The Accounting Cycle
End of the Period

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Textbook: Financial Accounting, Spiceland

- This presentation contains information, in addition to the material prepared and provided by the professor, from the book Financial Accounting, 4^{th}. Ed., Spiceland which is the textbook assigned for the course CONT 3105 – “Introducción a los Fundamentos de Contabilidad” at the University of Puerto Rico, Río Piedras Campus.

Topics

Topics

1.0 Adjusting entries (**step 5**)

2.0 Adjusted Trial Balance (**step 6**)

3.0 Financial Statements (**step 7**)

4.0 Closing entries (**step 8**)

5.0 Post-Closing Trial Balance (**step 9**)

Adjusting Entries
Step 5

Adjusting Entries
Step 5

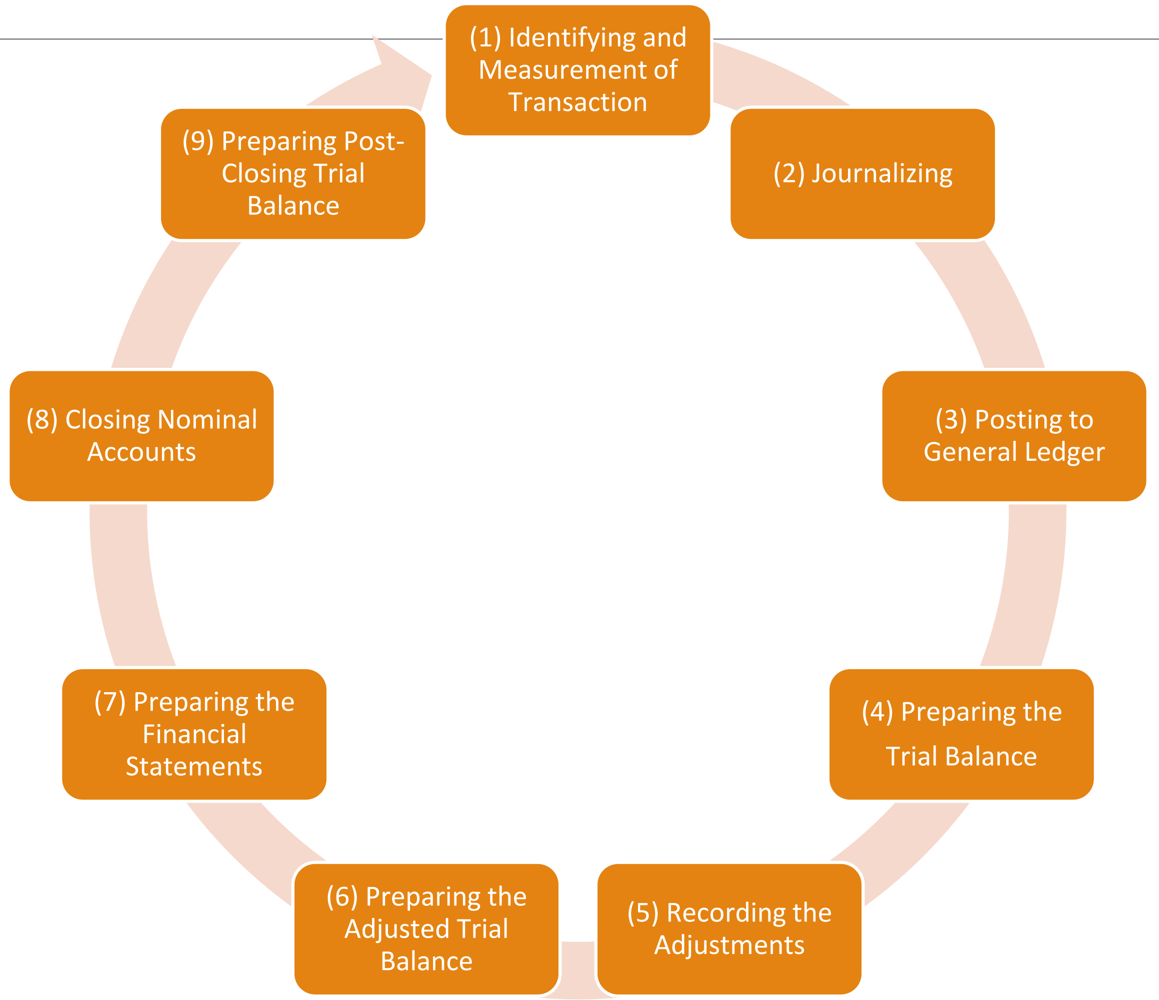
1.1 Introduction

Adjusting Entries
Step 5

1.1 Introduction

- The adjusting entries is the fifth step of the Accounting Cycle.
- See next page.

The Accounting Cycle



Adjusting Entries
Step 5

1.1 Introduction

- The adjusting entries record events that have occurred but that we have not yet recorded.
- At the end of a reporting period, even if we have accurately recorded every transaction that occurred during the period and accurately posted those transactions to appropriate accounts, our account balances are not updated for preparing financial statements.

Adjusting Entries
Step 5

1.1 Introduction

- Before we can prepare the financial statements we need to bring several of the account balances up-to-date.
- That is the purpose of adjusting entries.

Adjusting Entries
Step 5

1.2 Rationale

Adjusting Entries
Step 5

1.2 Rationale

- The adjusting entries are a necessary part of accrual-basis accounting.
- In order for revenues to be recorded in the period in which services are performed and for expenses to be recognized in the period in which they are incurred, companies make adjusting entries. [**Kieso**]
- In short, adjustments ensure that a company follows the Revenue Recognition and Expense Recognition principles.

Adjusting Entries
Step 5

1.2 Rationale

- In addition, the use of adjusting entries makes it possible to report on the balance sheet the appropriate assets, liabilities, and stockholders' equity at the statement date.
- Adjusting entries also make it possible to report on the income statement the proper revenues and expenses for the period. [**Kieso**]

Adjusting Entries
Step 5

1.3 Timing

Adjusting Entries
Step 5

1.3 Timing

- Adjusting entries are required every time a company prepares financial statements.
- At that time, the company must analyze **each** account in the trial balance to determine whether it is complete and up-to-date for financial statement purposes.
- The analysis requires a thorough understanding of company's operations and the interrelationship of accounts. [**Kieso**]

Adjusting Entries
Step 5

1.4 Revenue and Expense Reporting

Adjusting Entries
Step 5

1.4 <u>Revenue and Expense Reporting</u>

- In order to understand the adjusting entries process, we should first review the
  1. Revenue recognition principle
  2. Expense recognition principle

Adjusting Entries
Step 5

1.4 Revenue and Expense Reporting

1. **Revenue Recognition Principle**:

Adjusting Entries
Step 5

1.4 Revenue and Expense Reporting

1. **Revenue Recognition Principle**: This principle states that we record revenue in the period in which we provide goods and services to customers, not necessarily in the period in which we receive cash.
   - **Examples**:
     a. Banana Republic sells a pant.
     b. Uber takes a client to his destination.

