accumulated Depreciation—Furniture		$ 300	
Building	60,000		
Accumulated Depreciation—Building		250	3. Balance Sheet Accounts
Land	20,000		
Accounts Payable		200	
Utilities Payable		100	
Salaries Payable		1,200	
Interest Payable		100	
Unearned Revenue		400	
Notes Payable		60,000	
Bright, Capital		48,000	2. Statement of Owner's Equity Accounts
Bright, Withdrawals	5,000		
Service Revenue		17,500	
Rent Expense	3,000		
Salaries Expense	4,800		
Supplies Expense	400		1. Income Statement Accounts
Utilities Expense	100		
Depreciation Expense—Furniture	300		
Depreciation Expense—Building	250		
Interest Expense	100		
Total	**$ 128,050**	**$ 128,050**	

The financial statements for Smart Touch Learning are presented in Exhibit 4-2 (on the next page).

Relationships Among the Financial Statements

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

1. Net income from the income statement increases capital. A net loss decreases capital.
2. Ending Owner, Capital from the statement of owner's equity goes to the balance sheet and makes total liabilities plus owner's equity equal total assets, satisfying the accounting equation.

To solidify your understanding of these relationships, trace net income from the income statement to the statement of owner's equity. Then trace ending Owner, Capital to the

Exhibit 4-2 | Smart Touch Learning Financial Statements

SMART TOUCH LEARNING Income Statement Two Months Ended December 31, 2016		
Revenues:		
Service Revenue		$ 17,500
Expenses:		
Salaries Expense	$ 4,800	
Rent Expense	3,000	
Supplies Expense	400	
Depreciation Expense—Furniture	300	
Depreciation Expense—Building	250	
Utilities Expense	100	
Interest Expense	100	
Total Expenses		8,950
Net Income		**$ 8,550**

SMART TOUCH LEARNING Statement of Owner's Equity Two Months Ended December 31, 2016	
Bright, Capital, November 1, 2016	$ 0
Owner contribution	48,000
Net income for the two months	8,550
	56,550
Owner withdrawal	(5,000)
Bright, Capital, December 31, 2016	**$ 51,550**

1

2

SMART TOUCH LEARNING Balance Sheet December 31, 2016				
Assets			**Liabilities**	
Cash		$ 12,200	Accounts Payable	$ 200
Accounts Receivable		1,800	Utilities Payable	100
Office Supplies		100	Salaries Payable	1,200
Prepaid Rent		2,000	Interest Payable	100
Furniture	$ 18,000		Unearned Revenue	400
Less: Acc. Depr.—Furniture	(300)	17,700	Notes Payable	60,000
Building	60,000		Total Liabilities	62,000
Less: Acc. Depr.—Building	(250)	59,750		
Land		20,000	**Owner's Equity**	
			Bright, Capital	51,550
Total Assets		**$ 113,550**	Total Liabilities and Owner's Equity	**$ 113,550**

balance sheet. Note that these are the three main financial statements you learned about in the first chapter. They are always prepared in the order described previously: income statement, then statement of owner's equity, and then balance sheet.

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

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

Classified Balance Sheet

So far we have presented the *unclassified* balance sheet of Smart Touch Learning. We are now ready for the balance sheet that is actually used in practice—called a **classified balance sheet**. In a classified balance sheet, each asset and each liability are placed into a specific category or classification.

In a classified balance sheet, assets are shown in order of liquidity and liabilities are classified as either *current* (within one year) or *long-term* (more than one year). **Liquidity** measures how quickly and easily an account can be converted to cash (because cash is the most liquid asset). Accounts Receivable are relatively liquid because receivables are collected quickly. Office Supplies are less liquid, and Furniture and Buildings are even less so because they take longer to convert to cash or to be used up.

Assets

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

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

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

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

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

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

Plant Assets Another category of long-term assets is **plant assets** (also called *fixed assets* or *property, plant, and equipment*). Land, Buildings, Furniture, and Equipment used in operations are plant assets. Plant assets are also presented in order of liquidity, with assets such as Furniture and Equipment being presented first and Land presented last.

