



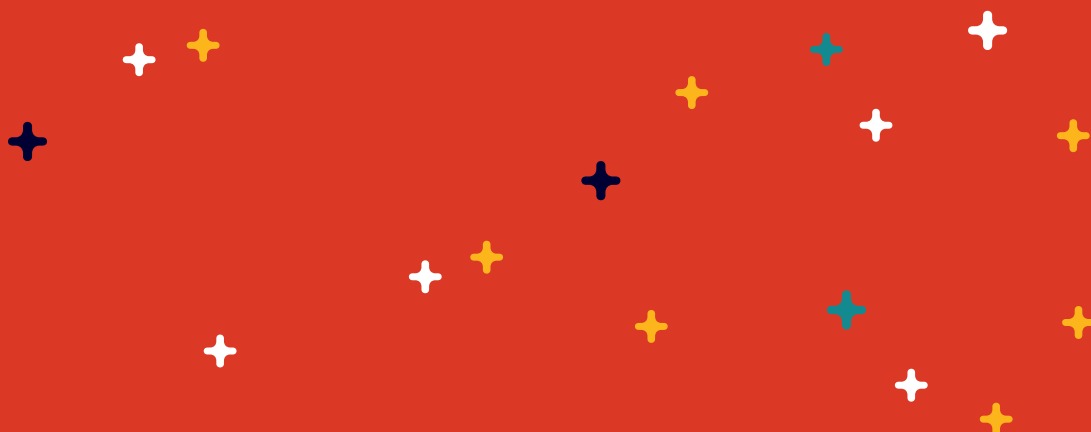
CMA Exam Review

Part 1

Financial Planning, Performance, and Analytics

For Exams Scheduled
After July 31, 2020

V 1.0



PART 1

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1A. External Financial Reporting Decisions

Module

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NOTES



This section is designed to provide an overview of the accounting cycle and provide a refresher on fundamental concepts. Although specific questions related to the accounting cycle may not be seen on the exam, the concepts here are foundational to accounting and are assumed to be known and understood by exam candidates.

1 Accounting Cycle

The primary objective of the accounting cycle is to capture the economic activity of a business. The accounting cycle can be broken down into the following steps:

1. Journalize transactions.
2. Post transaction to the general ledger.
3. Prepare an unadjusted trial balance.
4. Record adjusting entries.
5. Prepare an adjusted trial balance.
6. Prepare the financial statements.
7. Prepare closing entries.
8. Prepare the post-closing trial balance.

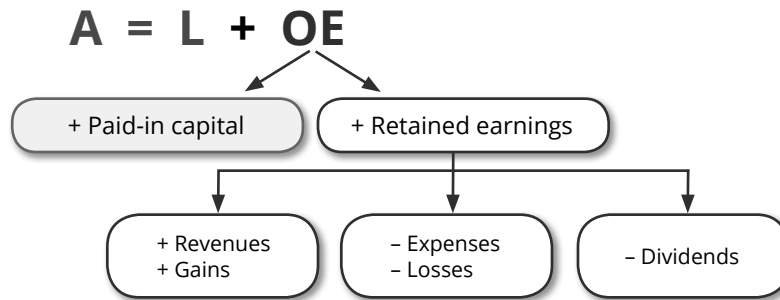
Each economic transaction captured by the accounting system has an effect on the accounting equation. The accounting equation can be expressed as follows:

$$\text{Assets} = \text{Liabilities} + \text{Owners' equity (or Stockholders' equity)}$$

This equation and any transaction captured by the accounting system demonstrates the equality of total economic resources (assets) and the claims against those resources (liabilities and ownership).

Properly recorded journal entries maintain equilibrium in the accounting equation.

The equity portion of the accounting equation is further broken down to demonstrate the relationship of an owner's equity to the income statement. Contributed capital and retained earnings are the two primary categories of equity. Contributed capital represents investments made by owners to the business. Retained earnings represent the utilization of assets in the creation of wealth for owners and the ability to create returns/profits to owners. These retained earnings may be reinvested back into the company or made available to pay out to shareholders as a return through dividends.



