

Chapter 6 • Closing Entries and the Postclosing Trial Balance

TEACHING OBJECTIVES

- 6-1) Journalize and post closing entries.
- 6-2) Prepare a postclosing trial balance.
- 6-3) Interpret financial statements.
- 6-4) Review the steps in the accounting cycle.
- 6-5) Define the accounting terms new to this chapter.

SECTIONS

- 1. Closing Entries
- 2. Using Accounting Information

CHAPTER OVERVIEW/ LEARNING OBJECTIVES

Learning Link: Chapter 5 introduced and showed how to use the worksheet. It also covered the preparation of adjusting entries and financial statements. Chapter 6 completes the accounting cycle by showing how the books are closed before a new financial period is begun.

- 6-1. This chapter discusses the closing process—the seventh step in the accounting cycle. The worksheet provides the data necessary for the closing entries. A temporary owner's equity account, Income Summary, is used during the process whereby the temporary revenue and expense accounts are closed to a \$0 balance. The owner's withdrawal account is also closed.

After the closing entries have been posted, the capital account reflects the results of operations for the period.

There are four steps in the *closing process*:

- a. The balance of the revenue account is transferred to Income Summary.
 - b. The balances in the expense accounts are transferred to Income Summary.
 - c. The balance in the Income Summary account is transferred to the Owner's Capital account.
 - d. The balance in the Owner's Withdrawal account is transferred to the Owner's Capital account.
- 6-2. The chapter explains how to prepare the post-closing trial balance. This is the eighth step in the accounting cycle. A post-closing trial balance is prepared to test the equality of total debit and credit balance in the general ledger. The report only lists permanent accounts.

- 6-3. The chapter discusses the ninth step in the accounting cycle--interpreting the financial statements.
- 6-4. The chapter reviews the steps in the accounting cycle. It reminds students that the accounting cycle consists of a series of steps that are repeated in each fiscal period.

The **steps in a Complete Accounting Cycle:**

- Step 1. Analyze transactions.
- Step 2. Journalize the data about the transactions
- Step 3. Post data about transactions.
- Step 4. Prepare a worksheet.
- Step 5. Prepare financial statements.
- Step 6. Record adjusting entries.
- Step 7. Record closing entries.
- Step 8. Prepare a post-closing trial balance.
- Step 9. Interpret the financial information.

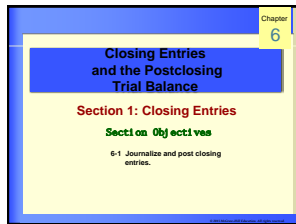
At the beginning of the chapter, there is a short paragraph about the *Carnival Corporation*. . . Let's read this together. . .



Ask. . . “How do Carnival Corporations’ executives and managers use financial statements to evaluate financial performance? How might these evaluations affect business policies or strategies?”

Answer-- Students’ should recognize that financial statements can be used to evaluate net profit or loss, return on investments, expense trends, or growth in company net assets. The income statement is used to measure net income or loss, while the balance sheet can be used to measure growth in assets or liabilities. Executives and managers would use financial statements to make decisions about expanding business, investing in new ventures, or hiring new employees.

- **FAST FACTS:** Carnival was a pioneer in the concept of cheaper and shorter cruises. Its ships are known for their Las Vegas-style decor and entertainment. The line calls its ships The Fun Ships. Its trademark is the smoke stack, or funnel, which is red, white and blue and shaped like a whale’s tail.
- Of the 3 million passengers Carnival serves annually, approximately 1,000,000 are seniors and 500,000 are children. Carnival has become the most popular cruise line in the world.
- Carnival became a publicly traded company in 1987 and generated over 15.4 Billion in revenue in 2012 and realized total net income of over 1.3 Billion.

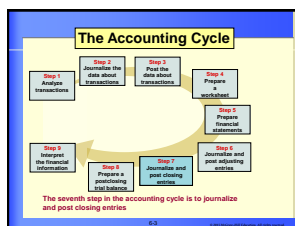


Section 1. CLOSING ENTRIES



Ask, "If you started a business today, and you ran the business until the age of 70, when would you determine if the business was profitable?"