   A service provided during 2018 (the period), the revenue should be reported in the 2018 Income Statement.

Adjusting Entries
Step 5

1.4 Revenue and Expense Reporting

2. **Expense Recognition Principle**:

Adjusting Entries
Step 5

1.4 Revenue and Expense Reporting

2. **Expense Recognition Principle**: In the same period we report revenues, we should also record all expenses incurred to generate those revenues (a concept commonly referred to as the matching principle) and not necessarily when we pay cash.

Implied in this principle is a *cause-and-effect* relationship between revenue and expenses recognition.

Adjusting Entries
Step 5

1.4 Revenue and Expense Reporting

2. Expense Recognition Principle:

Example: In the example of Banana Republic selling a pant, we can think about all the costs incurred around this transaction, such as:

a. The salary or commission paid to employee. (Salary)
b. The place the pant was stored. (Rent)
c. The electricity used in the store. (Utilities)

Adjusting Entries
Step 5

1.4 Revenue and Expense Reporting

2. **Expense Recognition Principle**:
   - However, sometimes some costs may be more difficult to match directly with the revenue they help to produce. This costs are commonly referred to as period costs.
     - **Example**: It is difficult to determine when, how much, or even whether additional revenues occur as a result of advertising. Because of this, firms generally recognize advertising expenditure as expense in the period the ads are provided.

Adjusting Entries
Step 5

1.5 Types of Adjusting Entries

Adjusting Entries
Step 5

1.5 <u>Types of Adjusting Entries</u>

- Adjusting entries are classified as either deferrals or accruals with the following subcategories:
  - **Deferrals**
    1. Prepaid expenses
    2. Deferred revenues
  - **Accruals**
    1. Accrued expenses
    2. Accrued revenues

Adjusting Entries
Step 5

1.6 Prepaid Expenses

Adjusting Entries
Step 5

1.6 Prepaid Expenses

- Prepaid expenses are the costs of assets acquired in one period that will be recorded as an expense in a future period.
  - **Examples** include the purchase of equipment or supplies and the payment of rent or insurance in advance. These payments create future benefits, so we initially record them as assets at the time of purchase.

Adjusting Entries
Step 5

1.6 Prepaid Expenses

- The benefits provided by these assets expire in future periods, so we need to expense their cost in those future periods.

Adjusting Entries
Step 5

1.6 <u>Prepaid Expenses</u>

- The adjusting entry for a prepaid expense <u>always</u> includes:

DEBIT	CREDIT
Expense Account	Asset Account

Adjusting Entries
Step 5

1.6 Prepaid Expenses

- Let's analyze the Trial Balance of Vienna School Corporation on next page (Refer to **Comprehensive Example B** discussed on **Presentation 2**).

VIENNA SCHOOL CORPORATION TRIAL BALANCE DECEMBER 31, 2017		
ACCOUNTS	**DEBIT**	**CREDIT**
Cash	$13,300	
Account Receivable	2,700	
Prepaid Rent	3,000	
Music Supplies	1,500	
Music Equipment	20,000	
Accounts Payable		1,500
Deferred Revenue		1,000
Note Payable		5,000
Common Stock		30,000
Dividends	1,500	
Service Revenue		7,700
Salary Expense	3,200	
TOTAL	**$45,200**	**$45,200**

Adjusting Entries
Step 5

1.6 Prepaid Expenses

- The Vienna School has three types of assets which accounts for a prepaid expense:
  1. Prepaid rent
  2. Supplies
  3. Equipment

  Let’s analyze each one.

Adjusting Entries
Step 5

1.6 <u>Prepaid Expenses</u>

1. **Prepaid Rent**:

Adjusting Entries
Step 5

1.6 Prepaid Expenses

1. **Prepaid Rent**: The benefits from using the rented space occur evenly over the time. At the end of the period, the company has used a portion of this asset, and that portion no longer represents a future benefit. Therefore, we need to record, at the date of the financial statements are prepared, the portion used as an expense.

Adjusting Entries
Step 5

1.6 Prepaid Expenses

1. **Prepaid Rent**:

Example 1: The trial balance of Vienna School as of December 31, 2017 presents a Prepaid Rent of $3,000. However, one month's cost of $500 is attributable to December 2017.

Adjusting Entries

Step 5

1.6 Prepaid Expenses

1. Prepaid Rent:

Example 1: Therefore, we need to record one month of the asset's cost as an expense in December and reduce the balance of the assets. The journal entry is recorded as of 12/31/2017.

GENERAL JOURNAL				J-11
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Dec. 31	Rent Expense		500	
	Prepaid Rent			500
	(*Record rent expense of December 2017)*			

Adjusting Entries
Step 5

1.6 Prepaid Expenses

2. **Supplies**:

Adjusting Entries
Step 5

1.6 Prepaid Expenses

2. **Supplies**: A business may use several different types of supplies. For example, a CPA firm will use office supplies such as stationary, envelopes, and accounting paper. An advertising firm will stock advertising supplies such as whiteboard markers and printer cartridges. [**Kieso**]

Adjusting Entries
Step 5

1.6 Prepaid Expenses

2. **Supplies**:

- Supplies are generally debited to an asset account when they are acquired. Recognition of supplies used is generally deferred until the adjustment process.
- At that time, a physical inventory of supplies is taken. The difference between the balance in the supplies (asset) account and the cost of supplies on hand represents the supplies used (an expense) for the period. [**Kieso**]

Adjusting Entries
Step 5

1.6 Prepaid Expenses

2. Supplies:

Example 2: The trial balance of Vienna School as of December 31, 2017 presents the Music Supplies account with a balance of $1,500. Suppose that at the end of December a count of supplies reveals that only $400 of supplies remains. Consequently, the other $1,100 of missing supplies are considered the amount of supplies used (expensed) during the month.

Adjusting Entries
Step 5

1.6 Prepaid Expenses

2. **Supplies:**

Example 2: Therefore, we need to record $1,100 of the Music Supplies' cost as an expense in December and reduce the balance of the Music Supplies. The journal entry is recorded as of 12/31/2017.