Every transaction of a business should be analyzed to determine the effect on the accounting equation. In any transaction, a minimum of two accounts will be affected. When analyzing the effects of each transaction, follow the steps indicated below:

1. Identify which accounts are involved in the transaction (remember there will be at least two).
2. Determine if the accounts are increasing or decreasing.
3. Ensure the accounting equation balances after the transaction is analyzed.

Illustration 1 Transaction Effects on Financial Statement Elements

For each of the following transactions, indicate the impact on the financial statements and ensure the accounting equation balances.

1. February 1: The corporation issued an additional 10,000 shares of capital stock to Harris Corp. in exchange for \$15,000 cash.
2. February 1: Purchased a building from Sweeney Enterprise for \$150,000. A cash payment of \$25,000 was made at the time of the purchase, and a note payable was issued for the remaining balance.
3. February 1: Paid \$7,800 for fire insurance on building for next 3 years.
4. February 9: Purchased additional supplies on account for \$3,500.
5. February 11: Billed students \$35,840 for tutoring services provided during the first half of February.
6. February 16: Paid \$12,300 in salaries earned by employees during the first half of February.
7. February 18: Received \$10,500 cash in advance from students for tutoring services to be provided in the future.
8. February 22: Collected cash from accounts receivable of \$40,000.
9. February 25: Paid \$3,330 for utilities during period.
10. February 25: Paid \$6,250 cash on accounts payable.
11. February 28: Declared and paid a \$2,000 dividend.

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	<i>Balance Sheet</i>		<i>Statement of Stockholders' Equity</i>		<i>Income Statement</i>	
	Assets =	Liabilities +	Stockholders' Equity	Dividends	Revenues - Expenses =	Net Income
February 1	+15,000		+15,000			
February 1	+125,000	+125,000				
February 1	Net effect \$0					
February 19	+3,500	+3,500				
February 11	+35,840		+35,840		+35,840	+35,840
February 16	(12,300)		(12,300)		+12,300	(12,300)
February 18	+10,500	+10,500				
February 22	Net effect \$0					
February 25	(3,330)		(3,330)		+3,330	(3,330)
February 25	(6,250)	(6,250)				
February 28	(2,000)		(2,000)	+2,000		

1.1 Journal Entries

Accountants record transactions using the double-entry accounting system using debits (on the left) and credits (on the right). A T-account is used to graphically represent each account used in the general ledger. The side an account increases on (shown in bold, below) is considered the normal balance.

