

19. The Accounting Cycle and Closing Process

Reflecting on the accounting processes thus far described reveals the following typical steps:

- transactions are recorded in the journal
- journal entries are posted to appropriate ledger accounts
- a trial balance is constructed
- adjusting entries are prepared and posted
- an adjusted trial balance is prepared
- formal financial statements are produced (perhaps with the assistance of a worksheet)

It appears that we have completed the accounting cycle -- capturing transaction and event data and moving it through an orderly process that results in the production of useful financial statements. And, importantly, we are left with substantial records that document each transaction (the journal) and each account's activity (the ledger). It is no wonder that the basic elements of this accounting methodology have endured for hundreds of years.

19.1 The Closing Process

There remains one final step. It is known as the closing process. The purpose of the closing process is two-fold:

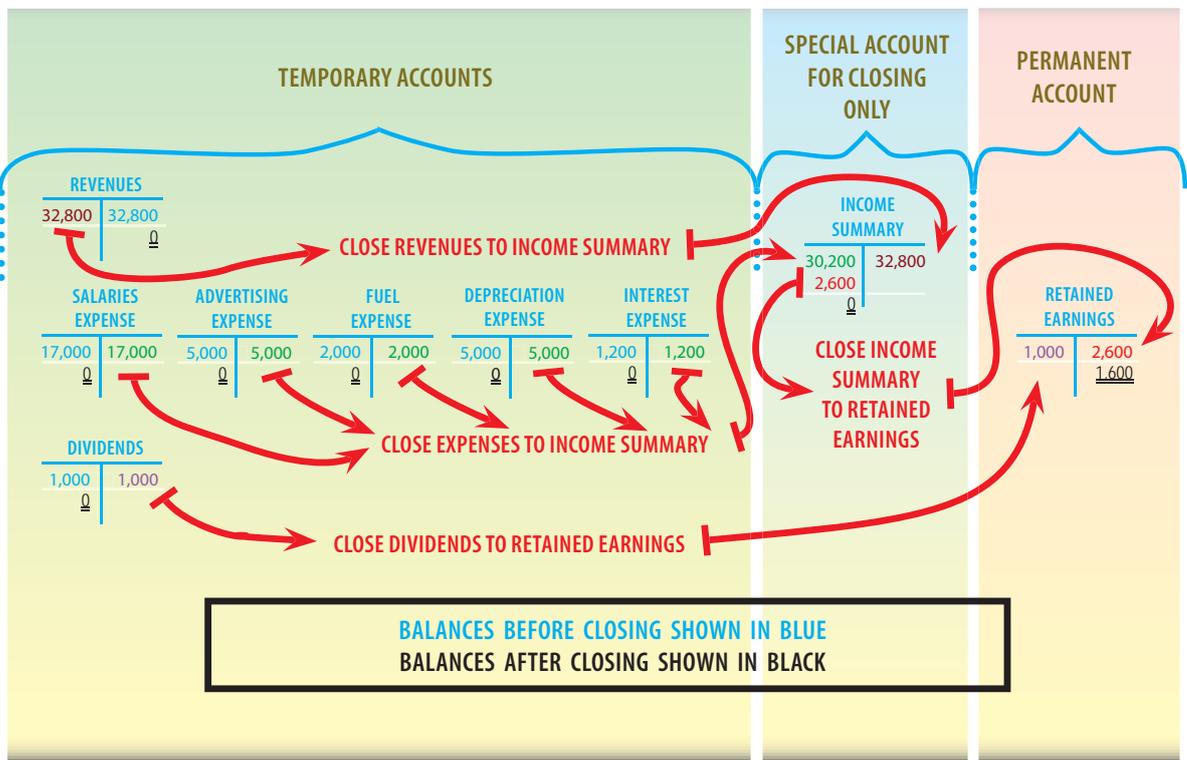
1. Closing is a mechanism to update the retained earnings account in the ledger to equal the end-of-period balance. Keep in mind the recording of each item of revenue, expense, or dividend does not automatically produce an updating debit or credit to retained earnings. As such, the beginning-of-period retained earnings amount remains in the ledger until the closing process "updates" the retained earnings account for the impact of the period's operations.
2. Revenue, expense, and dividend accounts represent amounts for a period of time; one must "zero out" these accounts at the end of each period (as a result, revenue, expense, and dividend accounts are called temporary or nominal accounts). In essence, by zeroing out these accounts, one has reset them to begin the next accounting period. In contrast, asset, liability, and equity accounts are called real accounts, as their balances are carried forward from period to period. For example, one does not "start over" each period accumulating assets like cash and so on -- their balances carry forward.

Closing involves a four step process: (a) close revenue accounts (to a unique account called Income Summary -- a non-financial statement account used only to facilitate the closing process), (b) close expense accounts to Income Summary, (c) close the Income Summary account to Retained Earnings, and (d) close the Dividend account to Retained Earnings. By doing this, all revenues and expenses are "corralled" in Income Summary (the net of which represents the income or loss for the period). In turn, the income or loss is then swept to Retained Earnings along with the dividends. Recall that beginning retained earnings, plus income, less dividends, equals ending retained earnings; likewise, the closing process updates the beginning retained earnings to move forward to the end-of-period balance.

Below are the closing entries for England Tours. You may find it helpful to compare the accounts and amounts below to those that appeared in the previous adjusted trial balance:

12-31-X3	Revenues	32,800	
	Income Summary		32,800
	<i>To close revenues to Income Summary</i>		
12-31-X3	Income Summary	30,200	
	Salaries Expense		17,000
	Advertising Expense		5,000
	Fuel Expense		2,000
	Depreciation Expense		5,000
	Interest Expense		1,200
	<i>To close expenses to Income Summary</i>		
12-31-X3	Income Summary	2,600	
	Retained Earnings		2,600
	<i>To close Income Summary to retained earnings (balance equals net income)</i>		
12-31-X3	Retained Earnings	1,000	
	Dividends		1,000
	<i>To close dividends</i>		

Be certain to note the effect of the above entries is to (1) update the retained earnings account and (2) cause a zero balance to occur in the temporary (revenue, expense, and dividends) accounts. The Income Summary account is also left “zeroed” out (\$32,800 (cr.) = \$30,200 (dr.) + \$2,600 (dr.)). The following T-accounts reveal the effects of the closing entries on the various accounts:



19.2 Post Closing Trial Balance

The post-closing trial balance reveals the balance of accounts after the closing process, and consists of balance sheet accounts only. The post-closing trial balance is a tool to demonstrate that accounts are in balance; it is not a formal financial statement. All of the revenue, expense, and dividend accounts were zeroed away via closing, and do not appear in the post-closing trial balance.

ENGLAND TOURS COMPANY Trial Balance December 31, 20X3		
	Debits	Credits
Cash	\$15,500	
Accounts receivable	4,500	
Equipment	45,000	
Accumulated depreciation		\$ 5,000
Accounts payable		4,000
Salaries payable		2,000
Interest payable		1,200
Notes payable		20,000
Unearned revenue		1,200
Capital stock		30,000
Retained earnings		1,600
	<u>\$65,000</u>	<u>\$65,000</u>

19.3 Revisiting Computerization

Many accounting software programs are based on data-base logic. These powerful tools allow the user to query with few restrictions. As such, one could request financial results for most any period of time (e.g., the 45 days ending October 15, 20XX), even if it related to a period several years ago. In these cases, the notion of closing the accounts becomes far less relevant. Very simply, the computer can mine all transaction data and pull out the accounts and amounts that relate to virtually any requested interval of time.

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