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

Liabilities

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

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

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

Owner's Equity

Owner's equity represents the owner's claim to the assets of the business. The owner's equity section reported on the balance sheet is transferred from the ending balance of the Owner, Capital account on the statement of owner's equity. The equity balance reflects the owner's contributions, net income or net loss of the business, and owner's withdrawals. It represents the amount of assets that is left over after the company has paid its liabilities.

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

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

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

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

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

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

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

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

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

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

Exhibit 4-3 | Classified Balance Sheet

This classified balance sheet only includes two asset categories: Current Assets and Plant Assets. Other categories that could be included in a company's asset section are Long-Term Investments and Intangible Assets.

SMART TOUCH LEARNING Balance Sheet December 31, 2016			
Assets			
Current Assets:			
Cash		$ 12,200	
Accounts Receivable		1,800	
Office Supplies		100	
Prepaid Rent		2,000	
Total Current Assets			$ 16,100
Plant Assets:			
Furniture	$ 18,000		
Less: Accumulated Depreciation—Furniture	(300)	17,700	
Building	60,000		
Less: Accumulated Depreciation—Building	(250)	59,750	
Land		20,000	
Total Plant Assets			97,450
Total Assets			**$ 113,550**
Liabilities			
Current Liabilities:			
Accounts Payable		$ 200	
Utilities Payable		100	
Salaries Payable		1,200	
Interest Payable		100	
Unearned Revenue		400	
Total Current Liabilities			$ 2,000
Long-term Liabilities:			
Notes Payable			60,000
Total Liabilities			62,000
Owner's Equity			
Bright, Capital			51,550
Total Liabilities and Owner's Equity			**$ 113,550**

HOW COULD A WORKSHEET HELP IN PREPARING FINANCIAL STATEMENTS?

Learning Objective 2
Use the worksheet to prepare financial statements

Previously you learned how a worksheet can be used to help prepare adjusting entries. Now you'll learn how the worksheet can be used to help in the preparation of financial statements. Exhibit 4-4 (on the next page) shows the completed worksheet for Smart Touch Learning. Sections 1 through 4 of the worksheet, shown with a purple background, were completed in Chapter 3. You are now ready to complete the remaining sections that will help in preparing the financial statements.

Section 5—Income Statement

The income statement section includes only revenue and expense accounts. The revenues and expenses from the adjusted trial balance section will be transferred into the appropriate column in the income statement section. For example, the $17,500 credit balance for Service Revenue in the adjusted trial balance section will be carried over into the credit column in the income statement section. Each debit and credit column will then be totaled.

Section 6—Balance Sheet

The balance sheet section includes the asset and liability accounts and all equity accounts except revenues and expenses. The balance of each of these accounts will be transferred from the adjusted trial balance section of the worksheet to the appropriate column in the balance sheet section. For example, Accumulated Depreciation—Furniture, a contra-asset, has a $300 credit balance in the adjusted trial balance section. This amount will be reported as a credit of $300 in the balance sheet section. Each debit and credit column will then be totaled.

Section 7—Determine Net Income or Net Loss

Compute net income or net loss as total revenues minus total expenses ($17,500 – $8,950). Enter net income (loss) as the balancing amount in the income statement and balance sheet sections. If net income exists, the balance will be entered in the *debit* column of the

