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. . .

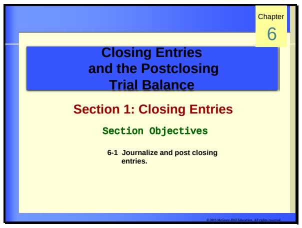
Ask. . . "How do Carnival Corporations' executives and managers use financial statements to evaluate financial performance? How might these evaluations affect business policies or strategies?"

<u>Answer</u>-- 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.

- <u>FAST FACTS:</u> 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.

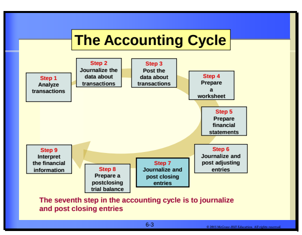
POWER POINT	Section	Topics/ Discussion

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 <u>timely</u> 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.



<u>Objective 6-1</u>

A. The Closing Process

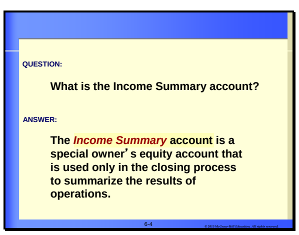
Explain that the <u>closing process does two things:</u>

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.

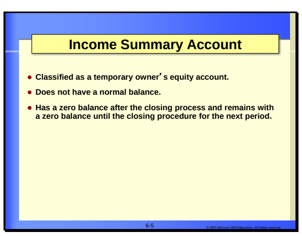
POWER POINT	Section	Topics/ Discussion

- 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.



♦ **<u>The Income Summary Account</u>**

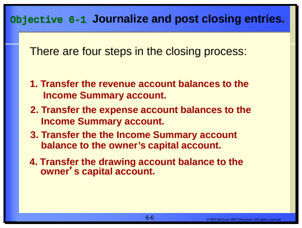
- Point out that the *Income Summary* account is a special owner's equity account that is used ONLY during the closing process.
- Because it only has a balance during the closing process, it is a *temporary* account.



♦ **<u>Steps in the Closing Process</u>**

- Point out that there are <u>four steps</u> in the closing process:

POWER POINT	Section	Topics/ Discussion

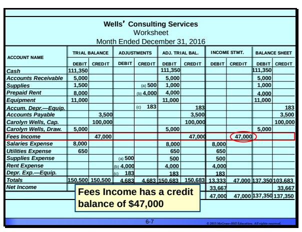


Step 1-Transfer (close) the balances of the revenue accounts to the Income Summary account.

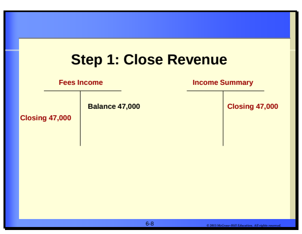
Step 2-Transfer (close) the balances of the expense accounts to the Income Summary account.

Step 3-Transfer (close) the balance in the Income Summary account to the owner's capital account.

Step 4-Transfer (close) the balance in the owner's drawing account to the owner's capital account.



- ♦ **<u>Step 1: Transfer Revenue Account Balances - Close Revenues</u>**
  - Review the worksheet at the beginning of the chapter for the business.
  - Focus on the Income Statement columns.

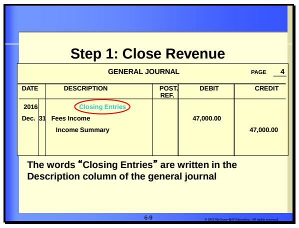


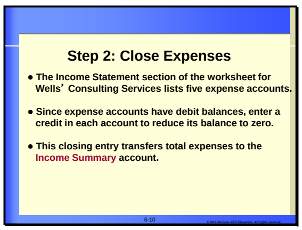
Ask, "Why don't the income statement columns balance?" Because revenues are greater than expenses, the business reported a *net income* for the period.

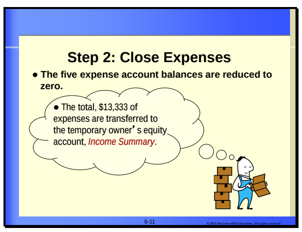
- Remind students that they are going to be transferring this net income figure to the capital account during the closing process.

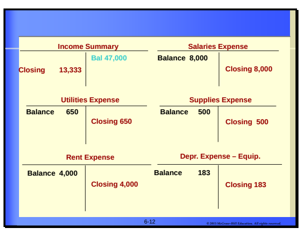
- <u>Teaching TIP</u>--Draw both the Fees Income account and the Income Summary T-accounts on the board. Write in their balances as shown on the Income Statement.

