



Before studying this chapter, you should understand or, if necessary, review:

- How to apply the revenue recognition and matching principles. (Ch. 3, p. 105)
- How to make adjusting entries. (Ch. 3, pp. 108–119)
- How to prepare an adjusted trial balance. (Ch. 3, pp. 123–124)
- How the balance sheet, income statement, and statement of owner's equity are connected. (Ch. 3, pp. 124–125)

Breezing through the Month End with Style

WINNIPEG, Man.—Owned and operated by the Gorenstein family of Winnipeg, Moulé has four gallery-style retail stores in Vancouver and Winnipeg. Each one features gifts, jewellery, and other treasures from around the world. The items have been crafted by talented artists working in glass, ceramics, metal, and other media. Founded in 1987, Moulé also designs and manufactures a signature line of soft, feminine, and sophisticated women's apparel. The clothing is sold in Moulé stores and distributed across North America and as far away as Japan.

Month end finds Moulé's chief operations officer, Laurie Gorenstein, running off extra reports for things like sales, GST and PST, commissions, and inventory on the Smart Vendor computer software he uses for most of the company's accounting. (He tracks payables with an Excel spreadsheet.) "Basically, I receive all the invoices from the stores at month end and check them against the figures in the computer. Then I run the general ledger and the trial balance."

"My accountant checks them, and we make any updates or corrections necessary—such as a cheque posted to the wrong account—with an adjusting or correcting entry," he continues. By checking things monthly, "it usually comes out pretty smoothly." Monthly financial statements then follow.

"So it really is pretty easy," says Mr. Gorenstein. Once a year, the load gets a little heavier when the books are



closed—as with many businesses, Moulé's fiscal year ends December 31—and the year's financial statements are prepared. At this point, he's very glad of the care taken to find discrepancies and to make adjustments at month end. If errors are left undetected, "then they come back to haunt you months later and you can spend forever trying to sort them out."

Moulé recently set up an "open-to-buy" system, which allows the store to use past sales data to predict future sales. By inputting merchandise sales daily and analyzing this information monthly, Mr. Gorenstein can track what sells best when, which leads to better planning and purchasing decisions. "The 'open-to-buy system' is specific to 20 different categories of merchandise, so we know what month is best for each," he explains. And tracking the merchandise so closely also significantly reduces the potential for error on the financial side.





- Understand *Concepts for Review*
- Read *Feature Story*
- Scan *Study Objectives*
- Read *Chapter Preview*
- Read text and answer *Before You Go On*
- Work *Demonstration Problem*
- Review *Summary of Study Objectives*
- Answer *Self-Study Questions*
- Complete assignments

chapter 4

Completion of the Accounting Cycle

study objectives >>

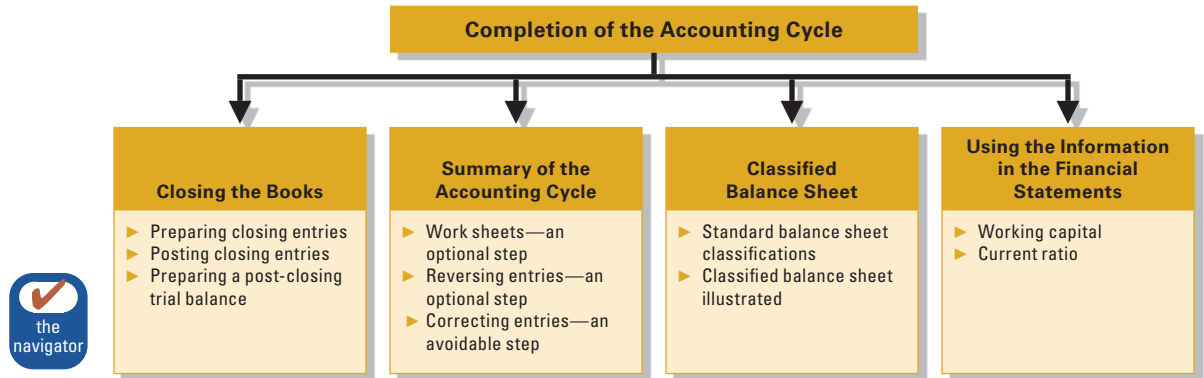


After studying this chapter, you should be able to:

1. Prepare closing entries and a post-closing trial balance.
2. List the steps in the accounting cycle.
3. Prepare correcting entries.
4. Prepare a classified balance sheet.
5. Illustrate measures used to evaluate liquidity.
6. Prepare a work sheet (Appendix 4A).
7. Prepare reversing entries (Appendix 4B).

In Chapter 3, we prepared financial statements directly from the adjusted trial balance. In this chapter, we will explain what the remaining steps in the accounting cycle are for—especially the closing process. Once again, we will use the Pioneer Advertising Agency as an example.

After that we will look at correcting entries. As Laurie Gorenstein of Moulé notes in the feature story, locating and correcting errors on a regular basis is very important. We end by discussing the classification and use of balance sheets. The chapter is organized as follows:



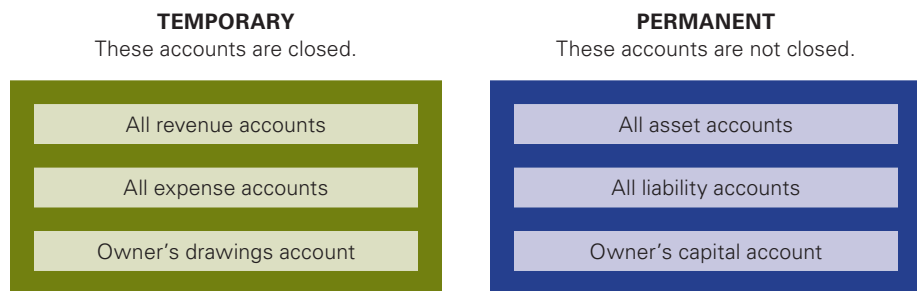
Closing the Books

study objective 1
Prepare closing entries and a post-closing trial balance.

At the end of the accounting period, the accounts are made ready for the next period. This is called **closing the books**. When closing the books, it is important to know the difference between temporary and permanent accounts. **Temporary accounts** only collect data for a single accounting period. They include all income statement (revenue and expense) accounts and the owner’s drawings account. In previous chapters, you learned that these accounts are subdivisions of the owner’s capital account. Revenues, expenses, and drawings are called temporary accounts because they give temporary (for a single accounting period) detail about the changes in the owner’s capital account. All temporary accounts are closed at the end of the period.

In contrast, all balance sheet accounts are considered **permanent accounts** because their balances are carried forward into the next accounting period. This means that permanent accounts are not closed. Illustration 4-1 identifies the accounts in each category.

Illustration 4-1 ▶
Temporary versus permanent accounts



Preparing Closing Entries

At the end of the accounting period, **closing entries** are used to transfer the temporary account balances (revenues, expenses, and drawings) to the permanent owner's capital account. Closing entries formally record in the ledger the transfer of net income (or net loss) and the owner's drawings to the owner's capital account. This updates the owner's capital balance to its balance at the end of the period, as shown on the statement of owner's equity and the balance sheet. These entries also result in a zero balance in each temporary account. The temporary accounts are then ready to collect data in the next accounting period.

Journalizing and posting closing entries is a required step in the accounting cycle. This step is done after financial statements have been prepared. Closing entries are generally journalized and posted only at the end of a company's annual accounting period. Moulé, introduced in the feature story, closes its books once a year.

When closing entries are prepared monthly, annual financial statements are more complicated to prepare. For example, to calculate the owner's drawings for the year, each month's owner's drawings have to be added together. This step would have to be done for each temporary account. As a result, most companies prepare and record closing entries only at their year end.

In preparing closing entries, each income statement account could be closed directly to the owner's capital account. This is often done in computerized accounting systems where the closing process occurs automatically when it is time to start a new accounting period. In manual accounting systems, however, closing directly to the owner's capital account can make it harder to find errors that may have happened when the revenue and expense accounts were being closed. Instead, it is helpful to first close the revenue and expense accounts to another temporary account, **Income Summary**. After the revenue and expense accounts have been closed, the balance in the Income Summary account is then checked to make sure it is equal to the net income or net loss for the period. Once that is done, the net income or net loss can then be transferred from the Income Summary account to owner's capital.

We will therefore use four steps in preparing closing entries:

1. Close revenue accounts: Debit each individual revenue account for its balance, and credit Income Summary for total revenues.
2. Close expense accounts: Debit Income Summary for total expenses, and credit each individual expense account for its balance.
3. Close Income Summary: Debit Income Summary for its balance, and credit the owner's capital account (if there is a net loss, credit Income Summary for the amount of the loss, and debit the owner's capital account).
4. Close drawings: Debit the owner's capital account and credit the owner's drawings account for the balance in drawings.

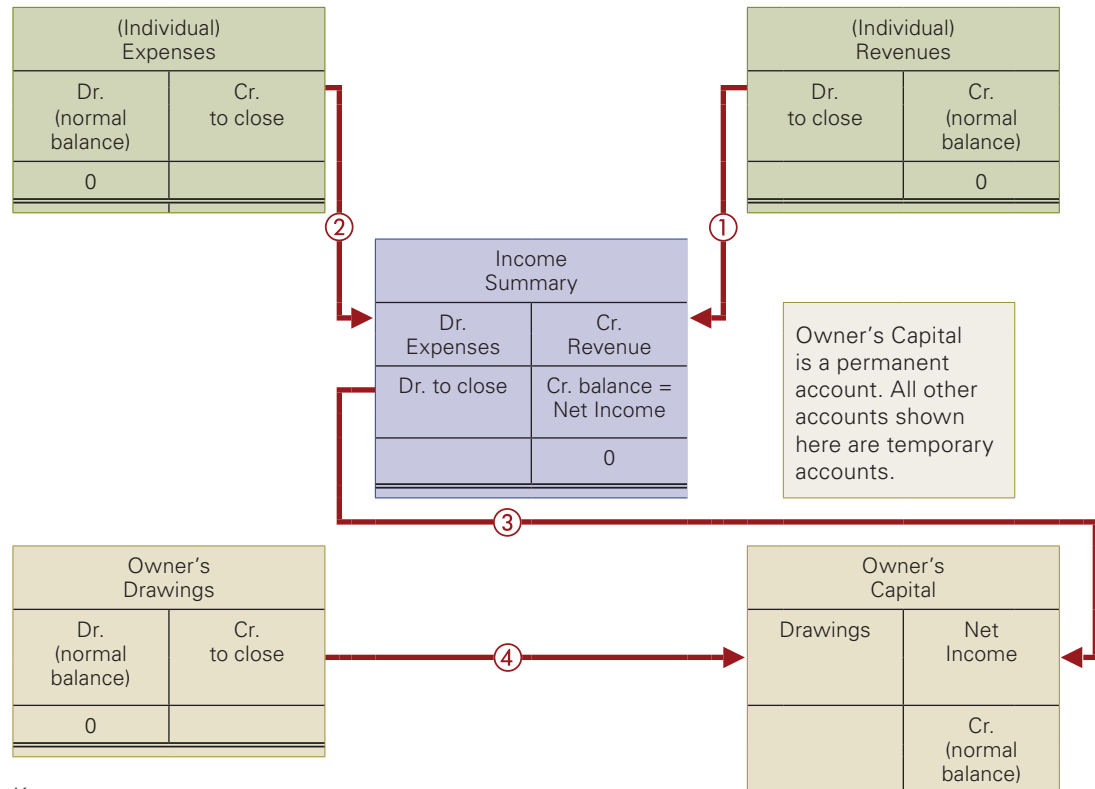
Separate closing entries could be prepared for each individual revenue and expense account. However, the compound entries described in the first two steps above are more efficient. Closing entries are journalized in the general journal after adjusting entries. To identify these entries, a centre caption titled "Closing Entries" can be inserted in the journal between the last adjusting entry and the first closing entry. Then the closing entries are posted to the ledger accounts.

Illustration 4-2 is a diagram of the four-step closing process for a proprietorship, using T accounts.

► Completion of the Accounting Cycle

Illustration 4-2 ►

Diagram of closing process



Owner's Capital is a permanent account. All other accounts shown here are temporary accounts.

Key:

- ① Close revenues to Income Summary
 ② Close expenses to Income Summary

- ③ Close Income Summary to Owner's Capital
 ④ Close Owner's Drawings to Owner's Capital

Closing Entries Illustrated

To illustrate the journalizing and posting of closing entries, we will continue using the example of Pioneer Advertising Agency introduced in Chapters 2 and 3. For the illustrations, we have assumed that the company uses October 31 as its fiscal year end. Pioneer Advertising's adjusted trial balance on October 31, first shown in Chapter 3 (Illustration 3-6), is shown again here in Illustration 4-3.

Closing entries can be prepared directly from (1) the adjusted balances in the general ledger or adjusted trial balance, or (2) the income statement and statement of owner's equity. We will use the adjusted trial balance shown here to prepare the four required closing entries.

The temporary accounts have been highlighted in red. C. Byrd, Capital is not a temporary account, but it has also been highlighted because it is used in the closing process. Remember that the capital account balance in the trial balance is the opening balance (plus any investments made by the owner during the period)—it is not the ending balance that appears in the statement of owner's equity and balance sheet. This permanent account is updated to its ending balance by transferring the net income (loss) and drawings for the period from the temporary accounts.

The closing entries at October 31 follow Illustration 4-3:

Illustration 4-3 ◀

Adjusted trial balance

PIONEER ADVERTISING AGENCY Adjusted Trial Balance October 31, 2008		
	Debit	Credit
Cash	\$15,200	
Accounts receivable	200	
Advertising supplies	1,000	
Prepaid insurance	550	
Office equipment	5,000	
Accumulated amortization—office equipment		\$ 83
Notes payable		5,000
Accounts payable		2,500
Unearned revenue		800
Salaries payable		2,000
Interest payable		25
C. Byrd, capital		10,000
C. Byrd, drawings	500	
Service revenue		10,600
Advertising supplies expense	1,500	
Amortization expense	83	
Insurance expense	50	
Salaries expense	6,000	
Rent expense	900	
Interest expense	25	
	<u>\$31,008</u>	<u>\$31,008</u>

GENERAL JOURNAL				J3
Date	Account Titles and Explanation	Ref.	Debit	Credit
	Closing Entries			
2008	(1)			
Oct. 31	Service Revenue	400	10,600	
	Income Summary	350		10,600
	To close revenue account.			
	(2)			
31	Income Summary	350	8,558	
	Advertising Supplies Expense	611		1,500
	Amortization Expense	711		83
	Insurance Expense	722		50
	Salaries Expense	726		6,000
	Rent Expense	729		900
	Interest Expense	905		25
	To close expense accounts.			
	(3)			
31	Income Summary	350	2,042	
	C. Byrd, Capital	301		2,042
	To close net income.			
	(4)			
31	C. Byrd, Capital	301	500	
	C. Byrd, Drawings	306		500
	To close drawings account.			

Be careful when you prepare closing entries: (1) Remember that the reason for making closing entries is to bring the temporary accounts to zero balances. Avoid unintentionally

► Completion of the Accounting Cycle

doubling the revenue, expense, drawings, and income summary account balances, rather than bringing them to zero. (2) Do not close owner's drawings with the expenses. The drawings that an owner makes are not an expense, so they are not a factor in determining net income.