- Point out that owners/managers need to know if the business is profitable on a **timely** basis—(more than one income statement needs to be prepared over the life of the business).
- Point out that net income is measured each accounting period--usually monthly.
- Explain that to measure income, the business must begin each month with the revenue and expense accounts at zero. The resetting of temporary accounts to zero is what is done when the closing process takes place.



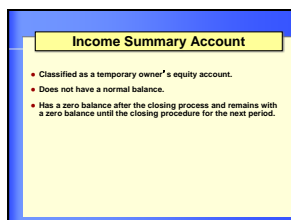
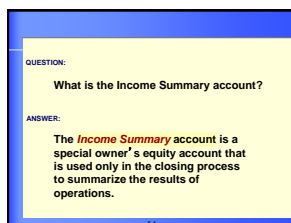
Objective 6-1

A. The Closing Process

Explain that the closing process does two things:

1. It transfers net income/net loss to the owner's capital account.
 2. It reduces revenue, expense and drawing account balances to \$0 so that a business can start "fresh".
- Point out that closing entries can be compared to keeping the records of a sports team.

- Explain that individual and team scores are kept and tallied at the end of a game. But each new game begins with a score of zero.
- In a similar fashion, although entries are recorded in the accounts during the accounting period, the accounts begin each new accounting period with a zero balance.
- To help students understand why closing entries are important, explain that closing the books gives the business owner important financial information.
- The owner can calculate the income of the business for the current period and can compare the income for the current period to that of the prior period.
- Point out that such information helps the business owner make decisions about the business and its operations.



◆ The Income Summary Account

- Point out that the *Income Summary* account is a special owner's equity account that is used ONLY during the closing process.
- Because it only has a balance during the closing process, it is a *temporary* account.

◆ Steps in the Closing Process

- Point out that there are four steps in the closing process:

Step 1: Close Revenue

GENERAL JOURNAL					PAGE 4
DATE	DESCRIPTION	POST. REF.	DEBIT	CREDIT	
2018 Dec. 31	Closing Entries Fee Income Income Summary		47,000.00	47,000.00	

The words "Closing Entries" are written in the Description column of the general journal

Step 2: Close Expenses

- The Income Statement section of the worksheet for Wells' Consulting Services lists five expense accounts.
- Since expense accounts have debit balances, enter a credit in each account to reduce its balance to zero.
- This closing entry transfers total expenses to the Income Summary account.

Step 2: Close Expenses

- The five expense account balances are reduced to zero.
- The total, \$13,333 of expenses are transferred to the temporary owner's equity account, Income Summary.

Income Summary		Salaries Expense	
Closing 13,333	Bal 47,000	Balance 8,000	Closing 8,000
Utilities Expense		Supplies Expense	
Balance 650	Closing 650	Balance 500	Closing 500
Rent Expense		Depr. Expense - Equip.	
Balance 4,000	Closing 4,000	Balance 183	Closing 183

Step 2: Close Expenses

GENERAL JOURNAL					PAGE 4
DATE	DESCRIPTION	POST. REF.	DEBIT	CREDIT	
2016 Dec. 31	Closing Entries Income Summary Salaries Expense Utilities Expense Supplies Expense Rent Expense Depreciation Exp.-Equip.		13,333.00	8,000.00 650.00 500.00 4,000.00 183.00	

The Income Summary account reflects all entries in the Income Statement section of the worksheet.

Income Summary	
Dr.	Cr.
Closing 13,333	Closing 47,000
	Balance 33,667
	Net Income

- Explain the first closing entry that is needed by first illustrating it on the board in the T-accounts you have drawn.

- Review the necessary closing journal entry as shown in the text.

- Point out that "Closing Entries" has been written in the *Description* column of the general journal on the line above the first closing entry.

◆ Step 2: Transfer Expense Account Balances - Close Expenses

- Teaching TIP--Draw several of the chapter's expense accounts beside the closed-revenue account and the Income Summary T-accounts on the board. Write in their balances as shown on the Income Statement.