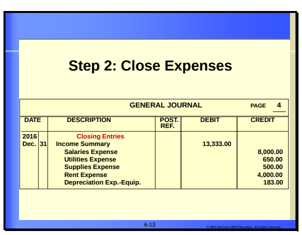
POWER POINT	Section	Topics/ Discussion

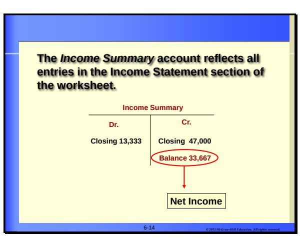












- Explain the first closing entry that is needed by first illustrating it on the board in the T-accounts you have drawn.
- Review the necessary closing journal entry as shown in the text.
- Point out that "*Closing Entries*" has been written in the *Description* column of the general journal on the line above the first closing entry.

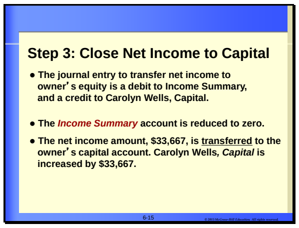
♦ **Step 2: Transfer Expense Account Balances - Close Expenses**

- 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**

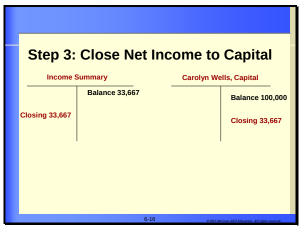
- Teaching TIP--Draw the owner's capital T-account on the board next to the Income Summary T-account already on the board. Next to the credit side $ amount, write "revenues."

POWER POINT	Section	Topics/ Discussion



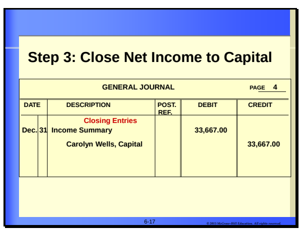
Next to the debit side $ amount, write "expenses."

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

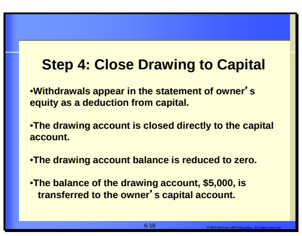


Ask, "What does that number represent?" **Net income.**

- Explain the third closing entry that is needed by first demonstrating it on the board in the T-accounts you have drawn—(Capital account and Income summary)

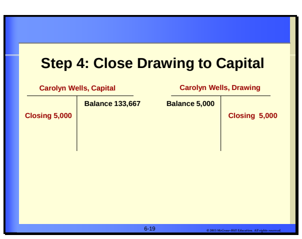


- Review the necessary 3rd closing journal entry as shown in the text.
- Remind students that net income causes the owner's capital account on the *Statement of Owner's Equity* to go up. By transferring the net income from the *Income Summary* account to the *Owner's Capital* account, we have caused it to go up.

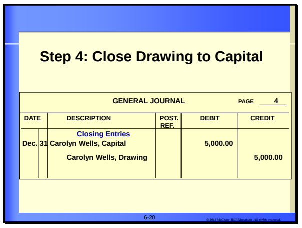


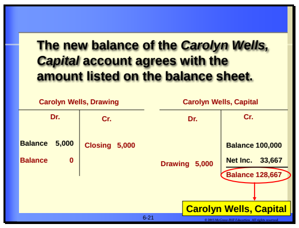
♦ **<u>Step 4: Transfer the Drawing Account Balance to Capital</u>**

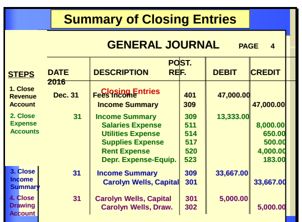
- Explain that the *Drawing* account is the last temporary account that needs to be closed.

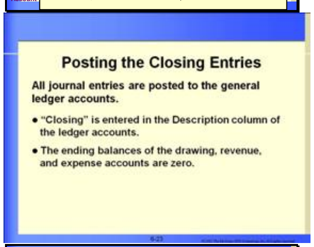


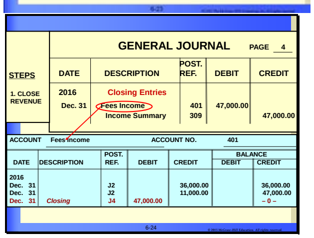
- Remind students that the owner's drawing account reduces owner's equity and that the owner will probably want to know

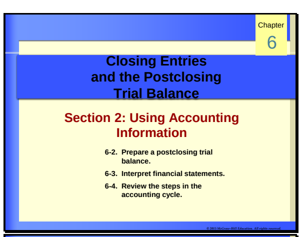


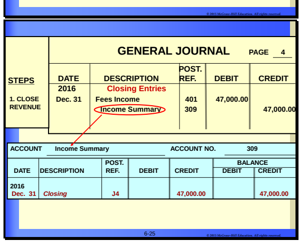










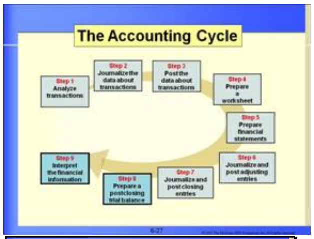


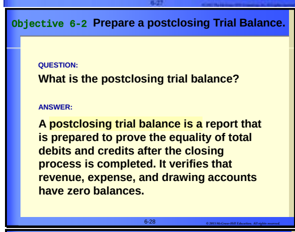
how much he or she has withdrawn in a particular period.

