

CHAPTER 5

The Accounting Cycle

Reporting Financial Results

After studying this chapter, you should be able to:

Learning Objectives

- LO5-1** Prepare an income statement, a statement of retained earnings, and a balance sheet.
- LO5-2** Explain how the income statement and the statement of retained earnings relate to the balance sheet.
- LO5-3** Explain the concept of adequate disclosure.
- LO5-4** Explain the purposes of closing entries; prepare these entries.
- LO5-5** Prepare an after-closing trial balance.
- LO5-6** Use financial statement information to evaluate profitability and liquidity.
- LO5-7** Explain how interim financial statements are prepared in a business that closes its accounts only at year-end.
- LO5-8** Prepare a worksheet and explain its uses.*

* Supplemental Topic, "The Worksheet."

Abercrombie & Fitch



ABERCROMBIE & FITCH

Abercrombie & Fitch is a multinational specialty retailer that operates stores and direct-to-consumer operations, selling a wide variety of products including casual sportswear, knit and woven shirts, jeans and woven pants, shorts, sweaters, personal care products, and various accessories.

The company reported restructuring charges of \$8.4 million in 2014 and \$81.5 million in 2013 related to the company's decision to close its line of Gilly Hicks stores in 2013. Disclosures accompanying Abercrombie & Fitch's financial statements reveal that the estimated total pre-tax restructuring charges are \$91.2

million, \$8.4 million of which was recognized in 2014 and \$81.5 million that was recognized in 2013. The remaining \$1.3 million of restructuring charges will be recognized in the future. The restructuring charges relate to lease terminations and store closure costs, and to asset impairments.

Disclosures such as these are absolutely essential for the proper interpretation of a company's financial statements. Abercrombie & Fitch's financial statements also include disclosures about share-based compensation, fair value, income taxes, borrowings, and many other important topics. ■

In this chapter, we examine how companies prepare general-purpose financial statements used by investors, creditors, and managers. In addition, we discuss how certain events are disclosed in the notes that accompany financial statements. We also illustrate several methods of evaluating liquidity and profitability using financial statement information.

In Chapter 3, we introduced the first of the eight steps in the accounting cycle by illustrating how Overnight Auto Service (1) captured (journalized) economic events, (2) posted these transactions to its general ledger, and (3) prepared an unadjusted trial balance from its general ledger account balances. We continued our illustration of the accounting cycle in Chapter 4 by (4) performing the adjusting entries made by Overnight and (5) presenting the company's adjusted trial balance at year-end.

In this chapter, we complete the accounting cycle by (6) preparing Overnight's financial statements, (7) performing year-end closing entries, and (8) presenting the company's after-closing trial balance.

LO5-1

LEARNING OBJECTIVE

Prepare an income statement, a statement of retained earnings, and a balance sheet.

Preparing Financial Statements

Publicly owned companies—those with shares listed on a stock exchange—have obligations to release annual and quarterly information to their stockholders and to the public. These companies don't simply prepare financial statements—they publish annual reports.

An annual report includes comparative financial statements for several years and a wealth of other information about the company's financial position, business operations, and future prospects. (For illustrative purposes, the financial statements of **Home Depot, Inc.**, appear in Appendix A.) Before an annual report is issued, the financial statements must be audited by a firm of certified public accountants (CPAs). Publicly owned companies must file their audited financial statements and detailed supporting schedules with the Securities and Exchange Commission (SEC), and the auditing firm must be registered with the Public Company Accounting Oversight Board (PCAOB).

The activities surrounding the preparation of an annual report become very intense as the new year approaches. Once the fiscal year has ended, it often takes several months before the annual report is available for distribution. Thus, many accountants refer to the months of December through March as the busy season.¹ We cannot adequately discuss all of the activities associated with the preparation of an annual report in a single chapter. Thus, here we focus on the preparation of financial statements.

The adjusted trial balance prepared in Chapter 4 is reprinted in Exhibit 5-1. The income statement, statement of retained earnings, and balance sheet can be prepared directly from the amounts shown in this adjusted trial balance. For illustrative purposes, we have made marginal notes indicating which accounts appear in which financial statements. Overnight's financial statements for the year ended December 31, 2015, are illustrated in Exhibit 5-2.

The income statement is prepared first because it determines the amount of net income to be reported in the statement of retained earnings. The statement of retained earnings is prepared second because it determines the amount of retained earnings to be reported in the balance sheet. Note that we have not included Overnight's statement of cash flows with the other three reports. An in-depth discussion of the statement of cash flows is the primary focus of Chapter 13.

THE INCOME STATEMENT

Alternative titles for the income statement include earnings statement, statement of operations, and profit and loss statement. However, *income statement* is the most popular term for this important financial statement. The income statement is used to summarize the operating results of a business by matching the revenue earned during a given period of time with the expenses incurred in generating that revenue.

¹ Some companies elect to end their fiscal year after a seasonal high point in business activity. However, most companies do end their fiscal year on December 31.

LO5-2

LEARNING OBJECTIVE

Explain how the income statement and the statement of retained earnings relate to the balance sheet.

