

**Copyright Notice.** Each module of the course manual may be viewed online, saved to disk, or printed (each is composed of 10 to 15 printed pages of text) by students enrolled in the author's accounting course for use in that course. Otherwise, no part of the *Course Manual* or its modules may be reproduced or copied in any form or by any means—graphic, electronic, or mechanical, including photocopying, taping, or information storage and retrieval systems—without the written permission of the author. Requests for permission to use or reproduce these materials should be mailed to the author.

## Module 4

<p style="text-align: center;"><b>Table of Contents</b></p> <ul style="list-style-type: none"><li>I. <a href="#"><u>Closing Entries</u></a></li><li>II. <a href="#"><u>The Income Summary Account</u></a></li><li>III. <a href="#"><u>Use of the Worksheet</u></a></li><li>IV. <a href="#"><u>Use of Reversing Entries</u></a></li><li>V. <a href="#"><u>Accounting Cycle Steps</u></a></li><li>VI. <a href="#"><u>Classified Balance Sheet</u></a></li><li>VII. <a href="#"><u>Ratios Used to Evaluate Liquidity</u></a><ul style="list-style-type: none"><li>i. <a href="#"><u>Practice Problem</u></a></li></ul></li></ul>	<p><b>Instructions:</b></p> <p>Click on any of the underlined titles in the table of contents to be directed to that section of the module. Click on the &lt;back&gt; symbol to return to the table of contents.</p>
---	--

### [Video Lectures](#)

*Because seeing and hearing is sometimes better than just reading, I have prepared two video lecture for this module. After you read through the sections below, click here to play or to download the videos :*

Closing Entries: <http://youtu.be/6FKUrcOY5Is>

The Worksheet: <http://my-accounting-tutor.com/Financial/Camtasia/4-F-2/Module4-2CamtasiaElements.htm>

Reversing Entries: <http://my-accounting-tutor.com/Financial/Camtasia/ReversingEntries/ReversingEntries.html>

## Module 4 Summary

I. **Closing entries** are made at the end of the accounting period in order to ready the accounts for use in the following period.

- A. As explained previously in module 2, the *Revenue*, *Expense*, and *Drawing* accounts are called *income statement accounts*, or *temporary accounts*. The remaining accounts (Asset, Liability, and the Capital accounts) are called *balance sheet accounts*, *permanent accounts*, or *real accounts*.

At the end of the accounting period, after adjustments have been made and the statements have been prepared, it will be necessary to **close** the balances in the temporary accounts. Permanent accounts are never closed.

- B. **Closing** an account simply means reducing the account balance to zero. For example, if an account has a debit balance of \$100, we will credit it for \$100 in order to “close it out.” If an account has a credit balance of \$100, we will debit it for \$100 to close the account. These entries are called *closing entries* or *clearing entries*.

*Why are accounts closed?* Closing the temporary accounts is necessary in order to prepare them for use in the next accounting period. After all, if the ending balances are left in these accounts, there will be a problem when it is time to prepare the income statement for the following period. If we do not close them out now, the account balances at the end of the following period will be composed of the current period’s data *and* the following period’s data!