- Explain the second closing entry that is needed by first demonstrating it on the board in the T-accounts you have drawn.

- Review the necessary 2nd closing journal entry as shown in the text.

◆ Step 3: Transfer Net Income or Net Loss to Owner's Equity

- Teaching TIP--Draw the owner's capital T-account on the board next to the Income Summary T-account already on the board. Next to the credit side \$ amount, write "revenues."

Step 3: Close Net Income to Capital

- The journal entry to transfer net income to owner's equity is a debit to Income Summary, and a credit to Carolyn Wells, Capital.
- The *Income Summary* account is reduced to zero.
- The net income amount, \$33,667, is transferred to the owner's capital account. Carolyn Wells, *Capital* is increased by \$33,667.

Next to the debit side \$ amount, write "expenses."



Ask, "What needs to be done to the *Income Summary* account to close the balance to \$0?" **Debit it for the difference.**



Ask, "What does that number represent?" **Net income.**

Step 3: Close Net Income to Capital

Income Summary		Carolyn Wells, Capital	
	Balance 33,667		Balance 100,000
Closing 33,667			Closing 33,667

Step 3: Close Net Income to Capital

GENERAL JOURNAL				PAGE 4
DATE	DESCRIPTION	POST. REF.	DEBIT	CREDIT
Dec. 31	Closing Entries			
	Income Summary		33,667.00	
	Carolyn Wells, Capital			33,667.00

Step 4: Close Drawing to Capital

- Withdrawals appear in the statement of owner's equity as a deduction from capital.
- The drawing account is closed directly to the capital account.
- The drawing account balance is reduced to zero.
- The balance of the drawing account, \$5,000, is transferred to the owner's capital account.

◆ **Step 4: Transfer the Drawing Account Balance to Capital**

- Explain that the *Drawing* account is the last temporary account that needs to be closed.
- Remind students that the owner's drawing account reduces owner's equity and that the owner will probably want to know

Step 4: Close Drawing to Capital

Carolyn Wells, Capital		Carolyn Wells, Drawing	
	Balance 133,667	Balance 5,000	
Closing 5,000			Closing 5,000

Step 4: Close Drawing to Capital				
GENERAL JOURNAL PAGE 4				
DATE	DESCRIPTION	POST. REF.	DEBIT	CREDIT
Dec. 31	Closing Entries Carolyn Wells, Capital		5,000.00	
	Carolyn Wells, Drawing			5,000.00

The new balance of the Carolyn Wells, Capital account agrees with the amount listed on the balance sheet.				
Carolyn Wells, Drawing		Carolyn Wells, Capital		
Dr.	Cr.	Dr.	Cr.	
Balance 5,000			Balance 100,000	
	Closing 5,000		Net Inc. 33,667	
Balance 0		Drawing 5,000		Balance 128,667

Summary of Closing Entries				
GENERAL JOURNAL PAGE 4				
STEPS	DATE	DESCRIPTION	POST. REF.	DEBIT CREDIT
1. Close Revenue Account	Dec. 31	Revenue	401	47,000.00
		Income Summary	309	47,000.00
2. Close Expense Accounts	31	Income Summary	309	13,333.00
		Salaries Expense	511	8,000.00
		Utilities Expense	514	600.00
		Supplies Expense	517	500.00
		Rent Expense	520	4,000.00
		Depn. Expense-Equip.	523	183.00
3. Close Income Summary	31	Income Summary	309	33,667.00
		Carolyn Wells, Capital	301	33,667.00
4. Close Drawing Account	31	Carolyn Wells, Capital	301	5,000.00
		Carolyn Wells, Draw.	302	5,000.00

Posting the Closing Entries				
All journal entries are posted to the general ledger accounts.				
<ul style="list-style-type: none"> "Closing" is entered in the Description column of the ledger accounts. The ending balances of the drawing, revenue, and expense accounts are zero. 				