GENERAL JOURNAL				**J-12**
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Dec. 31	Supplies Expense		1,100	
	Music Supplies			1,100
	(Record supplies used during December 2017)			

Adjusting Entries
Step 5

1.6 Prepaid Expenses

3. **Equipment**:

Adjusting Entries
Step 5

1.6 Prepaid Expenses

3. **Equipment**: Companies typically own various productive facilities, such as building, equipment, and motor vehicles. These assets provide a service for a number of years. The term of service is commonly referred to as the useful life of the asset. [**Kieso**]

Adjusting Entries
Step 5

1.6 Prepaid Expenses

3. **Equipment**: Because companies expects an asset such as building or equipment to provide services for many years, the companies record the building or equipment as an asset, rather than an expense, in the year the building or equipment is acquired. The asset is recorded at cost as required by the Historical Cost Principle.

Adjusting Entries
Step 5

1.6 Prepaid Expenses

3. **Equipment**: To follow the expense recognition principle, the companies report a portion of the cost of a long-lived asset as an expense during each period of the asset's useful life.

   Depreciation is the process of allocating the cost of an asset to expense over its useful life in a rational and systematic manner. [**Kieso**]

Adjusting Entries
Step 5

1.6 Prepaid Expenses

3. **Equipment**: To estimate depreciation expense, companies often divides the cost of the asset by its useful life.

   For **example**, if a company purchases equipment for $10,000 and expects its useful life to be 10 years, the company records annual depreciation of $1,000. [**Kieso**]

Adjusting Entries
Step 5

1.6 Prepaid Expenses

3. **Equipment**: However, to record the depreciation we do not reduce the asset account directly, by crediting the asset account itself. Instead, we reduced the asset indirectly by crediting an account called Accumulated Depreciation.

Adjusting Entries
Step 5

1.6 <u>Prepaid Expenses</u>

3. Equipment:

- The Accumulated Depreciation account is called a “contra account”.
- A contra account is an account with a balance that is opposite, or “contra” to that of its related accounts.
- The normal balance in the Accumulated Depreciation contra asset account is a <u>credit</u>, which is opposite to the normal debit balance in an asset account.

Adjusting Entries
Step 5

1.6 Prepaid Expenses

3. Equipment:

- The reason we use a contra account is to keep the original balance of the asset intact while reducing its current balance indirectly.
- In the balance sheet, we report equipment at its current book value, which equals its original cost less accumulated depreciation.

Adjusting Entries
Step 5

1.6 Prepaid Expenses

3. **Equipment**:

- **Example 3**: The trial balance of Vienna School as of December 31, 2017 presents the Music Equipment with a balance of $20,000. Suppose Vienna School estimates the equipment will be useful for the next 10 years (120 months).

Adjusting Entries
Step 5

1.6 Prepaid Expenses

3. Equipment:

- **Example 3**: Because one month has passed since the purchase of this asset, Vienna School has used one month of the equipment’s estimated 120-month useful life. The cost of the equipment for one month’s use is $167 ($20,000 x 1/120).

Adjusting Entries
Step 5

1.6 Prepaid Expenses

3. **Equipment**:

- **Example 3**: The School must record a depreciation expense for December 2017 of $167. The journal entry is recorded as of 12/31/2017.

GENERAL JOURNAL				J-13
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Dec. 31	Depreciation Expense		167	
	Accumulated Depreciation			167
	(*Record depreciation expense for the month of December 2017)*			

Adjusting Entries
Step 5

1.7 Deferred Revenues

Adjusting Entries
Step 5

1.7 Deferred Revenues

- We record deferred revenues when a company receives cash in advance from a customer for products or services to be provided in the future.
- Examples:
  1. American Airlines treats receipts from the sale of tickets as deferred revenue until they satisfy the performance obligation (to provide the flight service).
  2. A New York University records tuition received prior the start of the semester as deferred revenue.

Adjusting Entries
Step 5

1.7 <u>Deferred Revenues</u>

- When customers pay cash in advance, we debit cash and credit a liability. This liability reflects the company's obligation to provide goods or services to the customer in the future. Once it has provided these products or services, the company can record revenue and reduce its obligation to the customers.

Adjusting Entries
Step 5

1.7 Deferred Revenues

- The adjusting entry for a deferred revenue always includes:

DEBIT	CREDIT
Liability Account	Revenue Account

Adjusting Entries
Step 5

1.7 <u>Deferred Revenues</u>

- **Example 4**: The trial balance of Vienna School as of December 31, 2017 presents a deferred revenue of $1,000. Suppose at the end of December, Vienna School provided the music classes to customers.

VIENNA SCHOOL CORPORATION TRIAL BALANCE DECEMBER 31, 2017		
ACCOUNTS	**DEBIT**	**CREDIT**
Cash	$13,300	
Account Receivable	2,700	
Prepaid Rent	3,000	
Music Supplies	1,500	
Music Equipment	20,000	
Accounts Payable		1,500
Deferred Revenue		1,000
Note Payable		5,000
Common Stock		30,000
Dividends	1,500	
Service Revenue		7,700
Salary Expense	3,200	
TOTAL	**$45,200**	**$45,200**

Adjusting Entries
Step 5

1.7 Deferred Revenues

- **Example 4**: In that case, Vienna School can record the service revenue of $1,000 as of December 31, 2017 and reduces the liability to customers of $1,000.

GENERAL JOURNAL				J-14
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Dec. 31	Deferred Revenue		1,000	
	Service Revenue			1,000
	(Record services provided on December 2017)			

Adjusting Entries
Step 5

1.8 Accrued Expenses

Adjusting Entries
Step 5

1.8 <u>Accrued Expenses</u>

- Expenses incurred but not yet paid or recorded at the statement date. <u>Interest, rent, taxes, and salaries</u> are common examples.
- Adjustment for accrued expenses record the obligation that exist at the balance sheet date and recognize the expense that apply to the current accounting period.

Adjusting Entries
Step 5

1.8 Accrued Expenses

- The adjusting entry for accrued expenses always results in:

DEBIT	CREDIT
Expense Account	Liability Account

Adjusting Entries
Step 5

1.8 Accrued Expenses

- **Example 5**: At the end of December 2017 Vienna School receives an electricity bill for $450 associated with operations in December. At the end of the month, the bill was unpaid.