Posting Closing Entries

The posting of the closing entries is as follows:

GENERAL LEDGER			
Cash		101	
Oct. 1	10,000	Oct. 3	900
3	1,200	3	600
31	10,000	20	500
		24	4,000
Oct. 31 Bal.	15,200		
Accounts Receivable		112	
Oct. 21	10,000	Oct. 31	10,000
31 Adj.	200		
Oct. 31 Bal.	200		
Advertising Supplies		129	
Oct. 4	2,500	Oct. 31 Adj.	1,500
Oct. 31 Bal.	1,000		
Prepaid Insurance		130	
Oct. 3	600	Oct. 31 Adj.	50
Oct. 31 Bal.	550		
Office Equipment		151	
Oct. 2	5,000		
Oct. 31 Bal.	5,000		
Accumulated Amortization— Office Equipment		152	
		Oct. 31 Adj.	83
		Oct. 31 Bal.	83
Notes Payable		200	
		Oct. 2	5,000
		Oct. 31 Bal.	5,000
Accounts Payable		201	
		Oct. 4	2,500
		Oct. 31 Bal.	2,500
Unearned Revenue		209	
Oct. 31 Adj.	400	Oct. 3	1,200
		Oct. 31 Bal.	800
Salaries Payable		212	
		Oct. 31 Adj.	2,000
		Oct. 31 Bal.	2,000
Interest Payable		230	
		Oct. 31 Adj.	25
		Oct. 31 Bal.	25
C. Byrd, Capital		301	
		Oct. 1	10,000
Oct. 31 Clos.	500	31 Clos.	2,042
		Oct. 31 Bal.	11,542
C. Byrd, Drawings		306	
Oct. 20	500	Oct. 31 Clos.	500
Oct. 31 Bal.	0		
Income Summary		350	
Oct. 31 Clos.	8,558	Oct. 31 Clos.	10,600
31 Clos.	2,042		
		Oct. 31 Bal.	0
Service Revenue		400	
		Oct. 21	10,000
		31 Adj.	400
Oct. 31 Clos.	10,600	31 Adj.	200
		Oct. 31 Bal.	0
Advertising Supplies Expense		611	
Oct. 31 Adj.	1,500	Oct. 31 Clos.	1,500
Oct. 31 Bal.	0		
Amortization Expense		711	
Oct. 31 Adj.	83	Oct. 31 Clos.	83
Oct. 31 Bal.	0		
Insurance Expense		722	
Oct. 31 Adj.	50	Oct. 31 Clos.	50
Oct. 31 Bal.	0		
Salaries Expense		726	
Oct. 24	4,000		
31 Adj.	2,000	Oct. 31 Clos.	6,000
Oct. 31 Bal.	0		
Rent Expense		729	
Oct. 3	900	Oct. 31 Clos.	900
Oct. 31 Bal.	0		
Interest Expense		905	
Oct. 31 Adj.	25	Oct. 31 Clos.	25
Oct. 31 Bal.	0		

Stop and check your work after the closing entries are posted: (1) The balance in Income Summary, immediately before the final closing entry to transfer the balance to the owner's capital account, should equal the net income (or net loss) reported in the income statement (see Illustration 3-7 in Chapter 3). (2) All temporary accounts (revenues, expenses, owner's drawings, and Income Summary) should have zero balances. (3) The balance in the capital account should equal the ending balance reported in the statement of owner's equity and balance sheet (see Illustrations 3-7 and 3-8 in Chapter 3).



ACCOUNTING IN ACTION ▶ Across the Organization Insight

Ever since the first finance benchmarking studies in the 1980s, chief financial officers (CFOs) have been very interested in information that allows them to compare their companies to other companies. A recent survey of *CFO Magazine* readers that was done by the American Productivity and Quality Center has given even more data about the tasks done by a company's finance or accounting department.

CFOs should find some of these data reassuring. The average total cost of an accounting department is quite low—only 0.8 percent of revenues—and the average company spends only five days closing the books each month. Cycle times this short are considered respectable, if not spectacular.

Source: Don Durfee, "Flabby or Fit?" *CFO Magazine*, February 1, 2006, 24.



Why are CFOs interested in knowing how long it takes on average for companies to close their books?



Preparing a Post-Closing Trial Balance

After all closing entries have been journalized and posted, another trial balance is prepared from the ledger. It is called a **post-closing trial balance**. The post- (or after-) closing trial balance is a list of permanent accounts and their balances after closing entries have been journalized and posted. The purpose of this trial balance is to prove the equality of the permanent account balances that are carried forward into the next accounting period. Since all temporary accounts have zero balances after closing, the post-closing trial balance contains only permanent (balance sheet) accounts.

The post-closing trial balance for Pioneer Advertising Agency is shown in Illustration 4-4 on the following page. Note that the balances are the same as the ones in the company's balance sheet (Pioneer Advertising's balance sheet was last seen in Chapter 3, Illustration 3-8, and is shown again in this chapter in Illustration 4-13.)

Illustration 4-4 ▶

Post-closing trial balance

Helpful hint Total debits in a post-closing trial balance will not equal total assets on the balance sheet if contra accounts, such as accumulated amortization, are present. Accumulated amortization is deducted from assets on the balance sheet but added to the credit column in a trial balance.

PIONEER ADVERTISING AGENCY Post-Closing Trial Balance October 31, 2008		
	Debit	Credit
Cash	\$15,200	
Accounts receivable	200	
Advertising supplies	1,000	
Prepaid insurance	550	
Office equipment	5,000	
Accumulated amortization—office equipment		\$ 83
Notes payable		5,000
Accounts payable		2,500
Unearned revenue		800
Salaries payable		2,000
Interest payable		25
C. Byrd, capital		11,542
	<u>\$21,950</u>	<u>\$21,950</u>

A post-closing trial balance provides evidence that the journalizing and posting of closing entries has been completed properly. It also shows that the accounting equation is in balance at the end of the accounting period and the beginning of the next accounting period.

As in the case of the trial balance, the post-closing trial balance does not prove that all transactions have been recorded or that the ledger is correct. For example, the post-closing trial balance will still balance if a transaction is not journalized and posted, or if a transaction is journalized and posted twice. This is why it is so important, as Laurie Gorenstein of Moulé says in the feature story, to find and correct all errors before the books are closed.

BEFORE YOU GO ON . . .**▶ Review It**

1. How do permanent accounts differ from temporary accounts?
2. What four different types of entries are required in closing the books?
3. After closing entries are posted, what amounts on what financial statements should the balance in the owner's capital account agree with?
4. What are the differences between a trial balance, adjusted trial balance, and post-closing trial balance?

▶ Do It

The adjusted trial balance for the Nguyen Company shows the following: H. Nguyen, Drawings \$5,000; H. Nguyen, Capital \$42,000; Service Revenue \$18,000; Rent Expense \$2,000; Supplies Expense \$500; and Wages Expense \$7,500. Nguyen Company's statement of owner's equity for the year showed net income of \$8,000 and closing owner's capital of \$45,000. Prepare the closing entries at December 31. Create T accounts for Income Summary and H. Nguyen, Capital, and post the closing entries to these accounts.

Action Plan

- Debit each individual revenue account for its balance and credit the total to Income Summary.
- Credit each individual expense account for its balance and debit the total to Income Summary.
- Stop and check your work: Does the balance in Income Summary equal the reported net income (loss)?
- If there is net income, debit the balance in Income Summary and credit the amount to the owner's capital account (do the opposite if the result is a net loss).

- Credit the balance in the drawings account and debit the amount to the owner's capital account. Do not close drawings with the expenses.
- Stop and check your work: Do the temporary accounts have zero balances? Is the balance in Income Summary equal to net income after closing revenues and expenses? Does the ending balance in the owner's capital account equal the closing owner's capital reported on the statement of owner's equity?

Solution

Dec. 31	Service Revenue	18,000	
	Income Summary		18,000
	To close revenue account.		
31	Income Summary	10,000	
	Rent Expense		2,000
	Supplies Expense		500
	Wages Expense		7,500
	To close expense accounts.		
31	Income Summary	8,000	
	H. Nguyen, Capital		8,000
	To close Income Summary.		
31	H. Nguyen, Capital	5,000	
	H. Nguyen, Drawings		5,000
	To close drawings.		

Income Summary	
Clos. 10,000	Clos. 18,000
	Bal. 8,000 *
Clos. 8,000	
	Bal. 0

H. Nguyen, Capital	
Clos. 5,000	Bal. 42,000
	Clos. 8,000
	Bal. 45,000 **

* Check if this equals net income.

** Check if this equals closing owner's capital.

Related exercise material: BE4-1, BE4-2, BE4-3, E4-1, E4-2, and E4-3.



Summary of the Accounting Cycle

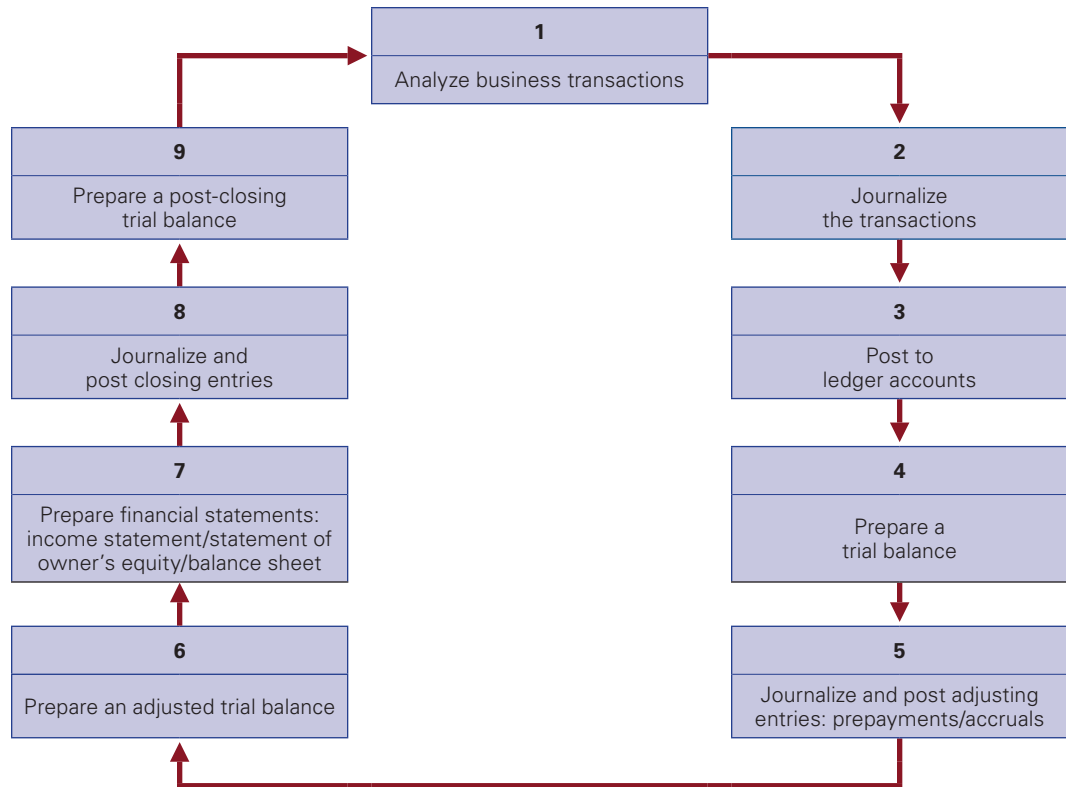
The steps in the accounting cycle are shown in Illustration 4-5 on the following page. You can see that the cycle begins with the analysis of business transactions and ends with the preparation of a post-closing trial balance. The steps in the cycle are done in sequence and are repeated in each accounting period.

study objective 2

List the steps in the accounting cycle.

Illustration 4-5

Steps in the accounting cycle



Optional steps: If a work sheet is prepared, steps 4, 5, and 6 are done in the work sheet, and adjusting entries are journalized and posted after step 7. If reversing entries are prepared, they occur between steps 9 and 1.

Steps 1 and 2 can occur every day during the accounting period, as explained in Chapter 2. Steps 3 through 7 are done on a periodic basis, such as monthly, quarterly, or annually. Steps 8 and 9, closing entries and a post-closing trial balance, are usually done only at the end of a company's annual accounting period.

There are also two optional steps in the accounting cycle. As the following two sections explain, a work sheet may be used in the adjustments process and in preparing financial statements; and reversing entries may be used at the beginning of a new accounting period.

Work Sheets—An Optional Step

To help them prepare adjusting entries and the financial statements, some accountants like to use an optional multiple-column form known as a **work sheet**. Work sheets can be prepared by hand, but today most work sheets are created by accounting software or spreadsheet programs.

As its name suggests, the work sheet is a working tool for the accountant. A work sheet is not a permanent accounting record; it is neither a journal nor a part of the general ledger. The work sheet is just something that is used to make it easier to prepare adjusting entries and financial statements. If a work sheet is used, adjusting entries are not formally recorded or posted until after the financial statements are prepared.

Although using a work sheet is optional, it is useful. It can help accountants avoid errors when they are working with a lot of information that involves many accounts and adjustments. A work sheet also makes it easier to prepare interim (e.g., monthly or quarterly) financial information for internal use because adjusting entries can be prepared and entered in the work sheet, and interim financial statements can then be developed easily. In small

companies that have relatively few accounts and adjustments, a work sheet may not be needed. In companies with a lot of accounts and adjustments, it is almost indispensable.

As the preparation of a work sheet is optional, its basic form and the procedure for preparing it are explained in Appendix 4A at the end of the chapter.

Reversing Entries—An Optional Step

Some accountants prefer to reverse certain adjusting entries at the beginning of a new accounting period. A **reversing entry** is made at the beginning of the next accounting period. It is the exact opposite of the adjusting entry made in the previous period. The preparation of reversing entries is an optional bookkeeping procedure that is not a required step in the accounting cycle. We have therefore chosen to explain this topic in Appendix 4B at the end of the chapter.

BEFORE YOU GO ON . . .

► Review It

1. What are the required steps in the accounting cycle?
2. What are the optional steps in the accounting cycle?
3. What are the differences between transaction, adjusting, closing, and reversing journal entries?

Related exercise material: BE4–4.



Correcting Entries—An Avoidable Step

Unfortunately, errors may happen in the recording process. Errors should be corrected as soon as they are discovered by journalizing and posting **correcting entries**. If the accounting records have no errors, no correcting entries are needed.

You should understand several differences between correcting entries and adjusting entries. First, adjusting entries are an integral part of the accounting cycle. Correcting entries, on the other hand, are unnecessary if the records have no errors. Second, adjustments are journalized and posted only at the end of an accounting period. In contrast, correcting entries are made whenever an error is discovered. Finally, adjusting entries always affect at least one balance sheet account (not Cash) and one income statement account. In contrast, correcting entries can involve any combination of accounts that need to be corrected. **Adjusting and correcting entries do have one thing in common, however: in both cases, they must be journalized and posted before closing entries.**

To determine the correcting entry, it is useful to compare the incorrect entry with the entry that should have been made. Doing this helps identify the accounts and amounts that should—and should not—be corrected. After comparison, a correcting entry is made to correct the accounts. This approach is shown in the following two cases:

Case 1. On May 10, a \$50 cash collection on account from a customer is journalized and posted as a debit to Cash \$50 and as a credit to Service Revenue \$50. The error is discovered on May 20 when the customer pays the remaining balance in full.

INCORRECT ENTRY (MAY 10)			CORRECT ENTRY (MAY 10)		
Cash	50		Cash	50	
Service Revenue		50	Accounts Receivable		50

study objective 3

Prepare correcting entries.

► Completion of the Accounting Cycle

A comparison of the incorrect entry with the correct entry that should have been made (but was not) reveals that the debit to Cash of \$50 is correct. However, the \$50 credit to Service Revenue should have been credited to Accounts Receivable. As a result, both Service Revenue and Accounts Receivable are overstated in the ledger. The following correcting entry is needed:

A	=	L	+	OE
-50				-50

Cash flows: no effect

Correcting Entry				
May 20	Service Revenue		50	
	Accounts Receivable			50
	To correct entry of May 10.			

Case 2. On May 18, office equipment that costs \$450 is purchased on account. The transaction is journalized and posted as a debit to Delivery Equipment \$45 and as a credit to Accounts Payable \$45. The error is discovered on June 3 when the monthly statement for May is received from the creditor.

INCORRECT ENTRY (MAY 8)		
Delivery Equipment	45	
Accounts Payable		45

CORRECT ENTRY (MAY 8)		
Office Equipment	450	
Accounts Payable		450

A comparison of the two entries shows that three accounts are incorrect. Delivery Equipment is overstated by \$45; Office Equipment is understated by \$450; and Accounts Payable is understated by \$405 (\$450 – \$45). The correcting entry is as follows:

A	=	L	+	OE
+450		+405		
-45				

Cash flows: no effect

Correcting Entry				
June 3	Office Equipment		450	
	Delivery Equipment			45
	Accounts Payable			405
	To correct May 18 entry.			

Instead of preparing a correcting entry, many accountants simply reverse the incorrect entry and then record the correct entry. Even though this approach will result in more entries and postings, it is an easier and often more logical procedure.

Sometimes errors are not found until after the temporary accounts have been closed. A correcting entry that fixes an error from a previous accounting year is called a prior period adjustment. These correcting entries can be very complex, and will be covered in a later chapter.



ACCOUNTING IN ACTION ► Business Insight

Canadian telecom equipment maker Nortel Networks' name has become synonymous with accounting woes in recent years. The company had to go over its financial statements for several years, making correcting entries for revenue recognized in the wrong period. "Although the need to restate certain financial statements is unfortunate, it's the right thing to do. This revenue is real—it was recognized in the wrong periods," chief executive Mike Zafirovski said in a press release. In 2006, Nortel expected to correct its revenues by about \$120 million for 2005, \$220 million for 2004, and \$100 million for 2003 (all in U.S. dollars).



Some of these errors happened several years ago. Why is it still important for Nortel to record entries to correct them?

BEFORE YOU GO ON . . .**Review It**

1. What are the differences between adjusting journal entries and correcting journal entries?
2. What is the advantage of reversing an incorrect journal entry and then preparing the correct journal entry, instead of making one compound correcting journal entry?

