ACC/AFA 100: Closing Entries

TRAIN TO LEARN EFFECTIVELY: TIP SHEETS

What are closing entries?

Closing entries is one of the final steps of the accounting cycle. The purpose of closing entries is:

1) to prepare the accounts for the next fiscal period
2) close nominal accounts and continue the balances of real accounts into the next fiscal period

Key Terms

Real accounts are also known as “permanent accounts”. They are accounts whose balances continue into the next fiscal period. Examples include Asset, Liability, and capital accounts.

Nominal accounts are also known as “temporary equity accounts”. They are accounts whose balances do not continue into the next fiscal period. Nominal accounts only deal with a single fiscal period. These accounts start off every new accounting period with a zero balance. Examples include Revenue and Expenses.

Closing an account means to cause the account to have a zero balance. As part of the year end procedures, nominal (temporary) accounts are closed. The purpose of closing nominal accounts is to prepare the financial accounts for the next fiscal period and to update the capital account.

Closing Entries

- The closing entries have two purposes:

1. To transfer the balances in the temporary accounts to retained earnings.
2. To establish a zero balance in each of the temporary accounts to start the accumulation in the next accounting period.

Closing the Books: End of the Accounting Cycle

- Statement of financial position accounts (assets, liabilities, and shareholders’ equity) are **permanent (real) accounts** and are not reduced to zero at the end of the accounting period.
  - The ending balance for the current accounting period becomes the beginning account balance for the next accounting period.
- Revenue, expense, gain, loss, and dividend accounts are used to accumulate transaction effects for the *current accounting period only*; they are called **temporary (nominal) accounts**.
  - At the end of each period, the **balances in the temporary accounts are transferred, or closed, to the retained earnings account** by recording **closing entries**.

How do we record closing entries?

A new account called *INCOME SUMMARY* is required. Here are the steps for closing entries:

Step 1) Close all **REVENUE** accounts into Income Summary. Transfer the balances in the revenue accounts (such as sales revenue, service revenue, interest revenue, fees earned etc) to a new nominal account called Income Summary. We debit the revenue accounts to decrease it to zero and credit income summary for the equal amount.

DR. Sales Revenue 1000

DR. Fees Earned 1000

CR. Income Summary 2000

Step 2) Close all **EXPENSE** accounts into Income Summary. Transfer the balance in the expenses account to the Income Summary account. We credit the expense accounts to decrease it to zero and debit income summary for the total amount.

DR. Income Summary 1100

CR. Advertising Expense 50

CR. Automobile Expense 250

CR. Depreciation Expense 300

CR. Rent Expense 150

CR. Telephone Expense 50

CR. Utilities Expense 200

CR. Wages Expense 100

Step 3) Close **DIVIDENDS DECLARED** into Retained Earnings (NOT to Income Summary). If there are no dividends declared for the year, skip this step and proceed to Step 4.

DR. Retained Earnings 100

CR. Dividends Declared 100

Step 4) Close **INCOME SUMMARY** to Retained Earnings. If the current balance represents <u>NET INCOME,</u> which means Income Summary currently has a credit balance, then we debit Income Summary for the equal amount to make it zero. The entry is as follows:

DR. Income Summary 900

CR. Retained Earnings 900

Otherwise, if the balance represents <u>NET LOSS,</u> which means Income Summary currently has a debit balance, then we credit Income Summary for the equal amount to make it zero. The entry is as follows:

DR. Retained Earnings 500

CR. Income Summary 500

Steps for Closing Entries

1. **Close all REVENUE (and GAIN) accounts to Income Summary** (a temporary account used during the closing process):
   - Debit each revenue account for its balance
     - Credit Income Summary for the total revenue amount
2. **Close all EXPENSE (and LOSS) accounts to Income Summary**:
   - Debit Income Summary for the total expense amount
     - Credit Each expense account for its balance
3. **Close DIVIDENDS DECLARED to Retained Earnings (<u>NOT to Income Summary</u>)**:
   - Dr. Retained Earnings
     - Cr. Dividends Declared account for the balance
4. **Close INCOME SUMMARY to Retained Earnings**:
   - Debit (or Credit) Income Summary for the balance in the account
     - Credit (or Debit) Retained Earnings

