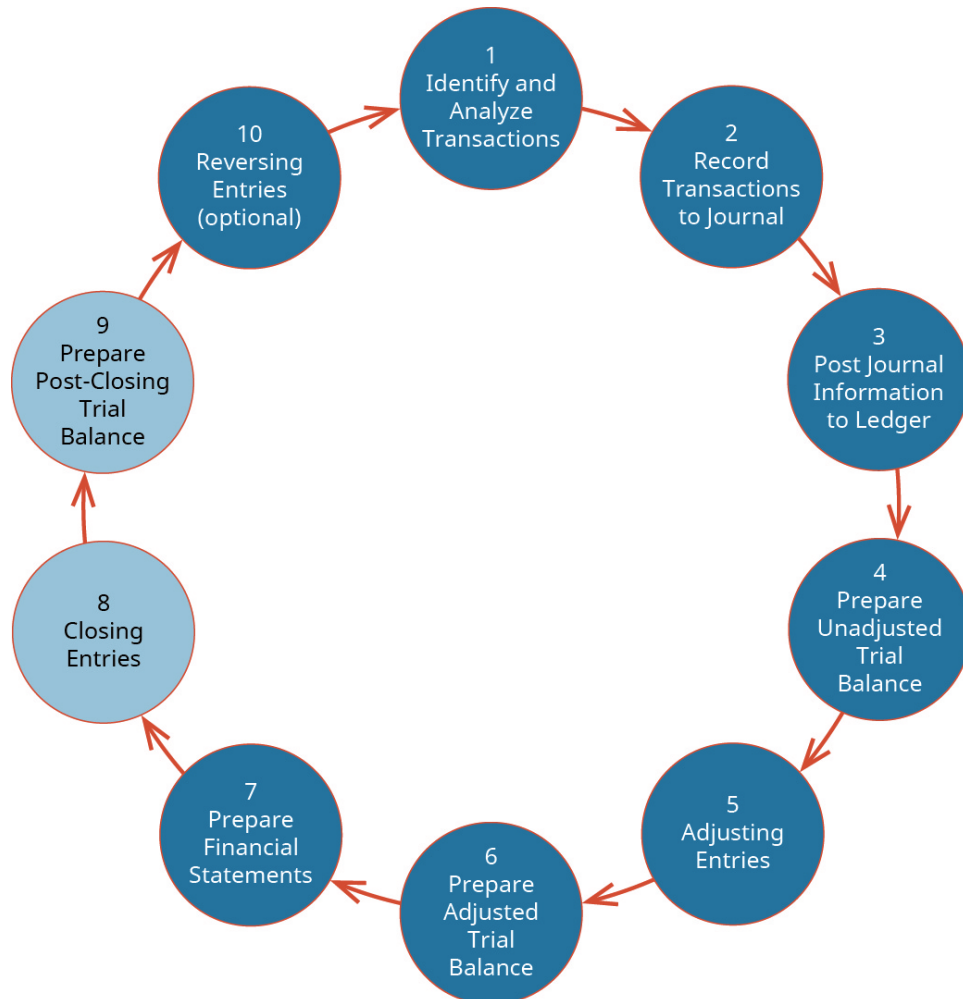


4.6: Describe and Prepare Closing Entries for a Business

In this chapter, we complete the final steps (steps 8 and 9) of the accounting cycle, the closing process. You will notice that we do not cover step 10, reversing entries. This is an optional step in the accounting cycle that you will learn about in future courses. Steps 1 through 4 were covered in [Analyzing and Recording Transactions](#) and Steps 5 through 7 were covered in [The Adjustment Process](#).



Our discussion here begins with journalizing and posting the closing entries (Figure 5.2). These posted entries will then translate into a **post-closing trial balance**, which is a trial balance that is prepared after all of the closing entries have been recorded.