Do It

The Chip 'N' Dough Company made the following adjusting journal entry to record \$5,200 of amortization expense on a delivery truck at year end:

Feb. 28	Amortization Expense	520	
	Cash		520
	To record amortization on delivery truck.		

Prepare the required correcting entry.

Action Plan

- Determine the correct entry that should have been made.
- Compare it to the incorrect entry made and make the required corrections.

Solution

Feb. 28	Cash	520	
	Amortization expense	4,680	
	Accumulated Amortization—Truck		5,200
	To correct amortization adjustment.		

Amortization expense is understated by \$4,680 (\$5,200 – \$520).

Related exercise material: BE4–5 and E4–4.



Classified Balance Sheet

The financial statements that we have seen so far have all been simplified. We classified items as assets, liabilities, and owner's equity in the balance sheet, and as revenues and expenses in the income statement. In reality, however, financial statements are more useful to management, creditors, and potential investors when the accounts are classified into significant subgroups. In this chapter, we will introduce you to the main balance sheet classifications. The classified income statement will be presented in Chapter 5.

study objective 4

Prepare a classified balance sheet.

Standard Balance Sheet Classifications

A **classified balance sheet** for a proprietorship generally has the following standard classifications:

<u>Assets</u>	<u>Liabilities and Owner's Equity</u>
Current assets	Current liabilities
Long-term investments	Long-term liabilities
Property, plant, and equipment	Owner's equity
Intangible assets	

These sections help the financial statement user determine such matters as (1) the amount of assets available to meet debts as they come due, and (2) the claims of short- and

► Completion of the Accounting Cycle

long-term creditors on total assets. A classified balance sheet also makes it easier to compare companies in the same industry, such as Forzani and Foot Locker. Each of the sections of a classified balance sheet is explained next.

Current Assets

Current assets are cash and other resources that will be realized within one year of the balance sheet date. They may be realized in cash or as items sold or consumed in the business. For example, accounts receivable are current assets because they will be realized in cash as the amounts are collected during the year. A prepayment such as supplies is a current asset because the business expects to use or consume the supplies within one year.


In a service company, four types of current assets are usually recognized: (1) cash and cash equivalents (e.g., noncash items such as treasury bills and money-market funds); (2) short-term investments (e.g., debt and equity securities); (3) receivables (e.g., notes receivable, accounts receivable, and interest receivable); and (4) prepaid expenses (e.g., rent, insurance, and supplies). In Chapter 5, we will introduce a fifth category of current assets, inventories (merchandise available for sale), which is used by merchandising companies.

Current assets are listed in the order of their liquidity—that is, in the order in which they are expected to be converted into cash. This arrangement is shown in the presentation used by Canada Post, in Illustration 4-6.

A company's current assets are important in assessing its short-term debt-paying ability, as explained later in the chapter.

Illustration 4-6 ►

Current assets section

CANADA POST Balance Sheet (partial) December 31, 2005 (in millions)		 From anywhere... to anyone
Current assets		
Cash and cash equivalents	\$	474
Short-term investments		230
Segregated cash and investments		68
Accounts receivable		555
Income taxes recoverable		21
Prepaid expenses		73
Current portion of future income taxes		45
		1,466

Long-Term Investments

Long-term investments are generally investments in debts (for example, loans, notes, bonds, or mortgages), or shares of other corporations that are expected to be held for many years. They also include investments in long-lived assets such as real estate if the asset is not being used as part of the company's operating activities. These assets are classified as long-term because they are not readily marketable or expected to be converted into cash within one year. Note that these are investments (assets) acquired by the company. They are not the same as investments in the company that are made by the owner (owner's equity).

Power Corporation of Canada's long-term investments are shown in the partial balance sheet in Illustration 4-7.


POWER CORPORATION OF CANADA	
Balance Sheet (partial)	
December 31, 2005	
(in millions)	
	
Investments	
Shares	\$ 4,867
Bonds	59,298
Mortgages and other loans	15,118
Loans to policyholders	6,646
Real estate	1,844
	<u>87,773</u>

Illustration 4-7 ◀

Long-term investments section

Property, Plant, and Equipment

Property, plant, and equipment are long-lived, tangible assets that are used in the business and are not intended for sale. This category includes land, buildings, equipment, and furniture.

Although the order of property, plant, and equipment on the balance sheet can vary among companies, these assets are normally listed in their order of permanency. Land is usually listed first because it has an indefinite life, and is followed by the next asset with the longest useful life (normally buildings), and so on.

Since property, plant, and equipment benefit future periods, their cost is matched to expense over their useful lives through amortization, as we learned in Chapter 3. Assets which are amortized should be reported at their net book value (cost minus accumulated amortization).

As Illustration 4-8 shows, La Senza Corporation reports the net book value (or “net carrying amount” as La Senza calls it) of its property, plant, and equipment on its balance sheet and gives the cost and accumulated amortization in a note to the financial statements. Note that, except for land (which has an unlimited useful life), all other property, plant, and equipment items are amortized. This includes leasehold improvements, which are long-lived additions or renovations made to leased property.

Alternative terminology

Property, plant, and equipment are also known as *capital assets* or *fixed assets*.


LA SENZA CORPORATION																																									
Notes to the Financial Statements (partial)																																									
January 28, 2006																																									
(in thousands)																																									
																																									
6. Property & equipment																																									
	<table border="1"> <thead> <tr> <th></th> <th style="text-align: center;">Cost</th> <th style="text-align: center;">Accumulated Amortization</th> <th style="text-align: center;">Net Carrying Amount</th> </tr> </thead> <tbody> <tr> <td>Land</td> <td style="text-align: right;">\$ 1,307</td> <td style="text-align: right;">\$ –</td> <td style="text-align: right;">\$ 1,307</td> </tr> <tr> <td>Building</td> <td style="text-align: right;">4,540</td> <td style="text-align: right;">1,745</td> <td style="text-align: right;">2,795</td> </tr> <tr> <td>Furniture and fixtures</td> <td style="text-align: right;">28,000</td> <td style="text-align: right;">16,623</td> <td style="text-align: right;">11,377</td> </tr> <tr> <td>Furniture and fixtures under capital lease</td> <td style="text-align: right;">12,965</td> <td style="text-align: right;">3,011</td> <td style="text-align: right;">9,954</td> </tr> <tr> <td>Leasehold improvements</td> <td style="text-align: right;">47,576</td> <td style="text-align: right;">35,291</td> <td style="text-align: right;">12,285</td> </tr> <tr> <td>Leasehold improvements under capital lease</td> <td style="text-align: right;">38,949</td> <td style="text-align: right;">9,846</td> <td style="text-align: right;">29,103</td> </tr> <tr> <td>Computer software and equipment</td> <td style="text-align: right;">19,694</td> <td style="text-align: right;">11,343</td> <td style="text-align: right;">8,351</td> </tr> <tr> <td>Computer software and equipment under capital lease</td> <td style="text-align: right;">8,429</td> <td style="text-align: right;">3,630</td> <td style="text-align: right;">4,799</td> </tr> <tr> <td></td> <td style="text-align: right;"><u>\$161,460</u></td> <td style="text-align: right;"><u>\$81,489</u></td> <td style="text-align: right;"><u>\$79,971</u></td> </tr> </tbody> </table>		Cost	Accumulated Amortization	Net Carrying Amount	Land	\$ 1,307	\$ –	\$ 1,307	Building	4,540	1,745	2,795	Furniture and fixtures	28,000	16,623	11,377	Furniture and fixtures under capital lease	12,965	3,011	9,954	Leasehold improvements	47,576	35,291	12,285	Leasehold improvements under capital lease	38,949	9,846	29,103	Computer software and equipment	19,694	11,343	8,351	Computer software and equipment under capital lease	8,429	3,630	4,799		<u>\$161,460</u>	<u>\$81,489</u>	<u>\$79,971</u>
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Illustration 4-8 ◀

Property, plant, and equipment section


Intangible Assets

Intangible assets are long-lived assets that do not have physical substance. They give a company rights and privileges and include such things as goodwill, patents, copyrights, trademarks, trade names, and licences. Similar to buildings and equipment, intangible assets with estimated useful lives are amortized. Similar to land, intangible assets with indefinite lives are not amortized.

Illustration 4-9 shows how Shaw Communications reported intangible assets in its balance sheet. All of Shaw Communications' intangible assets have indefinite lives, so they are not amortized.

Illustration 4-9 ►

Intangible assets section

SHAW COMMUNICATIONS INC. Balance Sheet (partial) May 31, 2006 (in thousands)		
Intangible assets		
Broadcast licences		\$4,684,647
Goodwill		88,111
		<u>4,772,758</u>

Current Liabilities

Current liabilities are listed first in the liabilities and equity section of the balance sheet. **Current liabilities** are obligations that are expected to be paid in the coming year from current assets or by creating other current liabilities. Current liabilities include notes payable, accounts payable, salaries payable, interest payable, sales taxes payable, unearned revenues, and current maturities of long-term liabilities (payments to be made within the next year on long-term debt). Corporations may also have income taxes payable included in the current liabilities section of the balance sheet.

Current liabilities are often listed in order of currency. That is, the liabilities that will be due first are listed first. Many companies do not use this approach, however. They simply list the items in their current liabilities section according to a company tradition. The current liabilities section from Sears Canada's balance sheet is shown in Illustration 4-10.

Illustration 4-10 ►

Current liabilities section

SEARS CANADA INC. Balance Sheet (partial) December 31, 2005 (in millions)		
Current liabilities		
Accounts payable		\$ 696.6
Accrued liabilities		430.1
Income and other taxes payable		322.5
Principal payments on long-term obligations due within one year		216.1
		<u>1,665.3</u>

Users of financial statements look closely at the relationship between current assets and current liabilities. This relationship is important in evaluating a company's ability to pay its current liabilities. We will talk more about this later in the chapter when we learn how to use the information in the financial statements.

Long-Term Liabilities

Obligations that are expected to be paid after one year or longer are classified as **long-term liabilities**. Liabilities in this category can include future income tax (income taxes payable after more than one year), bonds payable, mortgages payable, notes payable, and lease liabilities, among others. Many companies report long-term debt that matures after one year as a single amount in the balance sheet. Then they show the details of the debt in the notes that accompany the financial statements. As shown in Illustration 4-11, Westjet Airlines Ltd. had total long-term liabilities of \$1,166,042 thousand on a recent balance sheet.


WESTJET AIRLINES LTD. Balance Sheet (partial) December 31, 2005 (in thousands)		
Long-term liabilities		
Long-term debt (note 4)		\$1,044,719
Obligations under capital lease (note 6)		1,690
Other liabilities (note 5)		16,982
Future income tax (note 8)		<u>102,651</u>
		1,166,042

Illustration 4-11 ◀

Long-term liabilities section

Equity

As discussed briefly in Chapter 1, the content of the equity section varies with the form of business organization. In a proprietorship, there is one capital account under the heading “Owner’s equity.” In a partnership, there is a capital account for each partner under the heading “Partners’ equity.” For a corporation, shareholders’ equity is divided into two sections: share capital (sometimes called capital stock) and retained earnings. Amounts that are invested in the business by the shareholders are recorded as share capital. Income that is kept for use in the business is recorded in the retained earnings account. The share capital and retained earnings accounts are combined and reported as shareholders’ equity on the balance sheet. You will also recall from chapter one that income trusts are another type of corporation. In an income trust, unitholders’ equity is also divided into two sections: unitholders’ capital and undistributed income. We will learn more about corporation equity accounts in later chapters.

As noted in Chapter 1, it is difficult to gain access to the financial statements of proprietorships and partnerships. Public corporations and income trusts, on the other hand, issue financial statements for present and potential investors, among others. Illustration 4-12 shows how Andrés Wines Ltd., a corporation, reported its shareholders’ equity section in its balance sheet. Subsequent to March 31, 2006, the company has changed its name to Andrew Peller Limited. The company’s new name will be used on its March 31, 2007 financial statements.


ANDRÉS WINES LTD. Balance Sheet (partial) March 31, 2006 (in thousands)		
Shareholders’ equity		
Capital stock (note 10)		\$ 7,375
Retained earnings		<u>82,205</u>
		89,580

Illustration 4-12 ◀

Shareholders’ equity section

Classified Balance Sheet Illustrated

To illustrate the classified balance sheet, we will now return to our example of Pioneer Advertising Agency from earlier in the chapter. Its classified balance sheet can be prepared using either the adjusted trial balance shown in Illustration 4-3 or the post-closing trial balance in Illustration 4-4. The result is the classified balance sheet at October 31, 2008, shown in Illustration 4-13. Note that Pioneer Advertising has only one noncurrent asset, office equipment. Pioneer Advertising rents its premises so it does not report other property, plant, and equipment, such as land or building. As discussed earlier in this chapter, if it did, it would present the longest-lived asset (e.g., land) first. Also note that, for this illustration, we have assumed that \$1,000 of the notes payable is currently due and \$4,000 is long-term.

Illustration 4-13 ►

Classified balance sheet

PIONEER ADVERTISING AGENCY Balance Sheet October 31, 2008		
Assets		
Current assets		
Cash		\$15,200
Accounts receivable		200
Advertising supplies		1,000
Prepaid insurance		550
Total current assets		<u>16,950</u>
Property, plant, and equipment		
Office equipment	\$5,000	
Less: Accumulated amortization	<u>83</u>	4,917
Total assets		<u>\$21,867</u>
Liabilities and Owner's Equity		
Current liabilities		
Accounts payable		\$ 2,500
Unearned revenue		800
Salaries payable		2,000
Interest payable		25
Current portion of notes payable		<u>1,000</u>
Total current liabilities		6,325
Long-term liabilities		
Notes payable		<u>4,000</u>
Total liabilities		10,325
Owner's equity		
C. Byrd, capital		<u>11,542</u>
Total liabilities and owner's equity		<u>\$21,867</u>

The balance sheet is usually presented in report form, as in Illustration 4-13, with the assets shown above the liabilities and owner's equity. The balance sheet may also be presented in account form, with the assets section placed on the left and the liabilities and owner's equity sections on the right. Most Canadian companies use the report form to present their balance sheet.

Now that you are familiar with the components of the classified balance sheet, you should look more closely at The Forzani Group's balance sheet, reproduced in Appendix A at the end of this book. While there are some differences in Forzani's presentation, the format is very similar to the format used by the companies in this chapter.

BEFORE YOU GO ON . . .**► Review It**

1. What are the major sections in a classified balance sheet?
2. How are accounts ordered in the current assets; property, plant, and equipment; and current liabilities sections of the balance sheet? In other words, is the order alphabetical, from smallest to largest, or according to something else?
3. Using Forzani's balance sheet, identify the components of its current assets and current liabilities at January 29, 2006. Can you tell if current assets and current liabilities are listed in order of liquidity, or in some other order? The answers to these questions are at the end of the chapter.

► Do It

Canadian Tire Corporation, Limited has the following selected accounts listed in a recent balance sheet:

Accounts payable and other	Income taxes payable
Accounts receivable	Long-term debt
Cash and cash equivalents	Merchandise inventories
Credit card receivables	Other long-term liabilities
Current portion of long-term debt	Prepaid expenses and deposits
Goodwill	Property and equipment

Give the balance sheet classification for each of the accounts above.

Action Plan

- Current assets include all assets that will be realized within one year.
- Current liabilities are obligations that are expected to be paid within one year.
- Long-term assets are classified by the type of asset.
- Obligations that are due after more than one year are classified as long-term liabilities.

Solution

<u>Account</u>	<u>Balance Sheet Classification</u>
Accounts payable and other	Current liabilities
Accounts receivable	Current assets
Cash and cash equivalents	Current assets
Credit card receivables	Current assets
Current portion of long-term debt	Current liabilities
Goodwill	Intangible assets
Income taxes payable	Current liabilities
Long-term debt	Long-term liabilities
Merchandise inventories	Current assets
Other long-term liabilities	Long-term liabilities
Prepaid expenses and deposits	Current assets
Property and equipment	Property, plant, and equipment

Related exercise material: BE4-6, BE4-7, E4-5, and E4-6.



Using the Information in the Financial Statements

As we explained in Chapter 1, investors use the information in financial statements to decide if they should invest in a business, and creditors use the information to decide if they should grant credit to a business. In this chapter, we will now begin to learn about a tool called ratio analysis, which can help investors and creditors make such decisions. Ratio

study objective 5

Illustrate measures used to evaluate liquidity.

► Completion of the Accounting Cycle

analysis is helpful because it gives additional information about a company by expressing useful relationships between specific items in the financial statements.

As you study the chapters of this book, you will learn about three general types of ratios that are used to analyze financial statements: liquidity, profitability, and solvency ratios. Liquidity ratios measure a company's **liquidity**—the company's ability to pay its obligations as they come due within the next year and to meet unexpected needs for cash. As the name suggests, profitability ratios measure the income or operating success of a company for a specific period of time. Solvency ratios measure the ability of a company to pay its total liabilities and survive over a long period of time. In this chapter, we introduce two liquidity ratios: working capital and the current ratio.