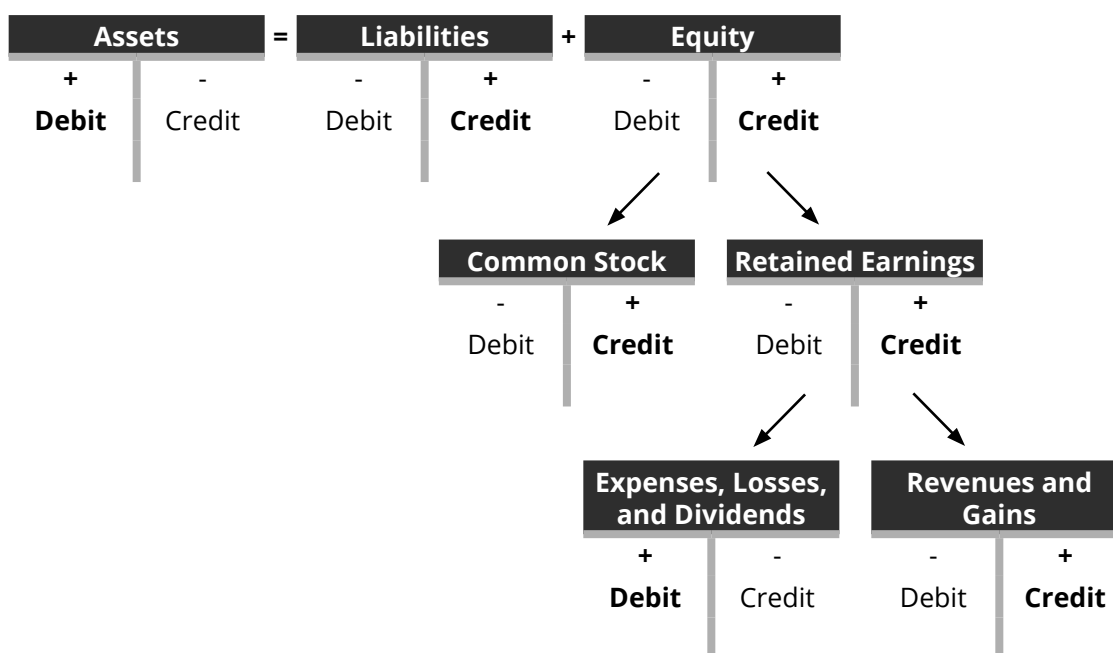


Illustration 2 Adjusting Journal Entries

Required: For each of the following transactions, record the journal entry.

1. February 1: The corporation issued an additional 10,000 shares of capital stock to Harris Corp. in exchange for \$15,000 cash.
2. February 1: Purchased a building from Sweeney Enterprise for \$150,000. A cash payment of \$25,000 was made at the time of the purchase, and a note payable was issued for the remaining balance.
3. February 1: Paid \$7,800 for fire insurance on building for next 3 years.
4. February 9: Purchased additional supplies on account for \$3,500.
5. February 11: Billed students \$35,840 for tutoring services provided during the first half of February.
6. February 16: Paid \$12,300 in salaries earned by employees during the first half of February.
7. February 18: Received \$10,500 cash in advance from students for tutoring services to be provided in the future.
8. February 22: Collected cash from accounts receivable of \$40,000.
9. February 25: Paid \$3,330 for utilities during period.
10. February 25: Paid \$6,250 cash on accounts payable.
11. February 28: Declared and paid a \$2,000 dividend.

February 1 journal entry: Assets (cash) and equity (common stock) increased by \$15,000.

DR	Cash	\$15,000	
CR	Common stock		\$15,000

February 1 journal entry: Assets (building and cash) and liabilities (note payable) increased by \$125,000.

DR	Building	\$150,000	
CR	Cash		\$25,000
CR	Note payable		125,000

February 1 journal entry: Assets increased (prepaid insurance) and decreased (cash) by \$7,800.

DR	Prepaid insurance	\$7,800	
CR	Cash		\$7,800

February 9 journal entry: Assets increased (supplies) and liabilities decreased (accounts payable) by \$3,500.

DR	Supplies	\$3,500	
CR	Accounts payable		\$3,500

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February 11 journal entry: Assets (accounts receivable) and revenues (sales revenue) increased as a result of the credit sale. The increase in revenue increases net income and eventually increases retained earnings.

DR	Accounts receivable	\$35,840	
CR	Sales revenue		\$35,840

February 16 journal entry: Assets (cash) decreased and expenses (wage expense) increased as a result of wages paid to employees. The increase in expenses decreases net income and eventually decreases retained earnings.

DR	Wage expense	\$12,300	
CR	Cash		\$12,300

February 18 journal entry: Assets (cash) and liabilities (unearned revenue) increased as a result of the advanced cash payment for tutoring services to be provided in the future by the company.

DR	Cash	\$10,500	
CR	Unearned revenue		\$10,500

February 22 journal entry: Assets (cash) increased and decreased (accounts receivable) by \$40,000.

DR	Cash	\$40,000	
CR	Accounts receivable		\$40,000

February 25 journal entry: Assets (cash) decreased and expenses (utilities) increased as a result of the utilities payment. The increase in expenses decreases net income and eventually decreases retained earnings.

DR	Utilities expense	\$3,330	
CR	Cash		\$3,330

February 25 journal entry: Assets (cash) decreased and liabilities (accounts payable) decreased by \$6,250.

DR	Accounts payable	\$6,250	
CR	Cash		\$6,250

February 28 journal entry: Assets (cash) decreased and dividends increased as a result of the dividend payment. The increase in dividends decreases retained earnings at the end of the period.

DR	Dividends	\$2,000	
CR	Cash		\$2,000

1.2 General Ledger

Each transaction journalized requires an update to the general ledger. The general ledger shows the debits and credits recorded for each account and shows the account balance at any point in time.