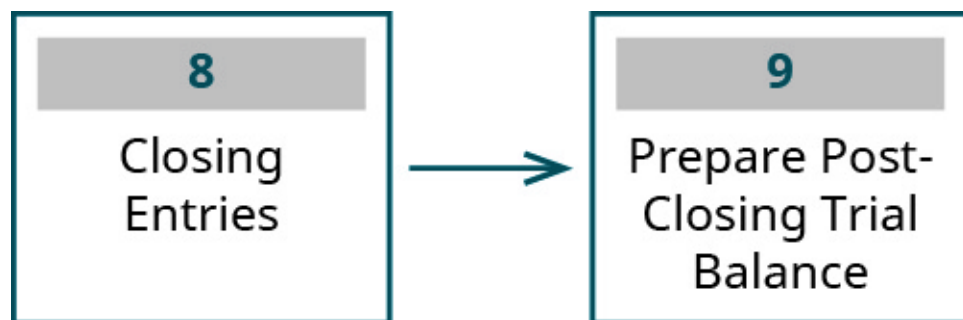


Figure 5.2 Final steps in the accounting cycle. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

THINK IT THROUGH

Should You Compromise to Please Your Supervisor?

You are an accountant for a small event-planning business. The business has been operating for several years but does not have the resources for accounting software. This means you are preparing all steps in the accounting cycle by hand.

It is the end of the month, and you have completed the post-closing trial balance. You notice that there is still a service revenue account balance listed on this trial balance. Why is it considered an error to have a revenue account on the post-closing trial balance? How do you fix this error?

Introduction to the Closing Entries

Companies are required to close their books at the end of each fiscal year so that they can prepare their annual financial statements and tax returns. However, most companies prepare monthly financial statements and close their books annually, so they have a clear picture of company performance during the year, and give users timely information to make decisions.

Closing entries prepare a company for the next accounting period by clearing any outstanding balances in certain accounts that should not transfer over to the next period. **Closing**, or clearing the balances, means returning the account to a zero balance. Having a zero balance in these accounts is important so a company can compare performance across periods, particularly with income. It also helps the company keep thorough records of account balances affecting retained earnings. Revenue, expense, and dividend accounts affect retained earnings and are closed so they can accumulate new balances in the next period, which is an application of the time period assumption.

To further clarify this concept, balances are closed to assure all revenues and expenses are recorded in the proper period and then start over the following period. The revenue and expense accounts should start at zero each period, because we are measuring how much revenue is earned and expenses incurred during the period. However, the cash balances, as well as the other balance sheet accounts, are carried over from the end of a current period to the beginning of the next period.

For example, a store has an inventory account balance of \$100,000. If the store closed at 11:59 p.m. on January 31, 2019, then the inventory balance when it reopened at 12:01 a.m. on February 1, 2019, would still be \$100,000. The balance sheet accounts, such as inventory, would carry over into the next period, in this case February 2019.

The accounts that need to start with a clean or \$0 balance going into the next accounting period are revenue, income, and any dividends from January 2019. To determine the income (profit or loss) from the month of January, the store needs to close the income statement information from January 2019. Zeroing January 2019 would then enable the store to calculate the income (profit or loss) for the next month (February 2019), instead of merging it into January's income and thus providing invalid information solely for the month of February.

However, if the company also wanted to keep year-to-date information from month to month, a separate set of records could be kept as the company progresses through the remaining months in the year. For our purposes, assume that we are closing the books at the end of each month unless otherwise noted.

Let's look at another example to illustrate the point. Assume you own a small landscaping business. It is the end of the year, December 31, 2018, and you are reviewing your financials for the entire year. You see that you earned \$120,000 this year in revenue and had expenses for rent, electricity, cable, internet, gas, and food that totaled \$70,000.

You also review the following information:

	Value December 31
Bank account balance	\$ 7,500
Electronics	3,250
Car	26,545
Furniture	7,200
Credit card balances	9,270
Bank loans	48,350

The next day, January 1, 2019, you get ready for work, but before you go to the office, you decide to review your financials for 2019. What are your year-to-date earnings? So far, you have not worked at all in the current year. What are your total expenses for rent, electricity, cable and internet, gas, and food for the current year? You have also not incurred any expenses yet for rent, electricity, cable, internet, gas or food. This means that the current balance of these accounts is zero, because they were closed on December 31, 2018, to complete the annual accounting period.

Next, you review your assets and liabilities. What is your current bank account balance? What is the current book value of your electronics, car, and furniture? What about your credit card balances and bank loans? Are the value of your assets and liabilities now zero because of the start of a new year? Your car, electronics, and furniture did not suddenly lose all their value, and unfortunately, you still have outstanding debt. Therefore, these accounts still have a balance in the new year, because they are not closed, and the balances are carried forward from December 31 to January 1 to start the new annual accounting period.

