

SUBJECT- FINANCIAL ACCOUNTINGPREPARATION OF FINANCIAL STATEMENTS- CLOSING ENTRIES-I

Balance-sheet accounts accumulate transaction data over the entire life of the business. The account balances are carried from year to year such that 1 year's ending balance becomes the next year's beginning balance.

Income statement accounts, on the other hand, accumulate transaction data for a set period of time - one accounting period (which is usually 1 year). At the end of each accounting period, income statement accounts are closed. This means their balances are removed and reset to zero. Hence, the balances in the revenue and expense accounts at the beginning of each accounting period are always zero. This is necessary so, that net income can be measured for each accounting period.

The closing process consists of four entries:

1. An entry to close the revenue account and transfer its balance to the income summary account (ISA). The ISA is a special temporary account used to make year-end adjusting and closing entries.
2. An entry to close each of the expense accounts and transfer their balances to the ISA.
3. An entry to close the ISA and transfer its balance to the owner's equity account - either capital (for a sole proprietorship) or

on retained earnings (for a corporation).

4. An entry to close the owner withdrawal account (of a sole proprietorship) on the dividends paid account (of a corporation) and transfer the balance to the capital account.

Closing entries are dated as of the last day of the accounting period. They are journalized and then posted to the ledger. Closing entries are made after all other entries have been recorded. The closing process has two effects:

1. It transfers net income (or net loss) to the capital account. Before it is closed, the ISA contains revenue on the credit side and expenses on the debit side. Hence, a credit balance indicates net income and a debit balance indicates net loss.
2. It establishes zero balances in each of the income statement accounts so they are ready for use in the next accounting period.

Example Problem: PD Consulting Service Continued

Figure 3-9 shows the year-end ledger accounts for PD Consulting Service before closing. The balance in each account and the account name are listed to prepare the trial balance shown in Figure 3-10. The trial balance is then used to prepare the financial statements shown in Figures 3-11 through 3-13.

PD Consulting Service
Ledger of Accounts

Cash	
950	

P. Dill Capital	
	1,000

Rent Expense	
1,200	

Accounts Receivable	
1,100	

P. Dill. Withdrawals	
500	

Phone Expense	
900	

Accounts Payable	
	500

Consulting Revenue	
	14,500

Salary Expense	
12,000	

year-end ledger of accounts for PD Consulting Service before closing entries are posted.

PD Consulting Service
 Trial Balance
 May 31, 2021

Account Name	Debit	Credit
Cash	950	-
Accounts receivables	1,100	-
Accounts payable	-	550
P. DILL, Capital	-	1,000
P. DILL, withdrawal	500	-
Consulting revenue	-	14,500
Rent expense	1,200	-
Phone expense	300	-
Salary expense	12,000	-
Totals	16,050/-	16,050/-

PD Consulting Service
 Income Statement
 Year ended May, 31, 2021

Consulting revenue		14,500
Expenses		
↳ Rent	1,200	
↳ Phone	300	
↳ Salary	12,000	
Total		13,500
Net income		1,000