FINANCE AT A GLANCE

Closing procedures

Lesson 58

Let us start this lesson by repeating the first paragraph of Lesson 50, which goes as follows:
The ledgers of income statement accounts are handled differently vis-à-vis those of balance sheet accounts. The major difference is that the balances of these accounts are made to equal zero using closing entries (which we will show later). This means that a debit or a credit is posted so that the ending balance is zero. In effect, the balances in the income statement accounts are "removed" and "transferred" to the Retained earnings account of the balance sheet. This step happens when financial statements are prepared, usually at the end of the year. (For our illustration later, we shall do this step at the end of the month of January, because we will be eventually generating an income statement for one month only.)

In this lesson, we shall be closing the balances of the income statement accounts to the Retained earnings. You will finally get to appreciate the fact that the Retained earnings account is where the income statement meets the balance sheet.

First, let us present once more the ledgers of the income statement accounts based on Lesson 57:

4.01 Sales

	Debit	Credit	
		0	Beginning bal
		50,000	Jan. 18, 2010
		50,000	Ending bal

5.01 Cost of goods sold

	Debit	Credit
Beginning bal	0	
Jan. 18, 2010	35,000	
Ending bal	**35,000**	

5.05 Salaries

	Debit	Credit
Beginning bal	0	
Jan. 25, 2010	5,000	
Ending bal	**5,000**	

5.06 Rent

	Debit	Credit
Beginning bal	0	
Jan. 31, 2010	2,000	
Ending bal	**2,000**	

5.07 Sales and marketing expenses

	Debit	Credit	
Beginning bal	0		
Jan. 25, 2010	2,500		
		500	Jan. 31, 2010
Ending bal	**2,000**		

5.08 Utilities

	Debit	Credit
Beginning bal	0	
Jan. 31, 2010	550	
Ending bal	**550**	

5.09 Depreciation

	Debit	Credit
Beginning bal	0	
Jan. 31, 2010	4,168	
Ending bal	**4,168**	

In practice, instead of closing each expense account and each revenue account directly to Retained earnings, it is customary to close them first to a temporary account called Income summary. For example, to make the Sales ledger end up with a zero balance, we make a debit of entry of 50,000, and put the credit entry to Income summary. Likewise, to make the Cost of goods sold ledger end up with a zero balance, we make a credit entry of 35,000, and post the debit entry to Income summary. For the other expense accounts, we do then as we do with Cost of goods sold. These entries are called *closing entries*. They are journalized as follows:

Dr		Sales	50,000		(a)
	Cr	Income summary		50,000	(a)
		To close Sales.			
Dr		Income summary	35,000		(b)
	Cr	Cost of goods sold		35,000	(b)
		To close Cost of goods sold.			
Dr		Income summary	5,000		(c)
	Cr	Salaries		5,000	(c)
		To close Sales.			
Dr		Income summary	2,000		(d)
	Cr	Rent		2,000	(d)
		To close Rent.			
Dr		Income summary	2,000		(e)
	Cr	Sales and marketing expenses		2,000	(e)
		To close Sales and marketing expenses.			
Dr		Income summary	550		(f)
	Cr	Utilities		550	(f)
		To close Utilities.			
Dr		Income summary	4,168		(g)
	Cr	Depreciation		4,168	(g)
		To close Depreciation.			

These closing entries are posted to the ledgers as follows:

4.01 Sales

	Debit	Credit	
		0	Beginning bal
		50,000	Jan. 18, 2010
(a)	50,000		
		0	Ending bal

Income summary

	Debit	Credit	
		0	Beginning bal
		50,000	(a)
(b)	35,000		
(c)	5,000		
(d)	2,000		
(e)	2,000		
(f)	550		
(g)	4,168		
		1,282	Ending bal

5.01 Cost of goods sold

	Debit	Credit	
Beginning bal	0		
Jan. 18, 2010	35,000		
		35,000	(b)
Ending bal	**0**		

5.05 Salaries

	Debit	Credit	
Beginning bal	0		
Jan. 25, 2010	5,000		
		5,000	(c)
Ending bal	**0**		

5.06 Rent

	Debit	Credit	
Beginning bal	0		
Jan. 31, 2010	2,000		
		2,000	(d)
Ending bal	**0**		

5.07 Sales and marketing expenses

	Debit	Credit	
Beginning bal	0		
Jan. 25, 2010	2,500		
		500	Jan. 31, 2010
		2,000	(e)
Ending bal	**0**		

5.08 Utilities

	Debit	Credit	
Beginning bal	0		
Jan. 31, 2010	550		
		550	(f)
Ending bal	**0**		

5.09 Depreciation

	Debit	Credit	
Beginning bal	0		
Jan. 31, 2010	4,168		
		4,168	(g)
Ending bal	**0**		

Intuitively, we would say that the next step would be to transfer the balance of the Income summary account to Retained earnings, and we then have the financial statements. We are, indeed, almost ready to generate the income statement and the balance sheet. There remains only one step: the computation of the income tax, which is an expense incurred for the month of January. This will be done in the next lesson. For now, look at the Income summary ledger. The Income statement actually can be derived from it up to the line of the Net profit before tax.

Income summary

	Debit	Credit	
		0	Beginning bal
		50,000	(a)
(b)	35,000		
(c)	5,000		
(d)	2,000		
(e)	2,000		
(f)	550		
(g)	4,168		
		1,282	Ending bal

(a) ⇨ This is the balance of the **Sales** account prior to closing.

(b) ⇨ This is the balance of the **Cost of goods sold** account prior to closing.

(c) ⇨ This is the balance of the **Salaries** account prior to closing.

(d) ⇨ This is the balance of the **Rent** account prior to closing.

(e) ⇨ This is the balance of the **Sales and marketing expenses** account prior to closing.

(f) ⇨ This is the balance of the **Utilities** account prior to closing.

(g) ⇨ This is the balance of the **Depreciation** account prior to closing.

⇨ This ending balance is actually the result obtained by deducting from **Sales (a)** all of the Expenses (**b** through **g**), which is actually **Net profit before tax.**

As mentioned above, we shall be computing the income tax in the next lesson.