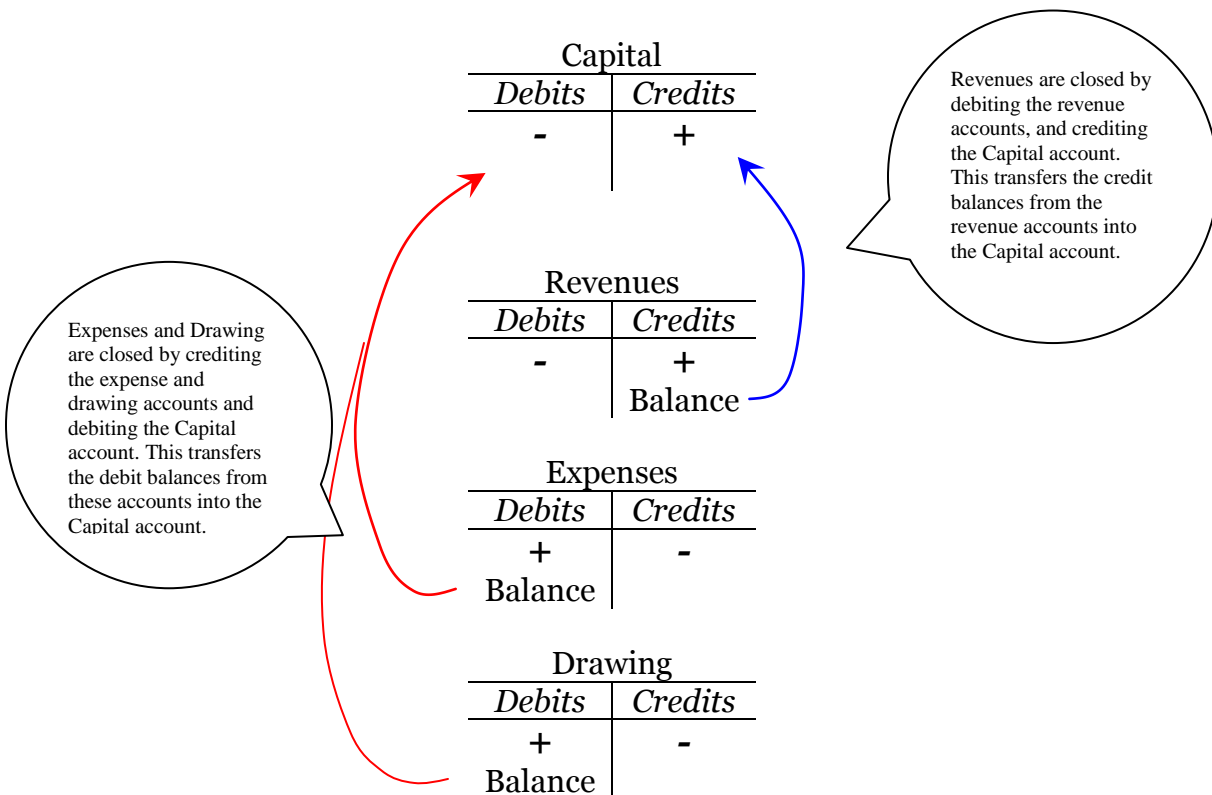
Therefore, if we are to have balances in these accounts at the end of an accounting period that represent the revenues, expenses, and withdrawals of just *that* period (and not the combined amounts from the prior period *plus* the current period), it will be necessary to close these accounts out before beginning a new accounting period.

- C. Why are only **temporary accounts** closed?
1. Remember that temporary accounts are simply subdivisions of the *Capital* account. They are, in effect, additional little capital accounts that are used alongside the “real” *Capital* account. We use them to temporarily “store” the revenue, expense, and dividends entries separately from *Capital*, so that the multitude of revenues and expenses can be easily sorted out and totaled up at the end of the period. Think of them as *temporary storage* accounts.

**Just imagine...** Can you imagine how difficult it would be to sort through hundreds of entries in a single *Capital* account, trying to figure out which of the credits are *Services Revenue* credits, which are *Rental Revenues*, which are owner contributions, and on and on? The debits would be even worse, since the company might have 50 or more different expense items to list on the income statement. Which of the debits represent *Wages Expense*, which are *Utilities Expense*, which are *withdrawals*, etc? And even if all the credits and debits are sorted out correctly into the proper accounts, they'll have to be added up to determine the balances to report on the income statement.

Even an accounting masochist would want to record these items separately in their own temporary accounts, just to make the job of preparing the income statement possible!

2. The closing process merely involves the transfer of the balances from the temporary accounts (temporary storage) back into the account where they really belong, the **Capital** account (permanent storage). This is illustrated in the diagram below.



## II. The *Income Summary* Account

- A. The closing entries that were illustrated in Module 2 and in the section above were simplified so that you would understand, conceptually, what is

happening when the temporary accounts are closed. In practice, the closing entries are a bit more complicated. (Remember what we say when we run into complications, accounting masochists?) The complication comes for the use of a special account, called **Income Summary**, during the closing process. This account is a special **closing account** (also called a **clearing account**), and all the revenue and expense accounts are closed into it instead of *Capital*. After they are, the balance in *Income Summary* is closed into the *Capital* account.

- B. Why use the *Income Summary* account if it is just going to be closed into *Capital* anyway? There is a very good reason. After closing the revenue and expense accounts into *Income Summary*, the balance in the account should be equal to the period's net income (or net loss). This fact gives us a way to verify the accuracy of the closing entries, and it is why a closing account is used. If the balance does not equal net income (or loss), then the closings must have been journalized and posted incorrectly. It is much better to discover this now, than it is to find out about it next period when the balance sheet does not balance!