Working Capital

When liquidity is being evaluated, an important relationship is the one between current assets and current liabilities. The difference between current assets and current liabilities is called **working capital**. Working capital is important because it shows a company's ability to pay its short-term debts. When current assets are more than current liabilities at the balance sheet date, the company will likely be able to pay its liabilities. When the reverse is true, short-term creditors may not be paid.

Forzani's working capital is \$119,414 thousand, as shown in Illustration 4-14, where amounts are in thousands.

Illustration 4-14 ►

Working capital

Current Assets	–	Current Liabilities	=	Working Capital
\$368,842	–	\$249,428	=	\$119,414

Current Ratio

A second measure of short-term debt-paying ability is the **current ratio**, which is calculated by dividing current assets by current liabilities. Two companies with the same amount of working capital may have very different current ratios. Of the two liquidity measures, the current ratio is more useful because it is difficult to compare dollar amounts by themselves.

Illustration 4-15 shows the current ratio for Forzani at January 29, 2006 (\$ in thousands):

Illustration 4-15 ►

Current ratio

Current Assets	÷	Current Liabilities	=	Current Ratio
\$368,842	÷	\$249,428	=	1.48:1

This ratio tells us that on January 29, 2006, Forzani had \$1.48 of current assets for every dollar of current liabilities. As a general rule, a higher current ratio indicates better liquidity. As we will learn in later chapters, however, there are also other factors that can affect a company's liquidity. It is also important to be aware that what would be considered a normal working capital ratio depends on the company and the industry the company is in.

Ratios should never be interpreted without considering certain factors: (1) general economic and industry conditions need to be considered; (2) other specific financial information about the company over time needs to be considered, and (3) the ratios should be compared to the ratios for other companies in the same or related industries. We will have more discussion about how to analyze ratios in Chapter 18.

**BEFORE YOU GO ON . . .****► Review It**

1. What is working capital? How can it be expressed as a ratio?
2. How can two companies with the same amount of working capital have different current ratios?

Related exercise material: BE4–8, BE4–9, E4–7, and E4–8.

**APPENDIX 4A ► WORK SHEETS**

As discussed in the chapter, a work sheet is a multiple-column form that may be used in the adjustment process and in preparing financial statements. The five steps for preparing a work sheet are described in the next section. They must be done in the order they are presented in.

Steps in Preparing a Work Sheet

We will use the October 31 trial balance and adjustment data for Pioneer Advertising Agency from Chapter 3 to show how to prepare a work sheet. Each step of the process is described below, and is shown in Illustration 4A-1.

study objective 6

Prepare a work sheet.

Step 1. Prepare a Trial Balance on the Work Sheet. All ledger accounts with balances are entered in the account title space. Debit and credit amounts from the ledger are entered in the trial balance columns.

Step 2. Enter the Adjustments in the Adjustment Columns. When a work sheet is used, all adjustments are entered in the adjustment columns. In entering the adjustments, relevant trial balance accounts should be used. If additional accounts are needed, they should be inserted on the lines immediately below the trial balance totals.

In a manually prepared work sheet, each adjustment is cross-referenced (usually by letter) to make it easier to journalize the adjusting entry in the general journal. This has been done in Illustration 4A-1. It is important to realize that year-end adjustments must still be journalized, but not until after the work sheet is completed and the financial statements have been prepared. The books should not be filled with interim adjustments unless they need to show the adjusted information on a more permanent basis.

The adjustments on Pioneer Advertising Agency's work sheet are the same as the adjustments shown on pages 110 to 119 of Chapter 3. They are recorded in the adjustment columns of the work sheet as follows:

- (a) An additional account, Advertising Supplies Expense, is debited \$1,500 for the cost of supplies used, and Advertising Supplies is credited \$1,500.
- (b) An additional account, Insurance Expense, is debited \$50 for the insurance that has expired, and Prepaid Insurance is credited \$50.
- (c) Unearned Revenue is debited \$400 for fees, and Service Revenue is credited \$400.
- (d) Accounts Receivable is debited \$200 for fees earned but not billed, and Service Revenue is credited \$200.
- (e) Two additional accounts relating to interest are needed. Interest Expense is debited \$25 for accrued interest, and Interest Payable is credited \$25.

► **Completion of the Accounting Cycle**

- (f) Salaries Expense is debited \$2,000 for accrued salaries, and an additional account, Salaries Payable, is credited \$2,000.
- (g) Two additional accounts are needed. Amortization Expense is debited \$83 for the month's amortization, and Accumulated Amortization—Office Equipment is credited \$83.

Note in the illustration that after all the adjustments have been entered, the adjustment columns are totalled (automatically if the worksheet is computer-generated) and the equality of the column totals is proven.

Step 3. Enter the Adjusted Balances in the Adjusted Trial Balance Columns.

The adjusted balance of an account is obtained by combining the amounts entered in the first four columns of the work sheet for each account. For example, the Prepaid Insurance account in the trial balance columns has a \$600 debit balance and a \$50 credit in the adjustment columns. These two amounts combine to result in a \$550 debit balance in the adjusted trial balance columns. For each account on the work sheet, the amount in the adjusted trial balance columns is equal to the account balance that will appear in the ledger after the adjusting entries have been journalized and posted. The balances in these columns are the same as those in the adjusted trial balance in Illustration 4-3.

After all account balances have been entered in the adjusted trial balance columns, the columns are totalled and their equality is proven. The agreement of the column totals makes it easier to complete the work sheet. If these columns are not in agreement, the error(s) must be found before going to the next step. If the errors are not found, the statement columns will not balance and the financial statements will be incorrect.

Helpful hint Every adjusted trial balance amount must appear in one of the four statement columns.

Step 4. Enter the Adjusted Trial Balance Amounts in the Correct Financial Statement Columns. The fourth step is to enter adjusted trial balance amounts in the income statement or balance sheet columns of the work sheet. Balance sheet accounts are entered in the correct balance sheet debit and credit columns. For instance, Cash is entered in the balance sheet debit column and Notes Payable is entered in the credit column.

Because the work sheet does not have columns for the statement of owner's equity, the balance in owner's capital is entered in the balance sheet credit column. In addition, the balance in the owner's drawings account is entered in the balance sheet debit column because it is an owner's equity account with a debit balance.

The amounts in revenue and expense accounts such as Service Revenue and Salaries Expense are entered in the correct income statement columns.

Step 5. Total the Statement Columns, Calculate the Net Income (or Net Loss), and Complete the Work Sheet.

Each of the financial statement columns must be totalled. The net income or loss for the period is then found by calculating the difference between the totals of the two income statement columns. If total credits are more than total debits, net income has resulted. In such a case, as shown in Illustration 4A-1, the words "Net income" are inserted in the account title space. The amount is then entered in the income statement debit column and the balance sheet credit column. The debit amount balances the income statement columns, and the credit amount balances the balance sheet columns. In addition, the credit in the balance sheet column indicates the increase in owner's equity that results from net income. Conversely, if total debits in the income statement columns are more than total credits, a net loss has occurred. In such a case, the amount of the net loss is entered in the income statement credit column and the balance sheet debit column.

After the net income or net loss has been entered, new column totals are determined. The totals shown in the debit and credit income statement columns will now match. The totals shown in the debit and credit balance sheet columns will also match. If either the

Microsoft Excel - Illustration 4A-1.xls												
File Edit View Insert Format Tools Data Window Help												
Arial 10 B I U [Font icons] 100% [Zoom icons]												
A	B	C	D	E	F	G	H	I	J	K	L	O
	Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance		Income Statement		Balance Sheet			
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.		
1	Account Titles											
2		15,200			15,200					15,200		
3	Cash					200					200	
4	Accounts receivable	0	200	(d)								
5	Advertising supplies	2,500		(a)	1,500					1,000		
6	Prepaid insurance	600		(b)	50					550		
7	Office equipment	5,000				5,000				5,000		
8	Notes payable						5,000				5,000	
9	Accounts payable						2,500				2,500	
10	Unearned revenue		1,200	(c)	400		800				800	
11	C. Byrd, capital		10,000				10,000				10,000	
12	C. Byrd, drawings	500				500				500		
13	Service revenue			(c)	400		10,600		10,600			
14				(d)	200							
15	Salaries expense	4,000		(f)	2,000		6,000					
16	Advertising supplies expense			(a)	1,500		1,500					
17	Rent expense		900			900						
18	Insurance expense			(b)	50		50					
19	Interest expense			(e)	25		25					
20	Interest payable			(e)		25					25	
21	Salaries payable			(f)	2,000		2,000				2,000	
22	Amortization expense			(g)	83		83				83	
23	Accumulated amortization			(g)		83						83
24	Totals	28,700	28,700	4,258	4,258	31,008	31,008	8,558	10,600	22,450	20,408	
25	Net income							2,042			2,042	
26								10,600	10,600	22,450	22,450	
27												
28												
29												
30												
31												

4. Enter adjusted balances in appropriate statement columns.
5. Total the statement columns, calculate net income (or net loss), and complete the work sheet.

3. Enter adjusted balances.

2. Enter adjustment data.

1. Prepare a trial balance on the work sheet.

Illustration 4A-1

Preparing a work sheet—Steps 1–5

► Completion of the Accounting Cycle

income statement columns or the balance sheet columns are not equal after the net income or net loss has been entered, there is an error in the work sheet.

Preparing Financial Statements from a Work Sheet

After a work sheet has been completed, all the data required to prepare the financial statements are at hand. The income statement is prepared from the income statement columns. The balance sheet and statement of owner's equity are prepared from the balance sheet columns.

Note that the amount shown for owner's capital in the work sheet is the account balance before considering drawings and net income (or loss). When there have been no additional investments of capital by the owner during the period, this amount is the balance at the beginning of the period.

Using a work sheet, accountants can prepare financial statements before adjusting entries have been journalized and posted. However, the completed work sheet is not a substitute for formal financial statements. Data in the financial statement columns of the work sheet are not properly arranged for statement purposes. Also, as noted earlier, the financial statement presentation for some accounts differs from their statement columns on the work sheet. A work sheet is basically an accountant's working tool. It is not given to management or other parties.

APPENDIX 4B ► REVERSING ENTRIES

After the financial statements are prepared and the books are closed, it can be helpful to reverse some of the adjusting entries before recording the regular transactions of the next period. Such entries are called reversing entries. A reversing entry is made at the beginning of the next accounting period and is the exact opposite of the adjusting entry that was made in the previous period. The recording of reversing entries is an optional step in the accounting cycle.

The purpose of reversing entries is to simplify the recording of future transactions that are related to an adjusting entry. As you may recall from Chapter 3, the payment of salaries on November 7 after an adjusting entry resulted in two debits: one to Salaries Payable and the other to Salaries Expense. With reversing entries, the entire later payment can be debited to Salaries Expense. You do not have to remember what has gone on before. The use of reversing entries does not change the amounts reported in the financial statements. It simply makes it easier to record future transactions.

Accounting with and without Reversing Entries

study objective 7

Prepare reversing entries.

Reversing entries are used to reverse accruals: accrued revenues and accrued expenses. To illustrate the optional use of reversing entries for accrued expenses, we will use the salaries expense transactions for Pioneer Advertising Agency. The transaction and adjustment data were as follows:

1. October 24 (initial salary entry): Salaries of \$4,000 earned between October 13 and October 24 are paid.
2. October 31 (adjusting entry): Salaries earned between October 27 and October 31 (Friday) are \$2,000. These will be paid in the November 7 payroll.

3. November 7 (subsequent salary entry): Salaries paid are \$4,000. Of this amount, \$2,000 applies to accrued salaries payable and \$2,000 was earned between November 1 and November 7.

The comparative entries with and without reversing entries are as follows.

* WHEN REVERSING ENTRIES ARE NOT USED (AS IN THE CHAPTER)				WHEN REVERSING ENTRIES ARE USED (AS IN THE APPENDIX)			
<u>Initial Salary Entry</u>				<u>Initial Salary Entry</u>			
Oct. 24	Salaries Expense	4,000	4,000	Oct. 24	Salaries Expense	4,000	4,000
	Cash				Cash		
<u>Adjusting Entry</u>				<u>Adjusting Entry</u>			
31	Salaries Expense	2,000	2,000	31	Salaries Expense	2,000	2,000
	Salaries Payable				Salaries Payable		
<u>Closing Entry</u>				<u>Closing Entry</u>			
31	Income Summary	6,000	6,000	31	Income Summary	6,000	6,000
	Salaries Expense				Salaries Expense		
<u>Reversing Entry</u>				<u>Reversing Entry</u>			
Nov. 1	No reversing entry is made.			Nov. 1	Salaries Payable	2,000	2,000
					Salaries Expense		
<u>Subsequent Salary Entry</u>				<u>Subsequent Salary Entry</u>			
11	Salaries Payable	2,000	4,000	11	Salaries Expense	4,000	4,000
	Salaries Expense	2,000			Cash		
	Cash						

The first three entries are the same whether or not reversing entries are used. The last two entries are different. The November 1 reversing entry eliminates the \$2,000 balance in Salaries Payable that was created by the October 31 adjusting entry. The reversing entry also creates a \$2,000 credit balance in the Salaries Expense account. As you know, it is unusual for an expense account to have a credit balance. The balance is correct in this instance, though, because it anticipates that the entire amount of the first salary payment in the new accounting period will be debited to Salaries Expense. This debit will eliminate the credit balance, and the resulting debit balance in the expense account will equal the actual salaries expense in the new accounting period (\$2,000 in this example).

When reversing entries are made, all cash payments of expenses can be debited to the expense account. This means that on November 7 (and every payday) Salaries Expense can be debited for the amount paid without regard to any accrued salaries payable. Being able to make the same entry each time simplifies the recording process: future transactions can be recorded as if the related adjusting entry had never been made.

The posting of the entries with reversing entries is as follows, using T accounts.

Salaries Expense		Salaries Payable	
Oct. 24 Paid	4,000	Nov. 1 Rev.	2,000
31 Adj.	2,000	Oct. 31 Adj.	2,000
Oct. 31 Bal.	6,000	Nov. 1 Bal.	0
Oct. 31 Bal.	0	Nov. 1 Rev.	2,000
Nov. 7 Paid	4,000		
Nov. 7 Bal.	2,000		

Demonstration Problem

At the end of its first month of operations, Paquet Answering Service has the following unadjusted trial balance, with the accounts presented in alphabetical order rather than in financial statement order:

PAQUET ANSWERING SERVICE		
Trial Balance		
August 31, 2008		
	Debit	Credit
Accounts payable		\$ 2,400
Accounts receivable	\$ 2,800	
Accumulated amortization—building		500
Accumulated amortization—equipment		1,000
Advertising expense	400	
Amortization expense	1,500	
Building	150,000	
Cash	5,400	
Equipment	60,000	
Insurance expense	200	
Interest expense	350	
Interest payable		1,350
Land	50,000	
Long-term debt investments	15,000	
Long-term equity investments	7,000	
Mortgage payable		140,000
Prepaid insurance	2,200	
R. Paquet, capital		155,000
R. Paquet, drawings	1,000	
Salaries expense	3,200	
Service revenue		5,700
Short-term investments	4,800	
Supplies	1,000	
Supplies expense	300	
Utilities expense	800	
Totals	<u>\$305,950</u>	<u>\$305,950</u>

Action Plan

- Identify which accounts are balance sheet accounts and which are income statement accounts.
- If revenues are more than expenses, this results in net income; if expenses are more than revenues, this results in a net loss.
- In preparing a classified balance sheet, know the contents of each of the sections.
- In journalizing closing entries, remember that there are four entries. Revenues and expenses are closed to the Income Summary account; the Income Summary account and the drawings account are closed to owner's capital.
- Always check your work. Make sure the balance in Income Summary equals net income before closing the Income Summary account. Make sure that the balance in the owner's capital account after posting the closing entries equals the amount reported on the balance sheet.

Instructions

- Calculate the net income or loss for the month.
- Calculate owner's equity at August 31, 2008.
- Prepare a classified balance sheet for Paquet Answering Service at August 31, 2008. Assume that \$5,000 of the mortgage payable is due over the next year.
- Journalize the closing entries.
- Create T accounts for Income Summary and R. Paquet, Capital, and post closing entries.

