Step 7… Closing entries

Definition and explanation

Closing entries may be defined as journal entries made at the end of an accounting period to transfer the balances of various temporary ledger accounts to some permanent ledger account.

Temporary accounts (also known as nominal accounts) are ledger accounts used to record transactions for only a single accounting period and are closed at the end of the period by making appropriate closing entries. In next accounting period, these accounts are opened again and normally start with a zero balance. Temporary or nominal accounts include revenue, expense, dividend and income summary accounts.

Permanent accounts (also known as real accounts) are ledger accounts the balances of which continue to exist beyond the current accounting period (i.e., these accounts are not closed at the end of the period). In the next accounting period, these accounts usually (but not always) start with a non-zero balance. All balance sheet accounts are examples of permanent or real accounts.

The permanent account to which all temporary accounts are closed is the ***retained earnings account*** in case of a company and ***owner's capital account*** in case of a sole proprietorship.

The process of preparing closing entries

The preparation of closing entries is a simple four step process which is briefly explained below:

Step 1 – closing the revenue accounts:

Transfer the balances of all revenue accounts to income summary account. It is done by debiting various revenue accounts and crediting income summary account. This step closes all revenue accounts.

Step 2 – closing the expense accounts:

Transfer the balances of various expense accounts to income summary account. It is done by debiting income summary account and crediting various expense accounts. This step closes all expense accounts.

Step 3 – closing the income summary account:

After making closing entries in step 1 and step 2, the income summary account shows a credit or debit balance which is transferred to retained earnings account to close the income summary account. The income summary account would have a credit balance if the total of the balances of all revenue accounts is greater than the total of the balances of all expense accounts. If, on the other hand, the total of the balances of all revenue accounts is less than the total of the balances of all expense accounts, the income summary account shows a debit balance. The journal entry to close the income summary account is made as follows:

1. If income summary account has a credit balance, it means the business has earned a profit during the period which causes an increase in retained earnings. Therefore, the income summary account is closed by debiting income summary account and crediting retained earnings account.
2. If income summary account has a debit balance, it means the business has suffered a loss during the period which causes a decrease in retained earnings. In such a situation, the income summary account is closed by debiting retained earnings account and crediting income summary account.

Step 4 – closing the dividends account:

Transfer the balance of dividends account directly to retained earnings account. Dividends paid to stockholders are not a business expense and is therefore not used while determining net income or net loss. Its balance is not transferred to the income summary account but is directly transferred to retained earnings account.

With the completion of step 4, the necessary closing entries are completed and all temporary accounts (i.e., revenue, expense, dividend and income summary accounts) are closed to a permanent account (i.e., retained earnings account).

Consider the following example for a better understanding of closing entries:

Example

The Business Consulting Company, which closes its accounts at the end of the year, provides you the following adjusted trial balance at December 31, 2015.

BUSINESS CONSULTING COMPANY.
Adjusted Trial Balance
December 31, 2015

Account Name	Debit	Credit
Cash	$ 85,550	
Accounts receivable	4,700	
Prepaid building rent	1,500	
Unexpired insurance	3,600	
Supplies	250	
Equipment	9,000	
Accumulated depreciation - equipment		$ 3,600
Notes payable		5,000
Accounts payable		1,600
Salaries payable		2,000
Income taxes payable		3,000
Unearned service revenue		4,400
Capital stock		50,000
Retained earnings		20,000
Dividends	3,000	
Service revenue earned		82,500
Salaries expense	42,500	
Supplies expense	1,950	
Rent expense	6,000	
Insurance expense	950	
Advertising expense	250	
Depreciation expense - equipment	900	
Interest expense	450	
Income taxe expense	11,500	
Totals	$ 172,100	$ 172,100

Required: Using above <u>trial balance</u>, prepare closing entries required at December 31, 2015.

Solution

BUSINESS CONSULTING COMPANY
General Journal
December 31, 2015

Date	Account title and explanation	Debit	Credit
2015			
Dec. 31	Service revenue earned	82,500	
	Income summary		82,500
	(To close service revenue earned account)		
Dec. 31	Income summary	64,500	
	Salaries expense		42,500
	Supply expense		1,950
	Rent expense		6,000
	Insurance expense		950
	Advertising expense		250
	Depreciation expense - equipment		900
	Interest expense		450
	Income tax expense		11,500
	(To close all expense accounts)		
Dec. 31	Income summary	*18,000	
	Retained earnings		18,000
	(To transfer net income earned in 2015 to the retained earnings account: $82,500 - $64,500)		
Dec. 31	Retained earnings	3,000	
	Dividends account		3,000
	(To transfer dividends declared in 2015 to retained earnings account)		

*82,500 – 64,500: In our example, income summary account has a credit balance because the balance of service revenue earned account ($82,500) is greater than the total of the balances of eight expense accounts ($64,500)