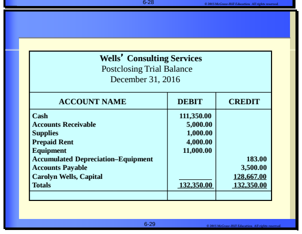
- To measure the amount that owner withdraws each period, each new accounting period must begin with a zero balance in the account.
- Teaching TIP--Draw the owner's *Drawing* T-account on the board next to the owner's *Capital* T-account already on the board.
- Explain the fourth closing entry that is 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.






Wells' Consulting Services
Postclosing Trial Balance
December 31, 2016

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
Carolyn Wells, Capital		128,667.00
Totals	132,350.00	132,350.00

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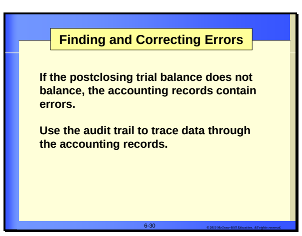
Objective 6-2

A. Preparing the Postclosing Trial Balance

- Point out that the eighth step in the accounting cycle is to prepare the post-closing 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**



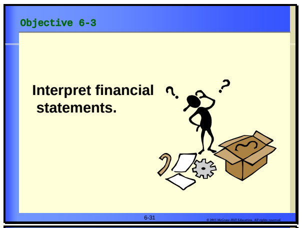
Ask, "If the post-closing trial balance does not balance, what does that mean?" Something is wrong!

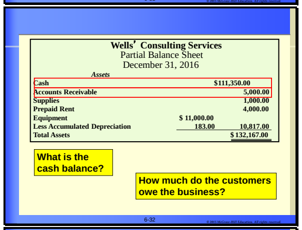
- Explain that if an error goes uncorrected from one period to the next, it is much more difficult to correct.

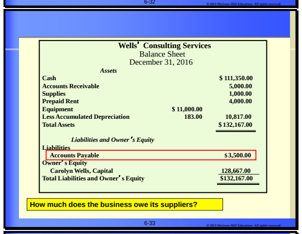
Ask, “Where would you go to locate an error?”

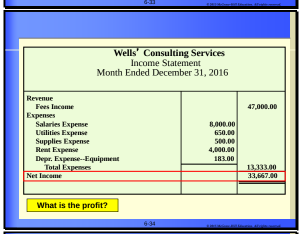
- √ You could compare the balances of the asset and liability accounts to the Trial Balance columns of the worksheet.
- √ You could verify that the capital account balance is the amount shown on the *Statement of Owner’s Equity.*
- √ You could confirm that drawing, revenue, and expense accounts have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

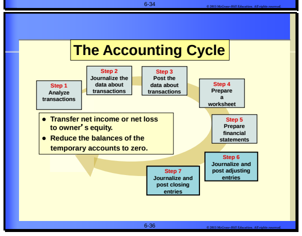
POWER POINT	Section	Topics/ Discussion











Objective 6-3

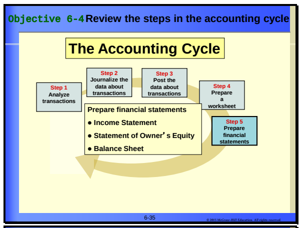
B. Interpreting the Financial Statements

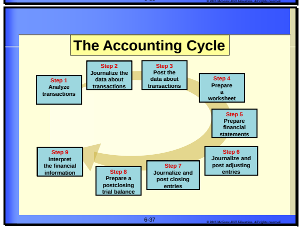
- The ninth and last step in the accounting cycle is interpreting the financial statements.
- By examining the financial statements for the period, the business owner can make better management decisions—he or she can better determine what effect a change will have on the financial position of the business.
- 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?

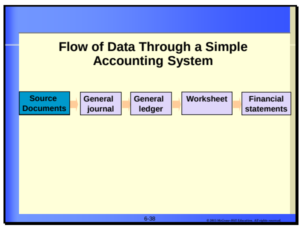
Managerial Implications


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.

POWER POINT	Section	Topics/ Discussion







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.)