Two entries are made in this part of the closing process:

<i>This debit is equal to total expenses.</i>	<b>Services Revenue</b>	<b>\$ X</b>	
	<b>Interest Revenue (etc.)</b>	<b>\$ X</b>	
	<b>Income Summary</b>		<b>\$ X</b>
	<b>Income Summary</b>	<b>\$ X</b>	
	<b>Wages Expense</b>	<b>\$ X</b>	
	<b>Utilities Expense</b>	<b>\$ X</b>	
	<b>Supplies Expense</b>	<b>\$ X</b>	
	<b>Insurance Expense</b>	<b>\$ X</b>	
	<b>Depreciation Expense</b>	<b>\$ X</b>	
	<b>Rent Expense (etc.)</b>	<b>\$ X</b>	

<b>Income Summary</b>	
<b>Debit Side</b>	<b>Credit Side</b>
<b>\$ X</b>	<b>\$ X</b>

*Therefore, a debit balance represents a net loss, and a credit balance represents net income.*

- C. Note that the Drawing account is not closed to Income Summary. This is because withdrawals are not expenses, and they are not listed on the income statement. If we want to arrive at a balance in Income Summary that is equal to the net income or loss amount, we cannot close the Drawing account to Income Summary!
- D. Once a credit balance is obtained in Income Summary that is equal to net income, or a debit balance is obtained that is equal to the loss, the Income Summary account is closed into Capital. This transfers the income/loss amount into the Capital account. The Drawing account is then closed to Capital, and the closing process is complete.

If there is a credit balance in Income Summary (net income), the entries would be made as follows:

<b>Income Summary</b>	<b>\$ X</b>	
<b>Capital</b>		<b>\$ X</b>
<b>Capital</b>	<b>\$ X</b>	
<b>Drawing</b>		<b>\$ X</b>

If there is a debit balance in Income Summary (net loss), the entries would be made as follows:

<b>Capital</b>	<b>\$ X</b>	
<b>Income Summary</b>		<b>\$ X</b>
<b>Drawing</b>	<b>\$ X</b>	

After closing, only the **permanent accounts** (assets, liabilities, and the Capital account) will have balances. *Permanent* accounts are also called *balance sheet accounts* or *real accounts*.

- E. **Post-Closing Trial Balance.** Once the closing entries have been journalized and posted, another trial balance, called the *post-closing trial balance*, is prepared as a final check. If it balances, we will know that no errors were made in journalizing and posting the closing entries that will prevent us from balancing out in the following accounting period.

### Video Lecture

*This video presents the same information that is printed above. Some students are "visual learners," and a video lecture format works well for them. Some students learn well by reading.*

Click here to play or to download the video:

Closing Entries: <http://youtu.be/6FKUrcOY5ls>

- F. To summarize, the closing process requires the following steps:
1. Debit the revenue accounts for their balances, crediting the closing account, *Income Summary*.
  2. Debit *Income Summary* and credit the expense accounts for their balances.
  3. The balance in *Income Summary* must now equal the amount of net income (a credit balance) or net loss (a debit balance). If it does not, an error has been made in journalizing or posting the closing entries for revenues and expenses and it will have to be corrected.
  4. *Income Summary* may now be closed to the *Capital* account. The effect of this entry is to credit (increase) *Capital* for the period's net income, or debit (decrease) *Capital* for the period's net loss.
  5. The *Drawing* account is now closed by debiting *Capital* and crediting *Drawing* for its balance. The effect of this entry is to debit (decrease) *Capital* for the period's withdrawals.
  6. After the closing entries are posted, there will be no balances left in the temporary accounts. They have all been closed, and the balance in *Capital* will now be equal to the actual end-of-period owner's equity. As a last step, a *post-closing trial balance* is prepared.

[<back>](#)

**III. Use of the Worksheet.** A worksheet may be used to organize the work performed at the end of the accounting period. Worksheets used to be commonly used accounting tools, and were standard coverage in college accounting courses. Computerized accounting systems have diminished their importance, but if your course still includes them, or if you are using a manual accounting system in your business, this section will be of interest to you. Otherwise, consider this section optional, and you may feel free to skip to Part IV of the module.