GENERAL JOURNAL PAGE 4				
STEPS	DATE	DESCRIPTION	POST. REF.	DEBIT CREDIT
1. CLOSE REVENUE	2016 Dec. 31	Closing Entries Fees Income Income Summary	401	47,000.00
			309	47,000.00
ACCOUNT Fees Income ACCOUNT NO. 401				
DATE	DESCRIPTION	POST. REF.	DEBIT	CREDIT BALANCE
2016 Dec. 31		J2		36,000.00
Dec. 31		J2		11,000.00
Dec. 31	Closing	J4	47,000.00	

Closing Entries and the Postclosing Trial Balance				
Section 2: Using Accounting Information				
6-2. Prepare a postclosing trial balance. 6-3. Interpret financial statements. 6-4. Review the steps in the accounting cycle.				

GENERAL JOURNAL PAGE 4				
STEPS	DATE	DESCRIPTION	POST. REF.	DEBIT CREDIT
1. CLOSE REVENUE	2016 Dec. 31	Closing Entries Fees Income Income Summary	401	47,000.00
			309	47,000.00
ACCOUNT Income Summary ACCOUNT NO. 309				
DATE	DESCRIPTION	POST. REF.	DEBIT	CREDIT BALANCE
2016 Dec. 31	Closing	J4	47,000.00	

how much he or she has withdrawn in a particular period.

- To measure the amount that owner withdraws each period, each new accounting period must begin with a zero balance in the account.
- Teaching TIP**--Draw the owner's *Drawing* T-account on the board next to the owner's *Capital* T-account already on the board.
- Explain the fourth closing entry that is needed by first demonstrating it on the board in the T-accounts you have drawn.
- Review the necessary 4th closing journal entry as shown in the text.
- Review the steps in the closing process.
- Remind students that the *Income Summary* account is used only during the closing process.
- Review the posted closing entries in the general ledger depicted in the text.

Section 2. USING ACCOUNTING INFORMATION

- In this section, we will complete the accounting cycle for a business.

The Accounting Cycle

Objective 6-2 Prepare a postclosing Trial Balance.

QUESTION:
What is the postclosing trial balance?

ANSWER:
A postclosing trial balance is a report that is prepared to prove the equality of total debits and credits after the closing process is completed. It verifies that revenue, expense, and drawing accounts have zero balances.

ACCOUNT NAME	DEBIT	CREDIT
Cash	111,350.00	
Accounts Receivable	5,000.00	
Supplies	1,000.00	
Prepaid Rent	4,000.00	
Equipment	11,000.00	
Accumulated Depreciation—Equipment		183.00
Accounts Payable		3,500.00
Caroline Wells, Capital		122,687.00
Totals	132,350.00	132,350.00

Objective 6-2

A. Preparing the Postclosing Trial Balance

- Point out that the eighth step in the accounting cycle is to prepare the postclosing trial balance.
- Explain that the post-closing trial balance is used to verify that accounts are still in balance after the closing process.
- Remind students that the post-closing trial balance only lists permanent accounts. (This means that the post-closing trial balance should ONLY contain assets, liabilities, and the capital account.)
- Review the process of preparing a trial balance.

◆ Finding and Correcting Errors



Ask, "If the post-closing trial balance does not balance, what does that mean?"
Something is wrong!

- Explain that if an error goes uncorrected from one period to the next, it is much more difficult to correct.

Finding and Correcting Errors

If the postclosing trial balance does not balance, the accounting records contain errors.

Use the audit trail to trace data through the accounting records.




Ask, "Where would you go to locate an error?"

- √ You could compare the balances of the asset and liability accounts to the Trial Balance columns of the worksheet.
- √ You could verify that the capital account balance is the amount shown on the *Statement of Owner's Equity*.
- √ You could confirm that drawing, revenue, and expense accounts have zero balances.

Objective 6-3

Interpret financial statements.



