

Financial Accounting

Module 4: Completing the Accounting Cycle



Module Learning Outcomes

Describe the complete accounting cycle

- 4.1: Describe the process of making adjusting journal entries
- 4.2: Create adjusting journal entries
- 4.3: Creating the adjusted trial balance
- 4.4: Use an adjusted trial balance to prepare financial statements
- 4.5: Prepare and post closing entries

The Adjusting Process

Learning Outcomes: The Adjusting Process

- 4.1: Describe the process of making adjusting journal entries
 - 4.1.1: Explain the need for adjusting journal entries
 - 4.1.2: Describe the adjustment process
 - 4.1.3: Differentiate between deferrals and accruals

The Need for Adjusting Journal Entries

- Adjusting entries are made during the accounting cycle after the unadjusted trial balance and before the company prepares its financial statements, bringing the amounts in the general ledger accounts to their proper balances.
- Each adjusting entry has a dual purpose:
 1. To make the income statement report the appropriate revenue or expense
 2. To make the balance sheet report the appropriate asset or liability

Three Adjusting Entry Rules

- **Rule 1:** Adjusting entries will almost never include cash.
 - The purpose of adjusting entries is to make the accounting records accurately reflect the matching principle—match revenue and expense of the operating period. There are some rare cases where cash needs to be adjusted, but ideally, that adjusting should have all been done prior to running the unadjusted trial balance.
- **Rule 2:** Debits always equal credits (as usual).
- **Rule 3:** The adjusting entry will have one balance sheet account (asset, liability, or equity) and one income statement account (revenue or expense) in the journal entry.
 - Remember, the goal of the adjusting entry is to match the revenue and expense of the accounting period. Adjusting entries between balance sheet accounts only, or between income statement accounts only, are usually called reclassifications.

How the Adjustment Process Works

- Accountants have followed these steps for 500 years:
 - Print out the unadjusted trial balance
 - Analyze each account
 - Look for anything that is missing
 - Make adjusting journal entries
 - Post the adjusting journal entries



Accruals versus Deferrals

- The word “accrue” means to add to. The word “defer” means to put off until later.
- In accounting:
 - If you earn revenue before you collect the cash, you have to accrue the revenue (add it to the books).
 - If you get the cash before you earn the revenue, you must defer recognition of the revenue.
- The same holds true for expenses.

Practice Question 1

Jack is just learning about how to adjust journal entries. He is asking you about the rules associated with the journal adjustments. What is one of the rules of adjusting journal entries you could tell Jack?

- A. Debits are always less than Credits
- B. One income statement account and one balance sheet account is in an entry
- C. Adjusting entries usually include Cash
- D. Adjusting entries include notes and disclosures like with financial statements

Creating Adjusting Journal Entries

Learning Outcomes: Creating Adjusting Journal Entries

4.2: Create adjusting journal entries

4.2.1: Analyzing revenue accounts and creating necessary adjustments

4.2.2: Analyzing expense accounts and creating necessary adjustments

4.2.3: Finding errors and creating adjustments

Analyzing Revenue Accounts and Creating Necessary Adjustments

An asset/revenue adjustment may occur when a company performs a service for a customer but has not yet billed the customer. The accountant records this transaction as an asset in the form of a receivable and as revenue because the company has earned a revenue.

JOURNAL		Page 101		
Date	Description	P.R.	Debit	Credit
20-				
Dec. 31	Accounts Receivable		5,000.00	
	Service Revenue			5,000.00
	To accrue revenue earned but not yet billed.			

Analyzing Expense Accounts and Creating Necessary Adjustments

An expense adjustment may occur when a company accrues expenses that have not been paid. A typical example would be wages employees earned but have not been paid. An accountant would record unpaid salaries as a liability and an expense as the company has incurred an expense.

JOURNAL		Page 86		
Date	Description	P.R.	Debit	Credit
20–				
Dec. 1	Supplies		1,200.00	
	Accounts Payable			1,200.00
	To record purchase of paint supplies			

Finding Errors and Creating Adjustments

Start the process by asking yourself these three questions when dealing with errors:

1. What type of error is it?
2. How should this error be fixed?
3. How did this error affect the financial statements?

Finding Errors and Creating Adjustments (cont.)

