

**ACCT 100 - Introduction to Accounting**  
**Chapter 6 - Closing Entries and the Post Closing Trial Balance**  
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Purpose: The purpose of this handout is to summarize key concepts of Chapter 6. This represents the last few steps of the accounting cycle.

**Where we have been:**

Remember, we are learning the components of an **accounting cycle**. So far we have performed the following sequence of steps:

- Analyze transactions (we used t-accounts to learn debits and credits - Chapters 2 and 3)
- Journalize transactions in the journal
- Post transactions to the ledger
- Prepare a trial balance
- Gather adjustment information and complete a worksheet
- Prepare financial statements
- Journalize and post adjusting entries from the worksheet

**What we still need to learn in this chapter:**

- Journalize and post closing entries
- Prepare a post closing trial balance

**Why do we need closing entries**

1. To clear out specific accounts -- To close out the account balances of nominal accounts (see definition below) so that we can start the new year with zero balances
2. To update the owner's capital account, so that the ending capital balance matches what we have shown on the Statement of Owner's Equity

**What accounts need to be closed out?**

Nominal accounts need to be closed. (Nominal accounts are those that need to start with zero balances each year. ) Another common term for these accounts is “temporary accounts.” The nominal accounts that need to be closed are:

- All Revenues
- All Expenses
- An account called income summary (see below)
- And the Drawing account

Permanent accounts are never closed. Permanent accounts are those that keep continuous balances in them, even when the new year starts. All Asset Liability and equity accounts, except drawing, are permanent accounts and never get closed out. (Note: Capital NEVER gets closed unless a company dissolves. Read that again! Things get closed out to capital, but the capital account itself is NOT CLOSED.)

### How do you do it?

## **In a nutshell, closing is a game of opposites**

First, the order of the steps is important. Once you remember which accounts need to be closed out, you will fare much better. You should perform the following steps in this order for each and every close:

- Close Out Revenues
- Close Out Expenses
- Close Out the dummy account, Income Summary
- Close Out the drawing

### **The first two entries: Closing out Revenues and Expenses**

We will close out the revenues by getting rid of the current balances. In other words, revenues have credit balances, so we will debit them to wipe them out. The offsetting entry will go to Income Summary. Income Summary is a dummy account that is used only to temporarily hold balances. It goes away after the closing process, so you should never see it appear on any financial statement.

We will close out expenses by getting rid of their current balances. Expenses all have debit balances so we will credit them to wipe the balances out. The offsetting entry will go to income summary.

**The third closing entry: Closing out the Income Summary: BEWARE!!!**

As stated previously, the income summary account is a dummy account. Now that it has served its purpose, we will get rid of it. After the first two entries, Income Summary looks like this:

| <u>Income Summary</u> |               |
|-----------------------|---------------|
| <u>Debit</u>          | <u>Credit</u> |
| Expenses              | Revenues      |
| Closed                | Closed        |

**A word of advice:** Draw yourself a t-account before proceeding with this entry. This entry will change depending on whether the company has a net income or loss:

If the above yields a credit balance, that means that the revenues are greater than the expenses and you have a net income. To get rid of it, or to wipe it out, you need to do the opposite or you need to debit the income summary.

If the above yields a debit balance, that means that the expenses are greater than the revenues and you have a net loss. To get rid of it, you need to credit the income summary account. In either case, the offset goes to the capital account.

If you make a t-account, you will visually see this and your journal entry will go smoothly. (If you don't, you are likely to get confused on which way the entry goes.)

This journal entry, in effect, transfers the amount of the net income (or loss) to the owner's capital account

### **The Last Journal Entry: Get rid of the drawing**

The drawing account always has a debit balance. To wipe it out, we need to credit the account. Since income summary is closed out now, we can't use it. Put the offset to the owner's capital account. This will reduce it.

### **Posting the Closing Entries**

The posting process works exactly the same, except that you need to write in "closing" in the item column of the ledger. After the entries are posted, the balance in all nominal accounts should be zero!

### **After the closing entries**

Well, once again debits and credits have been flying around. We need to make sure our balancing act is intact. Therefore, just as before, we will prepare a trial balance to insure the equality of the debits and credits. The only difference now is that when you go through the ledger to pick up any balances, the only accounts that should have them are the permanent accounts that have not been closed out. Therefore the post closing trial balance, which means after closing, should only contain asset, liabilities, and the capital account. If there are any other types of balances (ie revenues and expenses, or drawing), then there is an error.

### **Did we accomplish our Goals?**

Yes. All nominal accounts now have zero balances, and the capital account has been updated to reflect the changes from the net income (or loss) and the drawing account. In addition, now the ending capital balance in the ledger matches the ending capital on the statement of owner's equity.

### **Ta-Da - You Did It!**

Congratulations! You have learned the complete accounting cycle . You are now ready to start the cycle review problem on QuickBooks. This mini-case is located at the end of Chapter 6.