Exhibit 4-4 | **Completed Worksheet**

	A	B	C	D	E	F	G	H	I	J	K	L	M
1	SMART TOUCH LEARNING												
2	Worksheet												
3	December 31, 2016												
4													
5	Account Names	Unadjusted Trial Balance			Adjustments			Adjusted Trial Balance		Income Statement		Balance Sheet	
6		Debit	Credit		Debit	Credit		Debit	Credit	Debit	Credit	Debit	Credit
7	Cash	$ 12,200						$ 12,200				$ 12,200	
8	Accounts Receivable	1,000		(h)	$ 800			1,800				1,800	
9	Office Supplies	500				$ 400	(b)	100				100	
10	Prepaid Rent	3,000				1,000	(a)	2,000				2,000	
11	Furniture	18,000						18,000				18,000	
12	Accumulated Depreciation—Furniture					300	(c)		$ 300				$ 300
13	Building	60,000						60,000				60,000	
14	Accumulated Depreciation—Building					250	(d)		250				250
15	Land	20,000						20,000				20,000	
16	Accounts Payable		$ 200						200				200
17	Utilities Payable		100						100				100
18	Salaries Payable					1,200	(f)		1,200				1,200
19	Interest Payable					100	(g)		100				100
20	Unearned Revenue		600	(e)	200				400				400
21	Notes Payable		60,000						60,000				60,000
22	Bright, Capital		48,000						48,000				48,000
23	Bright, Withdrawals	5,000						5,000				5,000	
24	Service Revenue		16,500			1,000	(e,h)		17,500		$ 17,500		
25	Rent Expense	2,000		(a)	1,000			3,000		$ 3,000			
26	Salaries Expense	3,600		(f)	1,200			4,800		4,800			
27	Supplies Expense			(b)	400			400		400			
28	Utilities Expense	100						100		100			
29	Depreciation Expense—Furniture			(c)	300			300		300			
30	Depreciation Expense—Building			(d)	250			250		250			
31	Interest Expense			(g)	100			100		100			
32	Total	$ 125,400	$ 125,400		$ 4,250	$ 4,250		$ 128,050	$ 128,050	$ 8,950	$ 17,500	$ 119,100	$ 110,550
33									Net Income	8,550			8,550
34	Total									$ 17,500	$ 17,500	$ 119,100	$ 119,100
35													

Section 5

Section 6

Section 7

Sections 1–4

Net Income = $17,500 − $8,950

What if Smart Touch Learning had a net loss instead of net income? Would the amount of net loss be entered in the debit column of the income statement section and the credit column of the balance sheet section?

income statement section and the *credit* column of the balance sheet section. For example, Smart Touch Learning has net income of $8,550. This amount should be entered as a debit in the income statement section and a credit in the balance sheet section.

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). The main thing to remember is that the net income or net loss is the balancing amount on the worksheet. It should always be entered on the side that makes the debit and credit columns balance.

Smart Touch Learning has now completed the worksheet as of December 31. Remember that the worksheet is an internal tool that can be used to help in recording adjusting entries and preparing financial statements. The adjusting entries still need to be recorded in the journal and posted to the ledger (as shown in Chapter 3), and the financial statements must still be prepared (as shown in Exhibits 4-2 and 4-3).

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

Learning Objective 3

Explain the purpose of, journalize, and post closing entries

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

Closing Process

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

Recall that the income statement reports net income for a specific period. For example, Smart Touch Learning's net income for the two months ended December 31, 2016, relates exclusively to November and December, 2016. At December 31, 2016, Smart Touch Learning closes its revenue and expense accounts for the last two months of the year. For this reason, revenues and expenses are called **temporary accounts** (also known as *nominal accounts*). For example, Smart Touch Learning's balance of Service Revenue at December 31, 2016, is $17,500. This balance relates exclusively to the last two months of 2016 and must be zeroed out before the company records revenue for the next year. Similarly, the various expense account balances are for the last two months of 2016 only and must also be zeroed out at the end of the year.

Temporary Account

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

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

Permanent Account
An account that is *not* closed at the end of the period—the asset, liability, and Owner, Capital accounts.

Closing Entries
Entries that transfer the revenues, expenses, and Owner, Withdrawals balances to the Owner, Capital account to prepare the company's books for the next period.

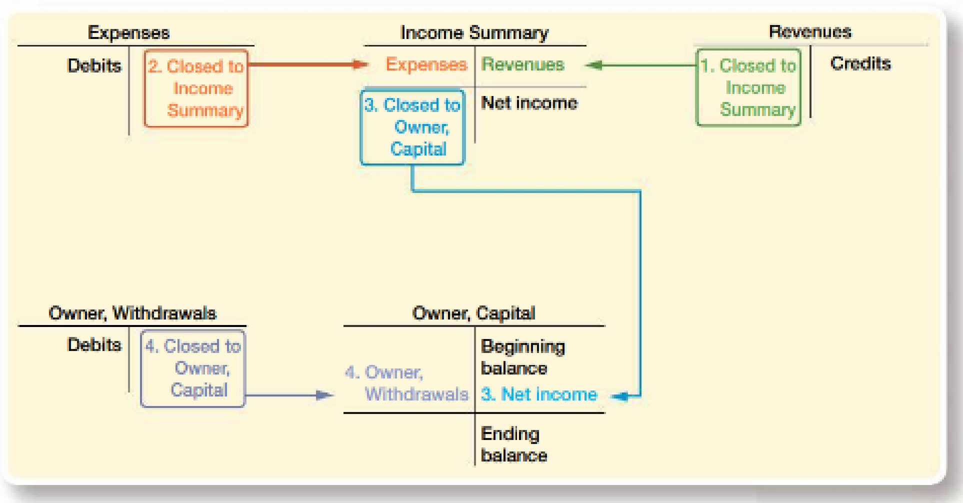
Income Summary
A temporary account into which revenues and expenses are transferred prior to their final transfer into the Owner, Capital account. Summarizes net income (or net loss) for the period.