Here are examples of common accounting errors to watch for:

- **Transposition Error.** Reversing or transposing digits (e.g. 3874 instead of 3784).
- **Omission Error.** A transaction isn't recorded like a sale or expense is overlooked (example: a cash sale of a TV wasn't written down in the rush of a black Friday sale).
- **Entry Reversal.** An entry is debited instead of credited or vice versa.
- **Subsidiary Entries.** A transaction is incorrectly entered, usually not caught until reconciling the bank statement.
- **Rounding Error.** When a number is rounded up or down and can have a cascading effect on subsequently.
- **Error of Commission.** An amount is entered as the correct account and amount, but is actually incorrect. For example, an amount was added instead of subtracted or charged on one invoice when it should have been applied to a different invoice.

Finding Errors and Creating Adjustments

Now that you understand what type of error it is, it's time to classify it as a deferral (also known as prepayment) or an accrual. Then ask, "Is it part of accrued revenue, accrued expense, deferred (unearned) revenue, or deferred (prepaid) expense?" Once those steps have been discovered, an adjusted journal entry is created to fix it.

JOURNAL		Page 86		
Date	Description	P.R.	Debit	Credit
20–				
Dec. 31	Cost of Goods Sold		600	
	Inventory			600
	Adjustment for inventory shrinkage			

Finding Errors and Creating Adjustments

Errors in the accrued and deferred (unearned or prepaid) revenues and expenses affect the Balance Sheet and Income Statement in the following manner:

Before Adjusting						
Adjusting Entry Not Recorded	Balance Sheet			Income Statement		
	Assets	Liabilities	Equity	Revenue	Expenses	Net Income
Accrued Revenues	Understated		Understated	Understated		Understated
Accrued Expenses		Understated	Overstated		Understated	Overstated
Unearned Revenues		Overstated	Overstated	Understated		Understated
Prepaid Expenses	Overstated		Overstated		Understated	Overstated

Preparing an Adjusted Trial Balance

Learning Outcomes: Preparing an Adjusted Trial Balance

4.3: Creating the adjusted trial balance

4.3.1: Posting adjusting entries to the ledgers and re-balancing the accounts

4.3.2: Creating an adjusted trial balance using a worksheet

Posting Adjusting Entries to the Ledgers and Re-Balancing the Accounts

- After preparing the journal entries, post them to the ledgers.
- Each account is analyzed and verified to start to create the adjusted trial balance:
 - Checking
 - Accounts Receivable
 - Supplies
 - Prepaid Rent
 - Accounts Payable
 - Capital Contributions
 - Owner Withdrawals
 - Service Revenue
 - Insurance Revenue
 - Rent Expense
 - Supplies Expense
 - Contractor Expense

Using the Worksheet (Trial Balance)

NeatNiks Trial Balance (unadjusted) For the month ended October 31, 20XX			
Reference No.	Accounts	Debits	Credits
110	Checking	3,500.00	
120	Accounts Receivable	5,650.00	
125	Supplies	2,600.00	
130	Prepaid Rent	12,000.00	
210	Account Payable		1,600.00
220	Contractor Payable		–
310	Nick Frank, Capital Contributions		20,000.00
330	Nick Frank, Withdrawals	4,000.00	
410	Service Revenue		8,750.00
510	Insurance Revenue	1,500.00	
520	Rent Expense	–	
530	Supplies Expense	–	
540	Contractor Expense	1,100.00	
	Totals	30,350.00	30,350.00

Using the Worksheet (Proposed Adjustment)

NeatNiks Trial Balance For the Month ended October 31, 20XX							
Reference No.	Accounts	Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance	
		DR	CR	DR	CR	DR	CR
110	Checking	3,500.00				3,500.00	
120	Accounts Receivable	5,650.00				5,650.00	
125	Supplies	2,600.00				2,600.00	
130	Prepaid Rent	12,000.00				12,000.00	
210	Accounts Payable		1,600.00				1,600.00
220	Contractor Payable		–				–
310	Nick Frank, Capital Contributions		20,000.00				20,000.00
330	Nick Frank, Withdrawals	4,000.00				4,000.00	
410	Service Revenue		8,750.00				8,750.00
510	Insurance Expense	1,500.00				1,500.00	
520	Rent Expense	–				–	
530	Supplies Expense	–				–	
540	Contractor Expense	1,100.00				1,100.00	
		30,350	30,350			30,350	0,350

Using the Worksheet (Proposed Adjustment)