Adjusting Entries
Step 5

1.8 Accrued Expenses

- **Example 5**: Vienna School must record the utility cost of $450 for December as an expense in December and records the corresponding obligation to the utility company at the same time.

GENERAL JOURNAL				J-15
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Dec. 31	Utility Expense		450	
	Accounts Payable			450
	(Record electricity cost for December 2017)			

Adjusting Entries
Step 5

1.8 Accrued Expenses

- **Example 6**: Vienna School borrowed $5,000 for the bank to begin operations. Assume the bank charges Vienna School annual interest of 10% on the borrowed amount.

Adjusting Entries
Step 5

1.8 Accrued Expenses

- **Example 6**: By the end of the month, the loan has accrued interest of $42 ($5,000 x 10% x 1/12). Although Vienna School will not pay the $100 until next year, it is a cost of using the borrowed funds during December.

GENERAL JOURNAL				**J-16**
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Dec. 31	Interest Expense		42	
	Interest Payable			42
	(*Record interest expense for December 2017)*			

Adjusting Entries
Step 5

1.9 Accrued Revenues

Adjusting Entries
Step 5

1.9 Accrued Revenues

- When a company provides products or services to customers but has not yet received cash, it still should record the revenue and an asset for the amount expected to be received.
- Accrued revenues may accumulated with the passing of time, as in the case of interest revenue.

Adjusting Entries
Step 5

1.9 Accrued Revenues

- Accrued revenues also may result from services that have been performed but not yet billed nor collected, as in the case of commissions and fees (services provided).
- An adjusting entry records the receivable that exists at the balance sheet date and the revenue for the services performed during the period.

Adjusting Entries
Step 5

1.9 Accrued Revenues

- **Example 7**: Assume Vienna School provided $2,000 music classes from December 27 to December 31. However, it usually takes the company one week to bill customers and one additional week for customers to pay. Therefore, the school expects to receive cash form these customers during January 2018.

Adjusting Entries
Step 5

1.9 Accrued Revenues

- **Example 7**: Because Vienna School provided the services to customers in December, the school should recognize in December the service revenue and the amount of receivable from those customers.

GENERAL JOURNAL				J-17
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Dec. 31	Accounts Receivable		2,000	
	Service Revenue			2,000
	(*Record services provided but not collected for December 2017)*			

Adjusting Entries
Step 5

1.10 No Adjustment Necessary

Adjusting Entries
Step 5

1.10 <u>No Adjustment Necessary</u>

- Adjusting entries are unnecessary in two cases:
  1. For transactions that do not involve revenue or expense activities, and
  2. For transactions that result in revenues or expenses being recorded at the same time as the cash flow.

Adjusted Trial Balance
Step 6

2.1 <u>Adjusted Trial Balance</u>

Adjusted Trial Balance
Step 6

2.1 Adjusted Trial Balance

- After **journalizing** and **posting** all adjusting entries, the companies prepare another trial balance from its ledger accounts named adjusted trial balance.
- The purpose of an adjusted trial balance is to prove the equality of the total debit balances and the total credit balances in the ledger after all adjustments. [**Kieso**]

Adjusted Trial Balance
Step 6

2.1 Adjusted Trial Balance

- Because the accounts contain all data needed for financial statements, the adjusted trial balance is the primary basis for the preparation of financial statements. [**Kieso**]

Adjusted Trial Balance
Step 6

2.1 Adjusted Trial Balance

- **Example 8**:
  - In order to prepare the Adjusted Trial Balance of Vienna School Corporation, we need to **post** all the adjusting entries to the general ledger. Let's post the adjusting entries recorded on Example 1 to 7 (Journal entries 11 to 17) to general ledger.
  - In the next pages you will find each journal entry and the posting to the corresponding general account.

Adjusted Trial Balance
Step 6

GENERAL JOURNAL				J-11
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Dec. 31	Rent Expense		500	
	Prepaid Rent			500
	(*Record rent expense of December 2017*)			

ACCOUNT TITLE: Rent Expense

Date	Description	Debit	Credit	Balance
Dec. 31	Record rent expense of Dec. 2017	500		500

ACCOUNT TITLE: Prepaid Rent

Date	Description	Debit	Credit	Balance
Dec. 3	Paid six months rent in advance	3,000		3,000
31	Record rent expense of Dec. 2017		500	2,500

Adjusted Trial Balance
Step 6

GENERAL JOURNAL				J-12
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Dec. 31	Supplies Expense		1,100	
	Music Supplies			1,100
	(*Record supplies used during December 2017*)			

ACCOUNT TITLE: Supplies Expense

Date	Description	Debit	Credit	Balance
Dec. 31	Record supplies used during Dec. 2017	1,100		1,100

ACCOUNT TITLE: Music Supplies

Date	Description	Debit	Credit	Balance
Dec. 5	Purchased supplies on account	1,500		1,500
31	Record supplies used during Dec. 2017		1,100	400

Adjusted Trial Balance
Step 6

GENERAL JOURNAL				J-13
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Dec. 31	Depreciation Expense		167	
	Accumulated Depreciation			167
	(*Record depreciation expense for the month of December 2017*)			

ACCOUNT TITLE: Depreciation Expense				
Date	**Description**	**Debit**	**Credit**	**Balance**
Dec. 31	Record depreciation expense Dec. 2017	167		167

ACCOUNT TITLE: Accumulated Depreciation				
Date	**Description**	**Debit**	**Credit**	**Balance**
Dec. 31	Record depreciation expense Dec. 2017		167	167

Adjusted Trial Balance
Step 6

GENERAL JOURNAL				J-14
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Dec. 31	Deferred Revenue		1,000	
	Service Revenue			1,000
	(*Record services provided on December 2017*)			

ACCOUNT TITLE: Deferred Revenue

Date	Description	Debit	Credit	Balance
Dec. 21	Received cash in advance for services		1,000	1,000
31	Record service provided on Dec. 2017	1,000		0

ACCOUNT TITLE: Services Revenue

Date	Description	Debit	Credit	Balance
Dec. 15	Provided services in cash		5,000	5,000
21	Provided services on account		2,700	7,700
31	Record service provided on Dec. 2017		1,000	8,700

Adjusted Trial Balance
Step 6

GENERAL JOURNAL				J-15
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Dec. 31	Utility Expense		450	
	Accounts Payable			450
	(Record electricity cost for December 2017)			

ACCOUNT TITLE: Utility Expense				
Date	**Description**	**Debit**	**Credit**	**Balance**
Dec. 31	Record electricity cost for Dec. 2017	450		450