Solution to Demonstration Problem

- Net income (loss) = Revenue – expenses
 $= \$5,700 - \$400 - \$1,500 - \$200 - \$350 - \$3,200 - \$300 - \800
 $= (\$1,050)$
- Owner's equity August 31, 2008 = Opening capital – net loss – drawings
 $= \$155,000 - \$1,050 - \$1,000$
 $= \$152,950$

(c)

PAQUET ANSWERING SERVICE Balance Sheet August 31, 2008			
Assets			
Current assets			
Cash			\$ 5,400
Short-term investments			4,800
Accounts receivable			2,800
Prepaid insurance			2,200
Supplies			<u>1,000</u>
Total current assets			16,200
Long-term investments			
Equity investments		\$ 7,000	
Debt investments		<u>15,000</u>	
Total long-term investments			22,000
Property, plant, and equipment			
Land		\$ 50,000	
Building	\$150,000		
Less: Accumulated amortization	<u>500</u>	149,500	
Equipment	\$ 60,000		
Less: Accumulated amortization	<u>1,000</u>	<u>59,000</u>	<u>258,500</u>
Total assets			<u>\$296,700</u>
Liabilities and Owner's Equity			
Current liabilities			
Accounts payable			\$ 2,400
Interest payable			1,350
Current portion of mortgage payable			<u>5,000</u>
Total current liabilities			8,750
Long-term liabilities			
Mortgage payable			<u>135,000</u>
Total liabilities			143,750
Owner's equity			
R. Paquet, capital			<u>152,950</u>
Total liabilities and owner's equity			<u>\$296,700</u>

(d)

Aug. 31	Service Revenue	5,700	
	Income Summary		5,700
	To close revenue account.		
31	Income Summary	6,750	
	Advertising Expense		400
	Amortization Expense		1,500
	Insurance Expense		200
	Interest Expense		350
	Salaries Expense		3,200
	Supplies Expense		300
	Utilities Expense		800
	To close expense accounts.		
31	R. Paquet, Capital	1,050	
	Income Summary		1,050
	To close Income Summary.		
31	R. Paquet, Capital	1,000	
	R. Paquet, Drawings		1,000
	To close drawings.		



(e)

Income Summary		R. Paquet, Capital	
Clos.	6,750	Clos.	5,700
Bal.	1,050	Clos.	1,050
		Clos.	1,000
		Bal.	152,950
		Bal.	155,000
		Bal.	0

Summary of Study Objectives

- 1. Prepare closing entries and a post-closing trial balance.** At the end of an accounting period, the temporary account balances (revenue, expense, income summary, and owner's drawings) are transferred to the owner's capital account by journalizing and posting closing entries. Separate entries are made to close revenues and expenses to Income Summary; then Income Summary to owner's capital; and, finally, owner's drawings to owner's capital. The temporary accounts begin the new period with a zero balance and the owner's capital account is updated to show its end of period balance. A post-closing trial balance has the balances in permanent accounts (i.e., balance sheet accounts) that are carried forward to the next accounting period. The purpose of this balance, as with other trial balances, is to prove the equality of these account balances.
- 2. List the steps in the accounting cycle.** The steps in the accounting cycle are (1) analyze business transactions, (2) journalize the transactions, (3) post to ledger accounts, (4) prepare a trial balance, (5) journalize and post adjusting entries, (6) prepare an adjusted trial balance, (7) prepare financial statements, (8) journalize and post closing entries, and (9) prepare a post-closing trial balance.
- 3. Prepare correcting entries.** One approach for determining the correcting entry is to compare the incorrect entry with the correct entry. After comparison, a correcting entry is made to correct the accounts. An equally acceptable alternative is to reverse the incorrect entry and then record the correct entry.
- 4. Prepare a classified balance sheet.** In a classified balance sheet, assets are classified as current assets; long-term investments; property, plant, and equipment; and intangible assets. Liabilities are classified as either current or long-term. There is also an equity section, which varies with the form of business organization.
- 5. Illustrate measures used to evaluate liquidity.** One of the measures that is used to evaluate a company's short-term liquidity is its working capital, which is the excess of current assets over current liabilities. This can also be expressed as the current ratio (current assets ÷ current liabilities).
- 6. Prepare a work sheet (Appendix 4A).** The steps in preparing a work sheet are (1) prepare a trial balance on the work sheet, (2) enter the adjustments in the adjustment columns, (3) enter adjusted balances in the adjusted trial balance columns, (4) enter adjusted trial balance amounts in correct financial statement columns, and (5) total the statement columns, calculate net income (or net loss), and complete the work sheet.
- 7. Prepare reversing entries (Appendix 4B).** Reversing entries are optional entries used to simplify bookkeeping. They are made at the beginning of the new accounting period and are the direct opposite of the adjusting entry made in the preceding period. Only accrual adjusting entries are reversed.



Glossary

Classified balance sheet A balance sheet that has several classifications or sections. (p. 175)

Closing entries Entries made at the end of an accounting period to transfer the balances of temporary accounts (revenues, expenses, income summary and drawings) to the permanent owner's equity account, owner's capital. (p. 165)

Closing the books The process of journalizing and posting closing entries to update the capital account and prepare the temporary accounts for the next period's postings. (p. 164)

Correcting entries Entries to correct errors that were made when transactions were recorded. (p. 173)

Current assets Cash and other resources that are expected to be realized in cash or sold or consumed in the business within one year. (p. 176)

Current liabilities Obligations that are expected to be paid from current assets or through the creation of other current liabilities within the next year. (p. 178)

Current ratio A measure of short-term debt-paying ability that is determined by dividing current assets by current liabilities. (p. 182)

Income summary A temporary account that is used in closing revenue and expense accounts. (p. 165)

Intangible assets Long-lived assets that do not have physical substance and are rights and privileges that result from ownership. They include goodwill, patents, copyrights, trademarks, trade names, and licences. (p. 178)

Liquidity The ability of a company to pay obligations as they come due within the next year and to meet unexpected needs for cash. (p. 182)

Long-term investments Investments in shares and debts of other companies that are not readily marketable and are expected to be held for more than one year. (p. 176)

Long-term liabilities Obligations that are expected to be paid after one year or longer. (p. 179)

Permanent accounts Balance sheet accounts whose balances are carried forward to the next accounting period. (p. 164)

Post-closing trial balance A list of debit and credit balances of the permanent (balance sheet) accounts after closing entries have been journalized and posted. (p. 169)

Property, plant, and equipment Tangible assets of a long-lived nature that are used in the operations of the business and are not intended for sale. They include land, buildings, equipment, and furniture. (p. 177)

Reversing entry An entry made at the beginning of the next accounting period that is the exact opposite of the adjusting entry made in the previous period. (p. 173)

Temporary accounts Revenue, expense, income summary, and drawings accounts whose balances are transferred to owner's capital at the end of an accounting period. (p. 164)

Working capital The difference between current assets and current liabilities. (p. 182)

Work sheet A multiple-column form that may be used in the adjustment process and in preparing financial statements. (p. 172)

Note: All questions, exercises, and problems below with an asterisk (*) relate to material in Appendices 4A and 4B.

Self-Study Questions

Answers are at the end of the chapter.

- (SO 1) K 1. To close an expense account, the expense account is:
- debited, and Income Summary is credited.
 - credited, and Income Summary is debited.
 - debited, and owner's capital is credited.
 - credited, and owner's drawings is debited.
- (SO 1) K 2. After the closing entries have been posted, the balance in the owner's capital account should equal:
- the net income reported on the income statement.
 - the opening capital balance reported on the statement of owner's equity.
 - the ending capital balance reported on the statement of owner's equity and balance sheet.
 - the opening capital balance plus any investments made by the owner during the period.
3. Which types of accounts will appear in the post-closing trial balance? (SO 1) K
- Permanent (balance sheet) accounts
 - Temporary (revenue, expense, and drawings) accounts
 - Contra accounts
 - All accounts

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- (SO 2) K 4. Which of the following is an optional step in the accounting cycle?
 (a) Journalizing and posting closing entries
 (b) Preparing an adjusted trial balance
 (c) Preparing a post-closing trial balance
 (d) Preparing reversing entries
- (SO 2) K 5. Which of the following statements about the work sheet is *incorrect*?
 (a) The work sheet is essentially a working tool of the accountant.
 (b) The work sheet is an optional step in the accounting cycle.
 (c) If a work sheet is used at the year end, it is not necessary to post adjusting entries to the general ledger.
 (d) Financial statements can be prepared directly from the work sheet before journalizing and posting the adjusting entries.
- (SO 3) AP 6. Cash of \$250 is received at the time a service is provided. The transaction is journalized and posted as a debit to Cash of \$250 and a credit to Accounts Receivable of \$250. The correcting entry is:
- | | | |
|-------------------------|-----|-----|
| (a) Service Revenue | 250 | |
| Accounts Receivable | | 250 |
| (b) Accounts Receivable | 250 | |
| Service Revenue | | 250 |
| (c) Cash | 250 | |
| Service Revenue | | 250 |
| (d) Accounts Receivable | 250 | |
| Cash | | 250 |
7. Current assets are listed:
 (a) by liquidity. (c) by longevity.
 (b) by importance. (d) alphabetically.
8. A company reports current assets of \$10,000 and current liabilities of \$8,000. Its current ratio is:
 (a) \$2,000.
 (b) 80%.
 (c) 1.25:1.
 (d) More information is needed to calculate the ratio.
- *9. In a work sheet, net income is entered in the following columns:
 (a) income statement (Dr.) and balance sheet (Dr.).
 (b) income statement (Cr.) and balance sheet (Dr.).
 (c) income statement (Dr.) and balance sheet (Cr.).
 (d) income statement (Cr.) and balance sheet (Cr.).
- *10. On December 31, Mott Company correctly made an adjusting entry to recognize \$2,000 of accrued salaries payable. On January 8 of the next year, total salaries of \$3,400 were paid. Assuming the correct reversing entry was made on January 1, the entry on January 8 will result in a credit to Cash of \$3,400, and the following debit(s):
 (a) Salaries Payable \$1,400, and Salaries Expense \$2,000.
 (b) Salaries Payable \$2,000, and Salaries Expense \$1,400.
 (c) Salaries Expense \$3,400.
 (d) Salaries Payable \$3,400.



Questions

- (SO 1) C 1. What are the two reasons for recording closing entries?
- (SO 1) K 2. Identify the account(s) debited and credited in each of the four closing entries.
- (SO 1) C 3. What is the purpose of using an income summary account? If an income summary account was not used, how would the closing entries change?
- (SO 1) C 4. Why is the owner's drawings account not closed with the expense accounts? Why is a separate entry required for this account?
- (SO 1) C 5. Brenda has been told that after the closing entries have been posted, she should stop and check her work. Explain to Brenda what she should be checking for.
- (SO 1) K 6. What are the content and purpose of a post-closing trial balance?
- (SO 2) K 7. Which steps in the accounting cycle may be done daily, which steps are done on a periodic basis (monthly, quarterly, or annually), and which steps are usually done only at the company's fiscal year end?
8. Although using a work sheet is optional, it is useful. Do you agree? Explain. (SO 2) C
9. How are correcting entries different from adjusting entries? (SO 3) C
10. What is the purpose of classifying assets and liabilities into categories on the balance sheet? (SO 4) C
11. Define "current assets." What basis is used for the order of the individual items in the current assets section? (SO 4) C
12. What are the differences between the three categories of noncurrent assets: long-term investments; property, plant, and equipment; and intangible assets? (SO 4) C
13. How are current liabilities different from long-term liabilities? (SO 4) C

- (SO 4) K 14. (a) What terms are used to describe the equity section of (1) a proprietorship, (2) a partnership, (3) a corporation, and (4) an income trust? (b) Identify the two equity accounts in a corporation and state the purpose of each.
- (SO 5) C 15. What is liquidity? Identify one measure of liquidity.
- (SO 5) C 16. What factors need to be considered when interpreting ratios?
- (SO 6) C*17. How is net income or loss calculated on a work sheet? How is this number entered on the work sheet if the company has net income? How is it entered if the company has a net loss?
- *18. Why is it necessary to journalize and post adjusting entries if they have already been entered on the work sheet? (SO 6) C
- *19. What are the differences between a reversing entry and an adjusting entry? Are reversing entries required? (SO 7) C
- *20. When and how is it helpful to use reversing entries? When should reversing entries not be used? (SO 7) C

Brief Exercises

BE4-1 The following selected accounts and balances (in U.S. thousands) appear in the financial statements of *The Jean Coutu Group (PJC) Inc.*: Identify temporary and permanent accounts. (SO 1) C

Accounts payable	\$1,109,902	Long-term debt	\$2,495,801
Accounts receivable	544,810	Other revenues	169,020
Amortization expense	195,308	Prepaid expenses	40,981
General and operating expenses	1,878,296	Property, plant, and equipment	1,492,499
Income taxes payable	32,870	Short-term investments	78,489
Interest on long-term debt expense	152,731		

Which accounts are temporary and which ones are permanent?

BE4-2 The adjusted trial balance for Mosquera Golf Club at its October 31, 2008, year end included the following: Prepare and post closing entries. (SO 1) AP

	<u>Debit</u>	<u>Credit</u>
Cash	\$ 8,500	
Prepaid expenses	3,000	
Equipment	85,000	
Accumulated amortization—equipment		\$ 17,000
Accounts payable		12,000
Unearned golf fees		1,500
N. Mosquera, capital		75,000
N. Mosquera, drawings	48,000	
Golf fees earned		160,000
Maintenance expense	25,000	
Rent expense	12,000	
Salaries expense	84,000	

Instructions

- (a) Prepare closing entries.
 (b) Using T accounts, post the closing entries and calculate the balance in each account.

BE4-3 Refer to the information in BE4-2 for Mosquera Golf Club. Prepare a post-closing trial balance. Prepare post-closing trial balance. (SO 1) AP

BE4-4 The required steps in the accounting cycle are listed below in random order. List the steps in the correct order by writing the numbers 1 to 9 in the blank spaces. List steps in accounting cycle. (SO 2) K

- (a) ___ Prepare a post-closing trial balance. (f) ___ Journalize and post the closing entries.
 (b) ___ Prepare an adjusted trial balance. (g) ___ Prepare the financial statements.

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- (c) ___ Analyze business transactions. (h) ___ Journalize and post the adjusting entries.
 (d) ___ Prepare a trial balance. (i) ___ Post to the ledger accounts.
 (e) ___ Journalize the transactions.

Identify impact of error and prepare correcting entries.
 (SO 3) AP

BE4-5 At Hébert Company, the following errors were discovered after the transactions had been journalized and posted:

1. A collection of cash on account from a customer for \$880 was recorded as a debit to Service Revenue of \$880 and a credit to Accounts Receivable of \$880.
 2. The purchase of office supplies on account for \$1,850 was recorded as a debit to Equipment of \$1,580 and a credit to Accounts Payable of \$1,580.
- (a) Indicate the impact of each error on the balance sheet and income statement by stating whether assets, liabilities, owner's equity, revenues, expenses, and net income are understated (U), overstated (O), or not affected (NA).
 (b) Prepare the correcting entries.

Classify balance sheet accounts.
 (SO 4) K

BE4-6 The standard balance sheet classifications for assets and liabilities are as follows:

- | | |
|-----------------------------------|--------------------------|
| 1. Current assets | 4. Intangible assets |
| 2. Long-term investments | 5. Current liabilities |
| 3. Property, plant, and equipment | 6. Long-term liabilities |

Match the classifications above with the accounts below by writing the correct number in the blank spaces:

- | | |
|---------------------------------------|---|
| (a) ___ Supplies | (g) ___ Unearned Revenue |
| (b) ___ Accounts Payable | (h) ___ Accounts Receivable |
| (c) ___ Building | (i) ___ Accumulated Amortization—Building |
| (d) ___ Prepaid Insurance | (j) ___ Patents |
| (e) ___ Note Payable (due in 5 years) | (k) ___ Land Held for Resale |
| (f) ___ Goodwill | (l) ___ Note Receivable (due in 3 years) |

Prepare current assets section of balance sheet.
 (SO 4) AP

BE4-7 The adjusted trial balance of Reuben Company includes the following accounts: Accounts Receivable \$12,500; Prepaid Insurance \$3,900; Cash \$18,400; Supplies \$5,200; and Short-term Investments \$8,200. Prepare the current assets section of the balance sheet as at December 31, 2008, with the accounts in the right order.

Calculate working capital and current ratio; compare liquidity.
 (SO 5) AP

BE4-8 Cool Delight Company specializes in creating novelty ice cream desserts. It reported current assets of \$165,211 and \$190,548 at August 31, 2008 and 2007, respectively. It reported current liabilities of \$136,742 and \$72,410 at August 31, 2008 and 2007, respectively. Calculate Cool Delight's working capital and current ratio for 2008 and 2007. Was Cool Delight's liquidity stronger or weaker in 2008 than it was in 2007?

Calculate working capital and current ratio and compare liquidity ratios measures.
 (SO 5) K

BE4-9 On December 31, 2008, Big Company had \$1,000,000 of current assets and \$900,000 of current liabilities. On the same day, Small Company had \$200,000 of current assets and \$100,000 of current liabilities. Calculate the working capital and current ratio for both companies and compare the results. Which liquidity measure is more relevant?