**OVERNIGHT AUTO SERVICE
ADJUSTED TRIAL BALANCE
DECEMBER 31, 2018**

**EXHIBIT 5-1
Adjusted Trial Balance**

Cash	\$ 18,592	
Accounts receivable	7,250	
Shop supplies	1,200	
Unexpired insurance	3,000	
Tools and equipment	12,000	
Accumulated depreciation: tools and equipment		2,200
Building	36,000	
Accumulated depreciation: building		\$ 1,650
Land	52,000	
Notes payable		4,000
Accounts payable		2,690
Wages payable		1,950
Income taxes payable		5,580
Interest payable		30
Unearned rent revenue		6,000
Capital stock		80,000
Retained earnings (Note: still must be updated for transactions recorded in the accounts listed below. Closing entries serve this purpose.)		0
Dividends	14,000	
Repair service revenue		172,000
Rent revenue earned		3,000
Advertising expense	3,900	
Wages expense	58,750	
Supplies expense	7,500	
Depreciation expense: building	1,650	
Depreciation expense: tools and equipment	2,200	
Utilities expense	19,400	
Insurance expense	15,000	
Interest expense	30	
Income taxes expense	26,628	
	<u>\$279,100</u>	<u>\$279,100</u>

Balance sheet accounts

Statement of retained earnings accounts

Income statement accounts

The revenue and expenses shown in Overnight's income statement are taken directly from the company's adjusted trial balance. Overnight's 2018 income statement shows that revenue exceeded expenses for the year, thus producing a net income of \$39,942. Bear in mind, however, that this measurement of net income is not absolutely accurate or precise due to the assumptions and estimates in the accounting process.

An income statement has certain limitations. For instance, the amounts shown for depreciation expense are based upon estimates of the useful lives of the company's building and equipment. Also, the income statement includes only those events that have been evidenced by actual business transactions. Perhaps during the year Overnight's advertising has caught the attention of many potential customers. A good customer base is certainly an important step toward profitable operations; however, the development of a customer base is not reflected in the income statement because its value cannot be measured objectively.

EXHIBIT 5-2

Overnight Auto Service's
Financial Statements

**OVERNIGHT AUTO SERVICE
INCOME STATEMENT
FOR THE YEAR ENDED DECEMBER 31, 2018**

Revenue:		
Repair service revenue		\$172,000
Rent revenue earned		<u>3,000</u>
Total revenue		\$175,000
Expenses:		
Advertising	\$ 3,900	
Wages expense	58,750	
Supplies expense	7,500	
Depreciation: building	1,650	
Depreciation: tools and equipment	2,200	
Utilities expense	19,400	
Insurance	15,000	
Interest	<u>30</u>	<u>108,430</u>
Income before income taxes		\$ 66,570
Income taxes		<u>26,628</u>
Net income		<u>\$ 39,942</u>

A=L+LOE
Amounts are taken directly
from the adjusted trial balance

A=L+LOE
Net income also appears in the
statement of retained earnings

**OVERNIGHT AUTO SERVICE
STATEMENT OF RETAINED EARNINGS
FOR THE YEAR ENDED DECEMBER 31, 2018**

Retained earnings, Jan. 20, 2018	\$ 0
Add: Net income	<u>39,942</u>
Subtotal	\$ 39,942
Less: Dividends	<u>14,000</u>
Retained earnings, Dec. 31, 2018	<u>\$ 25,942</u>

**OVERNIGHT AUTO SERVICE
BALANCE SHEET
DECEMBER 31, 2018**

Assets		
Cash		\$ 18,592
Accounts receivable		7,250
Shop supplies		1,200
Unexpired insurance		3,000
Tools and equipment	\$12,000	
Less: Accumulated depreciation	2,200	9,800
Building	36,000	
Less: Accumulated depreciation	<u>1,650</u>	<u>34,350</u>
Land		<u>52,000</u>
Total assets		<u>\$126,192</u>
Liabilities & Stockholders' Equity		
Liabilities:		
Notes payable		\$ 4,000
Accounts payable		2,690
Wages payable		1,950
Income taxes payable		5,580
Interest payable		30
Unearned rent revenue		<u>6,000</u>
Total liabilities		\$ 20,250
Stockholders' equity:		
Capital stock		80,000
Retained earnings		<u>25,942</u>
Total stockholders' equity		<u>\$105,942</u>
Total liabilities and stockholders' equity		<u>\$126,192</u>

A=L+LOE
The ending balance in the
Retained Earnings account
also appears in the balance
sheet

until actual transactions take place. Despite these limitations, the income statement is of vital importance to the users of a company's financial statements.

THE STATEMENT OF RETAINED EARNINGS

Retained earnings is that portion of stockholders' (owners') equity created by earning net income and retaining the related resources in the business. The resources retained from being profitable may include, but are certainly not limited to, cash. The statement of retained earnings summarizes the increases and decreases in retained earnings resulting from business operations during the period. Increases in retained earnings result from earning net income; decreases result from net losses and from the declaration of dividends.

The format of this financial statement is based upon the following relationships:

$$\begin{array}{rcccl} \text{Retained Earnings} & & & & \\ \text{at the beginning} & + & \text{Net} & - & \text{Retained Earnings} \\ \text{of the period} & & \text{Income} & \text{Dividends} & \text{at the end} \\ & & & = & \text{of the period} \end{array}$$

The amount of retained earnings at the beginning of the period is shown at the top of the statement. Next, the net income for the period is added (or net loss subtracted), and any dividends declared during the period are deducted. This short computation determines the amount of retained earnings at the end of the accounting period. The ending retained earnings (\$25,942 in our example) appears at the bottom of the statement and also in the company's year-end balance sheet.

Our illustration of the statement of retained earnings for Overnight is unusual in that the beginning balance of retained earnings at the date of the company's formation (January 20, 2018) was \$0. This occurred only because 2018 was the first year of Overnight's business operations. The ending retained earnings (\$25,942) becomes the beginning retained earnings for the following year.

A Word about Dividends In Chapter 3, the declaration and payment of a cash dividend were treated as a single event recorded by one journal entry. A small corporation with only a few stockholders may choose to declare and pay a dividend on the same day. In large corporations, an interval of a month or more will separate the date of declaration from the later date of payment. A liability account, Dividends Payable, comes into existence when the dividend is declared and is discharged when the dividend is paid. Because Overnight reports no dividends payable in its adjusted trial balance, we may assume that it declared and paid the entire \$14,000 on December 31, 2018.²

Finally, it is important to realize that dividends paid to stockholders are *not* reported in the income statement as an expense. In short, dividends represent a decision by a corporation to distribute a portion of its income to stockholders. Thus, the amount of the dividend is not included in the computation of income.