Example 1:

At July 31, account balances after adjustments for Maddux Cinema are as follows:

Accounts		Account Balances (After Adjustment)	
Cash		$6,000	
Concession Supplies		4000	
Theatre Equipment		50000	
Accumulated Deprecation - Theatre Equipment		12000	
Accounts Payable		5000	
Retained Earnings		20000	
Admission Ticket Revenues		60000	
Popcorn Revenues		37000	
Candy Revenues		19000	
Advertising Expense		12000	
Supplies Expense		19000	
Depreciation Expense		4000	
Film Rental Expense		16000	
Rent Expense		12000	
Salaries Expense		13000	
Utilities Expense		5000	

Closing Entries

31-Jul-23	DR. Admission Ticket Revenues	60000	
	DR. Popcorn Revenues	37000	
	DR. Candy Revenues	19000	
	CR. Income Summary		116000
31-Jul-23	DR. Income Summary	81000	
	CR. Advertising Expense		12000
	CR. Supplies Expense		19000
	CR. Depreciation Expense		4000
	CR. Film Rental Expense		16000
	CR. Rent Expense		12000
	CR. Salaries Expense		13000
	CR. Utilities Expense		5000
31-Jul-23	DR. Income Summary	35000	
	CR. Retained Earnings		35000

Example 2:

Record the closing entries. The following information is given:

Balance Sheet

SAKURA LTD.
Statement of Financial Position
As at December 31, 2020

Assets			
Current Assets			
Cash		$ 247,000	
Accounts receivable		485,000	
Total current assets		732,000	
Non-current Assets			
Note receivable		60,000	
Interest receivable		750	
Property, plant and equipment	500,000		
Less: Accumulated depreciation	156,250*	343,750	
Total Assets		$1,136,500	
Liabilities and Shareholders' Equity			
Current Liabilities			
Interest payable		$ 100	
Accounts payable		70,400	
Dividends payable		60,000	
Deferred rent revenue		2,000	(6,000 – 4,000)
Income taxes payable		74,700	
Note payable		30,000	
Total Current Liabilities		237,200	
Shareholders' Equity			
Contributed capital (100,000 shares)		620,000	
Retained earnings		279,300	($165,000 + $174,300 – $60,000)
Total Shareholders' Equity		899,300	
Total Liabilities and Shareholders' Equity		$1,136,500	

* ($140,625 + $15,625)

Income Statement

SAKURA LTD.
Statement of Earnings
For the Year Ended December 31, 2020

Sales revenue		$999,000	
Cost of sales		502,000	
Gross profit		497,000	
Operating expenses:			
Salaries expense		222,000	
Depreciation expense		15,625	
Other operating expenses		15,025	
Total operating expenses		252,650	
Earnings from operations		244,350	
Other income (expense):			
Rent revenue	4,000		
Interest revenue	750		
Interest expense	(100)	4,650	
Earnings before income taxes		249,000	
Income tax expense		74,700	($249,000 x 30%)
Net earnings		$174,300	
Earnings per share (EPS)		$1.74	($174,300/100,000)

Closing Entries

		Debit	Credit
1	**Sales revenue (-R)**	**999,000**	
	Rent revenue (-R)	**4,000**	
	Interest revenue (-R)	**750**	
	Income summary (+T)		**1,003,750**
	To close revenue accounts to income summary.		
2	**Income summary (-T)**	**829,450**	
	Cost of sales (-E)		**502,000**
	Salaries expense (-E)		**222,000**
	Depreciation expense (-E)		**15,625**
	Other operating expenses (-E)		**15,025**
	Interest expense (-E)		**100**
	Income tax expense (-E)		**74,700**
	To close expense accounts to income summary.		
3	**Retained earnings (-SE)**	**60,000**	
	Dividends declared (+SE)		**60,000**
	To close the dividends declared account to retained earnings.		
4	**Income summary (-T)**	**174,300** **(amount equal to net earnings)**	
	Retained earnings (+SE)		**174,300**
	To close the income summary account to retained earnings.		