#### [Video Lecture](#)

*This video presents the same information that is printed below, but adds much more detail than can be written in the space below. If you need to understand the way the worksheet is completed (some accounting textbooks omit this topic), you should play the video in order to pick up the details that are not included in the section below.*

Click here to play or to download the video:

The Worksheet: <http://my-accounting-tutor.com/Financial/Camtasia/4-F-2/Module4-2CamtasiaElements.htm>

- A. The worksheet is laid out in a series of columns that are filled in at the end of the accounting period. Note that the worksheet is a "rough draft" of the adjustment and closing processes. It can be used to facilitate the process of journalizing and posting adjusting and closing entries, and the preparation of the financial statements, but this work will actually be completed at a later time.
1. The debit and credit balances of the trial balance are entered in the first two columns of the worksheet and balanced.
  2. The debit and credit adjustments to the accounts are entered in the next two columns, directly across from the trial balance account balances that are to be adjusted. Some of the accounts from the general ledger may not have been listed in the trial balance columns because they had no balances. If the account affected by the adjustment is not listed on the trial balance, it is written in below the accounts that are.
  3. The adjustments are added to or subtracted from the account balances on the trial balance, and the adjusted debit and credit balances are then entered in the next two columns, the adjusted trial balance columns, of the worksheet. These columns are then added to verify that they do balance.
  4. The adjusted balances for the revenues and expenses can then be carried across into the income statement columns. The adjusted balances for all the assets, the liabilities, the *Capital* and the *Drawing* accounts are carried to the balance sheet columns.
  5. The income statement columns are added, and the debit or credit difference between them is entered on the worksheet as the net income or net loss of the period.
  6. This figure must be carried over to the balance sheet columns and listed as a credit (if net income) or a debit (net loss). If no errors were made adjusting the accounts or adding columns, the balance sheet should now balance (i.e., the debit and credit columns should be equal).
  7. The *Drawing* account balance and the net income or loss figure must be entered in the balance sheet columns, because the *Capital* account balance is not complete. It is merely the figure from the trial balance, which is equal to the beginning balance plus any investments made by the owner. It is necessary to add or subtract net income or loss, and to then subtract withdrawals in order to

arrive at the ending *Capital* account balance. This is what is being done when these figures are entered in the balance sheet columns.

- B. Once the worksheet is complete, the process of journalizing the adjusting entries and preparing formal financial statements can be more easily accomplished. Everything has been “roughed out” on the worksheet, and all the figures can be taken directly from it.

[<back>](#)

**IV. The Use of Reversing Entries.** *Reversing entries* are appropriate for most of the adjustments that are made to record accrued revenues and accrued expenses. Reversing entries are easier to make than to understand.

- A. Reversing entries are the easiest things in accounting to record correctly. To make the reversing entry, we just “reverse” the adjusting entry, crediting the account that was debited in the adjusting entry and debiting the account that was credited.

1. If the adjusting entry is the following:

<i>Utilities Expense</i>	<b>\$200</b>	
<i>Utilities Payable</i>		<b>\$200</b>

Then the reversing entry is:

<i>Utilities Payable</i>	<b>\$200</b>	
<i>Utilities Expense</i>		<b>\$200</b>

2. If the adjusting entry is the following:

<i>Accounts Receivable</i>	<b>\$200</b>	
<i>Service Revenue</i>		<b>\$200</b>

Then the reversing entry is:

<i>Service Revenue</i>	<b>\$200</b>	
<i>Accounts Receivable</i>		<b>\$200</b>

- B. ***Reversing entries*** are made after the closing entries have been posted to the accounts, and before the following period’s transactions are recorded. They are commonly used in practice, since they simplify accounting during the following accounting period. Reversals allow the bookkeeper to forget about any receivable or payable balances that may have been carried forward from last period’s adjusting entries. This helps reduce errors and increases efficiency.



- C. It is easier to illustrate the reversing entries than it is to explain them. If you would like to see them illustrated, just click the link below. Otherwise, here's my attempt to explain the way they work:
1. Reversals "work" by removing the balance from the receivable or the payable account while setting up a non-normal balance in the revenue or the expense account. This balance is equal to the amount of revenue or expense that had accrued in the previous period. It is the portion of the total revenue or expense amount that has already been recognized in the adjusting entry.
  2. When the revenue (expense) account is later credited (debited) for the total amount received (paid), the net amount left in the revenue (expense) account as a normal balance in the account will be equal to the portion that was earned (incurred) in the subsequent period. In other words, when the revenue (or expense) account is credited (or debited) for the entire amount received (or paid), it will all "work out" so that the balance remaining in the revenue (or expense) account is the correct amount.
- D. See? I told you it was hard to explain. So say to yourself what accounting masochists always say to themselves when they encounter complicated subjects, and play the video. (Don't forget the "hoo hoo" part and to roll up your sleeves.) Re-read the section above after you play the video, and it will make sense.