ACCOUNT TITLE: Accounts Payable				
Date	**Description**	**Debit**	**Credit**	**Balance**
Dec. 5	Purchased supplies on account		1,500	1,500
31	Record electricity cost for Dec. 2017		450	1,950

Adjusted Trial Balance
Step 6

GENERAL JOURNAL				J-16
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Dec. 31	Interest Expense		42	
	Interest Payable			42
	(*Record interest expense for December 2017*)			

ACCOUNT TITLE: Interest Expense

Date	Description	Debit	Credit	Balance
Dec. 31	Record interest expense for Dec. 2017	42		42

ACCOUNT TITLE: Interest Payable

Date	Description	Debit	Credit	Balance
Dec. 5	Record interest expense for Dec. 2017		42	42

Adjusted Trial Balance
Step 6

GENERAL JOURNAL				J-17
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Dec. 31	Accounts Receivable		2,000	
	Service Revenue			2,000
	(Record services provided but not collected for Dec. 2017)			

ACCOUNT TITLE: Accounts Receivable

Date	Description	Debit	Credit	Balance
Dec. 21	Provided services on account	2,700		2,700
31	Record services provided but not collected	2,000		4,700

ACCOUNT TITLE: Services Revenue

Date	Description	Debit	Credit	Balance
Dec. 15	Provided services in cash		5,000	5,000
21	Provided services on account		2,700	7,700
31	Record service provided on Dec. 2017		1,000	8,700
31	Record services provided but not collected		2,000	10,700

Adjusted Trial Balance
Step 6

2.1 Adjusted Trial Balance

- **Example 8**:
  - Having updated the balances of all the accounts in the General Ledger, we can prepare the Adjusted Trial Balance.
  - Let's prepare the Adjusted Trial Balance using the balance of each account of the General Ledger of Vienna School as of December 31, 2017.
  - See the Adjusted Trial Balance on next page.

VIENNA SCHOOL CORPORATION
ADJUSTED TRIAL BALANCE
DECEMBER 31, 2017

ACCOUNTS	DEBIT	CREDIT
Cash	$13,300	
Account Receivable	4,700	
Prepaid Rent	2,500	
Music Supplies	400	
Music Equipment	20,000	
Accumulated Depreciation		167
Accounts Payable		1,950
Interest Payable		42
Note Payable		5,000
Common Stock		30,000
Dividends	1,500	
Service Revenue		10,700
Salary Expense	3,200	
Rent Expense	500	
Supplies Expense	1,100	
Depreciation Expense	167	
Utility Expense	450	
Interest Expense	42	
TOTAL	**$47,859**	**$47,859**

Financial Statements
Step 7

Financial Statements
Step 7

3.1 Preparing the Financial Statements

Financial Statements
Step 7

3.1 Preparing the Financial Statements

1. **Purpose:**
   - In the following pages, you will see the use of the adjusted trial balance in preparing the financial statements.
   - In addition, you will understand the requirements to prepare a "classified balance sheet".
   - **However, a full explanation of the purpose of the financial statements and the procedures of how to prepare each statements are included on Presentation 1 (pages 77 to 140).**

Financial Statements
Step 7

3.1 <u>Preparing the Financial Statements</u>

2. **Relationship between Adjusted Trial Balance and Financial Statements**
   - Once the adjusted trial balance is complete, we can prepare financial statements.
   - Before preparing the financial statements, you should take the adjusted trial balance and classify each account according to its relationship to the financial statements.

Financial Statements
Step 7

3.1 Preparing the Financial Statements

2. Relationship between Adjusted Trial Balance and Financial Statements

- Mark each account with a color so you can easily identify it with the corresponding financial statement:
  - Balance Sheet (green)
  - Statement of Stockholders' Equity (red)
  - Income Statement (blue)
- In the next page you will find the adjusted trial balance of Vienna School Corporation and the color coding of the accounts.

VIENNA SCHOOL CORPORATION
ADJUSTED TRIAL BALANCE
DECEMBER 31, 2017

ACCOUNTS	DEBIT	CREDIT
Cash	$13,300	
Account Receivable	4,700	
Prepaid Rent	2,500	
Music Supplies	400	
Music Equipment	20,000	
Accumulated Depreciation		167
Accounts Payable		1,950
Interest Payable		42
Note Payable		5,000
Common Stock		30,000
Dividends	1,500	
Service Revenue		10,700
Salary Expense	3,200	
Rent Expense	500	
Supplies Expense	1,100	
Depreciation Expense	167	
Utility Expense	450	
Interest Expense	42	
TOTAL	**$47,859**	**$47,859**

Financial Statements
Step 7

3.2 Income Statement

Financial Statements
Step 7

3.2 Income Statement

- **Example 9**: Using the blue accounts in the adjusted trial balance of Vienna School Corporation, we can prepare the income statement of the school.
- See income statement on next page.

Financial Statements
Step 7

Vienna School Corporation Income Statement For the month ended December 31, 2017	
Revenue	
Service Revenue	$10,700
Expenses	
Salary Expense	3,200
Rent Expense	500
Supplies Expense	1,100
Depreciation Expense	167
Utility Expense	450
Interest Expense	42
Total Expenses	5,459
Net Income	**$5,241**

Financial Statements
Step 7

3.3 <u>Statement of Stockholders' Equity</u>

Financial Statements
Step 7

3.3 Statement of Stockholders' Equity

- Before preparing the Statement of Stockholders' Equity you must understand the relationship between the accounts presented in this statement with the Balance Sheet. Pay attention to the following:
    1. **Common Stock Account**: The account of common stock is first presented on the Statement of Stockholders' Equity. In this statement, we will explain any change in the common stock account. However, the final balance of the common stock account is presented on the Balance Sheet in the Stockholders' Equity section.

Financial Statements
Step 7

3.3 Statement of Stockholders' Equity

2. **Retained Earnings Account**: The retained earnings account is a stockholders' equity account and its ending balance is presented on the balance sheet. In the Statement of Stockholders' Equity we calculate the ending balance of the retained earnings.

   The retained earnings has three components: revenues, expenses and dividends. The revenue and expenses accounts are reported in the income statement. The difference between total revenues and total expenses equals net income or net loss.