Identify work sheet columns for selected accounts.
 (SO 6) C

***BE4-10** The following accounts appear in the adjusted trial balance columns of the work sheet for Khanna Company: Accounts Payable; Accounts Receivable; Accumulated Amortization; Amortization Expense; H. Khanna, Capital; H. Khanna, Drawings; Prepaid Expenses; Rent Expense; Service Revenue; and Unearned Service Revenue. Indicate the financial statement column (income statement Dr., balance sheet Cr., etc.) each balance should be extended to (recorded in).

Complete work sheet.
 (SO 6) AP

***BE4-11** The accountant for Coulombe Company is almost finished preparing the work sheet for the year ended July 31, 2008. The totals of the accounts in the income statement and balance sheet columns are presented below. Calculate the net income or loss, write this number in the proper

columns, and calculate the final totals for these columns. Clearly indicate whether the company had net income or a net loss.

	Income Statement		Balance Sheet	
	Dr.	Cr.	Dr.	Cr.
Totals	17,450	21,600	29,700	25,550
Net income or loss				
Totals				

***BE4–12** The accountant for Orange Line Company is almost finished preparing the work sheet for the year ended August 31, 2008. The totals of the accounts in the income statement and balance sheet columns are presented below. Calculate the net income or loss, write this in the proper columns, and calculate the final totals for these columns. Clearly indicate whether the company had a net income or net loss. Complete work sheet. (SO 6) AP

	Income Statement		Balance Sheet	
	Dr.	Cr.	Dr.	Cr.
Totals	35,800	29,750	56,150	62,200
Net income or loss				
Totals				

***BE4–13** At October 31, Orlaida Company made an accrued expense adjusting entry of \$1,200 for salaries. On November 4, it paid salaries of \$2,000; \$1,200 for October salaries and \$800 for November salaries. (a) Prepare the November 1 reversing entry and the November 4 journal entry to record the payment of salaries. (b) Indicate the balances in Salaries Payable and Salaries Expense after posting the two entries. Prepare and post reversing entry. (SO 7) AP

***BE4–14** At December 31, interest receivable totalled \$4,500. On January 10, interest of \$5,000 was received. (a) Assuming that reversing entries are made at January 1, prepare the January 1 and January 10 entries. (b) Repeat part (a), assuming reversing entries are not made. (c) Compare the balances of the Interest Receivable and Interest Revenue accounts after all entries are made and posted in (a) and (b). Prepare entries with and without reversing entries. (SO 7) AP

Exercises

E4–1 Selected T accounts for Roth Beauty Salon follow. All June 30 postings are from closing entries. Prepare closing entries. (SO 1) AP

Salaries Expense		J. Roth, Capital	
June 10	4,200	June 30	9,800
28	5,600	June 1 Bal.	12,000
June 30 Bal.	0	June 30	2,500
		June 30	2,000
		June 30 Bal.	11,500
Supplies Expense		J. Roth, Drawings	
June 12	600	June 13	1,000
24	700	June 25	1,500
June 30 Bal.	0	June 30 Bal.	0
Service Revenue		Income Summary	
June 30	16,100	June 30	14,100
		30	2,000
		June 30 Bal.	0
Rent Expense			
June 1	3,000	June 30	3,000
June 30 Bal.	0		

► Completion of the Accounting Cycle

Instructions

- Prepare the closing entries that were made.
- What should the ending balance of the account J. Roth, Capital, agree with and in which financial statement(s)?

Prepare and post closing entries and prepare post-closing trial balance.

(SO 1) AP

E4-2 At the end of its fiscal year, the adjusted trial balance of Rafael Company is as follows:

RAFAEL COMPANY Adjusted Trial Balance July 31, 2008		
	Debit	Credit
Cash	\$ 5,840	
Accounts receivable	15,540	
Prepaid expenses	1,620	
Supplies	470	
Equipment	17,600	
Accumulated amortization—equipment		\$ 5,400
Accounts payable		4,245
Interest payable		525
Unearned service revenue		2,750
Notes payable (due on July 1, 2010)		15,000
D. Rafael, capital		31,200
D. Rafael, drawings	14,000	
Service revenue		73,800
Amortization expense	2,700	
Salaries expense	56,050	
Interest expense	1,350	
Rent expense	15,900	
Supplies expense	1,850	
	\$132,920	\$132,920

Instructions

- Prepare the closing entries, and post them to the correct accounts.
- Prepare a post-closing trial balance at July 31, 2008.

Prepare and post closing entries and prepare post-closing trial balance.

(SO 1) AP

E4-3 An alphabetical list of the adjusted account balances (all accounts have normal balances) at December 31, 2008, for Summit's Bowl-A-Drome Alley is as follows:

Accounts payable	\$ 12,300	Insurance expense	\$ 870
Accounts receivable	13,880	Interest expense	2,600
Accumulated amortization— building	50,600	Interest payable	2,600
Accumulated amortization— equipment	17,770	Land	64,000
Amortization expense	7,360	Mortgage payable	99,780
Bowling revenues	14,180	Prepaid insurance	4,590
Building	128,800	Supplies	740
Cash	17,940	T. Bolgos, capital	115,000
Equipment	62,400	T. Bolgos, drawings	10,000
		Unearned bowling revenue	950

Instructions

- Prepare the closing entries at December 31.
- Prepare T accounts for the accounts affected by the closing entries. Post the closing entries.
- Prepare a post-closing trial balance at December 31, 2008.

E4-4 Choi Company has an inexperienced accountant. During the first two weeks on the job, the accountant made the following errors in journalizing transactions. All incorrect entries were posted. Prepare correcting entries. (SO 3) AP

1. A payment on account of \$920 to a creditor was debited \$290 to Accounts Payable and credited \$290 to Cash.
2. The purchase of supplies on account for \$560 was debited \$56 to Equipment and credited \$56 to Accounts Payable.
3. A \$400 withdrawal of cash for L. Choi's personal use was debited \$400 to Salaries Expense and credited \$400 to Cash.
4. The purchase of \$1,200 of office equipment with a three-year useful life was debited to Office Supplies.
5. A customer was billed \$175 for services provided. Accounts Receivable was debited \$175 and Unearned Service Revenue was credited \$175.

Instructions

Prepare the correcting entries.

E4-5 Sobeys Inc. has the following selected accounts listed in a recent balance sheet: Identify balance sheet classifications. (SO 4) K

Accounts payable and accrued liabilities	Long-term debt due within one year
Cash and cash equivalents	Long-term lease obligation
Employee future benefit obligation	Mortgages and loans receivable
Goodwill	Prepaid expenses
Income taxes payable	Property and equipment
Income taxes recoverable	Receivables
Inventories	Retained earnings
Long-term debt	

Instructions

Identify the classification on the balance sheet for each of the accounts.

E4-6 The adjusted trial balance for Rafael Company is presented in E4-2. Prepare financial statements. (SO 4) AP

Instructions

- (a) Prepare an income statement and statement of owner's equity for the year. Mr. Rafael invested \$5,000 cash in the business during the year.
- (b) Prepare a classified balance sheet at July 31, 2008.

E4-7 Refer to the list of adjusted account balances presented in E4-3 for Summit's Bowl-A-Drome Alley at December 31, 2008. Prepare financial statements and comment on liquidity. (SO 4, 5) AN

Instructions

- (a) Prepare an income statement and statement of owner's equity for the year ended December 31, 2008, and a classified balance sheet at December 31, 2008. Assume that \$12,750 of the mortgage payable will be paid in 2009.
- (b) Calculate working capital and the current ratio, and comment on the company's liquidity.

E4-8 Theratechnologies, located in Quebec, is a leader in the Canadian biopharmaceutical industry. The following data (in thousands) were taken from Theratechnologies' financial statements: Calculate working capital and current ratio; comment on liquidity. (SO 5) AN

	<u>Nov. 30, 2005</u>	<u>Nov. 30, 2004</u>	<u>Nov. 30, 2003</u>
Current assets	\$17,192	\$20,842	\$42,523
Current liabilities	4,639	4,996	7,132

Instructions

- (a) Calculate the working capital and current ratio for each year.
- (b) Discuss Theratechnologies' liquidity in 2005 compared to the two previous years.

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► Completion of the Accounting Cycle

Prepare work sheet.
(SO 6) AP

***E4-9** The unadjusted trial balance for Kwok Yuen Ho Company at its month end, April 30, 2008, is as follows:

KWOK YUEN HO COMPANY			
Trial Balance			
April 30, 2008			
	Debit	Credit	
Cash	\$14,770		
Accounts receivable	8,230		
Prepaid rent	3,050		
Equipment	23,040		
Accumulated amortization—equipment		\$ 4,480	
Accounts payable		5,670	
Notes payable		11,600	
K. Ho, capital		28,960	
K. Ho, drawings	3,650		
Service revenue		11,870	
Salaries expense	9,840		
	<u>\$62,580</u>	<u>\$62,580</u>	

Other data:

- Revenue of \$720 was earned but unrecorded as at April 30, 2008.
- On April 1, the company paid \$3,050 rent in advance for April 1 to August 31.
- The equipment has an estimated useful life of three years.
- Interest on the note payable is due on the first day of each month for the previous month's interest. The note payable has a 6% annual interest rate.

Instructions

Prepare the work sheet for the month ended April 30, 2008.

Prepare adjusting entries from work sheet data.
(SO 6) AP

***E4-10** Selected work sheet data for Blanchard Company follow:

	Trial Balance		Adjusted Trial Balance	
	Dr.	Cr.	Dr.	Cr.
Accounts receivable	(1)		34,000	
Prepaid insurance	25,000		18,000	
Supplies	7,000		(3)	
Accumulated amortization		12,000		(5)
Salaries payable				5,000
Service revenue		88,000		95,000
Insurance expense			(4)	
Amortization expense			10,000	
Supplies expense			4,000	
Salaries expense	(2)		49,000	

Instructions

- Fill in the missing amounts.
- Prepare the adjusting entries that were made.

Prepare and post adjusting, closing, reversing, and subsequent entries.
(SO 1, 7) AP

***E4-11** On December 31, the unadjusted trial balance of Masterson Employment Agency shows the following selected data:

Accounts receivable	\$24,000	Commission revenue	\$92,000
Interest expense	7,750	Interest payable	0
I. Masterson, capital	48,000		

Analysis shows that adjusting entries were made to (1) accrue \$4,400 of commission revenue, and (2) accrue \$1,550 of interest expense.

Instructions

- Prepare and post (1) the adjusting entries, and (2) the closing entries for the temporary accounts at December 31.
- Prepare and post reversing entries on January 1.
- Prepare and post the entries to record (1) the collection of \$6,000 of commissions (including the accrued commission from December 31) on January 10, and (2) the payment of \$2,235 interest on January 31 (consisting of the accrued interest from December 31 plus January's interest).

***E4-12** Rosborough Company provides property management services to a variety of companies. At its fiscal year end on April 30, 2008, adjustments were required for the following items:

Prepare adjusting, reversing, and subsequent entries.
(SO 7) AP

- Property management revenue of \$600 was earned but not recorded.
- Of the balance in the Unearned Property Management Revenue account, \$250 had been earned.
- Amortization expense for the year ended April 30, 2008, was \$4,850.
- Interest of \$545 on a note payable had accrued.
- Prepaid insurance of \$385 had expired.
- Property taxes are payable every year on June 30. The company estimated property taxes for 2008 to be \$3,912.

Instructions

- Identify the adjustments for which it could be useful to prepare reversing entries.
- Prepare these reversing entries on May 1, 2008.
- Explain why and how the reversing entries are useful for these adjustments but not for the other adjustments.

Problems: Set A

P4-1A The following T accounts show the balances before the accounts were closed, and the closing entries which were posted to them:

Analyze account data and prepare and post closing entries.
(SO 1) AN

Other Revenue	R. Laporte, Drawings
35,000 35,000	50,000 50,000
Repair Service Expense	R. Laporte, Capital
125,000 125,000	50,000 800,000 60,000
Repair Service Revenue	Other Expenses
180,000 180,000	30,000 30,000
	Income Summary
	? ?

Instructions

- Identify the normal account balance (debit or credit) for each of the above accounts.
- Reconstruct, in general journal format, the closing entries that were journalized and posted to the above T accounts. (*Hint*: Notice that some of the amounts in the T accounts are repeated several times. Think about which ones are related to each other in terms of the closing entries.)
- Post the closing entries to the Income Summary account.

200 CHAPTER 4

► Completion of the Accounting Cycle

Prepare adjusting entries, adjusted trial balance, financial statements, and closing entries.

(SO 1, 4) AP

P4–2A The following is Edge Sports Repair Shop's trial balance at September 30, 2008, the company's fiscal year end:

EDGE SPORTS REPAIR SHOP Trial Balance September 30, 2008		
	<u>Debit</u>	<u>Credit</u>
Cash	\$ 10,470	
Accounts receivable	1,450	
Prepaid insurance	4,140	
Supplies	3,780	
Land	55,000	
Building	98,000	
Accumulated amortization—building		\$ 17,150
Equipment	38,000	
Accumulated amortization—equipment		9,500
Accounts payable		4,300
Unearned revenue		2,280
Mortgage payable		105,000
L. Bachchan, capital		60,000
L. Bachchan, drawings	93,525	
Service revenue		198,450
Salaries expense	75,900	
Utilities expense	11,100	
Interest expense	5,315	
	<u>\$396,680</u>	<u>\$396,680</u>

Other data:

1. Service revenue earned but not recorded at September 30, 2008, was \$1,150.
2. The 12-month insurance policy was purchased on February 1, 2008.
3. A physical count of supplies shows \$960 on hand on September 30, 2008.
4. The building has an estimated useful life of 40 years. The equipment has an estimated useful life of 8 years.
5. Salaries of \$1,075 are accrued and unpaid at September 30, 2008.
6. The mortgage payable has a 6% interest rate. Interest is paid on the first day of each month for the previous month's interest.
7. On September 30, 2008, one quarter of the unearned revenue was still unearned.
8. During the next fiscal year, \$5,400 of the mortgage payable is to be paid.

Instructions

- (a) Prepare the adjusting entries.
- (b) Prepare an adjusted trial balance.
- (c) Prepare an income statement, statement of owner's equity, and classified balance sheet. L. Bachchan invested \$4,000 cash in the business on November 21, 2007.
- (d) Prepare the closing entries.

P4-3A The adjusted trial balance for Zazu Pits Raisin Company is as follows:

ZAZU PITS RAISIN COMPANY Adjusted Trial Balance December 31, 2008		
	<u>Debit</u>	<u>Credit</u>
Cash	\$ 8,400	
Accounts receivable	7,500	
Prepaid insurance	1,800	
Supplies	570	
Land	102,500	
Building	150,000	
Accumulated amortization—building		\$ 24,000
Equipment	28,000	
Accumulated amortization—equipment		8,400
Accounts payable		12,740
Salaries payable		2,850
Interest payable		1,400
Unearned revenue		2,190
Mortgage payable (\$3,000 is payable in 2009)		198,000
P. Zazu, capital		58,500
P. Zazu, drawings	7,200	
Service revenue		73,500
Salaries expense	47,040	
Amortization expense	5,800	
Utilities expense	5,280	
Interest expense	12,870	
Insurance expense	1,200	
Supplies expense	3,420	
	<u>\$381,580</u>	<u>\$381,580</u>

Prepare financial statements, closing entries, and post-closing trial balance.
(SO 1, 4) AP

Instructions

- Prepare an income statement, statement of owner's equity, and classified balance sheet. The owner, Patrice Zazu, invested \$4,500 cash in the business during 2008.
- Prepare the closing entries.
- Using T accounts, post the closing entries and calculate the balance in each account. (Ignore the accounts that are not affected by the closing entries.)
- Prepare a post-closing trial balance.

Analyze errors and prepare corrections.
(SO 3) AP

P4-4A Eric Mayers, CA, was hired by Interactive Computer Repair to prepare its financial statements for March 2008. Using all the ledger balances in the owner's records, Mayers put together the following trial balance:

INTERACTIVE COMPUTER REPAIR		
Trial Balance		
March 31, 2008		
	Debit	Credit
Cash	\$ 7,400	
Accounts receivable	3,600	
Supplies	1,100	
Equipment	11,400	
Accumulated amortization		\$ 5,795
Accounts payable		3,000
Salaries payable		750
Unearned revenue		935
H. Maurice, capital		12,725
Service revenue		6,450
Salaries expense	5,100	
Advertising expense	600	
Miscellaneous expense	210	
Amortization expense	95	
Repair expense	150	
Totals	<u>\$29,655</u>	<u>\$29,655</u>

Mayers then reviewed the records and found the following errors:

- Cash received from a customer on account was recorded as \$670 instead of \$760.
- The purchase on account of a computer monitor that cost \$900 was recorded as a debit to Supplies and a credit to Accounts Receivable for \$900.
- The computer monitor purchased in item 2 was purchased on March 1 and has an estimated useful life of five years. Amortization for March has not yet been recorded.
- A payment of \$75 for advertising expense was entered as a debit to Miscellaneous Expense of \$50 and a credit to Cash of \$50.
- The first salary payment made in March was for \$2,000, which included \$750 of salaries payable on February 28. The payment was recorded as a debit to Salaries Expense of \$2,000 and a credit to Cash of \$2,000. (No reversing entries were made on March 1.)
- A \$110 cash payment for a repair expense on equipment was recorded as a debit to Equipment of \$101 and a credit to Cash of \$101.
- The owner, Hubert Maurice, paid himself \$1,800 and recorded this as salary expense.
- March rent of \$1,150 was paid on March 26. The company has not recorded this transaction.