### [Video Lecture](#)

*This video presents the same information that is outlined above, but it also adds valuable detail. If you need to understand the way the reversing entries work (some accounting textbooks omit this topic), you should play the video in order to pick up the details that are not included up above.*

Click here to play or to download the video:

<http://my-accounting-tutor.com/Financial/Camtasia/ReversingEntries/ReversingEntries.html>

[<back>](#)

## V. The Accounting Cycle, Completed

- A. We have introduced new steps in the "accounting cycle" in each of these first 4 modules in our tutorial. You've probably gotten used to seeing new complications constantly pop up, but here's some good news for you. We have finally added all the details that needed to be added and modified all the steps that needed to be modified. The accounting cycle, as shown below, is finally complete. It will not change again. *Hallelujah!*

- B. The accounting cycle is composed of the following steps:
1. Referring to the source documents, the bookkeeper *analyzes business transactions* in order to determine which accounts are affected by the transactions.
  2. The bookkeeper then *journalizes the transactions*. This will occur daily or weekly throughout the period.
  3. The bookkeeper *posts to the general ledger, balances the accounts, and prepares a trial balance* (perhaps using a worksheet). These steps occur at the end of the accounting period.
  4. The bookkeeper gathers information about the necessary adjusting entries. If a worksheet is used, these entries are entered on the worksheet, and the adjusted trial balance, income statement and balance sheet columns are filled in. If a worksheet is not used, the adjusting entries are journalized and posted, and an adjusted trial balance is prepared.
  5. The financial statements are prepared for formal presentation to the investors, creditors, and managers of the business.
  6. Lastly, the closing entries are journalized and posted to the ledger accounts. The posting of the closing entries are verified by comparing the balance in *Income Summary* to the net income figure on the worksheet and in the Income Statement. The bookkeeper balances the general ledger accounts and prepares a *post-closing trial balance*.
  7. If reversing entries are utilized, they are now journalized.
- B. The accounting cycle is now complete. The bookkeeper returns to step 1 to begin the process all over again in the new accounting period.

[<back>](#)

**VI. The Classified Balance Sheet** is a balance sheet in which the accounts are *classified* as to type.

- A. Accounts are *classified* on the balance sheet to better help users in making decisions based upon the information that is being reported.
- B. Account classifications (the headings on the balance sheet under which the accounts are listed) are as follows:

### Asset Account Classifications

1. **Current Assets** are those that will be converted into cash, sold, or used up within a year. Examples: Cash, Accounts Receivable, Notes Receivable, Supplies, short-term investments and various prepaid expenses.
2. **Property, Plant, and Equipment** (also called *Fixed Assets*, *Tangible Assets*, *Long-Lived Assets*, or *Plant Assets*). These are the non-current assets that are used in operating the business (machinery, buildings, land, etc.).
  - a. These assets (except for land) are depreciated.
  - b. They are listed with their associated accumulated depreciation accounts, and carried on the balance sheet at their *book values* (also called their *carrying values*).
3. Other asset classifications also exist, and we will describe them in later modules. See Module 10 for “Intangible Assets,” and Module 15 for “Long-term Investments.”

### Liability Account Classifications

1. **Current liabilities** are those that will be paid or settled within a year. Examples: Accounts Payable, Notes Payable, Wages Payable, Unearned Revenues, etc.
2. **Long-Term Liabilities** are non-current liabilities (notes payable, mortgage payable, etc.) that will be paid after one year or the operating cycle of the business (whichever is longer).

### Owner's Equity (also called *Proprietorship* or *Net Worth*).

1. There are no separate classifications for owner's equity in a sole proprietorship or partnership. Instead, we simply list the Capital account (or accounts, in a partnership) in the owner's equity section of the balance sheet. The total owner's equity in the business is maintained in the Capital account (or accounts, in the case of a partnership).
2. Note that corporations do have several special owner's equity accounts, and they are classified as either “Paid-in Capital” accounts or as “Retained Earnings.” Corporation accounting is examined in Module 12.