This is no different from what will happen to a company at the end of an accounting period. A company will see its revenue and expense accounts set back to zero, but its assets and liabilities will maintain a balance. Stockholders' equity accounts will also maintain their balances. In summary, the accountant resets the temporary accounts to zero by transferring the balances to permanent accounts.

LINK TO LEARNING

Understanding the accounting cycle and preparing trial balances is a practice valued internationally. The Philippines Center for Entrepreneurship and the government of the Philippines hold regular seminars going over this cycle with small business owners. They are also transparent with their internal trial balances in several key government offices. Check out this [article talking about the seminars on the accounting cycle](#) and this public pre-closing trial balance presented by the Philippines Department of Health.

Temporary and Permanent Accounts

All accounts can be classified as either permanent (real) or temporary (nominal) ([Figure 5.3](#)).

Permanent (real) accounts are accounts that transfer balances to the next period and include balance sheet accounts, such as assets, liabilities, and stockholders' equity. These accounts will not be set back to zero at the beginning of the next period; they will keep their balances. Permanent accounts are not part of the closing process.

Temporary (nominal) accounts are accounts that are closed at the end of each accounting period, and include income statement, dividends, and income summary accounts. The new account, Income Summary, will be discussed shortly. These accounts are temporary because they keep their balances during the current accounting period and are set back to zero when the period ends. Revenue and expense accounts are closed to Income Summary, and Income Summary and Dividends are closed to the permanent account, Retained Earnings.

Type of Account	Financial Statement Presented On			Account	
	Income Statement	Statement of Retained Earnings	Balance Sheet	Temporary	Permanent
Asset			X		X
Contra Asset			X		X
Liability			X		X
Stockholders' Equity			X		X
Dividends*		X		X	
Revenues	X			X	
Expenses	X			X	

*Contra Stockholders' Equity

Figure 5.3 Location Chart for Financial Statement Accounts. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

The **income summary** account is an intermediary between revenues and expenses, and the Retained Earnings account. It stores all of the closing information for revenues and expenses, resulting in a “summary” of income or loss for the period. The balance in the Income Summary account equals the net income or loss for the period. This balance is then transferred to the Retained Earnings account.

Income summary is a nondefined account category. This means that it is not an asset, liability, stockholders' equity, revenue, or expense account. The account has a zero balance throughout the entire accounting period until the closing entries are prepared. Therefore, it will not appear on any trial balances, including the adjusted trial balance, and will not appear on any of the financial statements.

You might be asking yourself, “is the Income Summary account even necessary?” Could we just close out revenues and expenses directly into retained earnings and not have this extra temporary account? We could do this, but by having the Income Summary account, you get a balance for net income a second time. This gives you the balance to compare to the income statement, and allows you to double check that all income statement accounts are closed and have correct amounts. If you put the revenues and expenses directly into retained earnings, you will not see that check figure. No matter which way you choose to close, the same final balance is in retained earnings.

YOUR TURN

Permanent versus Temporary Accounts

Following is a list of accounts. State whether each account is a permanent or temporary account.

- A. rent expense
- B. unearned revenue
- C. accumulated depreciation, vehicle
- D. common stock
- E. fees revenue
- F. dividends
- G. prepaid insurance
- H. accounts payable

Solution

A, E, and F are temporary; B, C, D, G, and H are permanent.

Let's now look at how to prepare closing entries.

Journalizing and Posting Closing Entries

The eighth step in the accounting cycle is preparing closing entries, which includes journalizing and posting the entries to the ledger.

Four entries occur during the closing process. The first entry closes revenue accounts to the Income Summary account. The second entry closes expense accounts to the Income Summary account. The third entry closes the Income Summary account to Retained Earnings. The fourth entry closes the Dividends account to Retained Earnings. The information needed to prepare closing entries comes from the adjusted trial balance.

Let's explore each entry in more detail using Printing Plus's information from [Analyzing and Recording Transactions](#) and [The Adjustment Process](#) as our example. The Printing Plus adjusted trial balance for January 31, 2019, is presented in [Figure 5.4](#).

