

**FIGURE 1-8**  
**SIMPLE EXAMPLE COMPANY**  
**Year-End Worksheet**  
 December 31, 2022

ACC. NO.	ACCOUNT TITLE	12-31-21 POST-CLOSING TRIAL BALANCE		12-31-22 UNADJUSTED TRIAL BALANCE		ADJUSTMENTS		ADJUSTED TRIAL BALANCE		INCOME STATEMENT		BALANCE SHEET	
		Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr
101	Cash in bank	88		78				78				78	
102	Payroll cash	5		5				5				5	
103	Accounts receivable	267		298				272				272	
104	Allowance for doubtful accounts		41		41	(2)	26	41				(2)	41
105	Inventory	126		126		(1)	49	114				114	
106	Prepaid rent	7		8		(8)	12	4				4	
201	Delivery equipment		60	60		(3)	4	60				4	
202	Accumulated depreciation		45		45	(4)	15		60				60
301	Accounts payable		135		158				60				60
302	Wages and salaries payable		-0-		-0-	(5)	12		158				158
303	Payroll taxes payable		3		3	(6)	4		12				12
304	Rent payable		-0-		-0-	(6)	4		4				4
305	Withholding taxes payable		5		6				-0-				-0-
306	FICA taxes payable		9		5	(7)	5		6				6
307	Dividends payable		-0-		-0-				10				10
401	Notes payable		12		-0-				-0-				-0-
501	Common stock		200		200				200				200
502	Paid-in capital in excess of par		-0-		-0-				-0-				-0-
503	Retained earnings		103		103				-0-				-0-
504	Dividends		-0-		-0-				103				103
601	Sales				3,648				-0-		3,648		
602	Miscellaneous revenue				-0-				214		214		
603	Sales returns and allowances			214				214					
604	Sales discounts taken			182				182			182		
701	Cost of goods sold		-0-		-0-	(8)	2,132		2,132		2,132		
702	Purchases		2,166		2,166				-0-				-0-
703	Purchases discounts				46	(8)	46		48		48		
704	Purchases returns and allowances				-0-				69		69		
705	Rent expense		44		44	(3)	4		62		62		
706	Repair expense		69		62				49		49		
707	Utility expense		62		62				15		15		
708	Postage expense		49		49	(4)	15		57		57		
709	Depreciation expense		-0-		-0-				49		49		
710	Travel expense		57		57				270		270		
711	Bad debt expense		-0-		-0-	(1)	49		459		459		
712	Wages and salaries expense - admin.		264		264	(5)	6		56		56		
713	Wages and salaries expense - selling		453		453	(5)	6		45		45		
714	Employer's FICA expense		51		51	(7)	5		101		101		
715	Other payroll tax expense		41		41		4		2		2		
716	Miscellaneous expense		-0-		-0-	(6)							
717	Income tax expense		-0-		-0-								
718	Interest expense		2		2								
800	Income Summary - Net Income (Loss)												
	TOTALS	553	553	4,229	4,229	2,293	2,293	4,242	4,242	3,648	3,648	533	594

**6**  
**Prepare and  
 Post Adjusting  
 Entries**

The primary reason for preparing adjusting entries is to convert from the cash basis of accounting to the accrual basis. Most transactions are recorded in the journals on the accrual basis. An example is recording the purchase of inventory when the merchandise is received rather than when it is paid for. However, for many types of transactions it is more convenient to finalize the conversion to the accrual basis with adjusting entries. These are illustrated in this section.

The following are important requirements in recording adjusting entries:

- Adjusting entries are prepared only at the end of the period when a company plans to prepare financial statements. Some companies prepare statements monthly, others quarterly, and some only annually.
- Every adjusting entry affects both the balance sheet and the income statement.
- The total debits and credits must be equal for each adjusting entry.
- All adjusting entries are first recorded in the general journal. No other journal is used for adjusting entries.
- Each adjusting entry is prepared separately.
- Each amount in each adjusting entry is posted individually to the appropriate general ledger account.
- Most adjusting entries are not posted to subsidiary ledgers.

There are six general categories of adjusting entries:

- **Prepaid expense** – an expense paid for in advance of its use. An example is paying several months' rent in advance. The accrual accounting method requires

that rent expense be recorded in the period in which the asset is used rather than the period in which the cash payment is made. Prepaid expense involves adjustment of both an asset and an expense account.

- **Accrued expense** – an expense incurred for which payment has not been made. An example is paying rent after it is due. It is the opposite of a prepaid expense. For prepaids, cash is paid before the expense is incurred; for accrued expenses, cash is paid after the expense is incurred. Accrued expenses involve adjusting a liability and an expense account.
- **Accrued revenue** – a revenue earned for which the cash has not yet been received. An example is interest revenue on a note receivable. An accrued revenue is similar to an accrued expense, except it involves revenue rather than expense. Accrued revenue involves adjusting an asset and a revenue account.
- **Unearned revenue** – a revenue received in cash in advance of being earned. An example is receiving an interest payment on a note before it is due. Unearned revenue is the opposite of accrued revenue. For unearned revenue, cash is received before the revenue is earned; for accrued revenue, cash is received after it is earned. Unearned revenue involves adjusting a liability and a revenue account.
- **Estimated items** – an expense recorded on the basis of estimates. Examples include bad debt expense, federal income tax expense, and depreciation expense. An adjusting entry for estimated items includes adjusting an expense account and an asset or a liability account.