NeatNiks Trial Balance For the Month ended October 31, 20XX									
Ref No.	Accounts	Unadjusted Trial Balance		Reference	Adjustments			Adjusted Trial Balance	
		DR	CR		DR	Reference	CR	DR	CR
110	Checking	3,500.00						3,500.00	
120	Accounts Receivable	5,650.00						5,650.00	
125	Supplies	2,600.00				AJE1	1,600.00	2,600.00	
130	Prepaid Rent	12,000.00				AJE2	2,000.00	12,000.00	
210	Accounts Payable		1,600.00						1,600.00
220	Contractor Payable		–			AJE3	1,200.00		–
310	Nick Frank, Capital Contributions		20,000.00						20,000.00
330	Nick Frank, Withdrawals	4,000.00						4,000.00	
410	Service Revenue		8,750.00						8,750.00
510	Insurance Expense	1,500.00						1,500.00	
520	Rent Expense	–		AJE2	2,000.00			–	
530	Supplies Expense	–		AJE1	1,600.00			–	
540	Contractor Expense	1,100.00		AJE3	1,200.00			1,100.00	
		30,350	30,350		4,800.00		4,800.00	30,350	0,350

Creating An Adjusted Trial Balance Using a Worksheet

Once we have made all the adjustments to the ledger accounts and we have run the adjusted trial balance and feel confident all assets, liabilities, capital accounts, revenues, and expenses are recorded and are being reported according to GAAP (or, if we are a small business, as close to GAAP as we want to be), then we are ready for the final step: to create the financial statements.



Practice Question 2

Kwan Chou has finished putting together adjusting entries and rebalanced the accounts for the most recent accounting period. She now needs to put together an Adjusted Trial Balance. Which of the following tools is best for her to use to prepare for the Trial Balance?

- A. Worksheet
- B. Balance Sheet
- C. Income Statement
- D. Bank Statement

Preparing Financial Statements

Learning Outcomes: Preparing Financial Statements

- 4.4: Use an adjusted trial balance to prepare financial statements
 - 4.4.1: Prepare an income statement
 - 4.4.2: Prepare a statement of owner's equity
 - 4.4.3: Prepare a balance sheet
 - 4.4.4: Identify the three main components of the statement of cash flows

Prepare an Income Statement

- The first statement to prepare from the Adjusted Trial Balance is the Income Statement.
 - The income statement, sometimes called a statement of earning, or a profit and loss (P&L) shows the results of operations by reporting net income. Net income is revenues less expenses (see the highlighted accounts on the adjusted trial balance above).
 - When we compile these reports, we don't use debits and credits. Those are only used when we are recording transactions. For these reports, we just use regular numbers that ordinary people can easily grasp.
 - The expenses are all listed and a single underline showing we are subtotalling them, with that subtotal listed directly underneath the revenue - the bottom line. Net Income is shown as the combination of the two numbers above it. The external user knows the net income is revenue minus expenses, so we don't have to reiterate that on the statement.

Prepare a Statement of Owner's Equity

The statement of owner's equity builds off the income statement, starting with revenues and expenses combined (\$1,350 net income), adding capital, and subtracting any withdrawals.

NeatNiks Statement of Owner's Equity For the month ended October 31, 20XX	
Nick Frank, Capital, October 1, 20XX	\$0
Owner contributions	20,000
Net income/(loss) for the month	1,350
	<hr/>
	21,350
Owner withdrawals	(4,000)
	<hr/>
Nick Frank, Capital, October 31, 20XX	\$17,350

Prepare a Balance Sheet

The balance sheet shows the accounting equation: $A = L + E$.

Neatniks Balance Sheet As of October 31, 20XX	
Description	Amount
Assets	
Cash	\$3,500
Accounts Receivable	5,650
Supplies	1,000
Prepaid Rent	10,000
Total Assets	\$20,150
Liabilities	
Accounts Payable	\$1,600
Wages Payable	1,200
Total Liabilities	\$2,800
Owner's Equity	
	17,350
Total Liabilities and Owner's Equity	\$20,150

Identify the Three Main Components of the Statement of Cash Flows

- There are three sections to the statement of cash flows:
 - Cash from operations
 - Cash from investing
 - Cash from financing
- Two different ways to present the statement of cash flows: the direct method and the indirect method. They are only different in the way they present cash from operations.
 - **Direct method** reports cash receipts and disbursements as if the income statement had been prepared on a cash basis.
 - **Indirect method** starts with accrual basis net income and reconciles it to cash basis.