Illustration 3 Posting to the General Ledger

For each of the following transactions, post the activity recorded in the journal (in the previous illustration) into the ledger.

1. February 1: The corporation issued an additional 10,000 shares of capital stock to Harris Corp. in exchange for \$15,000 cash.
2. February 1: Purchased a building from Sweeney Enterprise for \$150,000. A cash payment of \$25,000 was made at the time of the purchase, and a note payable was issued for the remaining balance.
3. February 1: Paid \$7,800 for fire insurance on building for next 3 years.
4. February 9: Purchased additional supplies on account for \$3,500.
5. February 11: Billed students \$35,840 for tutoring services provided during the first half of February.
6. February 16: Paid \$12,300 in salaries earned by employees during the first half of February.
7. February 18: Received \$10,500 cash in advance from students for tutoring services to be provided in the future.
8. February 22: Collected cash from accounts receivable of \$40,000.
9. February 25: Paid \$3,330 for utilities during period.
10. February 25: Paid \$6,250 cash on accounts payable.
11. February 28: Declared and paid a \$2,000 dividend.

Assets

Cash		
Date	Debit	Credit
Beg. Bal.	\$32,000	
Feb. 1	15,000	
Feb. 1		\$25,000
Feb. 1		7,800
Feb. 16		12,300
Feb. 18	10,500	
Feb. 22	40,000	
Feb. 25		3,330
Feb. 28		6,250
Feb. 28		2,000
End. Bal.	\$40,820	

Liabilities

Accounts Payable		
Date	Debit	Credit
Beg. Bal.		\$4,200
Feb. 9		3,500
Feb. 25	\$6,250	
End. Bal.		\$1,450

Unearned Revenue

Date	Debit	Credit
Beg. Bal.		\$ 0
Feb. 18		10,500
End. Bal.		\$10,500

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Assets

Accounts Receivable		
Date	Debit	Credit
Beg. Bal.	\$11,000	
Feb. 11	35,840	
Feb. 22		\$40,000
End. Bal.	\$ 6,840	

Supplies

Date	Debit	Credit
Beg. Bal.	\$5,600	
Feb. 9	3,500	
End. Bal.	\$9,100	

Prepaid Insurance

Date	Debit	Credit
Beg. Bal.	\$ 0	
Feb. 1	7,800	
End. Bal.	\$7,800	

Land

Date	Debit	Credit
Beg. Bal.	\$68,000	
End. Bal.	\$68,000	

Building

Date	Debit	Credit
Beg. Bal.	\$ 0	
Feb. 1	150,000	
End. Bal.	\$150,000	

Expenses**Wage Expense**

Date	Debit	Credit
Feb. 16	\$12,300	
End. Bal.	\$12,300	

Utility Expense

Date	Debit	Credit
Feb. 25	\$3,330	
End. Bal.	\$3,330	

Liabilities

Notes Payable		
Date	Debit	Credit
Beg. Bal.		\$ 0
Feb. 1		125,000
End. Bal.		\$125,000

Equity**Common Stock**

Date	Debit	Credit
Beg. Bal.		\$ 85,000
Feb. 1		15,000
End. Bal.		\$100,000

Retained Earnings

Date	Debit	Credit
Beg. Bal.		\$27,400
End. Bal.		\$27,400

Dividends

Date	Debit	Credit
Feb. 28	\$2,000	
End. Bal.	\$2,000	

Revenue**Revenue**

Date	Debit	Credit
Feb. 11		\$35,840
End. Bal.		\$35,840

1.3 Unadjusted Trial Balance

The unadjusted trial balance reflects the balances in each financial statement account at a point in time. This trial balance is prepared at the end of the period, prior to any adjusting entries necessary to ensure total debits posted equal total credits posted and serve as a basis for determining any adjusting entries needed.

Illustration 4 Adjusted Trial Balance

The unadjusted trial balance below reflects activity journalized and posted during the month of February.