Instructions

- Prepare an analysis of each error that shows (1) the incorrect entry, (2) the correct entry, and (3) the correcting entry.
- Prepare a correct trial balance.

Determine impact of errors on financial statements.
(SO 3) AP

P4-5A The following accounting errors were made in the records of Fu Company and were not found. If nothing is said about it, assume that the other side of the entry was correctly recorded and posted.

- A \$700 debit to Supplies was debited to Supplies Expense.
- A \$600 debit to Accounts Payable was debited to Cash.
- A \$350 cash sale was posted to the Cash and Service Revenue accounts twice.
- The amortization adjusting entry was recorded and posted as \$850, rather than \$580.
- A \$680 posting to Accounts Receivable and Service Revenue was posted by mistake as \$600.
- A \$750 debit to Interest Expense was posted to Interest Revenue as a debit.
- A \$500 collection in advance was not posted to the Cash and Unearned Service Revenue accounts.

8. A \$300 collection in advance was credited to Service Revenue instead of Unearned Service Revenue.
9. A \$950 payment for rent for the owner's apartment was debited to Rent Expense.

Instructions

- (a) For each item, indicate the effect and amount of the error—understatement (U), overstatement (O), or no effect (NE)—on the income statement and balance sheet components. Use the following format, where the first one has been done for you as an example.

Item	Income Statement			Balance Sheet		
	Revenue	Expenses	Net Income	Assets	Liabilities	Owner's Equity
1.	NE	O \$700	U \$700	U \$700	NE	U \$700

- (b) Determine the total amount of the understatement or overstatement that results from the errors.

P4-6A Below is an alphabetical list of the adjusted accounts of Matrix Consulting Services at its year end, March 31, 2008. All accounts have normal balances.

Prepare financial statements and liquidity ratios.
(SO 4, 5) AP

Accounts payable	\$ 8,000	N. Anderson, capital	\$41,000
Accounts receivable	7,400	N. Anderson, drawings	12,000
Accumulated amortization— computer equipment	18,000	Note payable	26,000
Advertising expense	12,000	Note receivable	10,000
Amortization expense	6,000	Patent	16,000
Cash	4,600	Prepaid insurance	4,400
Computer equipment	44,000	Salaries expense	45,000
Insurance expense	4,000	Salaries payable	2,600
Interest expense	2,000	Service revenue	79,800
Interest payable	1,000	Short-term investments	4,000
Interest receivable	800	Supplies	2,300
Interest revenue	600	Supplies expense	3,700
		Unearned revenue	1,200

Other data:

1. Of the notes payable, \$10,000 becomes due on July 1, 2008, and the rest on July 1, 2009.
2. The note receivable is due on June 1, 2008.
3. On September 20, 2007, Neo Anderson invested \$3,600 cash in the business.

Instructions

- (a) Prepare an income statement and statement of owner's equity for the year ended March 31, 2008, and a classified balance sheet as at March 31, 2008.
- (b) On March 31, 2007, Matrix Consulting Services had current assets of \$30,700 and current liabilities of \$15,950. Calculate the company's working capital and current ratio on March 31, 2007, and March 31, 2008. Has the company's ability to pay its debts improved or weakened over the year?

P4-7A **Big Rock Brewery** creates and sells premium natural unpasteurized beer. Its 2005 balance sheet showed current assets of \$12,770,157 and current liabilities of \$3,895,903. The 2004 balance sheet reported current assets of \$9,947,060 and current liabilities of \$4,014,186. The 2003 balance sheet had current assets of \$10,006,747 and current liabilities of \$4,958,338.

Calculate working capital and current ratio, and comment on liquidity.
(SO 5) AN

Instructions

- (a) Calculate Big Rock's working capital and current ratio for each year.
- (b) What do each of the measures calculated in (a) show? Comment on Big Rock's liquidity.

***P4-8A** The unadjusted trial balance and adjustment data for Edge Sports Repair Shop are presented in P4-2A.

Prepare work sheet.
(SO 6) AP

Instructions

Prepare a work sheet for the year ended September 30, 2008.

Prepare work sheet, classified balance sheet, adjusting and closing entries, and post-closing trial balance.

(SO 1, 4, 6) AP

***P4-9A** Kumar Management Services manages condominiums for owners (service revenue) and rents space in its own office building (rent revenue). The trial balance and adjusted trial balance columns of the work sheet at the end of the fiscal year are as follows:

KUMAR MANAGEMENT SERVICES				
Work Sheet (partial)				
Year Ended December 31, 2008				
	Trial Balance		Adjusted Trial Balance	
	Dr.	Cr.	Dr.	Cr.
Cash	\$ 12,550		\$ 12,550	
Accounts receivable	23,600		25,100	
Supplies	3,150		690	
Prepaid insurance	3,100		1,400	
Land	58,000		58,000	
Building	112,500		112,500	
Accumulated amortization— building		\$ 22,500		\$ 25,000
Equipment	51,000		51,000	
Accumulated amortization— equipment		17,000		21,250
Accounts payable		10,640		11,340
Salaries payable		0		845
Interest payable		0		1,250
Unearned rent revenue		5,000		3,100
Mortgage payable		100,000		100,000
M. Kumar, capital		113,150		113,150
M. Kumar, drawings	28,500		28,500	
Service revenue		66,100		67,600
Rent revenue		24,000		25,900
Salaries expense	38,675		39,520	
Utilities expense	15,800		16,500	
Property tax expense	5,265		5,265	
Insurance expense	0		1,700	
Interest expense	6,250		7,500	
Amortization expense	0		6,750	
Supplies expense	0		2,460	
	<u>\$358,390</u>	<u>\$358,390</u>	<u>\$369,435</u>	<u>\$369,435</u>

Instructions

- Complete the work sheet, using the partial information provided above.
- Prepare a classified balance sheet. (*Note:* In the next year, \$10,000 of the mortgage payable is due for payment.)
- Journalize the adjusting entries.
- Journalize the closing entries.
- Prepare a post-closing trial balance.

Use work sheet relationships to determine missing amounts.

(SO 6) AN

***P4-10A** A work sheet for Nohe's Carpet Cleaners follows, with certain amounts replaced by letters:

NOHE'S CARPET CLEANERS Work Sheet Month Ended April 30, 2008										
	Trial Balance		Adjustments		Adjusted Trial Balance		Income Statement		Balance Sheet	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	(a)				950				950	
Accounts receivable	1,350		(e)		1,500				1,500	
Cleaning supplies	1,400			(i)	(m)				500	
Prepaid insurance	(b)			(j)	1,650				1,650	
Equipment	7,510				7,510				7,510	
Accumulated amortization		1,200		(k)		1,500				1,500
Accounts payable		2,115				2,115				(z)
Unearned revenue		800	550			250				250
J. Nohe, capital		9,400				9,400				9,400
J. Nohe, drawings	(c)				1,280				1,280	
Service revenue		4,000		(l)		(q)		(u)		
Rent expense	975				975		975			
Salaries expense	(d)		(f)		(n)		2,790			
Totals	<u>17,515</u>	<u>17,515</u>								
Amortization expense			(g)		(o)		(s)			
Insurance expense			210		210		210			
Cleaning supplies expense			(h)		(p)		(t)			
Salaries payable				600		(r)				600
Totals			<u>2,710</u>	<u>2,710</u>	<u>18,565</u>	<u>18,565</u>	5,175	(v)	(x)	13,865
Net income							0	475	(y)	
Totals							<u>5,175</u>	<u>(w)</u>	<u>13,865</u>	<u>13,865</u>

Instructions

Determine the amounts that should appear in the work sheet where there is currently a letter. (*Hint:* You will not be able to determine the missing items in alphabetical order.)

***P4-11A** The Friendly Food Company had the following balances on its December 31, 2007, balance sheet:

Rent receivable	\$3,700	Property taxes payable	\$ 3,150
Prepaid insurance	5,250	Unearned service revenue	25,000

Prepare and post transaction entries, with and without reversing entries.

(SO 7) AP

During 2008, the following transactions occurred:

- On January 5, rent for November 2007, December 2007, and January 2008 totalling \$5,550 cash was collected.
- On April 15, property tax of \$8,400 was paid.
- On July 31, 2008, the company's insurance policy expired and a new one-year policy was purchased for \$9,000.
- Services provided of \$415,000 in 2008 included \$390,000 of services for cash and \$25,000 of services to customers who had made advance payments in 2007.

Instructions

- Assuming that the company does not use reversing entries:
 - Prepare journal entries to record the transactions above for 2008.
 - Post your entries to T accounts and calculate the balance in each account.
- Assuming that the company uses reversing entries:
 - Prepare reversing entries where appropriate for January 1, 2008.
 - Prepare journal entries to record the transactions above for 2008.
 - Post your entries to T accounts and calculate the balance in each account.
- Compare the account balances in (a) to those in (b). Comment on the usefulness of reversing entries.

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Prepare adjusting, reversing, and subsequent cash entries. (SO 7) AP

***P4–12A** The unadjusted trial balance for Larry’s Laser Games at its fiscal year end of April 30, 2008, is as follows:

LARRY’S LASER GAMES		
Trial Balance		
April 30, 2008		
	Debit	Credit
Cash	\$ 3,525	
Accounts receivable	0	
Supplies	3,370	
Equipment	135,000	
Accumulated amortization—equipment		\$ 40,500
Wages payable		0
Interest payable		0
Note payable		85,000
Unearned game fee revenue		1,875
L. Ng, capital		32,800
L. Ng, drawings	28,500	
Game fee revenue		82,545
Rent expense	14,400	
Wages expense	53,250	
Supplies expense	0	
Amortization expense	0	
Interest expense	4,675	
	<u>\$242,720</u>	<u>\$242,720</u>

Other data:

1. On April 30, 2008, Larry’s Laser Games had earned but not collected or recorded \$775 of game fee revenue. On May 17, 2008, Larry’s Laser Games collected this amount plus an additional \$1,150 for game fee revenue earned in May.
2. There was \$540 of supplies on hand on April 30, 2008.
3. The equipment has an estimated useful life of 10 years.
4. On April 30, salaries earned but not paid or recorded were \$720. The next pay day is May 10 and the employees will be paid a total of \$2,785 that day.
5. The note payable has a 6% annual interest rate. Interest is paid quarterly. Interest was last paid on March 31, 2008. The next payment is due on June 30, 2008.
6. On April 30, \$1,475 of the unearned game fee revenue had been earned.

Instructions

- (a) Prepare adjusting journal entries for the year ended April 30, 2008, as required.
- (b) Prepare reversing entries where appropriate.
- (c) Prepare journal entries to record the May and June 2008 cash transactions.
- (d) Now assume reversing entries were not prepared as in (b) above. Prepare journal entries to record the May and June 2008 cash transactions.

► Completion of the Accounting Cycle

4. The building has an estimated useful life of 45 years. The equipment has an estimated useful life of 15 years.
5. Salaries of \$1,325 are accrued and unpaid at January 31, 2008.
6. The mortgage payable has a 7% interest rate. Interest is paid on the first day of each month for the previous month's interest.
7. By January 31, 2008, \$1,700 of the unearned revenue has been earned.
8. During the next fiscal year, \$4,500 of the mortgage payable is to be paid.

Instructions

- (a) Prepare the adjusting entries.
- (b) Prepare an adjusted trial balance.
- (c) Prepare an income statement, statement of owner's equity, and classified balance sheet. K. Dude invested \$3,000 cash in the business on November 17, 2007.
- (d) Prepare the closing entries.

Prepare financial statements, closing entries, and post-closing trial balance.

(SO 1, 4) AP

P4-3B The adjusted trial balance for Raisin Oatmeal Company is as follows:

RAISIN OATMEAL COMPANY		
Adjusted Trial Balance		
December 31, 2008		
	<u>Debit</u>	<u>Credit</u>
Cash	\$ 6,185	
Accounts receivable	13,500	
Prepaid insurance	3,500	
Supplies	1,140	
Land	46,800	
Building	187,580	
Accumulated amortization—building		\$ 37,520
Equipment	26,000	
Accumulated amortization—equipment		5,600
Accounts payable		13,220
Salaries payable		3,000
Interest payable		350
Unearned revenue		2,190
Notes payable (\$7,500 must be paid in 2009)		63,925
R. Ospina, capital		140,000
R. Ospina, drawings	59,200	
Service revenue		139,800
Advertising expense	2,400	
Amortization expense	10,300	
Utilities expense	2,175	
Interest expense	4,155	
Insurance expense	8,400	
Salaries expense	32,100	
Supplies expense	2,170	
	<u>\$405,605</u>	<u>\$405,605</u>

Instructions

- (a) Prepare an income statement, statement of owner's equity, and classified balance sheet. The owner, Ricardo Ospina, invested \$2,500 cash in the business during the year.
- (b) Prepare the closing entries.
- (c) Use T accounts post the closing entries and calculate the balance in each account. (Ignore the accounts not affected by the closing entries.).
- (d) Prepare a post-closing trial balance.

P4-4B Bob Thebeau, CA, was hired by Campus DVD Repair to prepare its financial statements for April 2008. Using all the ledger balances in the owner's records, Thebeau put together the following trial balance:

Analyze errors and prepare corrections.
(SO 3) AP

CAMPUS DVD REPAIR Trial Balance April 30, 2008		
	Debit	Credit
Cash	\$ 4,960	
Accounts receivable	3,200	
Supplies	3,800	
Equipment	10,926	
Accumulated amortization—equipment		\$ 2,925
Accounts payable		2,100
Salaries payable		500
Unearned revenue		590
S. Morris, capital		16,900
Service revenue		6,886
Salaries expense	6,000	
Advertising expense	400	
Miscellaneous expense	290	
Amortization expense	225	
Repair expense	100	
Totals	<u>\$29,901</u>	<u>\$29,901</u>

Thebeau reviewed the records and found the following errors:

- Cash received from a customer on account was recorded as \$690 instead of \$580.
- The purchase on account of a computer that cost \$3,240 was recorded as a debit to supplies and a credit to accounts payable for \$3,240.
- The computer in error 2 was purchased February 1, 2008, and is expected to have a three-year useful life. Amortization for the month of April has not been recorded.
- A payment of \$145 for a miscellaneous expense was entered as a debit to Advertising Expense of \$45 and a credit to Cash of \$45.
- The first salary payment made in April was for \$1,900, which included \$500 of salaries payable on March 31. The payment was recorded as a debit to Salaries Expense of \$1,900 and a credit to Cash of \$1,900. (No reversing entries were made on April 1.)
- A cash payment for a repair expense on equipment of \$126 was recorded as a debit to Equipment of \$126 and a credit to Cash of \$126.
- The owner, Stuart Morris, paid himself \$2,200 and recorded this as salary expense.
- April rent of \$950 was paid on April 26. The company has not recorded this transaction.

Instructions

- Prepare an analysis of each error that shows (1) the incorrect entry, (2) the correct entry, and (3) the correcting entry.
- Prepare a correct trial balance.

P4-5B The following accounting errors were made in the records of Mróz Company and were not found. If nothing is said about it, assume that the other side of each entry was correctly recorded and posted.

Determine impact of errors on financial statements.
(SO 3) AP

- A \$500 debit to Rent Expense was debited to Rent Payable.
- A \$300 debit to Supplies was debited to Rent Expense.
- A \$450 credit to Cash was posted to the Cash account twice.
- A debit to Utilities Expense of \$91 was posted as a debit of \$19.

► Completion of the Accounting Cycle

- A collection of \$580 on account from a customer was debited to Service Revenue and credited to Accounts Receivable.
- A \$600 accrual of Interest Expense was posted as a debit to Interest Payable and a credit to Interest Expense.
- A \$250 debit to Accounts Receivable was not posted.
- A \$300 advance from a customer was credited to Service Revenue.

Instructions

- (a) For each item, indicate the effect and amount of the error—understatement (U), overstatement (O), or no effect (NE)—on the income statement and balance sheet components. Use the following format, where the first one has been done for you as an example.