3. The classified balance sheet for Ellen's Catering Service, Inc., is presented below:

Ellen's Catering Service Balance Sheet December 31, 20X1		
<u>Current Assets:</u>		
Cash	\$	14,200
Supplies		3,000
Prepaid Rent		700
Accounts Receivable		7,500
Total Current Assets		\$ 25,400
<u>Property, Plant and Equipment</u>		
Delivery Van	\$20,000	
Accumulated Depreciation, Van	(5,800)	\$ 14,200
Building	30,000	
Accumulated Depreciation, Building	(8,000)	22,000
Land		5,000
Total Property, Plant and Equipment		41,200
Total Assets		\$ 66,600
<u>Current Liabilities</u>		
Accounts Payable	\$	2,000
Salaries Payable		800
Utilities Payable		200
Total Current Liabilities		\$ 3,000
<u>Long-term Liabilities</u>		
Notes Payable		10,000
Total Liabilities		\$ 13,000
<u>Owner's Equity:</u>		
Ellen Eagerbeaver, Capital		53,600
Total Liabilities and Owner's Equity		\$ 66,600

[<back>](#)

## VII. Using Accounting Information to Evaluate Liquidity

- A. To illustrate the usefulness of the classified balance sheet, let's consider three commonly used measures of short-term solvency and liquidity:
1. **Working capital** is relevant in assessing a business' liquidity, and it can be easily determined if the balance sheet is classified. It is equal to *current assets minus current liabilities*.

$$\text{Working Capital} = \text{Current Assets} - \text{Current Liabilities}$$

Since most current liabilities are paid out of current assets, the difference between them, the *working capital*, is cash that the business will have "to work with" after the liabilities have been paid. Therefore, the greater the amount of working capital in a business, the more liquid the business.

2. The **Current Ratio** (current assets divided by current liabilities) is another financial ratio that also measures liquidity. The greater the ratio, the greater the working capital and liquidity. In practice, a current ratio below 2 is often considered poor, though this varies by company and industry.

$$\text{Current Ratio} = \frac{\text{Total Current Assets}}{\text{Total Current Liabilities}}$$

3. The **Quick Ratio** (the "quick" assets divided by current liabilities) is another financial ratio that also measures liquidity. This is a modified current ratio that strips out the current assets that do not become cash (assets such as supplies, prepaid insurance and rent) or those that may be difficult to turn into cash (merchandise inventory). It is also called the "**acid test**" ratio, since it burns away the illiquid assets and leaves only those that can easily and "quickly" be converted into cash.

$$\text{Quick Ratio} = \frac{\text{Cash} + \text{Short-Term Investments} + \text{Receivables}}{\text{Total Current Liabilities}}$$

Since the numerator of the ratio is being reduced, the quick ratio value will always be less than the current ratio value. In practice, a quick ratio of 1 or more is considered to be an indicator of excellent liquidity, though this also varies by company and industry.

4. These three measures of liquidity require that we separate the current assets from the other assets the company owns, and that we separate the current liabilities from the long-term liabilities. Since the accounts are classified as current or non-current on the classified balance sheet, we are able to do so easily. The classified balance sheet can be very useful resource when the company's financial statement are being analyzed by investors and creditors!

***Here's an illustration...***

*If we refer to the Ellen's Catering Service balance sheet above, we can see that the working capital is \$22,400 (\$25,400 - \$3,000). This may or may not be considered an adequate amount of liquidity, since working capital is used to pay expenses as well as current liabilities, but we can note that the current assets are clearly much greater*

than the current liabilities. This means that the company should have no trouble paying its liabilities in the coming year. The current ratio of 8.5 ( $\$25,400 / \$3,000$ ) certainly confirms this, since it is telling us that the company has \$8.50 in current assets for every \$1 of current liabilities that it must pay in the coming year. If we calculate the quick ratio, omitting the current assets that will not be converted to cash or that are questionable, we arrive at a ratio value of 7.2 [ $(\$14,200 + 7,500) / \$3,000$ ]. This indicates that the company has \$7.20 of “quick” assets for every \$1 of current liabilities. Our company appears to be very liquid, indeed!