Closing the Books

Learning Outcomes: Closing the Books

4.5: Prepare and post closing entries

4.5.1: Identify permanent and temporary accounts

4.5.2: Prepare closing entries

4.5.3: Post closing entries and prepare the post-closing trial balance

4.5.4: Demonstrate reversing entries

Identify Permanent and Temporary Accounts

- **Permanent accounts:** balance sheet accounts including assets, liabilities, and equity accounts (except for withdrawals). These account balances roll over into the next period. The ending balance of this period will be the beginning balance for next period.
- **Temporary accounts:** revenues, expenses, and withdrawals accounts. These account balances do not roll over into the next period after closing. The closing process reduces revenue, expense, and withdrawals account balances (temporary accounts) to zero so they are ready to accumulate data for the next accounting period.

Preparing Closing Entries

In accounting, we often refer to the process of closing as closing the books. The four basic steps in the closing process are:

- **Closing the Revenue Accounts:** transferring the credit balances in the revenue accounts to a clearing account called Income Summary.
- **Closing the Expense Accounts:** transferring the debit balances in the expense accounts to a clearing account called Income Summary.
- **Closing the Income Summary Account:** transferring the balance of the Income Summary account to the owner's capital account.
- **Closing the Withdrawal Account:** transferring the debit balance of the owner withdrawal account to the capital account.

Post Closing Entries and Prepare the Post-Closing Trial Balance

- After we complete journal entries, we post to the ledger and run a post-closing trial balance.
- Once we are satisfied everything is balanced, carry the balances forward to the new blank pages of the next (now current) year's ledger and are now ready to start posting transactions.
- Remember, closing entries are only used in systems using actual bound books made of paper. They are an important concept and officially represent the end of the process.

Post Closing Entries (part II)

Due to Bank		Wage Expense	
	5,000	1/1 bal fwd -	
10/31 5,000		9/20 4,700	
	-	4,700	
	<u> </u>		4,700 closing entry B
	12/31 bal	12/31 bal -	
		<u> </u>	

Post Closing Entries (part IV)

Income Summary		
closing entry B	4,700	13,100
closing entry C	8,400	
		closing entry A

MacroAuto

Post Closing Trial Balance

As of 12/31/2020

	DR	CR	
Checking	10,800		permanent accounts
Due to Bank		-	
Owner's Capital		10,800	
Owner Withdrawals	-		temporary accounts
Service Revenue		-	
Wages Expense	-		
	<u>10,800</u>	<u>10,800</u>	

Demonstrate Reversing Entries

- After everything is closed and the old year is done, accountants sometimes perform one more step that could be called the beginning of the next accounting cycle as easily as it could be called the end of the old.
- See if you can figure out what is wrong with these accounts. Once you do, you'll be able to see why we make reversing entries for some accruals.

Wages Payable	Wage Expense
1200	2300
	1200

Wages Payable		Wage Expense
1200	BAL FWD	2300
	11/10 pay	1200
	11/25 pay	1600
2200	11/30 AJE	2200
3400		7300

Practice Question 3

Which of the following choices is an example of a temporary account that is closed at the end of the fiscal year?

- A. Accounts Payable
- B. Land
- C. Inventory
- D. Service Revenue

Class Activity: Financial Statement Discussion

- Refer to the four financial statements in the course for NeatNiks:
 - Income Statement,
 - Statement of Owner's Equity,
 - Balance Sheet,
 - Statement of Cash Flows.
- Look through them carefully and find the connections and differences between each other.
- Discussion these questions with a group of your classmates:
 - Why is the Income Statements the first financial statement to prepare?
 - What does each of the financial statements show or emphasize?
 - How are each of the statements different from each other?
 - Are some or all of the Statements necessary to have for a company? Why?

Quick Review

- Why is there a need for adjusting journal entries?
- What is the adjustment process?
- What is the difference between deferrals and accruals?
- How do you analyze revenue accounts and create the necessary adjustments?
- How do you analyze expense accounts and create the necessary adjustments?
- How do you find errors and create adjustments?
- How can you post adjusting entries to the ledgers and re-balance the accounts?
- How can you create an adjusted trial balance using a worksheet?

More Quick Review

- How does an accountant prepare an income statement?
- How does an accountant prepare a statement of owner's equity?
- How does an accountant prepare a balance sheet?
- What are the three main components of the statement of cash flows?
- Which accounts are permanent and which temporary?
- How do you prepare closing entries
- When do you post closing entries and prepare the post-closing trial balance?
- What is the process for reversing entries?