Financial Statements
Step 7

3.3 Statement of Stockholders' Equity

2. **Retained Earnings Account**:

Consequently, to calculate the ending balance of retained earnings we use the following formula:

Beginning balance of retained earnings

+ net income

- net loss

- dividends

Ending balance of retained earnings

Financial Statements
Step 7

3.3 Statement of Stockholders’ Equity

- **Example 10**: Using the red accounts in the adjusted trial balance, we can prepare the statement of stockholders'’ equity.
- However, remember you must calculate the ending balance of the retained earnings account using the net income (previously calculated in the income statements) and dividends paid during the period.
- See statement of stockholders’ equity on next page.

Financial Statements
Step 7

Vienna School Corporation Statements of Stockholders' Equity For the month ended December 31, 2017			
	Common Stock	**Retained Earnings**	**Total Stockholders' Equity**
Beginning balance (Dec. 1)	$0	$0	$0
Issuance of common stock	30,000		30,000
Add: Net income		5,241	5,241
Less: Dividends		(1,500)	(1,500)
Ending balance (Dec. 31)	**$30,000**	**$3,741**	**$33,741**

Financial Statements
Step 7

3.4 Balance Sheet

Financial Statements
Step 7

3.4 Balance Sheet

1. **Classified Balance Sheet**:

- A classified balance sheet groups a company's asset and liability accounts into current and long-term categories.
- This classification is based on the operating cycle of a company. An operating cycle is the average time it takes to provide a service to a customer and then collect that customer's cash (**normally one year**). For a company that sells products, an operating cycle would include the time it typically takes to purchase or manufacture those products to the time the company collects cash from selling those products to customers.

Financial Statements
Step 7

3.4 Balance Sheet

2. **Classification of Balance Sheet Accounts**:
   - The assets accounts are separated into two major categories:
     - **Current Assets**: Those assets that provide a benefit within the next year.
     - **Long-term Assets**: Those assets that provide a benefit for more than one year.

Financial Statements
Step 7

3.4 Balance Sheet

2. Classification of Balance Sheet Accounts:

- The liabilities accounts are also separated into two major categories:
  - **Current Liabilities**: Those liabilities that are due within the next year.
  - **Long-term Liabilities**: Those liabilities that are due in more than one year.

Financial Statements
Step 7

3.4 Balance Sheet

2. Classification of Balance Sheet Accounts:

A. Current Assets:

- The current assets are typically listed in order of liquidity. The liquidity of an asset refers to how quickly it will be converted to cash.
- For example, cash is the most liquid of all assets, so it is listed first. Accounts receivable are amounts owed by customers to the company. They are generally collected within one month (average), so they are highly liquid assets and typically listed after cash.

Financial Statements
Step 7

3.4 Balance Sheet

2. **Classification of Balance Sheet Accounts**:

   A. **Current Assets**:

   - Next, we list prepaid expenses, such as supplies and prepaid rent. While these assets will not be converted to cash, they are expected to be consumed within the next year, so they are included as current assets.

Financial Statements
Step 7

3.4 Balance Sheet

2. Classification of Balance Sheet Accounts:

B. Long-term Assets:

- The long-term assets include assets expected to be converted to cash after one year or to be consumed for longer than one year. Long-term assets consist of the following types of assets:
  a. **Long-term investments**: Investment in another company's debt (bonds) or stock.
  b. **Property, plant, and equipment**
  c. **Intangible assets**: Patent, copyrights, franchises, etc.

Financial Statements
Step 7

3.4 Balance Sheet

2. Classification of Balance Sheet Accounts:

C. Current Liabilities:

- Current liabilities are listed in the order they are expected to be paid, typically within one year.
- The purpose of this classification is to better help investors and creditors understand the company's liquidity. A company can compare the total current assets with the total current liability in order to know whether the cash being generated by the assets will be enough to meet the company's obligations in the near future.

Financial Statements
Step 7

3.4 Balance Sheet

2. Classification of Balance Sheet Accounts:

D. Long-term Liabilities:

- Long-term liabilities are amounts that are due in more than one year.
- Most of the time, the long-term liabilities includes loans payable represented by a note. This loans are normally named as "Note Payable." However, you can find different names for the loans, according to the purpose of the loan. For example, a "Mortgage Payable" is a guarantee loan secured by a real estate property. An "Auto Loan" is a loan assumed in the purchase of a vehicle.

Financial Statements
Step 7

3.4 Balance Sheet

- **Example 11**: Using the green accounts in the adjusted trial balance, we can prepare the balance sheet.
- You can find all the accounts for the section of assets and the section of liabilities in the adjusted trial balance.
- For preparing the stockholders' equity section, however, you must use the information presented in the Statement of Stockholders' Equity (**Example 10**).
- See balance sheet on next page.

Vienna School Corporation
Balance Sheet
December 31, 2017

Assets		**Liabilities**	
Current Assets		Current Liabilities	
Cash	$13,300	Accounts Payable	$1,950
Accounts Receivable	4,700	Interest Payable	42
Prepaid Rent	2,500	**Total current liabilities**	**1,992**
Music Supplies	400	Long-term Liabilities	
Total current assets	**20,900**	Note Payable	5,000
		Total Liabilities	**6,992**
Long-term Assets			
Music Equipment	20,000	**Stockholders' Equity**	
Less: Accum. Deprec.	(167)	Common Stock	30,000
Total Long-term Assets	**19,833**	Retained Earnings	3,741
		Total Stockholders' Equity	**33,741**
TOTAL ASSETS	**$40,733**	**TOTAL LIABILITY AND STOCKHOLDERS' EQUITY**	**$40,733**

Closing Entries
Step 8

Closing Entries
Step 8

4.1 <u>Rationale</u>

Closing Entries
Step 8

4.1 Rationale

- Accounts are classified in two groups: Temporary accounts and permanent accounts.
- All accounts that appear in the balance sheet, including Retained Earrings, are permanent accounts, and we carry forward their balances from period to period.
- However, the revenues, expenses, and dividends accounts are termed temporary accounts. We keep them for each period and then transfer the balances of revenues, expenses, and dividends to the Retained Earnings account.

Closing Entries
Step 8

4.1 Rationale

- After we have reported revenues and expenses in the income statements and dividends in the statement of stockholders' equity, it is time to transfer these amounts to the Retained Earnings account itself.
- We treat only revenues, expenses, and dividends as temporary, so it will appear as if we had recorded all these types of transactions directly in Retained Earnings during the year.
- But to accomplish this, we need to record the closing entries.

Closing Entries
Step 8

4.2 <u>Definition of Closing Entries</u>

Closing Entries
Step 8

4.2 Definition of Closing Entries

- Closing entries transfer the balances of all temporary accounts (revenues, expenses, and dividends) to the balance of the Retained Earnings account.