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

Closing entries transfer the revenues, expenses, and Owner, Withdrawals balances to the Owner, Capital account to prepare the company's books for the next period. This transfer to the Owner, Capital account also causes the Owner, Capital ledger account to now equal its balance reported on the Balance Sheet.

As an intermediate step, the revenues and the expenses may be transferred first to an account titled **Income Summary**. The Income Summary account *summarizes* the net income (or net loss) for the period by collecting the sum of all the expenses (a debit) and the sum of all the revenues (a credit). The Income Summary account is like a temporary "holding tank" that shows the amount of net income or net loss of the current period. Its ending balance—net income or net loss—is then transferred (closed) to the Owner, Capital account (the final account in the closing process). Exhibit 4-5 summarizes the closing process.

Exhibit 4-5 | **The Closing Process**



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

Closing Temporary Accounts—Net Income for the Period

As stated previously, all temporary accounts are closed (zeroed out) during the closing process. Revenue, expenses, and Owner, Withdrawals accounts are not permanent. Only the balance sheet accounts are permanent. The four steps in closing the books follow (and are illustrated in Exhibit 4-6).

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

For example, Smart Touch Learning has a $17,500 credit balance in Service Revenue. To close this account (make it zero), we *debit* Service Revenue and *credit* Income Summary.

Service Revenue

		17,500	Adj. Bal.
Clos. 1	17,500		
		0	Bal.

Income Summary

		17,500	Clos. 1

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

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

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

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

Rent Expense

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

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

A	=	L	+	E↑↓
				Income Summary↓ Expenses↓

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

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

Income Summary

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

Step 3: Make the Income Summary account equal zero via the Owner, Capital account. This closing entry transfers net income (or net loss) to the Owner, Capital account.

Smart Touch Learning has an $8,550 credit balance in the Income Summary account. This represents net income for the period. Net income will now be transferred to the Bright, Capital account. We will *debit* Income Summary and *credit* Bright, Capital. Notice that this closing entry, in effect, increases the Bright, Capital account for the net income of the period.

Income Summary

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

Net Income

Bright, Capital

		48,000	Adj. Bal.
		8,550	Clos. 3

A	=	L	+	E↑↓
				Income Summary↓ Bright, Capital↑

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

Step 4: Make the Owner, Withdrawals account equal zero via the Owner, Capital account. This entry transfers the withdrawals to the *debit* side of the Owner, Capital account.

Smart Touch Learning has a $5,000 debit balance in the Bright, Withdrawals account. This account will be closed with a *debit* to Bright, Capital and a *credit* to Bright, Withdrawals.

Bright, Capital

		48,000	Adj. Bal.
Clos. 4	5,000	8,550	Clos. 3
		51,550	Bal.

Bright, Withdrawals

Adj. Bal.	5,000		
		5,000	Clos. 4
Bal.	0		

Date	Accounts and Explanation	Debit	Credit
Dec. 31	Bright, Capital	5,000	
	Bright, Withdrawals		5,000
	To close withdrawals.		

A = L + E↑↓
Bright, Capital↓
Bright, Withdrawals↓

Closing Temporary Accounts—Net Loss for the Period

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

What if a business had a net loss for the period? Would the closing entries be the same?

Income Summary

Clos. 2	5,000	3,000	Clos. 1
Bal.	2,000		
		2,000	Clos. 3
		0	Bal.

Net Loss

Owner, Capital

Clos. 3	2,000	48,000	Adj. Bal.