*A word of caution: Cash is needed for all sorts of things in addition to paying current liabilities, so we cannot safely conclude that the company is highly liquid just on the basis of the current and quick ratio values. We must also consider whether the working capital is sufficient to cover operating cash requirements in the coming year. Also, remember that the balance sheet reports the company’s balances as of the close of business on December 31. These balances will be different on January 1, and they were different on December 30. Do companies ever “manage” things (while still following the rules of accounting established by GAAP) so that the balances on December 31 will produce good, positive ratio values? You bet they do. It’s called “**window dressing**” the financial statements.*

*Here’s an example of how this might happen. Suppose a company has just one current asset, cash of \$10,000. It has current liabilities of \$5,000, so its current ratio is 2 ( $\$10,000/5,000$ ). Suppose, on December 31, the company uses \$4,000 of its cash to pay \$4,000 of the current liabilities early, before they come due. Now, as of the close of business on December 31, the company has \$6,000 of cash and \$1,000 of current liabilities. Its current ratio value is now 6 ( $\$6,000 / 1,000$ ) instead of 2, and its chances of getting a loan approval are much better than before!*

**-END-**

## Module 4 Supplement Comprehensive Practice Problem

### Part I (Optional).

The worksheet for Elmer Goodguy's Real Estate Agency has been set up as an Excel workbook. [Download the file](#) by clicking the link below. Complete the worksheet that is displayed in sheet 1 of the workbook. You may check your work by looking at the solution in sheet 2 of the workbook.

[http://my-accounting-tutor.com/Financial/Modules/Module4/Module4\\_ComprehensiveExercise.xls](http://my-accounting-tutor.com/Financial/Modules/Module4/Module4_ComprehensiveExercise.xls)

#### *What if I don't have Excel on my computer?*

There is a freeware alternative to Microsoft Office available, called *Open Office*. This suite of freeware programs contains a spreadsheet program called "Calc," which can be used in our tutorials in place of Excel. You may download Open Office from the following address: <http://www.sun.com/software/star/openoffice/>. Alternatively, Microsoft Office (which includes Excel along with Word, PowerPoint, and other powerful programs) can be purchased at student rates for, at the time of this writing, less than \$100. If you are a student at a high school, college or university, check with your bookstore or visit Microsoft's site, <http://www.microsoft.com/education/en-us/buy/Pages/academicsavings.aspx>, for more information.

### Part II (Required).

The trial balance of Goodguy's Real Estate Agency as of December 31 is presented below.

Trial Balance

	Dr.	Cr.
Cash	5,000	
Supplies	2,000	
Prepaid Insurance	4,000	
Accounts Receivable	3,000	
Equipment	15,000	
Accumulated Depreciation, Equipment		3,000
Building	50,000	
Accumulated Depreciation, Building		5,000
Land	10,000	
Accounts Payable		6,000
Loan Payable		20,000
Elmer Goodguy, Capital		40,000
Elmer Goodguy, Drawing	1,000	
Services Revenue		40,000
Salaries Expense	15,000	
Utilities Expense	6,000	
Advertising Expense	3,000	
<b>Total</b>	<b>114,000</b>	<b>114,000</b>

- 1) Use the following information to journalize the necessary adjusting entries:
  - a) An inventory of supplies reveals that \$1,500 worth of supplies are still on hand on 12/31/20X1.
  - b) \$1,000 of the insurance coverage has expired as of 12/31/20X1.
  - c) Depreciation expense is estimated to be \$1,000 for the equipment and \$500 for the building.
  - d) Accrued services revenue amounts to \$2,000 as of 12/31/20X1.
  - e) Accrued salaries amount to \$500 and accrued utilities amount to \$100 as of 12/31/20X1.
- 2) Prepare an adjusted trial balance.
- 3) Prepare the income statement, the statement of owner's equity, and the classified balance sheet.
- 4) Journalize the closing entries, then prepare the post-closing trial balance.
- 5) Calculate the company's working capital, its current ratio, and its quick ratio.

Try to work the exercise without looking at the solution. Check your answers by comparing them with the solutions that appear on the following pages.



## ***Solution to Comprehensive Practice Problem, Part 2***

### Adjusting Entries:

Dec 31	Supplies Expense	500	
	Supplies		500
31	Insurance Expense	1,000	
	Prepaid Insurance		1,000
31	Depreciation Expense	1,000	
	Accumulated Depreciation - Equip.		1,000
31	Depreciation Expense	500	
	Accumulated Depreciation - Building		500
31	Accounts Receivable	2,000	
	Services Revenue		2,000
31	Salaries Expense	500	
	Salaries Payable		500
31	Utilities Expense	100	
	Utilities Payable		100