Closing Entries
Step 8

4.3 Closing Entries

Closing Entries
Step 8

4.3 Closing Entries

- There are two types of closing entries: (1) to close temporary accounts with credit balances, and (2) to close temporary accounts with debit balances.
  1. All revenues accounts have credit balances. To transfer these balances to the Retained Earnings account, we debit each of these revenues accounts for its balance and credit Retained Earnings for the total.

Closing Entries
Step 8

4.3 Closing Entries Procedure

2. Similarly, all expenses and dividend accounts have debit balances. So, we credit each of these accounts for its balance and debit Retained Earnings for the total.

Closing Entries
Step 8

4.3 Closing Entries Procedure

- By doing this, we accomplish two necessary tasks:
  1. We update the balance in the Retained Earnings account to reflect transactions related to revenues, expenses, and dividends in the current period.
  2. We reduce the balance of all revenue, expenses, and dividend accounts to zero so we can start from scratch in measuring those amounts in the next accounting period.

Closing Entries
Step 8

4.3 <u>Closing Entries Procedure</u>

- **Remainder**:
  - When you prepare the financial statements, specially the Statement of Stockholders' Equity, you must update the Retained Earnings ending balance.
  - However, when you prepare this statement <u>you are not updating the balance of the accounts in general ledger</u>. That is why you must prepare the closing entries. To transfer the net effect of the revenues and expenses and the dividends to Retained Earnings.

Closing Entries
Step 8

4.3 Closing Entries Procedure

- **Remainder**:
  - If a company does not record the closing entries, the balance of the retained earnings account will be the same balance at the beginning of the period, and
  - All the revenues, expenses, and dividend accounts balances will move forward to the next accounting period with the disadvantage that the company will be reporting in the financial statements the revenues, expenses and dividends of, at least, two accounting periods.

Closing Entries
Step 8

4.3 Closing Entries Procedure

- **Example 12**: Let's close the temporary accounts of Vienna School Corporation. We will record three closing entries, to close:
  1. Revenues accounts, then
  2. Expenses accounts, and finally
  3. Dividend account.

Closing Entries
Step 8

4.3 Closing Entries Procedure

- **Example 12**: To close revenues accounts, we debit each revenue account by its balance and credit Retained Earnings. After posting this journal entry to the general ledger, the balance of service revenue account is $0 and the balance of Retained Earnings account is increased by the revenues of the period. See the **posting** on the next two pages.

GENERAL JOURNAL				J-18
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Dec. 31	Service Revenue		10,700	
	Retained Earnings			10,700
	(*Closing revenue accounts as of 12/31/17*)			

Closing Entries
Step 8

GENERAL JOURNAL				J-18
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Dec. 31	Service Revenue		10,700	
	Retained Earnings			10,700
	(*Closing revenue accounts as of 12/31/17*)			

ACCOUNT TITLE: Services Revenue				
Date	**Description**	**Debit**	**Credit**	**Balance**
Dec. 15	Provided services in cash		5,000	5,000
21	Provided services on account		2,700	7,700
31	Record service provided on Dec. 2017		1,000	8,700
31	Record services provided but not collected		2,000	10,700
31	Closing revenue accounts as of 12/31/17.	10,700		0

Closing Entries
Step 8

GENERAL JOURNAL				J-18
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Dec. 31	Service Revenue		10,700	
	Retained Earnings			10,700
	(*Closing revenue accounts as of 12/31/17*)			

ACCOUNT TITLE: Retained Earnings

Date	Description	Debit	Credit	Balance
Dec. 1	Beginning Balance			0
31	Closing revenue accounts as of 12/31/17.		10,700	10,700

Closing Entries
Step 8

4.3 Closing Entries Procedure

- **Example 12**: To close expenses accounts, we credit each expense account by its balance and debit Retained Earnings. After posting this journal entry to the general ledger, the balance of each expense account is $0 and the balance of Retained Earnings account is decrease by the total amount of expenses of the period.
  - See the **closing entry** on next page.
  - See the **posting** on the seven pages after next page.

Closing Entries
Step 8

4.3 <u>Closing Entries Procedure</u>

- **Example 12**:

GENERAL JOURNAL				J-19
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Dec. 31	Retained Earnings		5,459	
	Salary Expense			3,200
	Rent Expense			500
	Supplies Expense			1,100
	Depreciation Expense			167
	Utility Expense			450
	Interest Expense			42
	(Closing expense accounts as of 12/31/17)			

GENERAL JOURNAL				J-19
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Dec. 31	Retained Earnings		5,459	
	Salary Expense			3,200
	Rent Expense			500
	Supplies Expense			1,100
	Depreciation Expense			167
	Utility Expense			450
	Interest Expense			42
	(Closing expense accounts as of 12/31/17)			

ACCOUNT TITLE: Retained Earnings

Date	Description	Debit	Credit	Balance
Dec. 1	Beginning Balance			0
31	Closing revenue accounts as of 12/31/17.		10,700	10,700
31	Closing expense accounts as of 12/31/17.	5,459		5,241

GENERAL JOURNAL				J-19
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Dec. 31	Retained Earnings		5,459	
	Salary Expense			3,200
	Rent Expense			500
	Supplies Expense			1,100
	Depreciation Expense			167
	Utility Expense			450
	Interest Expense			42
	(Closing expense accounts as of 12/31/17)			

ACCOUNT TITLE: Salary Expense

Date	Description	Debit	Credit	Balance
Dec. 27	Paid salaries to employees	3,200		3,200
31	Closing expense accounts as of 12/31/17		3,200	0

GENERAL JOURNAL J-19

Date	Account Title	Ref.	Debit	Credit
Dec. 31	Retained Earnings		5,459	
	Salary Expense			3,200
	Rent Expense			500
	Supplies Expense			1,100
	Depreciation Expense			167
	Utility Expense			450
	Interest Expense			42
	(Closing expense accounts as of 12/31/17)			

ACCOUNT TITLE: Rent Expense

Date	Description	Debit	Credit	Balance
Dec. 31	Record rent expense of Dec. 2017	500		500
31	Closing expense accounts as of 12/31/17.		500	0

GENERAL JOURNAL				J-19
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Dec. 31	Retained Earnings		5,459	
	Salary Expense			3,200
	Rent Expense			500
	Supplies Expense			1,100
	Depreciation Expense			167
	Utility Expense			450
	Interest Expense			42
	(Closing expense accounts as of 12/31/17)			