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- **Inventory adjustment** – under the periodic inventory method, the ending inventory must be recorded. At the same time the account balances in purchases, purchases returns and allowances, freight-in, and purchase discounts are transferred to cost of goods sold. The debit part of the adjusting entry includes ending inventory, cost of goods sold, purchases returns and allowances, and discounts. The credit part includes beginning inventory, purchases, and freight-in. The adjusting entry for inventory has some characteristics of a closing entry, however, it is more convenient to

call the inventory adjustment an adjusting entry. (Closing is discussed in the next section. Inventories are discussed more fully in Chapter 6.)

Figure 1-9 summarizes the six categories of adjusting journal entries. Figure 1-10 shows the eight adjusting entries for Simple Example Company as they are recorded in the general journal.

Although the general journal includes all adjusting entries, it can also include other transactions. For example, it is common to record bank service charges in the general journal even though this is not an adjusting entry.

**FIGURE 1-9**  
**Categories of Adjusting Entries**

Category	Balance Sheet Account	Income Statement Account	Type of Account
Prepaid expense	Prepaid insurance Prepaid rent	Insurance expense Rent expense	Asset/Expense
Accrued expense	Wages and salaries payable Rent payable Interest payable	Wages and salaries expense Rent expense Interest expense	Liability/Expense
Accrued revenue	Interest receivable Rent receivable	Interest revenue Rent revenue	Asset/Revenue
Unearned revenue	Unearned interest Unearned rent	Interest revenue Rent revenue	Liability/Revenue
Estimated items	Accumulated depreciation Allowance for doubtful accounts	Depreciation expense Bad debt expense	Contra-asset or liability/Expense
Inventory adjustment	Inventory	Cost of goods sold Purchases Purchases returns and allowances	Asset/Expense

**7**  
**Prepare Adjusted Trial Balance**

All adjusting entries in the general journal must be posted to the worksheet. After posting all entries, the adjusting entries are combined with the unadjusted trial balance totals. The

result is the adjusted trial balance. Both adjusting entries and the adjusted trial balance for Simple Example Company were shown in Figure 1-8.

Adjusting entries must also be posted to the general ledger. This can be done at the same time postings are made to the worksheet.

For convenience, most companies wait until after financial statements are prepared to post adjustments to the general ledger.

**FIGURE 1-10**  
**Simple Example Company**  
**Adjusting Entries**  
 (Recorded in General Journal)  
 December 2022

	Date	Account Number	Account Name	Post	Debit	Credit
(1)	12-31-22	711	Bad debt expense	✓	49 00	
		104	Allowance for doubtful accounts	✓		49 00
			To record 2022 provision for bad debts			
(2)	12-31-22	104	Allowance for doubtful accounts	✓	26 00	
		103	Accounts receivable	✓		26 00
			To write off uncollectible account receivable			
(3)	12-31-22	705	Rent expense	✓	4 00	
		106	Prepaid rent	✓		4 00
			To record December rent expense			
(4)	12-31-22	709	Depreciation expense	✓	15 00	
		202	Accumulated depreciation	✓		15 00
			To record 2022 depreciation			
(5)	12-31-22	712	Wages and salaries expense — admin.	✓	6 00	
		713	Wages and salaries expense — selling	✓	6 00	
		302	Wages and salaries payable	✓		12 00
			To record accrued payroll at 12-31-22			
(6)	12-31-22	715	Other payroll tax expense	✓	4 00	
		303	Payroll taxes payable	✓		4 00
			To accrue other payroll taxes at 12-31-22			
(7)	12-31-22	714	Employer's FICA expense	✓	5 00	
		306	FICA taxes payable	✓		5 00
			To accrue FICA taxes at 12-31-22			
(8)	12-31-22	703	Purchases discounts	✓	46 00	
		701	Cost of goods sold	✓	2132 00	
		105	Inventory	✓		12 00
		702	Purchases	✓		2166 00
			To adjust inventory (to reflect results of 12-31-22 physical count) and to record cost of goods sold*			

\* Note to student: If purchases returns and allowances and freight-in exist, both of these accounts would be included in this journal entry.

## 8 Prepare Financial Statements

The final step on the worksheet is completing the income statement and balance sheet columns. The information in these columns is used to prepare the financial statements.

As shown in the worksheet in Figure 1-8, the totals from the adjusted trial balance are transferred into either the income statement or balance sheet columns. In addition, the net loss is shown as a reduction in both the income statement debit column and the balance sheet credit column. If there had been net income for the year, the amounts would have been shown as increases in the same columns.

The financial statements are prepared directly from the income statement and balance sheet columns in the worksheet. There are several differences between the worksheet totals and the financial statements.