### Goodguy's Real Estate Agency Adjusted Trial Balance

	Dr.	Cr.
Cash	5,000	
Supplies	1,500	
Prepaid Insurance	3,000	
Accounts Receivable	5,000	
Equipment	15,000	
Accumulated Depreciation, Equipment		4,000
Building	50,000	
Accumulated Depreciation, Building		5,500
Land	10,000	
Accounts Payable		6,000
Utilities Payable		100
Salaries Payable		500
Loan Payable		20,000
Elmer Goodguy, Capital		40,000
Elmer Goodguy, Drawing	1,000	
Services Revenue		42,000
Salaries Expense	15,500	
Utilities Expense	6,100	
Advertising Expense	3,000	
Supplies Expense	500	
Insurance Expense	1,000	
Depreciation Expense-Equipment	1,000	
Depreciation Expense-Bldg	500	
Total	118,100	118,100

Goodguy's Real Estate Agency  
Income Statement  
for the year ended December 31, 20X1

Services Revenue	42,000
Expenses:	
Salaries Expense	15,500
Utilities Expense	6,100
Advertising Expense	3,000
Supplies Expense	500
Insurance Expense	1,000
Depreciation Expense - Equipment.	1,000
Depreciation Expense - Bldg.	<u>500</u>
Total Expenses	<u>(27,600)</u>
Net Income	<u><u>14,400</u></u>

Goodguy's Real Estate Agency  
Statement of Owner's Equity  
for the year ended December 31, 20X1

Capital, 1/1/X1	40,000
Add: Investments	0
Net Income	<u>14,400</u>
Total	<u>54,400</u>
Less: Drawing	<u>(1,000)</u>
Capital, 12/31/X1	<u><u>53,400</u></u>

Goodguy's Real Estate Agency  
Balance Sheet  
December 31, 20X1

<u>Current Assets:</u>	
Cash	5,000
Supplies	1,500
Prepaid Insurance	3,000
Accounts Receivable	<u>5,000</u>
Total Current Assets	14,500
<u>Fixed Assets</u>	
Equipment	15,000
Accumulated Depreciation, Equip.	<u>(4,000)</u>
Building	50,000
Accumulated Depreciation, Building	<u>(5,500)</u>
Land	<u>10,000</u>
Total Fixed Assets	<u>65,500</u>
Total Assets	<u><u>80,000</u></u>
<u>Current Liabilities</u>	
Accounts Payable	6,000
Salaries Payable	500
Utilities Payable	<u>100</u>
Total Current Liabilities	6,600
<u>Long-term Liabilities</u>	
Loan Payable	<u>20,000</u>
Total Liabilities	26,600
<u>Owner's Equity:</u>	
Elmer Goodguy, Capital	<u>53,400</u>
Total Liabilities and Owner's Equity	<u><u>80,000</u></u>

Closing Entries:

Dec 31	Services Revenue	42,000	
	Income Summary		42,000
31	Income Summary	27,600	
	Salaries Expense		15,500
	Utilities Expense		6,100
	Advertising Expense		3,000
	Supplies Expense		500
	Insurance Expense		1,000
	Depreciation Expense - Equipment.		1,000
	Depreciation Expense - Bldg.		500
31	Income Summary	14,400	
	E. G., Capital		14,400
31	E. G., Capital	1,000	
	Drawing		1,000

Income Summary		
C-2	<u>27,600</u>	<u>42,000</u> C-1
C-3	<u>14,400</u>	<u>14,400</u> balance = net income
		0 balance

E. G., Capital		
		40,000 beginning balance
C-4	<u>1,000</u>	<u>14,400</u> C-3
		53,400 balance

Goodguy's Real Estate Agency  
Post-Closing Trial Balance

	Dr.	Cr.
Cash	5,000	
Supplies	1,500	
Prepaid Insurance	3,000	
Accounts Receivable	5,000	
Equipment	15,000	
Accumulated Depreciation, Equipment		4,000
Building	50,000	
Accumulated Depreciation, Building		5,500
Land	10,000	
Accounts Payable		6,000
Utilities Payable		100
Salaries Payable		500
Loan Payable		20,000
Elmer Goodguy, Capital		<u>53,400</u>
Total	<u>89,500</u>	<u>89,500</u>

Working Capital = \$14,500 Current Assets - \$6,600 Current Liabilities = \$7,900.

Current Ratio = \$14,500 Current Assets / \$6,600 Current Liabilities = 2.2 times.

Quick Ratio = (\$5,000 + 3,000) Quick Assets / \$6,600 Current Liabilities = 1.2 times.

-End-