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

A = L + E↑↓
Owner, Capital↓
Income Summary↑

Notice that the effect of this closing entry decreases Owner, Capital. This is because a net loss decreases the Owner, Capital account.

Exhibit 4-6 (on the next page) shows the complete closing process for Smart Touch Learning. Panel A gives the closing entries, and Panel B shows the accounts after posting. After the closing entries, Bright, Capital ends with a balance of $51,550. Trace this balance to the statement of owner's equity and then to the balance sheet in Exhibit 4-2.

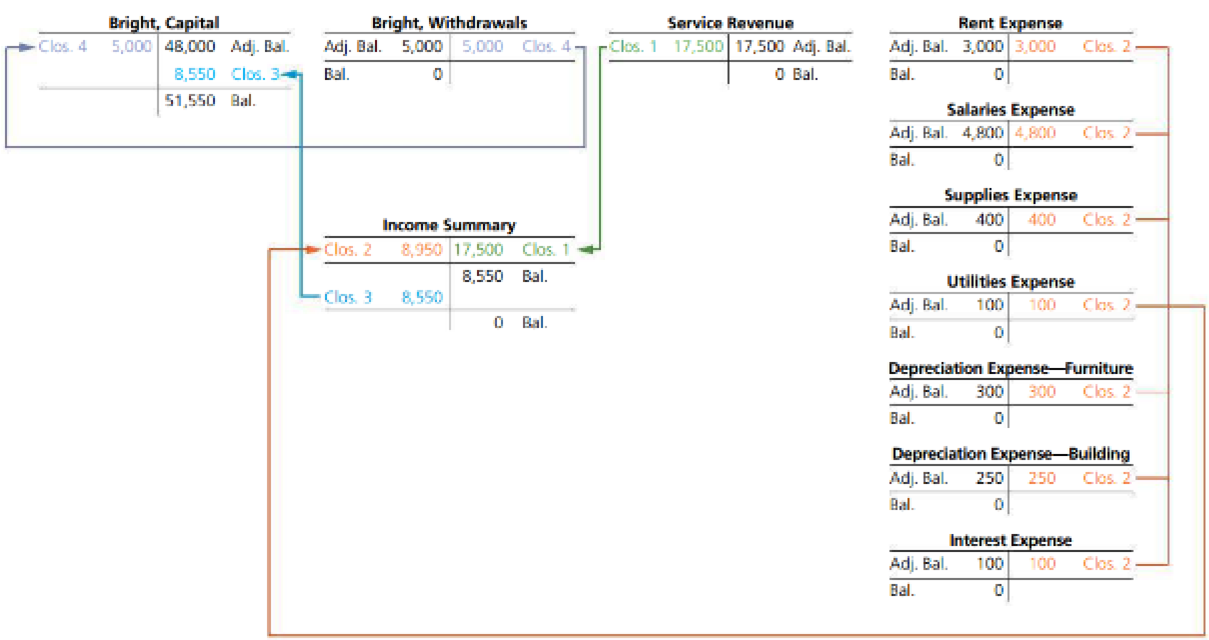
Exhibit 4-6 | **Journalizing and Posting Closing Entries**

Panel A: Journalizing

Date	Accounts and Explanation	Debit	Credit
Dec. 31	Service Revenue	17,500	
	Income Summary		17,500
	To close revenue.		
31	Income Summary	8,950	
	Rent Expense		3,000
	Salaries Expense		4,800
	Supplies Expense		400
	Utilities Expense		100
	Depreciation Expense—Furniture		300
	Depreciation Expense—Building		250
	Interest Expense		100
	To close expenses.		
31	Income Summary	8,550	
	Bright, Capital		8,550
	To close Income Summary.		
31	Bright, Capital	5,000	
	Bright, Withdrawals		5,000
	To close withdrawals.		

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

Panel B: Posting



HOW DO WE PREPARE A POST-CLOSING TRIAL BALANCE?