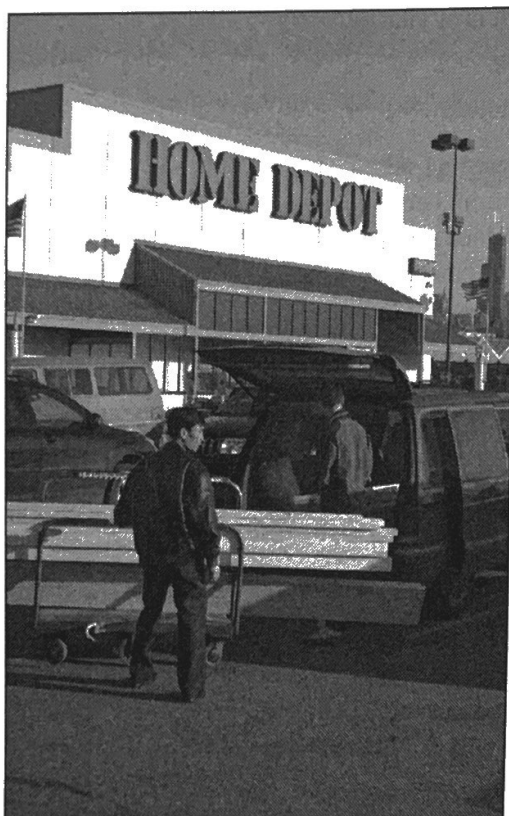
THE BALANCE SHEET

The balance sheet lists the amounts of the company's assets, liabilities, and owners' equity at the end of the accounting period. The balances of Overnight's asset and liability accounts are taken directly from the adjusted trial balance in Exhibit 5-1. The amount of retained earnings at the end of the period, \$25,942, was determined in the statement of retained earnings.

Balance sheets can be presented with asset accounts appearing on the left and liabilities and owners' equity accounts appearing on the right. They may also be presented in report form, with liabilities and owners' equity listed below (rather than to the right of) the asset section. It is also common for corporations to refer to owners' equity as stockholders' equity.

² Details related to the declaration and payment of dividends are discussed in Chapter 12.

Statement of retained earnings



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Separate Balance Sheet Subtotals Many companies group together as separate balance sheet subtotals those assets and liabilities that are considered current. This is referred to as preparing a **classified balance sheet**. To be classified as a **current assets**, an asset must already be cash or must be capable of being converted into cash within a relatively short period of time. For most companies, this period of time is usually one year or less. Those assets that get used up quickly (e.g., insurance policies and office supplies) are also classified as current assets. Of Overnight's \$126,192 in total assets shown in Exhibit 5-2, the current assets include Cash, Accounts Receivable, Shop Supplies, and Unexpired Insurance. Thus, \$30,042 of Overnight's total assets is considered current.

A **current liability** is an existing debt or obligation that a company expects to satisfy relatively soon using its current assets. Once again, this period of time is typically one year or less. While not a debt, unearned revenue is often considered a current liability also. All of Overnight's \$20,250 in total liabilities shown in Exhibit 5-2 are considered current liabilities.

Computing separate subtotals for current assets and current liabilities is very useful when evaluating a company's ability to pay its debts as they come due (see this chapter's Pathways Connection). The financial statements of Home Depot, Inc., in Appendix A at the end of this textbook illustrate how subtotals for current assets and current liabilities are presented in the balance sheet. Coverage of several other balance sheet subtotals appears in Chapter 14.



INTERNATIONAL CASE IN POINT

International Financial Reporting Standard (IFRS) 1 identifies the international reporting requirements for the presentation of the income statement, balance sheet, cash flow statement, and statement showing changes in equity. One very significant difference between the financial reporting requirements under U.S. GAAP and IFRS requirements is that, under the latter, management and auditors are required to depart from compliance with standards when it is necessary to achieve a fair presentation. This "true and fair" override is required if, in the judgment of the management and auditors, compliance with IFRS is misleading.

Relationships among the Financial Statements

A set of financial statements becomes easier to understand if we recognize that the income statement, statement of retained earnings, and balance sheet all are related to one another. These relationships are emphasized by the arrows in the right-hand margin of Exhibit 5-2.

DRAFTING THE NOTES THAT ACCOMPANY FINANCIAL STATEMENTS

To the users of financial statements, **adequate disclosure** is perhaps the most important accounting principle. This principle simply means that financial statements should be accompanied by any information necessary for the statements to be interpreted properly.

LO5-3

LEARNING OBJECTIVE
Explain the concept of adequate disclosure.

Most disclosures appear within the numerous pages of **notes** that accompany the financial statements. Drafting these notes can be one of the most challenging tasks confronting accountants at the end of the period. The content of these disclosures often cannot be drawn directly from the accounting records. Rather, they require an in-depth understanding of the company and its operations, of accounting principles, and of how accounting information is interpreted by users of financial statements.

Two items always disclosed in the notes to financial statements are the accounting methods in use and the due dates of major liabilities. Thus Overnight's 2018 financial statements should at least include the following notes.

Note 1: Depreciation policies

Depreciation expense in the financial statements is computed by the straight-line method. Estimated useful lives are 20 years for the building and 5 years for tools and equipment.

Note 2: Maturity dates of liabilities

The Company's notes payable consist of a single obligation that matures on February 28 of the coming year. The maturity value of this note, including interest charges, will amount to \$4,090.