Wells' Consulting Services
Partial Balance Sheet
December 31, 2016

Assets	
Cash	\$111,350.00
Accounts Receivable	7,000.00
Supplies	2,000.00
Prepaid Rent	4,000.00
Equipment	\$11,000.00
Less Accumulated Depreciation	183.00
Total Assets	\$135,167.00

What is the cash balance?

How much do the customers owe the business?

Wells' Consulting Services
Balance Sheet
December 31, 2016

Assets		Liabilities and Owner's Equity	
Cash	\$111,350.00	Accounts Payable	\$13,500.00
Accounts Receivable	7,000.00	Owner's Equity	121,667.00
Supplies	2,000.00	Less: Withdrawals	(10,000.00)
Prepaid Rent	4,000.00	Total Liabilities and Owner's Equity	\$135,167.00
Equipment	\$11,000.00		
Less Accumulated Depreciation	183.00		
Total Assets	\$135,167.00		

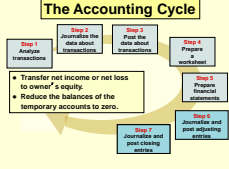
How much does the business owe its suppliers?

Wells' Consulting Services
Income Statement
Month Ended December 31, 2016

Revenue		
Fees Income		47,000.00
Expenses		
Salaries Expense	8,000.00	
Utilities Expense	650.00	
Supplies Expense	500.00	
Rent Expense	4,000.00	
Depreciation Expense—Equipment	183.00	
Total Expenses		13,333.00
Net Income		\$33,667.00

What is the profit?

The Accounting Cycle



Step 1: Analyze transactions
Step 2: Journalize the data about transactions
Step 3: Post the data about transactions
Step 4: Prepare worksheet
Step 5: Prepare financial statements
Step 6: Journalize and post adjusting entries
Step 7: Journalize and post closing entries
Step 8: Prepare final financial statements

• Transfer net income or net loss to owner's equity.
• Reduce the balances of the temporary accounts to zero.

Objective 6-3

B. Interpreting the Financial Statements

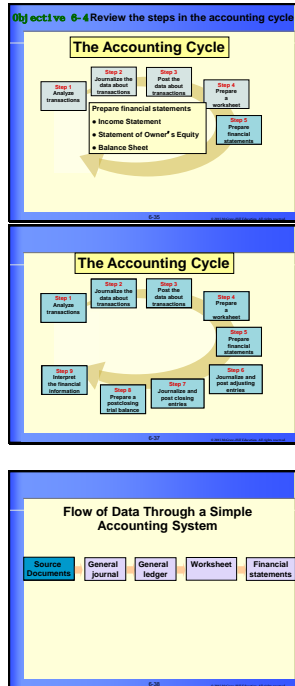
- The ninth and last step in the accounting cycle is interpreting the financial statements.
- By examining the financial statements for the period, the business owner can make better management decisions—he or she can better determine what effect a change will have on the financial position of the business.
- Information on the financial statements provides information regarding:
 - i. How much the business owes suppliers?
 - ii. How much customers owe the business?
 - iii. How profitable the business was during the last accounting period?

Managerial Implications



Ask, "If you owned or managed a business, how often would you want financial statements prepared? Why?"

Answers will vary but could include monthly or quarterly. Students should want financial statements prepared frequently so that trends can be observed and timely decisions made before the business is negatively impacted.



Objective 6-4

C. The Accounting Cycle

- Review the definition of the word "cycle." (a series of events or operations that recur regularly and usually lead back to the starting point.)
- Write the accounting cycle steps, 1-9 on the board but leave a few of the steps blank. Then. . .



Ask, "Can anyone figure out any of the missing steps?"

- Review the accounting cycle steps written on the board (also listed at the end of the chapter).

TEACHING TIP: Tell the students that they will be getting a short pop quiz over the accounting cycle steps. But they don't have to remember the steps by themselves, instead they must **create a mnemonic** to help them remember the nine steps. Students could also work in pairs or teams to complete the quiz. Give them about 10 minutes to complete the mnemonic and then, have them write it, as well as the 9 steps, on a piece of paper. (If they get all 9 steps correct, you may offer some extra credit.)