Harris Enterprise Unadjusted Trial Balance At February 28, Year 2		
Account	Debit	Credit
Cash	\$ 40,820	
Accts. receivable	6,840	
Supplies	9,100	
Prepaid insurance	7,800	
Land	68,000	
Building	150,000	
Accounts payable		\$ 1,450
Unearned revenue		10,500
Notes payable		125,000
Common stock		100,000
Retained earnings		27,400
Dividends	2,000	
Tutoring service revenue		35,840
Wage expense	12,300	
Utility expense	3,330	
Total	<u>\$300,190</u>	<u>\$300,190</u>

Note that total debits equal total credits.

1.4 Adjusting Entries

Adjusting journal entries are necessary under accrual accounting to ensure all revenues earned during the period and expenses incurred are captured so that the correct balances are reflected on the balance sheet and income statement. Accrual-based accounting does not delay the recognition of revenues and expenses until cash is collected or cash is paid. The matching principle requires companies to record expenses when incurred to match them properly against the associated revenues. Because accrual accounting is based on the timing of revenue and expense recognition and not when cash is received or paid, adjusting entries are necessary at the end of each accounting period in order to ensure all revenues earned and expenses incurred are captured in the accounting system.

There are three broad categories of adjusting journal entries: prepayments/deferrals, accruals, and estimates.

1.4.1 Prepayments/Deferrals

Prepayments, also referred to as deferrals, are transactions in which cash flows precede the revenue or expense recognition. Examples of prepayments/deferrals include:

- **Prepaid/Deferred Expense:** Represents assets associated with a cash distribution resulting in benefits to be received or to be used beyond the current reporting period. Common examples would include prepaid rent, prepaid insurance, and office supplies. As prepaid expenses (which are classified as assets) are used, an expense is recognized and the asset is reduced.
- **Unearned Revenue:** Represents the receipt of cash prior to the providing of a good or service to a customer. Advance collections of cash from customers result in liabilities on the part of the company because there is a required future action or event that must take place before the business earns the revenue.

Illustration 5 Initial Entries With Year-end Adjusting Entries: Rent

Assume that on November 1, Year 1, Swift Corp. prepaid four months of rent by paying \$8,000.

November 1 initial journal entry:

DR	Prepaid rent	\$8,000	
CR	Cash		\$8,000

December 31 adjusting journal entry:

DR	Rent expense	\$4,000	
CR	Prepaid rent		\$4,000

November and December rent expense of \$2,000 per month must be recognized and the prepaid rent account needs to reflect only two months of prepaid rent remaining.

Prepaid Rent				Rent Expense					
Date	Debit	Credit	Balance		Date	Debit	Credit	Balance	
			Debit	Credit				Debit	Credit
Nov. 1	\$8,000		\$8,000		Dec. 31	\$4,000		\$4,000	
Dec. 31		\$4,000	\$4,000						

Assume that on January 1, Year 1, Swift purchases \$1,000 of supplies. A physical count of office supplies available at the end of the month showed that only \$200 in supplies remain.

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January 1 initial entry:

DR	Office supplies	\$1,000	
CR	Cash		\$1,000

January 31 adjusting entry:

DR	Supply expense	\$800	
CR	Office supplies		\$800

The supplies that have been used during the period no longer have a benefit to the company (they are no longer an asset), therefore, an entry is necessary to record the expense associated with the use of the supplies and to adjust the office supplies account to reflect supplies still on hand at the end of the period.

Office Supplies				
Date	Debit	Credit	Balance	
			Debit	Credit
Jan. 1	\$1,000		\$1,000	
Dec. 31		\$800		\$ 200

Supply Expense				
Date	Debit	Credit	Balance	
			Debit	Credit
Dec. 31	\$800		\$800	

When advance collections of cash create a liability (unearned revenue) on the part of a company, adjusting entries are necessary as services are earned.

Assume on May 1, Year 1, Swift receives \$600 in prepayments from customers for three events that Swift will host for \$200 per event. By the end of May, Swift has hosted two of the three events. Prepare both the initial and adjusting entries necessary.