Note 1 can be used to help ascertain whether the company may need to replace its depreciable assets in the near future. For instance, given that the estimated useful life of Overnight's building is 20 years, and only \$1,650 of its \$36,000 initial cost has been depreciated, it is reasonable for one to assume that it will not need to be replaced in the foreseeable future.

The maturity dates reported in Note 2 should be of particular importance to American National Bank. Specifically, the bank will want to know if Overnight will have enough cash to pay this \$4,090 liability in just two months. The company's balance sheet currently reports to pay this \$4,090 liability in just two months. The company's balance sheet currently reports cash of \$18,592; however, several other liabilities will require an outlay of cash in excess of \$10,000 in the near future. Furthermore, the company has an \$18,000 insurance policy to renew on March 1. Thus, even though Overnight's income statement reports net income of \$39,942, the company's balance sheet suggests that the company may not have adequate liquid assets to satisfy all of its upcoming obligations.

WHAT TYPES OF INFORMATION MUST BE DISCLOSED?

There is no comprehensive list of all information that should be disclosed in financial statements. The adequacy of disclosure is based on a combination of official rules, tradition, and accountants' professional judgment. The importance of adequate disclosure is so important that the Financial Accounting Standards Board (FASB), the body that promulgates U.S. accounting standards, has added a project to its agenda to develop a disclosure framework. The FASB's goal in seeking to develop a disclosure framework is to improve the effectiveness of disclosures in notes to the financial statements.

As a general rule, a company should disclose any facts that an informed user would consider necessary for the statements to be interpreted properly. Thus, businesses often disclose such things as:

- Lawsuits pending against the business.
- Scheduled plant closings.
- Significant events occurring after the balance sheet date but before the financial statements are actually issued.
- Customers that account for 10 percent or more of the company's revenues.
- Unusual transactions or conflicts of interest between the company and its key officers.

In some cases, companies must disclose information that could have a damaging effect on the business. For example, a manufacturer may need to disclose that it is being sued by customers who have been injured by its products. The fact that a disclosure might prove embarrassing—or even damaging to the business—is not a valid reason for not disclosing the



YOUR TURN

You as Overnight Auto's Independent Auditor

Assume that Overnight Auto Service is being sued by a former employee who was injured while on the job. The person claims that Overnight has been negligent in providing a safe work environment. If the plaintiff prevails, Overnight may have to pay damages well in excess of what is covered by its insurance policies. As Overnight's independent auditor, you have asked that the company disclose information about this lawsuit in the notes that accompany the financial statements. Overnight's management disagrees with your suggestion because, in its opinion, the likelihood of the plaintiff prevailing is extremely remote. How should you respond?

(See our comments in Connect.)

information. The concept of adequate disclosure demands a good faith effort by management to keep the users of financial statements informed about the company's operations. For a look at the types of disclosure made by publicly owned corporations, see the **Home Depot, Inc.**, financial statements, which appear in Appendix A.

LO5-4

LEARNING OBJECTIVE

Explain the purposes of closing entries; prepare these entries.

Closing the Temporary Accounts

As previously stated, revenue increases retained earnings, and expenses and dividends decrease retained earnings. If the only financial statement that we needed was a balance sheet, these changes in retained earnings could be recorded directly in the Retained Earnings account. However, owners, managers, investors, and others need to know amounts of specific revenues and expenses and the amount of net income earned in the period. Therefore, separate ledger accounts must be maintained to measure each type of revenue and expense, and to account for dividends declared.

Revenue, expense, and dividends accounts are called temporary, or nominal, accounts, because they accumulate the transactions of only one accounting period. At the end of an accounting period, the changes in retained earnings accumulated in these temporary accounts are transferred into the Retained Earnings account. This process serves two purposes. First, it updates the balance of the Retained Earnings account for changes occurring during the accounting period. Second, it returns the balances of the temporary accounts to zero, so that they are ready for measuring the revenue, expenses, and dividends of the next accounting period.

Retained Earnings and other balance sheet accounts are called permanent, or real, accounts, because their balances continue to exist beyond the current accounting period. Transferring the balances of the temporary accounts into the Retained Earnings account is called the closing process. The journal entries made for the purpose of closing the temporary accounts are called **closing entries**.

Revenue and expense accounts are closed at the end of each accounting period by transferring their balances to an account called the **Income Summary**. After the credit balances of the revenue accounts and the debit balances of the expense accounts have all been transferred to the Income Summary account, its balance will be the net income or net loss for the period. If revenues (credit balances) exceed expenses (debit balances), the Income Summary account will have a credit balance representing net income. Conversely, if expenses exceed revenues, the Income Summary account will have a debit balance representing a net loss. This is consistent with the rule that increases in owners' equity are recorded by credits and decreases are recorded by debits.

While adjusting entries are usually made on a monthly basis, it is common practice to close accounts only once each year. Thus, we will demonstrate the closing of the temporary accounts of Overnight Auto Service at December 31, 2018, the end of its first year of operations.

On the following pages, Overnight's temporary accounts are illustrated in T account form. We have eliminated the detail of every transaction posted to each account throughout the year. Therefore, each account shows only its December 31, 2018, balance as reported in the

Closing the Temporary Accounts

adjusted trial balance in Exhibit 5-1. The closing process is relatively straightforward and involves just four steps.

- Closing all revenue accounts to the Income Summary.
- Closing all expense accounts to the Income Summary.
- Closing the Income Summary to Retained Earnings.
- Closing the Dividends account to Retained Earnings.

The first two items in the bulleted list need to be completed before the third item. The entry to close the dividends account to Retained Earnings can be made before or after closing the revenue and expense accounts.