- The financial statements' descriptions and details must be carefully stated to

## 9 Prepare Closing Entries

At the end of each year, all revenue and expense accounts are closed. Closing the accounts means eliminating the ending balance and starting with a zero balance in the next year.

The closing process happens only annually, even when monthly or quarterly statements are prepared. Many organizations use a calendar year for preparing annual statements. The closing process, therefore, occurs on December 31. Other companies choose different year-ends and thus

conform to generally accepted accounting principles.

- Frequently, more than one account balance is combined in the trial balance to make up a financial statement total. For example, all selling expenses may be combined and only total selling expense included in the financial statements.
- Classified financial statements must distinguish between current and non-current assets and liabilities. Trial balances usually do not.
- Financial statements must include a cash flow statement. Some information to prepare that statement may or may not be available on the trial balance. Examples include proceeds from new loans and payments made on loans during the period.
- Footnote information and other disclosures required for financial statements are usually not available on the trial balance.

close at different dates. There are three closing entries for a typical company:

1. Close all revenue accounts to income summary. (Debit all revenue accounts and credit the income summary account.)
2. Close all expense accounts to income summary. (Debit income summary and credit expense accounts.)
3. Close the income summary to stockholders' equity.

For a sole proprietorship or partnership, the income summary is closed to one or more capital accounts. In a corporation it is closed to retained earnings.

Several facts about closing entries are important to understand:

- Closing entries are prepared only at the end of the organization's year. The year-end may be December 31 or another month-end.
- Closing entries are prepared after all transactions and adjusting entries have been prepared and posted to the general ledger. Closing entries complete the accounting process for the current period.

- Every revenue and expense account must be closed to enable the company to begin a new year with a zero balance.
- The total debits and total credits must be equal for each closing entry.
- Each account in each closing entry is posted individually to the appropriate general ledger account.
- Closing entries are recorded initially in the general journal and then posted to the general ledger.

Closing entries for Simple Example Company are shown in Figure 1-11. To avoid confusion when you study each cycle in Chapters 3 through 6, they have not yet been posted to the general ledger.

**FIGURE 1-11**  
**Simple Example Company**  
**Closing Entries**  
 (Recorded in General Journal)  
 December 2022

	Date	Account Number	Account Name	Post	Debit	Credit
(1)	12-31-22	601	Sales	✓	3648 00	
		603	Sales returns and allowances	✓		214 00
		604	Sales discounts taken	✓		182 00
		800	Income summary	✓		3252 00
			To close revenue accounts to income summary			
(2)	12-31-22	800	Income summary	✓	3313 00	
		701	Cost of goods sold	✓		2132 00
		705	Rent expense	✓		48 00
		706	Repair expense	✓		69 00
		707	Utility expense	✓		62 00
		708	Postage expense	✓		49 00
		709	Depreciation expense	✓		15 00
		710	Travel expense	✓		57 00
		711	Bad debt expense	✓		49 00
		712	Wages and salaries expense - admin.	✓		270 00
		713	Wages and salaries expense - selling	✓		459 00
		714	Employer's FICA expense	✓		56 00
		715	Other payroll tax expense	✓		45 00
		717	Interest expense	✓		2 00
	To close expense accounts to income summary					
(3)	12-31-22	503	Retained earnings	✓	61 00	
		800	Income summary	✓		61 00
			To close income summary to retained earnings			

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## Post-Closing Trial Balance

After closing entries are posted to the general ledger, only balance sheet accounts will have balances. The amount in each balance sheet account, except retained earnings, should be the same as the amount in the adjusted trial balance. The balance in retained earnings should equal the ending balance in the statement of retained earnings.

Many accountants prepare a post-closing trial balance after all closing entries are posted.

The purposes are to make sure that debits equal credits in the general ledger before the recording process starts for the next year, the retained earnings balance is correct, and there are no balances in any income statement accounts.

The post-closing trial balance is a two-column listing, much like the first two columns in a worksheet. The source of each amount is the general ledger balance.

Figure 1-12 illustrates a post-closing trial balance for Simple Example Company at 12-31-22.

**FIGURE 1-12**  
**Simple Example Company**  
**Post-Closing Trial Balance**  
December 31, 2022

Account	Dr	Cr
101 Cash in bank	78 00	
102 Payroll cash	5 00	
103 Accounts receivable	272 00	
104 Allowance for doubtful accounts		41 00
105 Inventory	114 00	
106 Prepaid rent	4 00	
201 Delivery equipment	60 00	
202 Accumulated depreciation		60 00
301 Accounts payable		158 00
302 Wages and salaries payable		12 00
303 Payroll taxes payable		4 00
305 Withholding taxes payable		6 00
306 FICA taxes payable		10 00
501 Common stock		200 00
503 Retained earnings		42 00
	533 00	533 00

## Relationships Among Financial Statements, Trial Balances, Ledgers, Journals, Documents, and Transactions

To summarize the recording process, Figure 1-13 shows the relationships among financial

statements, trial balances, ledgers, journals, documents, and transactions. The documents, journals, and ledgers are used to record transactions. Each of them is essential to the proper preparation of financial statements.