PRINTING PLUS Adjusted Trial Balance For the Month Ended January 31, 2019		
Account Title	Debit	Credit
Cash	\$24,800	
Accounts Receivable	1,200	
Interest Receivable	140	
Supplies	400	
Equipment	3,500	
Accumulated Depreciation: Equipment		\$ 75
Accounts Payable		500
Salaries Payable		1,500
Unearned Revenue		3,400
Common Stock		20,000
Dividends	100	
Interest Revenue		140
Service Revenue		10,100
Supplies Expense	100	
Depreciation Expense: Equipment	75	
Salaries Expense	5,100	
Utility Expense	300	
Total	<u>\$35,715</u>	<u>\$35,715</u>

Figure 5.4 Adjusted Trial Balance for Printing Plus. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

The first entry requires revenue accounts close to the Income Summary account. To get a zero balance in a revenue account, the entry will show a debit to revenues and a credit to Income Summary. Printing Plus has \$140 of interest revenue and \$10,100 of service revenue, each with a credit balance on the adjusted trial balance. The closing entry will debit both interest revenue and service revenue, and credit Income Summary.

JOURNAL			
Date	Account	Debit	Credit
Jan. 31, 2019	Interest Revenue	140	
	Service Revenue	10,100	
	Income Summary		10,240
	<i>To close revenue accounts to Income Summary</i>		

The T-accounts after this closing entry would look like the following.

Service Revenue <hr/> <div> <div>5,500 Jan. 10</div> <div>2,800 Jan. 17</div> <div>1,200 Jan. 27</div> <div>600 Jan. 31</div> <div>Jan. 31 Cls. 10,100</div> <div>10,100</div> <div>0</div> <div>=</div> </div>		Interest Revenue <hr/> <div> <div>140 Jan. 31</div> <div>Jan. 31 Cls. 140</div> <div>140</div> <div>0</div> <div>=</div> </div>	
		Income Summary <hr/> <div> <div>10,240 Jan. 31</div> <div>Cls. #1</div> <div>Bal. 10,240</div> </div>	

Notice that the balances in interest revenue and service revenue are now zero and are ready to accumulate revenues in the next period. The Income Summary account has a credit balance of \$10,240 (the revenue sum).

The second entry requires expense accounts close to the Income Summary account. To get a zero balance in an expense account, the entry will show a credit to expenses and a debit to Income Summary. Printing Plus has \$100 of supplies expense, \$75 of depreciation expense—equipment, \$5,100 of salaries expense, and \$300 of utility expense, each with a debit balance on the adjusted trial balance. The closing entry will credit Supplies Expense, Depreciation Expense—Equipment, Salaries Expense, and Utility Expense, and debit Income Summary.

JOURNAL			
Date	Account	Debit	Credit
Jan. 31, 2019	Income Summary	5,575	
	Supplies Expense		100
	Depreciation Expense: Equipment		75
	Salaries Expense		5,100
	Utility Expense		300
	<i>To close expense accounts to Income Summary</i>		

The T-accounts after this closing entry would look like the following.

Supplies Expense <div> <div>Jan. 31 100</div> <div>100 Jan. 31 Cls.</div> <div>0</div> </div>	Salaries Expense <div> <div>Jan. 20 3,600</div> <div>Jan. 31 1,500</div> <div>5,100 Jan. 31 Cls.</div> <div>0</div> </div>
Depreciation Expense: Equipment <div> <div>Jan. 31 75</div> <div>75 Jan. 31 Cls.</div> <div>0</div> </div>	Utility Expense <div> <div>Jan. 12 300</div> <div>300 Jan. 31 Cls.</div> <div>0</div> </div>
Income Summary <div> <div>Jan. 31 Cls. #2 5,575</div> <div>10,240 Jan. 31 Cls. #1</div> <div>Bal. 4,665</div> </div>	

Notice that the balances in the expense accounts are now zero and are ready to accumulate expenses in the next period. The Income Summary account has a new credit balance of \$4,665, which is the difference between revenues and expenses (Figure 5.5). The balance in Income Summary is the same figure as what is reported on Printing Plus's Income Statement.