CLOSING ENTRIES FOR REVENUE ACCOUNTS

Revenue accounts have credit balances. Therefore, closing a revenue account means transferring its credit balance to the Income Summary account. This transfer is accomplished by a journal entry debiting the revenue account in an amount equal to its credit balance, with an offsetting credit to the Income Summary account. Note that the process of closing a revenue account, debiting the account, is the opposite of credit entries that are normally made to revenue accounts. The debit portion of this closing entry returns the balance of the revenue account to zero; the credit portion transfers the former balance of the revenue account into the Income Summary account.

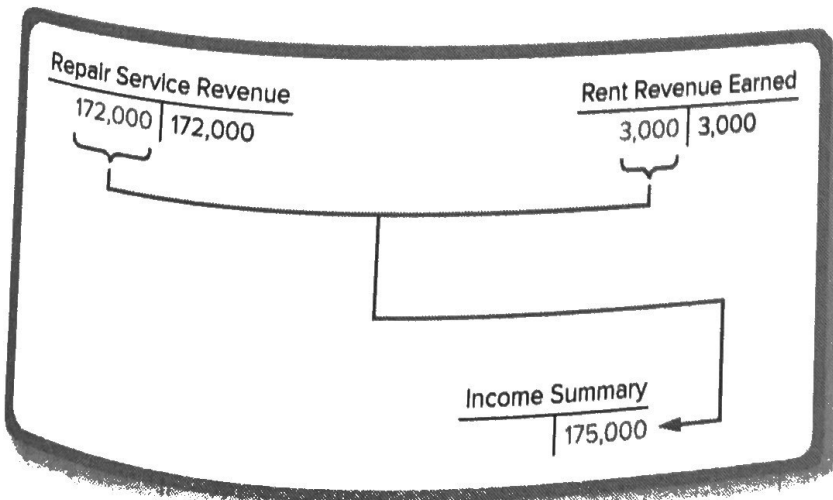
Overnight uses two revenue accounts: (1) Repair Service Revenue, which had a credit balance of \$172,000 at December 31, 2018, and (2) Rent Revenue Earned, which had a credit balance of \$3,000 at December 31, 2018. Two separate journal entries could be made to close these accounts, but the use of one compound journal entry is an easier, time-saving method of closing more than one account. The compound closing entry for Overnight's revenue accounts is displayed in Exhibit 5-3.

EXHIBIT 5-3
Closing of Revenue Accounts

OVERNIGHT AUTO SERVICE GENERAL JOURNAL DECEMBER 31, 2018			
Date	Account Titles and Explanation	Debit	Credit
2018			
Dec. 31	Repair Service Revenue.....	172,000	
	Rent Revenue Earned.....	3,000	
	Income Summary		175,000
	To close the Repair Service Revenue and Rent Revenue Earned accounts.		

After this closing entry has been posted, the two revenue accounts each have zero balances, whereas Income Summary has a credit balance of \$175,000, as illustrated in Exhibit 5-4.

EXHIBIT 5-4
Transferring Revenue Account Balances to the Income Summary



CLOSING ENTRIES FOR EXPENSE ACCOUNTS

Expense accounts have debit balances. Closing an expense account means transferring its debit balance to the Income Summary account. The journal entry to close an expense, therefore, consists of a credit to the expense account in an amount equal to its debit balance, with an offsetting debit to the Income Summary account. Again, note that the process of closing an expense account, crediting the account, is the opposite of debit entries that are normally made to expense accounts.

There are nine expense accounts in Overnight's ledger (see the adjusted trial balance in Exhibit 5-1). Again, a compound journal entry is used to close each of these accounts. The required closing entry is displayed in Exhibit 5-5.

EXHIBIT 5-5

Closing of Expense Accounts

OVERNIGHT AUTO SERVICE GENERAL JOURNAL DECEMBER 31, 2018				
Date	Account Titles and Explanation	Debit	Credit	
2018				
Dec. 31	Income Summary.....	135,058		
	Advertising Expense.....		3,900	
	Wages Expense.....		58,750	
	Supplies Expense.....		7,500	
	Depreciation Expense: Building.....		1,650	
	Depreciation Expense: Tools and Equipment.....		2,200	
	Utilities Expense.....		19,400	
	Insurance Expense.....		15,000	
	Interest Expense.....		30	
	Income Taxes Expense.....		26,628	
	To close the expense accounts.			

After this closing entry has been posted, the Income Summary account has a credit balance of \$39,942 (\$175,000 credit posted minus the \$135,058 debit posted), and the nine expense accounts each have zero balances as shown in Exhibit 5-6. This \$39,942 credit balance equals the net income reported in Overnight's income statement. Had the company's income statement reported a net loss for the year, the Income Summary account would have a debit balance equal to the amount of the loss reported.

EXHIBIT 5-6

Transferring Expense Account Balances to the Income Summary

Advertising Expense	3,900	3,900	
Wages Expense	58,750	58,750	
Supplies Expense	7,500	7,500	
Depreciation Expense: Bldg.	1,650	1,650	
Tools and Depreciation Expense: Equipment	2,200	2,200	
Utilities Expense	19,400	19,400	
Insurance Expense	15,000	15,000	
Interest Expense	30	30	
Income Taxes Expense	26,628	26,628	
			Income Summary 135,058 175,000 ----- ----- 39,942

Closing the Temporary Accounts

CLOSING THE INCOME SUMMARY ACCOUNT

The net income of \$39,942 earned during the year causes an increase in Overnight's owners' equity. Thus, the \$39,942 credit balance of the Income Summary account is transferred to the Retained Earnings account by the closing entry in Exhibit 5-7.

OVERNIGHT AUTO SERVICE GENERAL JOURNAL DECEMBER 31, 2018			
Date	Account Titles and Explanation	Debit	Credit
2018			
Dec. 31	Income Summary.....	39,942	
	Retained Earnings.....		39,942
	Transferring net income earned in 2018 to the Retained Earnings account.		