May 1 initial journal entry:

DR	Cash	\$600	
CR	Unearned revenue		\$600

May 31 adjusting journal entry:

DR	Unearned revenue	\$400	
CR	Service revenue		\$400

Swift has earned the revenue by hosting two events and at May 31, Swift is only responsible for hosting one remaining event. Two of the three events hosted results in revenue of \$400 earned; the \$200 remaining balance in the liability account, unearned revenue, reflects the one remaining event.

Unearned Revenue				
Date	Debit	Credit	Balance	
			Debit	Credit
May 1		\$600		\$600
Dec. 31	\$400			\$200

Service Expense				
Date	Debit	Credit	Balance	
			Debit	Credit
Dec. 31		\$400	-	

1.4.2 Accruals

Accruals involve transactions where the cash outflow or inflow takes place in the period following the adjusting entry. The adjusting entry for accruals happens first followed by the cash inflow in future periods.

Common examples of accruals include accruals for liabilities as well as for receivables at the end of a period.

- Accrued liabilities represent liabilities recorded when an expense has been incurred, but no cash has been paid yet. Common examples of accrued liabilities would include wages payable and interest payable. For example, when employees perform work associated with wages, at the end of the accounting period, the company must accrue earned wages for unpaid work. A corresponding liability is recognized at the time of the accrual. The liability is reversed when payments occur in the following period.
- Accrued receivables involve situations when revenue has been earned and is eligible for recognition, but cash has not yet been received. For example, when investments in debt made by a company result in the periodic receipt of interest payments, any interest earned at the end of the period is accrued and a receivable representing the right to receive the interest is reflected on the balance sheet.

Illustration 6 Initial Entries With Year-end Adjusting Entries: Interest

Assume Harris Investments has earned \$1,500 in interest on investments in Dawson Enterprises at December 31, Year 1. The interest payment will not be made until January 1, Year 2.

December 31 adjusting journal entry:

DR	Interest receivable	\$1,500	
CR	Interest revenue		\$1,500

January 1 subsequent journal entry:

DR	Cash	\$1,500	
CR	Interest receivable		\$1,500

The interest revenue is recognized in the period earned, regardless of the collection of cash. With revenue/receivable accruals, the adjusting entry precedes the collection of cash.

Interest Receivable					Interest Revenue				
Date	Debit	Credit	Balance		Date	Debit	Credit	Balance	
			Debit	Credit				Debit	Credit
Dec. 31	\$1,500		\$1,500		Dec. 31		\$1,500	\$1,500	
Jan. 1		\$1,500		—					

Assume employees earn wages of \$35,000 per week based on a five-day work week. December 31 is a Tuesday, and payday is Friday.

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December 31 adjusting entry:

DR	Wage expense	\$14,000	
CR	Wage payable		\$14,000

January 3 subsequent entry:

DR	Wage expense	\$21,000	
DR	Wage payable	14,000	
CR	Cash		\$35,000

The wage expense incurred in December should be recognized in December regardless of cash payment in January. $\$35,000 / 5 \text{ days} = \$7,000 \text{ per day} \times 2 \text{ days} = 14,000$ expense associated with December. With expense/liability accruals, the adjusting entry precedes the payment of cash.

Wages Payable				Wage Expense					
			Balance					Balance	
Date	Debit	Credit	Debit	Credit	Date	Debit	Credit	Debit	Credit
Dec. 31		\$14,000		\$14,000	Dec. 31	\$14,000		\$14,000	

1.4.3 Estimates

Many adjusting entries involve either prepayments or accruals; however, estimates made in the accounting process also result in adjusting entries. A common example of this is depreciation. When long-term assets are acquired, an allocation of the cost of the asset over period of benefit is used to match depreciation expense against revenues earned during the period.

Many estimates go into the calculation of the allocation process. For example, the purchase of equipment at a cost of \$10,000 on January 1, with an expected useful life of four years and no salvage value would be depreciated on a straight-line basis \$2,500 per year for four years ($\$10,000 / 4 \text{ years} = \$2,500 \text{ per year}$). Depreciation is not an attempt to reflect market value of an asset, but merely to allocate cost over the period of expected benefit, matching the expense of the asset to the revenues generated during its use.

Illustration 7 Initial Entries With Year-end Adjusting Entries: Depreciation

Assume Jones Co. purchased a \$50,000 building with a 25-year life on January 1, Year 1.

