

Visual Learning Maps

Introductory Financial Accounting



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VIRTUAL TEXT BOOK

CLOSING (also called closing the books) & ACCOUNTING ENTRIES – 1 of 5

Closing Process – Why & When?

Closing must occur because the business wants to measure net income, or loss, for each accounting period – and does not want to mix up the measurement of income in the new period with the last period. Measurement of income is accomplished by preparing and issuing the financial statements. Closing Entries are made at the end of every accounting period.

Once this is completed, “the books” must be closed so that they are congruent with the financial statements.

If you used a step meter for walking and jogging each day to keep track of your daily steps, you would reset the meter wouldn't you? The same applies to the trip meter on a vehicle – resetting it to zero for each trip. This keeps track of each walk, jog or trip. The same principle applies in Accounting, but instead of calling it “resetting,” it is called “Closing.” It keeps track of net income / net loss.

“Closing” makes the income statement zero; then transfers the “Net” to the Capital account on the balance sheet through **4 rigid sequenced steps**.

← The “Net” **always** equals net income, or net loss.

Accounting Entries ...Begin by Finding the Income Statement

▶ The 4 Steps

Step 1. Close the Credits - Make this Journal Entry through the General Journal -

Debit all accounts that have credit balances with the exact amount in the account, so that the resulting balance in each account **is Zero**.

- Each and all revenue accounts
- Purchase Discounts ▪ Purchase Returns & Allowances

Add the total of the debit entries and post that total in the credit column adjacent to the **temporary account** (see page 3) **“Income Summary.”**

CLOSING PROCESS & ACCOUNTING ENTRIES – 2 of 5

The 4 Steps...continued

Step 2. Close the Debits - Make this Journal Entry through the General Journal -

Credit all accounts that have debit balances with the exact amount in the account, so that the resulting balance in each account **is Zero**.

- Each and all expense accounts
- Sales Discounts
- Sales Returns & Allowances

Add the total of the credit entries and put that total in the debit column adjacent to the **temporary account** ^(see page 3) **“Income Summary.”**

CHECK TO MAKE SURE THAT:

- All balances in all income statement accounts are now **ZERO!**
- The balance in the **income summary account** should equal net income (a credit balance) or net loss (a debit balance).

Step 3. Close the Income Summary Account - Make this Journal Entry through the General Journal - If the income summary account is in DEBIT balance (net income), CREDIT this account with the same amount and Debit the Capital account with the same amount.

Step 4. Close the Withdrawals Account - Make this Journal Entry through the General Journal - If the income summary account is in DEBIT balance (net income), CREDIT this account with the same amount and Debit the Capital account with the same amount.

At This Point:

- The balances in all the accounts in the income statement are ZERO
- The balance in the income summary account is ZERO
- The balance in the Withdrawals account is ZERO
- Net Income or Net Loss has been transferred to the Capital account

CLOSING PROCESS & ACCOUNTING ENTRIES – 3 of 5

Temporary and Permanent Accounts

Temporary accounts are accounts that are closed (zeroed out) at the end of each accounting period to update the Capital account in the Owner's Equity section of the balance sheet. This is the **E** in the Foundation Equation.

Temporary accounts are:

- All revenue accounts
- All expense accounts
- All discount, returns & allowances accounts (Sales and Purchase)
- Income summary account
- Withdrawals account

Permanent accounts are all balance sheet accounts. These are never closed.

Closing Example

Terry starts a business on January 1st by investing \$10,000 in cash. At this point Terry's balance sheet looks like this:

Assets – Cash	<u>10,000</u>
=	
Liabilities	0
Equity – Capital	<u>10,000</u>
Total Liabilities and Equity	<u>10,000</u>

Terry has \$10,000 of equity in the business.

During the next 12 months, the following events occur:

- \$60,000 in cash sales
- \$35,000 expenses incurred and paid
- \$5,000 bank loan
- \$20,000 cash taken out of the business by Terry

CLOSING PROCESS – Closing Example...continued – 4 of 5

At December 31, **BEFORE CLOSING** the Books look like this:

	<u>Debit</u>	<u>Credit</u>	
Cash	20		
Bank loan payable		5	
Withdrawals	20		
Capital		10	
Sub total	<u>40</u>	<u>15</u>	
Revenue		60	} Net Income Is \$25
Expense	<u>35</u>	<u> </u>	
Sub total	<u>35</u>	<u>60</u>	
Grand total	<u>75</u>	<u>75</u>	

Notice - the balance sheet accounts **DOESN'T BALANCE!**

Notice - Net Income is the **exact amount that the balance sheet is out!**

Here is the balance sheet **AFTER CLOSING.**

<u>Balance Sheet as at December 31</u>	
A	TOTAL ASSETS - Cash <u>20</u>
=	
L	Liabilities - Bank loan payable 5
+	
E	Owner's Equity - Capital 15
	TOTAL LIABILITIES AND EQUITY <u>20</u>

What Entries Were Made?...see page 5

CLOSING PROCESS – Closing Example...continued – 5 of 5

What Entries Were Made? Here They Are...

Begin by finding the income statement accounts

	DEBIT	CREDIT
Step 1: Close the Credits		
Revenue	60	
Income Summary		60
Step 2: Close the Debits		
Income Summary		35
Expenses	35	
Step 3: Close Income Summary		
Income Summary	25	
Expenses		25
Step 4: Close Withdrawals		
Capital	20	
Withdrawals		20

NOTE About the Income Summary Account...

This account exists only for a few moments. When the income statement debits and credits are closed, a quick check is made to make sure the balance in the income statement account is equal to the net income, or net loss, on the income statement – which gets to the purpose of closing:

The books must be closed so that they are congruent with the financial statements.