EXHIBIT 5-7
Closing the Income Summary Account

After this closing entry has been posted, the Income Summary account has a zero balance, and the net income for the year ended December 31, 2018, appears as an increase (or credit entry) in the Retained Earnings account as shown in Exhibit 5-8.

EXHIBIT 5-8 Income Increases Retained Earnings

Income Summary		Retained Earnings	
135,058 (Expenses)	175,000 (Revenue)	1/20 bal. 0	
39,942	39,942 (Income)	12/31 39,942 (Income)	

Income is transferred to Retained Earnings as Income Summary is closed.

CLOSING THE DIVIDENDS ACCOUNT

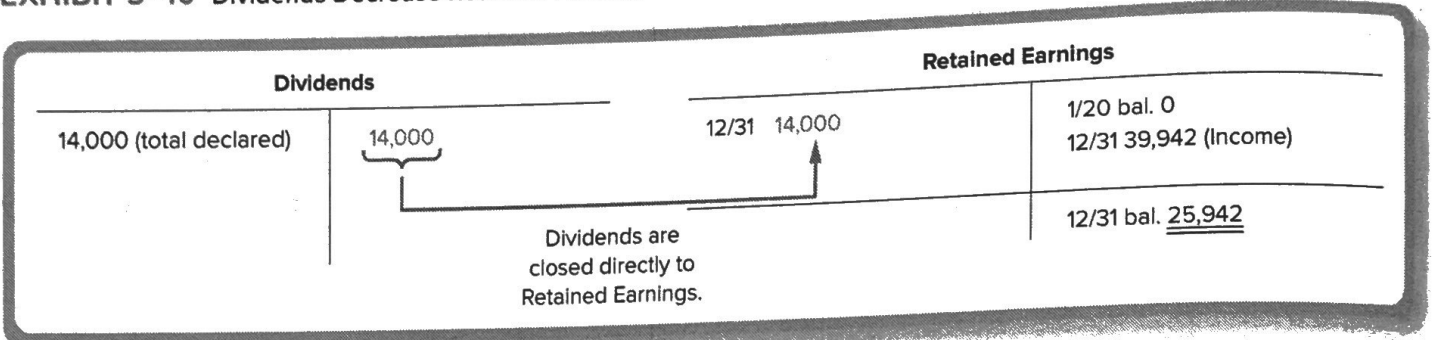
As explained earlier in the chapter, dividends to stockholders are *not* considered an expense of the business; therefore, they are *not* taken into account in determining net income for the period. Since dividends are not an expense, the Dividends account is *not* closed to the Income Summary account. Instead, it is closed directly to the Retained Earnings account, as shown in Exhibit 5-9.

OVERNIGHT AUTO SERVICE GENERAL JOURNAL DECEMBER 31, 2018			
Date	Account Titles and Explanation	Debit	Credit
2018			
Dec. 31	Retained Earnings.....	14,000	
	Dividends.....		14,000
	To transfer dividends declared in 2018 to the Retained Earnings account.		

EXHIBIT 5-9
Closing the Dividends Account

After this closing entry has been posted, the Dividends account will have a zero balance, and the Retained Earnings account will have an ending credit balance of \$25,942, as shown in Exhibit 5-10.