ACCOUNT TITLE: Supplies Expense

Date	Description	Debit	Credit	Balance
Dec. 31	Record supplies used during Dec. 2017	1,100		1,100
31	Closing expense accounts as of 12/31/17		1,100	0

GENERAL JOURNAL				J-19
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Dec. 31	Retained Earnings		5,459	
	Salary Expense			3,200
	Rent Expense			500
	Supplies Expense			1,100
	Depreciation Expense			167
	Utility Expense			450
	Interest Expense			42
	(Closing expense accounts as of 12/31/17)			

ACCOUNT TITLE: Depreciation Expense				
Date	**Description**	**Debit**	**Credit**	**Balance**
Dec. 31	Record depreciation expense Dec. 2017	167		167
31	Closing expense accounts as of 12/31/17		167	0

GENERAL JOURNAL				J-19
Date	Account Title	Ref.	Debit	Credit
Dec. 31	Retained Earnings		5,459	
	Salary Expense			3,200
	Rent Expense			500
	Supplies Expense			1,100
	Depreciation Expense			167
	Utility Expense			450
	Interest Expense			42
	(Closing expense accounts as of 12/31/17)			

ACCOUNT TITLE: Utility Expense

Date	Description	Debit	Credit	Balance
Dec. 31	Record electricity cost for Dec. 2017	450		450
31	Closing expense accounts as of 12/31/17		450	0

GENERAL JOURNAL				J-19
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Dec. 31	Retained Earnings		5,459	
	Salary Expense			3,200
	Rent Expense			500
	Supplies Expense			1,100
	Depreciation Expense			167
	Utility Expense			450
	Interest Expense			42
	(Closing expense accounts as of 12/31/17)			

ACCOUNT TITLE: Interest Expense				
Date	**Description**	**Debit**	**Credit**	**Balance**
Dec. 31	Record interest expense for Dec. 2017	42		42
31	Closing expense accounts as of 12/31/17.		42	0

Closing Entries
Step 8

4.3 Closing Entries Procedure

- **Example 12**: Finally, to close dividend account, we credit the dividend account by its balance and debit Retained Earnings. After posting this journal entry to the general ledger, the balance of dividend account is $0 and the balance of Retained Earnings account is decrease by the amount of dividends paid during the period.

GENERAL JOURNAL				J-20
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Dec. 31	Retained Earnings		1,500	
	Dividends			1,500
	(*Closing dividend accounts as of 12/31/17*)			

- See the **posting** on the next two pages.

Closing Entries
Step 8

GENERAL JOURNAL				J-20
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Dec. 31	Retained Earnings		1,500	
	Dividends			1,500
	(*Closing dividend accounts as of 12/31/17*)			

ACCOUNT TITLE: Retained Earnings				
Date	**Description**	**Debit**	**Credit**	**Balance**
Dec. 1	Beginning Balance			0
31	Closing revenue accounts as of 12/31/17.		10,700	10,700
31	Closing expense accounts as of 12/31/17.	5,459		5,241
31	Closing dividend accounts as of 12/31/17.	1,500		3,741

Closing Entries
Step 8

GENERAL JOURNAL				J-20
Date	**Account Title**	**Ref.**	**Debit**	**Credit**
Dec. 31	Retained Earnings		1,500	
	Dividends			1,500
	(*Closing dividend accounts as of 12/31/17*)			

ACCOUNT TITLE: Dividends				
Date	**Description**	**Debit**	**Credit**	**Balance**
Dec. 30	Paid dividends to stockholders	1,500		1,500
31	Closing dividend accounts as of 12/31/17.		1,500	0

Closing Entries
Step 8

4.3 Closing Entries Procedure

- **Example 12**:
  - After posting the closing entries, the balance of all the accounts of revenues, expenses and dividend are $0.
  - Finally, the balance of the Retained Earnings account is updated to includes the net results of operations and the payments of dividends during the period.
  - See Balance Sheet of next page to confirm Retained Earnings balance as of December 31, 2017.

Vienna School Corporation
Balance Sheet
December 31, 2017

Assets		Liabilities	
Current Assets		Current Liabilities	
Cash	$13,300	Accounts Payable	$1,950
Accounts Receivable	4,700	Interest Payable	42
Prepaid Rent	2,500	**Total current liabilities**	**1,992**
Music Supplies	400	Long-term Liabilities	
Total current assets	**20,900**	Note Payable	5,000
		Total Liabilities	**6,992**
Long-term Assets			
Music Equipment	20,000	**Stockholders' Equity**	
Less: Accum. Deprec.	(167)	Common Stock	30,000
Total Long-term Assets	**19,833**	Retained Earnings	3,741
		Total Stockholders' Equity	**33,741**
TOTAL ASSETS	**$40,733**	**TOTAL LIABILITY AND STOCKHOLDERS' EQUITY**	**$40,733**

Post-Closing Trial Balance
Step 9

Post-Closing Trial Balance
Step 9

5.1 Purpose

- The Post-Closing Trial Balance is a list of all permanent accounts and their balances at a particular date after the closing entries have been posted to the General Ledger.
- The Post-Closing Trial Balance helps to verify that we prepared and posted closing entries correctly and that the accounts are now ready for the next period's transactions.
- Consequently, only assets, liabilities and stockholders' equity accounts are listed in the Post-Closing Trial Balance.

Post-Closing Trial Balance
Step 9

5.1 Purpose

- **Example 13**: The Post-Closing Trial Balance of Vienna School Corporation is presented on next page.
- Only the accounts presented on Balance Sheet (assets, liabilities and stockholders' equity accounts) are listed in the Post-Closing Trial Balance. These are the permanent accounts.
- The Income Statements accounts (revenues and expenses) and the dividend accounts (temporary accounts) were closed at the end of the year. These accounts now has $0 balance and they are ready to record the transactions of the next accounting period.

Post-Closing Trial Balance
Step 9

VIENNA SCHOOL CORPORATION POST-CLOSING TRIAL BALANCE DECEMBER 31, 2017		
ACCOUNTS	**DEBIT**	**CREDIT**
Cash	$13,300	
Account Receivable	4,700	
Prepaid Rent	2,500	
Music Supplies	400	
Music Equipment	20,000	
Accumulated Depreciation		167
Accounts Payable		1,950
Interest Payable		42
Note Payable		5,000
Common Stock		30,000
Retained Earnings		3,741
TOTAL	**$40,900**	**$40,900**