PRINTING PLUS		
Income Statement		
For the Month Ended January 31, 2019		
Revenues		
Interest Revenue	\$ 140	
Service Revenue	10,100	
Total Revenues		\$10,240
Expenses		
Supplies Expense	100	
Depreciation Expense: Equipment	75	
Salaries Expense	5,100	
Utility Expense	300	
Total Expenses		5,575
Net Income		\$ 4,665

Figure 5.5 Income Statement for Printing Plus. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

Why are these two figures the same? The income statement summarizes your income, as does income summary. If both summarize your income in the same period, then they must be equal. If they do not match, then you have an error.

The third entry requires Income Summary to close to the Retained Earnings account. To get a zero balance in the Income Summary account, there are guidelines to consider.

- If the balance in Income Summary before closing is a credit balance, you will debit Income Summary and credit Retained Earnings in the closing entry. This situation occurs when a company has a net income.
- If the balance in Income Summary before closing is a debit balance, you will credit Income Summary and debit Retained Earnings in the closing entry. This situation occurs when a company has a net loss.

Remember that net income will increase retained earnings, and a net loss will decrease retained earnings. The Retained Earnings account increases on the credit side and decreases on the debit side.

Printing Plus has a \$4,665 credit balance in its Income Summary account before closing, so it will debit Income Summary and credit Retained Earnings.

JOURNAL			
Date	Account	Debit	Credit
Jan. 31, 2019	Income Summary Retained Earnings <i>To close Income Summary to Retained Earnings</i>	4,665	4,665

The T-accounts after this closing entry would look like the following.

Retained Earnings		Income Summary	
	4,665 Jan. 31 Cls. #3	Jan. 31 Cls. #2 5,575 10,240 Jan. 31 Cls. #1	
	Bal. 4,665	Jan. 31 Cls. 4,665	
		0	

Notice that the Income Summary account is now zero and is ready for use in the next period. The Retained Earnings account balance is currently a credit of \$4,665.

The fourth entry requires Dividends to close to the Retained Earnings account. Remember from your past studies that dividends are not expenses, such as salaries paid to your employees or staff. Instead, declaring and paying dividends is a method utilized by corporations to return part of the profits generated by the company to the owners of the company—in this case, its shareholders.

If dividends were not declared, closing entries would cease at this point. If dividends are declared, to get a zero balance in the Dividends account, the entry will show a credit to Dividends and a debit to Retained Earnings. As you will learn in [Corporation Accounting](#), there are three components to the declaration and payment of dividends. The first part is the date of declaration, which creates the obligation or liability to pay the dividend. The second part is the date of record that determines who receives the dividends, and the third part is the date of payment, which is the date that payments are made. Printing Plus has \$100 of dividends with a debit balance on the adjusted trial balance. The closing entry will credit Dividends and debit Retained Earnings.

JOURNAL			
Date	Account	Debit	Credit
Jan. 31, 2019	Retained Earnings Dividends <i>To close dividends account to Retained Earnings</i>	100	100

The T-accounts after this closing entry would look like the following.

Retained Earnings		Dividends	
Jan. 31 Cls. #4 100 4,665 Jan. 31 Cls. #3		Jan. 14 100	
Bal. 4,565		100 100 Jan. 31 Cls.	
		0	

Why was income summary not used in the dividends closing entry? Dividends are not an income statement account. Only income statement accounts help us summarize income, so only income statement accounts should go into income summary.

Remember, dividends are a contra stockholders' equity account. It is contra to retained earnings. If we pay out dividends, it means retained earnings decreases. Retained earnings decreases on the debit side. The remaining balance in Retained Earnings is \$4,565

(Figure 5.6). This is the same figure found on the statement of retained earnings.

PRINTING PLUS Statement of Retained Earnings For the Month Ended January 31, 2019	
Beginning Retained Earnings (Jan. 1)	\$ 0
Net Income	<u>4,665</u>
Dividends	<u>(100)</u>
Ending Retained Earnings (Jan. 31)	<u><u>\$4,565</u></u>

Figure 5.6 Statement of Retained Earnings for Printing Plus. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

The statement of retained earnings shows the period-ending retained earnings after the closing entries have been posted. When you compare the retained earnings ledger (T-account) to the statement of retained earnings, the figures must match. It is important to understand retained earnings is *not* closed out, it is only updated. Retained Earnings is the only account that appears in the closing entries that does not close. You should recall from your previous material that retained earnings are the earnings retained by the company over time—not cash flow but earnings. Now that we have closed the temporary accounts, let's review what the post-closing ledger (T-accounts) looks like for Printing Plus.