EXHIBIT 5-10 Dividends Decrease Retained Earnings



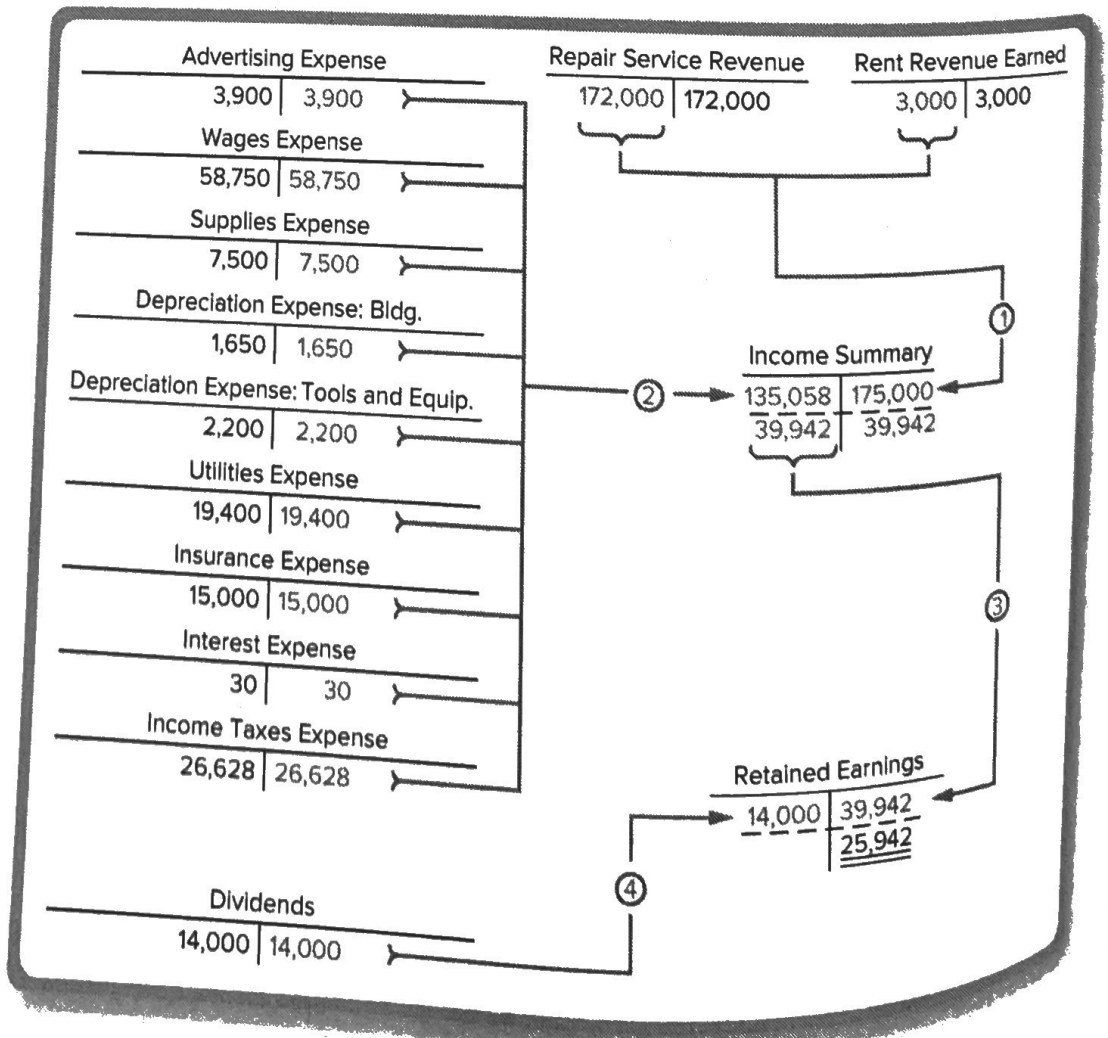
Summary of the Closing Process

As illustrated, the closing process involves four simple steps.

1. Closing the various revenue accounts and transferring their balances to the Income Summary account.
2. Closing the various expense accounts and transferring their balances to the Income Summary account.
3. Closing the Income Summary account and transferring its balance to the Retained Earnings account. It is important to emphasize that the balance in the Income Summary account, after the revenue and expense accounts have been closed, will equal the company's net income or net loss for the period. In this example, the \$39,942 credit balance indicates that revenues exceed expenses and corresponds with the net income amount reported in Exhibit 5-2.
4. Closing the Dividends account and transferring its balance to the Retained Earnings account.

The entire closing process is illustrated in Exhibit 5-11 using T accounts.

EXHIBIT 5-11
Flowchart of the Closing Process



After-Closing Trial Balance

After the revenue and expense accounts have been closed, it is desirable to prepare an **after-closing trial balance** that consists solely of balance sheet accounts. There is always the possibility that an error in posting the closing entries may have upset the equality of debits and credits in the ledger. The after-closing trial balance, or post-closing trial balance as it is often called, is prepared from the ledger. It gives assurance that the accounts are in balance and ready for recording transactions in the new accounting period. The after-closing trial balance of Overnight Auto Service is shown in Exhibit 5-12.

LO5-5

LEARNING OBJECTIVE
Prepare an after-closing trial balance.

OVERNIGHT AUTO SERVICE AFTER-CLOSING TRIAL BALANCE DECEMBER 31, 2018

Cash	\$ 18,592	
Accounts receivable	7,250	
Shop supplies	1,200	
Unexpired insurance	3,000	
Tools and equipment	12,000	
Accumulated depreciation: tools and equipment		\$ 2,200
Building	36,000	
Accumulated depreciation: building		1,650
Land	52,000	
		4,000
Notes payable		2,690
Accounts payable		1,950
Wages payable		5,580
Income taxes payable		30
Interest payable		6,000
Unearned rent revenue		80,000
Capital stock		25,942
Retained earnings, Dec. 31	<u>\$ 130,042</u>	<u>\$ 130,042</u>

EXHIBIT 5-12

After-Closing Trial Balance

In comparison with the adjusted trial balance in Exhibit 5-1, an after-closing trial balance contains only balance sheet accounts. Also, the Retained Earnings account no longer has a zero balance. Through the closing of the revenue, expense, and dividends accounts, the Retained Earnings account has been brought up-to-date.

A LAST LOOK AT OVERNIGHT: WAS 2018 A GOOD YEAR?

Let us now consider the financial results of Overnight's first fiscal year.

Evaluating Profitability In 2018, Overnight earned a net income of nearly \$40,000. Thus, net income for the first year of operations amounts to 50 percent of the stockholders' \$80,000 investment. This is a very impressive rate of return for the first year of operations. Of course, Overnight's stockholders (members of the McBryan family) have taken a certain amount of risk by investing their financial resources in this business. Does a 50 percent return on investment adequately compensate the stockholders for their risk? Stated differently, could they invest their \$80,000 in a less risky venture and still generate a 50 percent rate of return? Probably not.

But in evaluating profitability, the real question is not how the business did, but how it is likely to do in the future. To generate a substantial return on investment in the first year of operations indicates good profit potential. Overnight's rental contract with Harbor Cab

LO5-6

LEARNING OBJECTIVE
Use financial statement information to evaluate profitability and liquidity.

Company is also promising. In 2018, only \$3,000 in revenue was earned by renting storage space to the company for its cabs (December's rent). In 2019, Overnight will earn 12 full months of rent revenue from Harbor Cab (\$33,000 more than it earned in 2018). In addition, if Harbor Cab stores its cabs in Overnight's garage, Overnight becomes the likely candidate to perform any necessary maintenance and repairs.

Evaluating Liquidity *Liquidity* refers to a company's ability to meet its cash obligations as they become due. Liquidity, at least in the short term, may be independent of profitability. And in the short term, Overnight appears to have potential cash flow problems. In the very near future, Overnight must make cash expenditures for the following items.

A-1-LOE
Items requiring cash payment
in near future

Note and interest payable	\$ 4,090
Accounts payable	2,690
Wages payable	1,950
Income taxes payable	5,580
Insurance policy renewal	18,000
Total expenditures coming due	<u>\$32,310</u>

These outlays exceed the company's liquid assets (cash and accounts receivable) reported in its December 31, 2018, balance sheet.