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

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

Learning Objective 4
Prepare the post-closing trial balance

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

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

Exhibit 4-7 | **Post-Closing Trial Balance**

SMART TOUCH LEARNING Post-Closing Trial Balance December 31, 2016		
	Balance	
Account Title	**Debit**	**Credit**
Cash	$ 12,200	
Accounts Receivable	1,800	
Office Supplies	100	
Prepaid Rent	2,000	
Furniture	18,000	
Accumulated Depreciation—Furniture		$ 300
Building	60,000	
Accumulated Depreciation—Building		250
Land	20,000	
Accounts Payable		200
Utilities Payable		100
Salaries Payable		1,200
Interest Payable		100
Unearned Revenue		400
Notes Payable		60,000
Bright, Capital		51,550
Total	**$ 114,100**	**$ 114,100**

Permanent Accounts

WHAT IS THE ACCOUNTING CYCLE?

We have now completed the accounting cycle for Smart Touch Learning. The **accounting cycle** is the process by which companies produce their financial statements for a specific period. It is the steps that are followed throughout the time period. The accounting cycle starts with the beginning asset, liability, and owner's equity account balances left over from the preceding period. Exhibit 4-8 outlines the complete accounting cycle of Smart Touch Learning and every other business. Start with Step 1 and move clockwise.

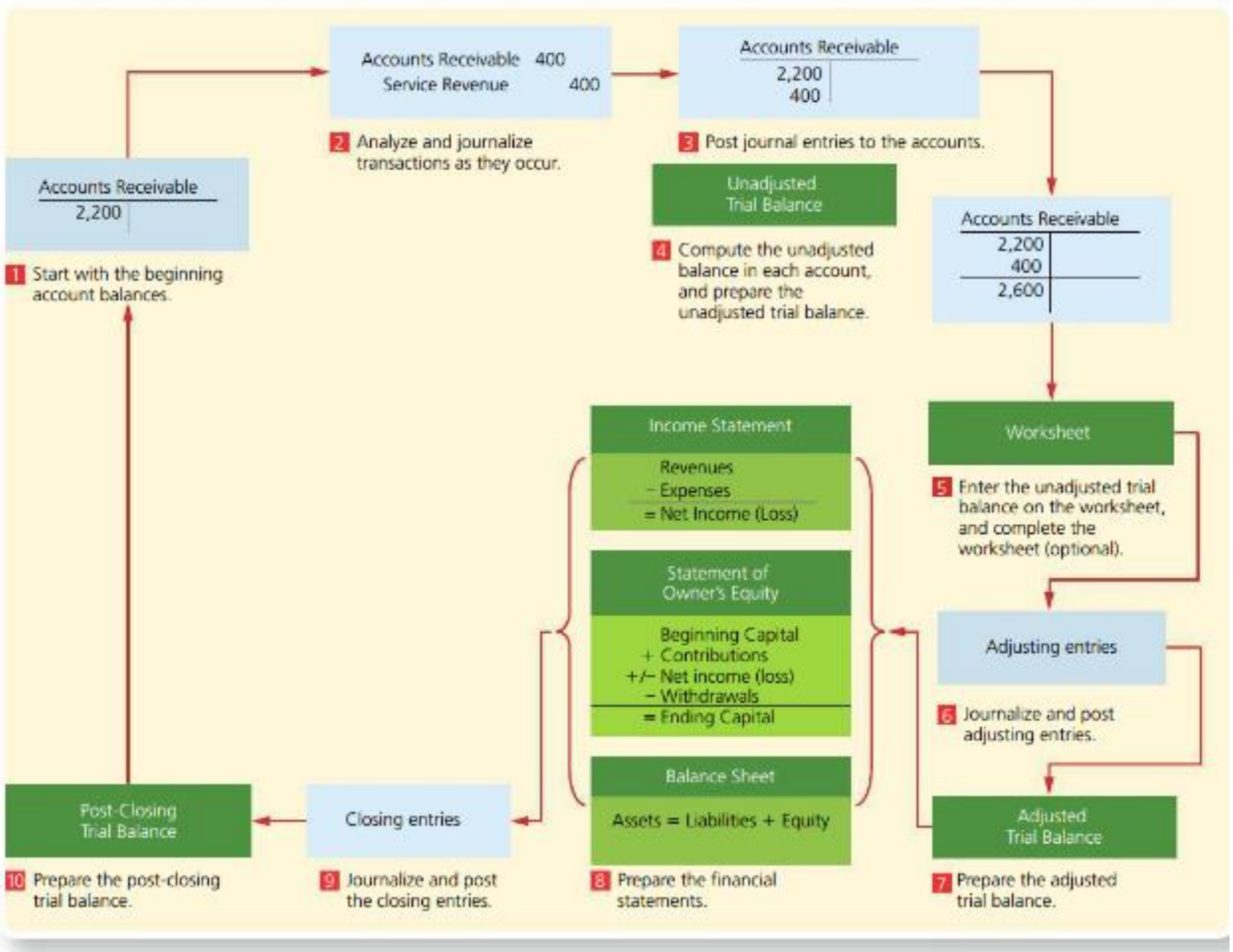
Accounting takes place at two different times:

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

Learning Objective 5
Describe the accounting cycle

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

Exhibit 4-8 | The Accounting Cycle



HOW DO WE USE THE CURRENT RATIO TO EVALUATE BUSINESS PERFORMANCE?

Learning Objective 6

Use the current ratio to evaluate business performance

Accounting is designed to provide information that business owners, managers, and lenders can use to make decisions. A bank considering lending money to a business must predict whether that business can repay the loan. If a business already has a lot of debt, repayment is less certain than if it does not owe much money. In this chapter, we will introduce another ratio that can be used to measure the business's financial position, the current ratio.

Current Ratio

Measures the company's ability to pay current liabilities from current assets. Total current assets / Total current liabilities.

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

Current ratio = Total current assets / 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.

A rule of thumb: A strong current ratio is 1.50, which indicates that the business 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.

Returning to **Green Mountain Coffee Roasters, Inc.** we can now evaluate Green Mountain's current ratio. Green Mountain had the following total current assets and current liabilities, found on the balance sheet located in Appendix A at the back of the book.

	As of Sep. 28, 2013	As of Sep. 29, 2012
Total current assets (in thousands)	$ 1,521,492	$ 1,322,956
Total current liabilities (in thousands)	597,063	519,987

The current ratio for Green Mountain as of September 28, 2013, follows:

Current ratio = $1,521,492 / $597,063 = 2.55*

*rounded

In comparison, the current ratio as of September 29, 2012, for Green Mountain was:

Current ratio = $1,322,956 / $519,987 = 2.54

The current ratio has increased very little from 2012 to 2013. This indicates that Green Mountain is remaining steady in its ability to pay its current debts. Given that the current ratio is above 1.5 for both years, Green Mountain would be considered a less risky investment than another business with a lower current ratio. Similarly, creditors would be more willing to extend credit to Green Mountain than another company with a lower current ratio.

APPENDIX 4A: Reversing Entries: An Optional Step

WHAT ARE REVERSING ENTRIES?

Learning Objective 7
Explain the purpose of, journalize, and post reversing entries

Reversing entries are special journal entries that ease the burden of accounting for transactions in a later period. Reversing entries are the exact opposite of certain adjusting entries. Reversing entries are used in conjunction with accrual-type adjustments, such as accrued salaries expense and accrued service revenue. Generally Accepted Accounting Principles do not require reversing entries. They are used only for convenience and to save time.

Accounting for Accrued Expenses

To see how reversing entries work, let's return to Smart Touch Learning. In the unadjusted trial balance, Salaries Expense has a debit balance of $3,600 for salaries paid during November and December. At December 31, the business still owes it employees an additional $1,200 for the last half of the month, so the business makes the following adjusting entry:

A		L↑	+	E↓
	=	Salaries Payable↑		Salaries Expense↑

Date	Accounts and Explanation	Debit	Credit
Dec. 31	Salaries Expense	1,200	
	Salaries Payable		1,200
	To accrue salaries expense.		

After posting, the accounts are updated as of December 31:

Salaries Payable			
		1,200	Adj.
		1,200	Adj. Bal.

Salaries Expense		
Nov. 15	1,200	
Dec. 1	1,200	
Dec. 15	1,200	
Adj.	1,200	
Adj. Bal.	4,800	

After the adjusting entry, the following are noted:

- The income statement reports Salaries Expense of \$4,800.
- The balance sheet reports Salaries Payable of \$1,200.

The \$4,800 debit balance of Salaries Expense is closed at December 31, 2016, with the following closing entry:

Date	Accounts and Explanation	Debit	Credit
Dec. 31	Income Summary	4,800	
	Salaries Expense		4,800
	To close expense.		