January 1 initial entry:

DR	Building	\$50,000	
CR	Cash/note payable		\$50,000

December 31 adjusting entry:

DR	Depreciation expense	\$2,000	
CR	Accumulated depreciation—building		\$2,000

The year-end adjusting entries would include \$2,000 in depreciation expense for one year of benefit received out of the estimated 25-year life.

Accumulated Depreciation—Building					Depreciation Expense				
			Balance					Balance	
Date	Debit	Credit	Debit	Credit	Date	Debit	Credit	Debit	Credit
Dec. 31		\$2,000		\$2,000	Dec. 31	\$2,000		\$2,000	

1.5 Adjusted Trial Balance

After adjusting entries are made, the general ledger is updated to reflect the adjusted balances and an adjusted trial balance is prepared. The adjusted trial balance is the starting point for the preparation of the company's financial statements, because all transactions and financial changes for the period reported have been captured by the accounting system. The format of an adjusted trial balance is identical to the initial trial balance, but the title is updated to indicate "adjusted" because new revenue and expense items may exist as well as increases/decreases to related assets and liabilities after the adjustments are made.

Illustration 8 Unadjusted Trial Balance

Based on adjusting entries, the adjusted trial balance for Harris Enterprises is shown below.

Harris Enterprises Adjusted Trial Balance February 28, Year 2		
Account	Debit	Credit
Cash	\$ 40,820	
Accts. receivable	6,840	
Supplies	1,500	
Prepaid insurance	7,583	
Land	68,000	
Building	150,000	
Accumulated depreciation		\$ 625
Accounts payable		1,450
Unearned revenue		5,750
Wage payable		11,600
Interest payable		1,250
Note payable		125,000
Common stock		100,000
Retained earnings		27,400
Dividends	2,000	
Tutoring service revenue		40,590
Wage expense	23,900	
Utility expense	3,330	
Insurance expense	217	
Supply expense	7,600	
Depreciation expense	625	
Interest expense	1,250	
Total	<u>\$313,665</u>	<u>\$313,665</u>

Note that total debits equal total credits.

1.6 Closing Entries and the Post-Closing Trial Balance

Once the adjusted trial balance is prepared, the financial statements can be prepared. At the end of a reporting period, all temporary accounts must be closed. Temporary accounts include all revenues, expenses, and dividends during the period. Revenues less expenses (net income) and dividends paid to shareholders during the period are then closed into the retained earnings account.

Only permanent accounts (assets, liabilities, and equity) remain after closing. Once all closing journal entries have been made, a post-closing trial balance is prepared to reflect assets, liabilities, and equity. The only permanent account that will have a change from the adjusted to post-closing trial balance is the retained earnings account.

Illustration 9 Preparing Closing Entries

Use the information from Harris Enterprises Income Statement to prepare the closing entries.

February 28 close revenue accounts to retained earnings:

DR	Tutoring service revenue	\$40,590	
CR	Retained earnings		\$40,590

February 28 close expense accounts to retained earnings:

DR	Retained earnings	\$36,922	
CR	Wage expense		\$23,900
CR	Utility expense		3,330
CR	Insurance expense		217
CR	Supply expense		7,600
CR	Depreciation expense		625
CR	Interest expense		1,250

February 28 close dividends to retained earnings:

DR	Retained earnings	\$2,000	
CR	Dividends		\$2,000

(continued)

(continued)

Once the closing entries are prepared, the post-closing trial balance is checked to ensure only balance sheet accounts remain:

Harris Enterprises Post-Closing Trial Balance February 28, Year 2		
Account	Debit	Credit
Cash	\$ 40,820	
Accts. receivable	6,840	
Supplies	1,500	
Prepaid insurance	7,583	
Land	68,000	
Building	150,000	
Accumulated depreciation		\$ 625
Accounts payable		1,450
Unearned revenue		5,750
Wage payable		11,600
Interest payable		1,250
Note payable		125,000
Common stock		100,000
Retained earnings		<u>29,068</u>
Total	<u>\$274,743</u>	<u>\$274,743</u>

Note that total debits equal total credits.