It is important to note that the cash and accounts receivable amounts reported in Overnight's balance sheet represent the balances of those accounts at a point in time. Thus, while these liquid assets are currently insufficient to cover the cash expenditures coming due, this may not be the case for long. On the basis of its past performance, Overnight is likely to generate revenue in excess of \$40,000 during the next several months. If a substantial amount of this revenue is received in cash, and expenses are kept under control, the company may actually become more liquid than it appears to be now.



PATHWAYS CONNECTION

The Pathways Model introduced in Chapter 1 indicates that accounting is designed to provide information that helps users of the accounting information make good decisions. Among the more important uses of accounting information is to evaluate a company's business prospects, often for the purpose of making an investment decision. Two important aspects of evaluating the financial position of a business is to evaluate the business' profitability and liquidity. Below we present basic tools for evaluating profitability and liquidity.

MEASURES OF PROFITABILITY

The \$39,942 net income figure reported in Overnight's income statement is more meaningful when examined in the context of management's ability to control costs or when measured relative to the company's shareholders' equity.

Two commonly used measures of profitability that address these issues are the net income percentage and return on equity. Using data from Overnight's financial statements, these measures are computed as follows.

$$\begin{aligned} \text{Net Income Percentage} &= \text{Net Income} \div \text{Total Revenue} \\ &= \$39,942 \div \$175,000 = \underline{\underline{22.8\%}} \end{aligned}$$

$$\begin{aligned} \text{Return on Equity} &= \text{Net Income} \div \text{Average} \\ &\quad \text{Stockholders' Equity} \\ &= \$39,942 \div \$92,971 = \underline{\underline{43.0\%}} \end{aligned}$$

All companies must incur costs in order to generate revenue. The net income percentage is simply a measure of management's ability to control these costs. In 2018, Overnight was able to convert 22.8 percent of its revenue into net income; thus, it incurred approximately 78 cents in costs for every dollar of revenue it generated.

Return on equity is a measure of net income relative to average stockholders' equity throughout the year. In 2018, Overnight's average stockholders' equity was \$92,971 (i.e., the average of its beginning stockholders' equity of \$80,000, and its ending stockholders' equity of \$105,942). Thus, the company earned income of approximately 43 cents on every dollar of equity capital.

MEASURES OF LIQUIDITY

At the end of 2018, Overnight's balance sheet reports liabilities of \$20,250, most of which will require payment early in 2019. However, the balance sheet reports cash of only \$18,522 which may be an indication of potential liquidity problems.

Two common measures of liquidity are a company's working capital and its current ratio. Using data from Overnight's financial statements, these measures are computed as follows.

$$\begin{aligned} \text{Working Capital} &= \text{Current Assets} - \text{Current Liabilities} \\ &= \$30,042 - \$20,250 = \underline{\underline{\$9,792}} \end{aligned}$$

$$\begin{aligned} \text{Current Ratio} &= \text{Current Assets} \div \text{Current Liabilities} \\ &= \$30,042 \div \$20,250 = \underline{\underline{1.48:1}} \end{aligned}$$

Working capital is a measure of short-term debt-paying ability expressed in dollars. Current assets represent a company's potential cash inflows in the near future, whereas current liabilities represent cash outlays coming due soon.

Overnight's current assets exceed its current liabilities by \$9,792; however, shop supplies and unexpired insurance policies are not truly liquid assets. Likewise, unearned rent revenue does not actually represent a future cash obligation.

The current ratio is simply working capital expressed as a ratio. Thus, Overnight has approximately \$1.48 of potential cash inflow for every dollar of current obligations coming due. Again, this figure does not take into account that shop supplies and insurance policies will not actually convert into cash, or that unearned revenue will not actually require a future outlay of cash.

Throughout the remainder of this textbook additional measures of performance will be discussed. Chapter 14 is devoted entirely to financial analysis.

PREPARING FINANCIAL STATEMENTS COVERING DIFFERENT PERIODS OF TIME

Many businesses prepare financial statements every quarter, as well as at year-end. In addition, they may prepare financial statements covering other time periods, such as one month or the year-to-date.

When a business closes its accounts only at year-end, the revenue, expense, and dividends accounts have balances representing the activities of the year-to-date. Thus, at June 30, these account balances represent the activities recorded over the past six months. Year-to-date financial statements can be prepared directly from an adjusted trial balance. But how might this business prepare **interim financial statements** covering only the month of June? Or the quarter (three months) ended June 30?

The answer is by doing a little subtraction. As an example, assume that the adjusted balance in Overnight's Repair Service Revenue account at the ends of the following months was as shown.

March 31 (end of the first quarter)	\$38,000
May 31	67,000
June 30	80,000

L05-7

LEARNING OBJECTIVE
Explain how interim financial statements are prepared in a business that closes its accounts only at year-end.

Revenue amounts are for the year-to-date

At each date, the account balance represents the revenue earned since January 1. Thus the March 31 balance represents three months' revenue; the May 31 balance, five months' revenue; and the June 30 balance, the revenue earned over a period of six months.

To prepare an income statement for the six months ended June 30, we simply use the June 30 balance in the revenue account—\$80,000. But to prepare an income statement for the month ended June 30, we would have to subtract from the June 30 balance of this account its balance as of May 31. The remainder, \$13,000, represents the amount of revenue recorded in the account during June (\$80,000 - \$67,000 = \$13,000).

To prepare an income statement for the quarter ended June 30, we would subtract from the June 30 balance in this revenue account its balance as of March 31. Thus the revenue earned during the second quarter (April 1 through June 30) amounts to \$42,000 (\$80,000 - \$38,000 = \$42,000).

Computations like these are not required for the balance sheet accounts. A balance sheet always is based on the account balances at the balance sheet date. Therefore, a June 30 balance sheet looks exactly the same regardless of the time period covered by the other financial statements.