Item	Income Statement			Balance Sheet		
	Revenue	Expenses	Net Income	Assets	Liabilities	Owner's Equity
1.	NE	U \$500	O \$500	NE	U \$500	O \$500

- (b) Determine the total amount of the understatement or overstatement that results from the errors.

Prepare financial statements and liquidity ratios.
(SO 4, 5) AP

P4–6B Below is an alphabetical list of the adjusted accounts of Cormier Company at its year end, December 31, 2008. All accounts have normal balances.

Accounts payable	\$ 6,000	Office equipment	\$34,000
Accounts receivable	7,200	P. Cormier, capital	32,800
Accumulated amortization— office equipment	8,000	P. Cormier, drawings	10,000
Amortization expense	8,000	Patent	22,000
Cash	6,200	Prepaid insurance	2,800
Insurance expense	5,000	Rent expense	14,000
Interest expense	1,800	Salaries expense	38,100
Interest payable	800	Salaries payable	3,500
Interest receivable	600	Service revenue	92,000
Interest revenue	600	Short-term investments	4,500
Note payable	18,000	Supplies	2,000
Note receivable	7,500	Unearned revenue	2,000

Other data:

- In 2009, \$4,000 of the notes payable becomes due.
- The note receivable is due in 2010.
- On July 18, 2008, Pierre Cormier invested \$3,200 cash in the business.

Instructions

- (a) Prepare an income statement, statement of owner's equity, and classified balance sheet.
(b) On December 31, 2007, Cormier Company had current assets of \$17,400 and current liabilities of \$22,300. Calculate the company's working capital and current ratio on December 31, 2007, and December 31, 2008. Has the company's ability to pay its debts improved or weakened over the year?

Calculate working capital and current ratio, and comment on liquidity.
(SO 5) AN

P4–7B **Sleeman Breweries Ltd.** is the largest craft brewer in Canada and the country's leading maker of premium beers. Its 2005 balance sheet showed current assets of \$97,998 thousand and current liabilities of \$71,887 thousand, including a bank overdraft (negative cash balance) of \$9,744 thousand. The 2004 balance sheet reported current assets of \$90,574 thousand and current liabilities of \$60,823 thousand, including bank indebtedness of \$9,634 thousand. The 2003 balance sheet reported current assets of \$73,118 thousand and current liabilities of \$55,512 thousand, including bank indebtedness of \$555 thousand.

Instructions

- (a) Calculate Sleeman's working capital and current ratio for each year.
(b) What do each of the measures calculated in (a) show? Comment on Sleeman's liquidity.

***P4–8B** The unadjusted trial balance and adjustment data for Campus Cycle Shop are presented in P4–2B. Prepare work sheet. (SO 6) AP

Instructions

Prepare a work sheet for the year ended January 31, 2008.

***P4–9B** Water World Park’s year end is September 30. Selected data from the September 30 work sheet follow: Prepare work sheet, classified balance sheet, adjusting and closing entries, and post-closing trial balance. (SO 1, 4, 6) AP

WATER WORLD PARK Work Sheet (partial) Year Ended September 30, 2008				
	Trial Balance		Adjusted Trial Balance	
	Dr.	Cr.	Dr.	Cr.
Cash	\$ 11,770		\$ 11,770	
Accounts receivable	0		1,250	
Supplies	18,600		1,200	
Prepaid insurance	31,900		3,900	
Land	80,000		80,000	
Building	480,000		480,000	
Accumulated amortization—building		\$120,000		\$136,000
Equipment	120,000		120,000	
Accumulated amortization—equipment		44,000		52,000
Accounts payable		14,600		15,850
Wages payable		0		2,960
Interest payable		0		2,040
Unearned admission revenue		3,700		700
Mortgage payable		350,000		350,000
M. Berge, capital		159,700		159,700
M. Berge, drawings	14,000		14,000	
Admission revenue		250,070		253,070
Concession revenue		16,720		17,970
Wages expense	123,000		125,960	
Repairs expense	30,500		31,750	
Advertising expense	9,660		9,660	
Utilities expense	16,900		16,900	
Insurance expense	0		28,000	
Interest expense	22,460		24,500	
Amortization expense	0		24,000	
Supplies expense	0		17,400	
	<u>\$958,790</u>	<u>\$958,790</u>	<u>\$990,290</u>	<u>\$990,290</u>

Instructions

- (a) Complete the work sheet, using the partial information provided above.
- (b) Prepare a classified balance sheet. (Note: In the next fiscal year, \$50,000 of the mortgage payable is due for payment.)
- (c) Journalize the adjusting entries.
- (d) Journalize the closing entries.
- (e) Prepare a post-closing trial balance.

***P4–10B** A work sheet for Steam Carpet Cleaners follows, with certain amounts replaced by letters: Use work sheet relationships to determine missing amounts. (SO 6) AN

STEAM CARPET CLEANERS Work Sheet Month Ended January 31, 2008										
	Trial Balance		Adjustments		Adjusted Trial Balance		Income Statement		Balance Sheet	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	(a)				1,200				1,200	
Accounts receivable	4,400		(e)		5,000				5,000	
Cleaning supplies	1,950			(i)	(m)				900	
Prepaid insurance	(b)			(j)	1,650				1,650	
Equipment	7,000				7,000				7,000	
Accumulated amortization		1,000		(k)		1,250				1,250
Accounts payable		1,200				1,200				(x)
Unearned service revenue		750	450			300				300
H. Kohl, capital		10,000				10,000				10,000
H. Kohl, drawings	(c)				900				900	
Service revenue		6,000		(l)		(q)		(u)		
Rent expense	200				200		200			
Salaries expense	(d)		(f)		(n)		2,000			
Totals	<u>18,950</u>	<u>18,950</u>								
Amortization expense			(g)		(o)		(s)			
Insurance expense			150		150		150			
Cleaning supplies expense			(h)		(p)		(t)			
Salaries payable				500		(r)				500
Totals			<u>3,000</u>	<u>3,000</u>	<u>20,300</u>	<u>20,300</u>	3,650	(v)	16,650	(y)
Net income							3,400			(z)
Totals							<u>7,050</u>	<u>(w)</u>	<u>16,650</u>	<u>16,650</u>

Instructions

Determine the amounts that should appear in the work sheet where there is currently a letter. (*Hint:* You will not be able to determine the missing items in alphabetical order.)

Prepare and post transaction entries, with and without reversing entries.

(SO 7) AP

***P4–11B** Farid Company had the following balances on its December 31, 2007, balance sheet:

Interest receivable	\$1,500	Wages payable	\$28,000
Prepaid insurance	5,000	Unearned service revenue	15,000

During 2008, the following transactions occurred:

- On January 10, \$85,000 was paid to employees for wages earned between December 11, 2007, and January 10, 2008.
- On January 31, \$2,000 cash was collected for interest on a note receivable for the period October 1, 2007, to January 31, 2008.
- On May 1, the company's insurance policy expired and the company paid \$15,000 for a one-year policy.
- Services of \$190,000 provided in 2008 included \$175,000 of services for cash and \$15,000 of services to customers who had made advance payments during 2007.

Instructions

- Assuming that the company does not use reversing entries:
 - Prepare journal entries to record the transactions above for 2008.
 - Post your entries to T accounts, and calculate the balance in each account.
- Assuming that Farid uses reversing entries:
 - Prepare reversing entries as appropriate on January 1, 2008.
 - Prepare journal entries to record the transactions above for 2008.
 - Post your entries to T accounts and calculate the balance in each account.
- Compare the account balances in (a) to those in (b). Comment on the usefulness of reversing entries.

***P4–12B** The unadjusted trial balance for Veda's Video Arcade at its fiscal year end of May 31, 2008, is as follows:

Prepare adjusting, reversing, and subsequent cash entries.
(SO 7) AP

VEDA'S VIDEO ARCADE Trial Balance May 31, 2008		
	<u>Debit</u>	<u>Credit</u>
Cash	\$ 4,485	
Accounts receivable	0	
Supplies	2,810	
Equipment	128,000	
Accumulated amortization—equipment		\$ 38,400
Wages payable		0
Interest payable		0
Note payable		60,000
Unearned game fee revenue		1,500
V. Gupta, capital		35,000
V. Gupta, drawings	22,500	
Game fee revenue		82,545
Rent expense	13,800	
Wages expense	42,600	
Supplies expense	0	
Amortization expense	0	
Interest expense	3,250	
	<u>\$217,445</u>	<u>\$217,445</u>

Other data:

- On May 31, 2008, Veda's Video Games had earned but not collected or recorded \$1,050 of game fee revenue. On June 19, it collected this amount plus an additional \$770 for game fee revenue earned in June.
- There was \$950 of supplies on hand on May 31, 2008.
- The equipment has an estimated useful life of 10 years.
- Accrued salaries to May 31 were \$910. The next payday is June 10 and the employees will be paid a total of \$1,980 that day.
- The note payable has a 6.5% annual interest rate. Interest is paid quarterly. Interest was last paid on March 31, 2008. The next payment is due on June 30, 2008.
- On May 28, \$950 of the unearned game fee revenue had been earned.

Instructions

- Prepare adjusting journal entries for the year ended May 31, 2008, as required.
- Prepare reversing entries where appropriate.
- Prepare journal entries to record the June 2008 cash transactions.
- Now assume reversing entries were not prepared as in (b) above. Prepare journal entries to record the June 2008 cash transactions.

Continuing Cookie Chronicle

(Note: This is a continuation of the Cookie Chronicle from Chapters 1 through 3.)

Natalie had a very busy December. At the end of the month, after Natalie has journalized and posted her December transactions and adjusting entries, her company has the following adjusted trial balance:

COOKIE CREATIONS Adjusted Trial Balance December 31, 2007			
	<u>Debit</u>	<u>Credit</u>	
Cash	\$1,130		
Accounts receivable	875		
Baking supplies	350		
Prepaid insurance	1,210		
Baking equipment	1,300		
Accumulated amortization—baking equipment		\$ 43	
Accounts payable		75	
Salaries payable		56	
Unearned revenue		300	
Interest payable		15	
Note payable, 6%, principal and interest due November 16, 2009			2,000
N. Koebel, capital			900
N. Koebel, drawings	500		
Teaching revenue			4,315
Salaries expense	856		
Telephone expense	125		
Advertising supplies expense	165		
Baking supplies expense	1,025		
Amortization expense	43		
Insurance expense	110		
Interest expense	15		
	<u>\$7,704</u>		<u>\$7,704</u>

Instructions

Using the information in the adjusted trial balance, do the following:

- Prepare an income statement and a statement of owner's equity for the two months ended December 31, 2007, and a classified balance sheet as at December 31, 2007.
- Natalie has decided that her year end will be December 31, 2007. Prepare closing entries as at December 31, 2007.
- Prepare a post-closing trial balance.

Cumulative Coverage—Chapters 2 to 4

Lee Chan opened Lee's Window Washing on July 1, 2008. In July, the following transactions were completed:

- July
- Invested \$14,000 cash in the business.
 - Purchased a used truck for \$26,400, paying \$6,400 cash and signing a note payable for the balance.
 - Purchased cleaning supplies for \$850 on account.
 - Paid \$1,800 on a one-year insurance policy, effective July 1.
 - Billed customers \$3,800 for cleaning services.

- July 18 Paid \$400 of amount owed on cleaning supplies.
 20 Paid \$1,600 for employee salaries.
 21 Collected \$1,400 from customers billed on July 12.
 25 Billed customers \$3,000 for cleaning services.
 31 Paid gas and oil for the month on the truck, \$350.
 31 Withdrew \$1,600 cash for personal use.

Instructions

- (a) Journalize and post the July transactions.
- (b) Prepare a trial balance at July 31.
- (c) Journalize and post the following adjustments:
 1. Earned but unbilled fees at July 31 were \$1,500.
 2. The truck has an estimated useful life of four years.
 3. One-twelfth of the insurance expired.
 4. An inventory count shows \$375 of cleaning supplies on hand at July 31.
 5. Accrued but unpaid employee salaries were \$400.
 6. The note payable has a 6% annual interest rate.
- (d) Prepare an adjusted trial balance.
- (e) Prepare the income statement and statement of owner's equity for July, and a classified balance sheet at July 31, 2008. Of the note payable, \$5,000 must be paid by July 1, 2009.
- (f) Journalize and post the closing entries, and complete the closing process.
- (g) Prepare a post-closing trial balance at July 31.

B R O A D E N I N G Y O U R P E R S P E C T I V E

Financial Reporting and Analysis

Financial Reporting Problem

BYP4–1 The financial statements and accompanying notes of **The Forzani Group** are presented in Appendix A at the end of this book.

Instructions

- (a) How is Forzani's balance sheet classified? What classifications does it use?
- (b) How are Forzani's assets and liabilities ordered (e.g., in order of liquidity, permanency, etc.)?
- (c) Forzani's working capital and current ratio for the fiscal year 2006 are calculated in the chapter. Calculate its working capital and current ratio for the fiscal year 2005. Compare them to the 2006 results and comment on the differences.

Interpreting Financial Statements

BYP4–2 The following information was reported by **The Gap, Inc.** in its 2005 annual report:

	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>
Total assets (in U.S. millions)	\$10,048	\$10,713	\$10,283	\$8,096	\$7,387
Working capital (in U.S. millions)	\$4,062	\$4,156	\$2,972	\$1,018	\$(153)
Current ratio	2.81:1	2.63:1	2.08:1	1.48:1	0.95:1

► Completion of the Accounting Cycle**Instructions**

- By what percentage did The Gap's total assets increase overall from 2001 to 2005? What was the average increase for each year?
- Comment on the change in The Gap's liquidity. Which measure seems to give a better indication of The Gap's liquidity: working capital or the current ratio? What could the reason be for the change in The Gap's liquidity during the period?
- Do you believe that The Gap's creditors should be concerned about its liquidity?
- If you were a creditor of The Gap and noted that it did not have enough current assets to cover its current liabilities in 2001, what additional information could you ask for to help you assess its liquidity?

Critical Thinking

Collaborative Learning Activity

Note to instructor: Additional instructions and material for this group activity can be found on the Instructor Resource Site.

BYP4–3 In this group activity, you will classify and define accounts.

Instructions

- Your instructor will divide the class into groups and provide each with an envelope filled with account names. As a group, place each account in the proper financial statement classification on the handout provided.
- Using the second handout provided, identify each account's normal balance and whether it is permanent or temporary.
- You may be asked by your instructor to write a short quiz on this topic.

Communication Activity

BYP4–4 Your best friend is thinking about opening a business. He has never studied accounting and has no idea about the steps that must be followed in order to produce financial statements for his business.

Instructions

Write a memo to your friend that lists and explains each of the steps in the accounting cycle in the order in which they should be completed. Include information on when each of these steps should be done and explain the purpose of the different types of journal entries and trial balances. Your memo should also discuss the optional steps in the accounting cycle.

Ethics Case

BYP4–5 As the controller of Breathless Perfume Company, you discover a significant misstatement that overstated net income in the previous year's financial statements. The misleading financial statements are in the company's annual report, which was issued to banks and other creditors less than a month ago.

After much thought about the consequences of telling the president, Eddy Lieman, about this misstatement, you gather your courage to inform him. Eddy says, "Hey! What they don't know won't hurt them. But, just so we set the record straight, we'll adjust this year's financial statements for last

year's misstatement. We can absorb that misstatement better this year than last year anyway! Just don't make that kind of mistake again."

Instructions

- (a) Who are the stakeholders in this situation?
- (b) What are the ethical issues in this situation?
- (c) As a controller, what would you do in this situation?

ANSWERS TO CHAPTER QUESTIONS

Across the Organization Insight, p. 169

Q: Why are CFOs interested in knowing how long it takes on average for companies to close their books?

A: There are two basic reasons: (1) the more time a company needs to close its books, the more it costs the company; and (2) accounting information must be timely to be useful.

Business Insight, p. 174

Q: Some of these errors happened several years ago. Why is it still important for Nortel to record entries to correct them?

A: Investors and creditors often use several years of a company's financial statements to determine if the company's performance is getting better or worse. If statements from previous years are incorrect, investors and creditors would not be able to make useful comparisons.

Answer to Forzani Review It Question 3, p. 181

Forzani's current assets include Cash, \$19,266; Accounts Receivable, \$68,927; Inventory, \$278,002; and Prepaid Expenses, \$2,647. Its current liabilities include Accounts Payable and Accrued Liabilities, \$244,293; and the Current Portion of Long-Term Debt, \$5,135. All amounts are listed in thousands. Forzani's current assets and current liabilities appear to be listed in order of liquidity, with the most current or liquid account listed first.

Answers to Self-Study Questions

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



Remember to go back to the Navigator Box at the beginning of the chapter to check off your completed work.