T-Account Summary

The T-account summary for Printing Plus after closing entries are journalized is presented in Figure 5.7.

Cash			
Jan. 3	20,000	300	Jan. 12
Jan. 9	4,000	100	Jan. 14
Jan. 17	2,800	3,500	Jan. 18
Jan. 23	5,500	3,600	Jan. 20
Bal. 24,800			

Accounts Payable			
Jan. 18	3,500	3,500	Jan. 5
		500	Jan. 30
Bal. 500			

Salaries Payable			
		1,500	Jan. 31
Bal. 1,500			

Unearned Revenue			
Jan. 31	600	4,000	Jan. 9
Bal. 3,400			

Common Stock			
		20,000	Jan. 3
Bal. 20,000			

Dividends			
Jan. 14	100		
	100	100	Jan. 31
			Cls.
0		=	

Service Revenue			
		5,500	Jan. 10
		2,800	Jan. 17
		1,200	Jan. 27
		600	Jan. 31
Jan. 31	10,100	10,100	
Cls.			
0		=	

Interest Revenue			
		140	Jan. 31
Jan. 31	Cls. 140	140	
0		=	

Supplies Expense			
Jan. 31	100		
	100	100	Jan. 31
			Cls.
0		=	

Salaries Expense			
Jan. 20	3,600		
Jan. 31	1,500		
	5,100	5,100	Jan. 31
			Cls.
0		=	

Depreciation Expense - Equipment			
Jan. 31	75		
	75	75	Jan. 31
			Cls.
0		=	

Utility Expense			
Jan. 12	300		
	300	300	Jan. 31
			Cls.
0		=	

Income Summary			
Jan. 31	5,575	10,240	Jan. 31
Cls. #2			Cls. #1
Jan. 31	4,665	4,665	
Cls.			
0		=	

Retained Earnings			
Jan. 31	100	4,665	Jan. 31
Cls. #4			Cls. #3
Bal. 4,565			

Accounts Receivable			
Jan. 10	5,500	5,500	Jan. 23
Jan. 27	1,200		
Bal. 1,200			

Interest Receivable			
Jan. 31	140		
Bal. 140			

Supplies			
Jan. 30	500	100	Jan. 31
Bal. 400			

Equipment			
Jan. 5	3,500		
Bal. 3,500			

Accumulated Depreciation - Equipment			
	75		Jan. 31
Bal. 75			

Figure 5.7T-Account Summary. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

Notice that revenues, expenses, dividends, and income summary all have zero balances. Retained earnings maintains a \$4,565 credit balance. The post-closing T-accounts will be transferred to the post-closing trial balance, which is step 9 in the accounting cycle.

THINK IT THROUGH

Closing Entries

A company has revenue of \$48,000 and total expenses of \$52,000. What would the third closing entry be? Why?

YOUR TURN

Frasker Corp. Closing Entries

Prepare the closing entries for Frasker Corp. using the adjusted trial balance provided.

FRASKER CORPORATION
Adjusted Trial Balance
For the Month Ended June 30, 2018

Cash	\$ 5,840	
Accounts Receivable	6,575	
Prepaid Machine Rental	6,000	
Office Supplies	435	
Accounts Payable		\$ 2,840
Common Stock		10,000
Retained Earnings		4,350
Dividends	15,000	
Fees Earned		22,350
Salaries Expense	2,970	
Advertising Expense	325	
Machine Rental Expense	1,000	
Office Rent Expense	1,250	
Utility Expense	145	
	<u>\$39,540</u>	<u>\$39,540</u>

Solution

June 30	Fee Earned	\$22,350	
	Income Summary		\$22,350
	<i>To close all income statement accounts with credit balances</i>		
June 30	Income Summary	5,690	
	Salaries Expense		2,970
	Advertising Expense		325
	Machine Rental Expense		1,000
	Office Rent Expense		1,250
	Utilities Expense		145
	<i>To close out all income statement accounts with debit balances</i>		
June 30	Retained Earnings	16,660	
	Income Summary		16,660
	<i>To close out income summary and update retained earnings</i>		
June 30	Retained Earnings	15,000	
	Dividends		15,000
	<i>To close out dividends and update retained earnings</i>		

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