A	=	L	+	E↑↓
				Income Summary↓ Salaries Expense↓

After posting the closing entry, Salaries Expense has a zero balance as follows:

Salaries Expense			
Nov. 15	1,200		
Dec. 1	1,200		
Dec. 15	1,200		
Adj.	1,200		
Adj. Bal.	4,800		
		4,800	Clos.
Bal.	0		

Accounting Without a Reversing Entry

Assume that Smart Touch Learning will pay its employees the second half of December's salaries along with the first half of January on January 15, 2017. On January 15, the company would record the following journal entry:

Date	Accounts and Explanation	Debit	Credit
2017			
Jan. 15	Salaries Payable	1,200	
	Salaries Expense	1,200	
	Cash		2,400
	To record payment of salaries.		

A↓	=	L↓	+	E↓
Cash↓		Salaries Payable↓		Salaries Expense↑

After posting the cash payment, the Salaries Payable and Salaries Expense accounts are as follows:

Salaries Payable			Salaries Expense	
	1,200 Bal. 1/1/17		Jan. 15 1,200	
Jan. 15 1,200				
	0 Bal.			

This method of recording the cash payment is correct. However, it wastes time because the business must refer back to the December 31 adjustments. Otherwise, the business does not know the amount of the debit to Salaries Payable (in this example $1,200). Searching December's adjusting entries wastes time and money. To save time, accountants can use reversing entries.

Accounting with a Reversing Entry

Reversing Entry
A special journal entry that eases the burden of accounting for transactions in the next period. Such entries are the exact opposite of a prior adjusting entry.

A **reversing entry** switches the debit and the credit of a previous entry. A reversing entry, then, is the exact opposite of a prior adjusting entry. The reversing entry is dated the first day of the new period.

To illustrate reversing entries, recall that on December 31 Smart Touch Learning made the following adjusting entry to accrue Salaries Expense:

A	=	L↑	+	E↓
		Salaries Payable↑		Salaries Expense↑

Date	Accounts and Explanation	Debit	Credit
Dec. 31	Salaries Expense	1,200	
	Salaries Payable		1,200
	To accrue salaries expense.		

The reversing entry just reverses the debit and the credit of the adjustment:

A	=	L↓	+	E↑
		Salaries Payable↓		Salaries Expense↓

Date	Accounts and Explanation	Debit	Credit
2017			
Jan. 1	Salaries Payable	1,200	
	Salaries Expense		1,200
	To reverse the salaries adjusting entry.		

Observe that the reversing entry is dated the first day of the new period. It is the exact opposite of the adjusting entry. Ordinarily, the accountant who makes the adjusting entries will also prepare reversing entries at the same time. Smart Touch Learning dates the reversing entry as of January 1 so that it affects only the new period. Note how the accounts appear after the accounting clerk posts the reversing entry:

Salaries Payable			Salaries Expense	
	1,200 Adj.		Bal. 1/1/17 0	
	1,200 Bal. 1/1/17			1,200 Rev. Jan. 1
Rev. Jan. 1 1,200				
	0 Bal.			

The arrow between the T-accounts shows the transfer of the $1,200 from Salaries Payable to Salaries Expense. This credit in Salaries Expense does not mean that the entity has negative salaries expense, as you might think. Instead, the odd credit balance in the Salaries Expense account is merely a temporary result of the reversing entry. The credit balance is eliminated on January 15, when Smart Touch Learning pays the payroll and debits Salaries Expense:

Date	Accounts and Explanation	Debit	Credit
Jan. 15	Salaries Expense	2,400	
	Cash		2,400
	To record payment of salaries.		

A↓		L	+	E↓
Cash↓	=			Salaries Expense↑

This payment is posted to the Salaries Expense account as follows:

Salaries Expense

Bal. 1/1/17	0		
Jan. 15	2,400	1,200	Rev. Jan. 1
Bal.	1,200		

Now Salaries Expense has a debit balance of $1,200, which is correct and represents only the January salaries. The payment of salaries covered two periods: $1,200 related to 2016 and $1,200 related to 2017. The Salaries Expense account should only contain the amount that relates to 2017.