

Preparing for New Fiscal Years

◀ 8.3

The exercises in Section 8.2 required you to use a worksheet to record the year-end adjustments for P. Tang and Company and for Mission Marketing. These adjustments allowed you to prepare financial statements that complied with the accounting principles covered in Section 8.1.

Section 8.1 included the time period concept, which guides accountants to measure net income in units of time called fiscal periods. A typical fiscal period is one year.

Closing Procedures with Accounting Software

Although computers are not used in this section, we will begin the presentation of closing procedures by seeing how accounting software handles these tasks. The reason for doing this is to give you a clear picture of what is going to happen to account balances. Once you see what needs to be done, taking those steps with pen and paper will be straightforward.

First, you should be aware that whether or not a worksheet is used, adjustments like the ones you learned in the first two sections of this chapter must be journalized and posted. These steps ensure that ledger account balances match the amounts that appear on the year-end financial statements.

Once adjusting journal entries have been posted, preparing accounts for a new fiscal period with spreadsheet software is easy. For the most part, all you have to do is change the date to a new year. To see how this works, assume that Sage Simply Accounting software is being used for Global Logistics—the business you followed as you learned about adjusting entries in Section 8.2. By simply changing the date to a new fiscal year—and taking a few other minor steps—many of the account balances change in response. Examine these changes now. They are revealed in two trial balances shown in Figure 8.10.

Reminder: Fiscal years do not have to be calendar years (January 1 to December 31). They just have to be 12 consecutive months.

Global Logistics	Trial Balance As at 12/31/20–4		Trial Balance As at 01/01/20–5	
	Debits	Credits	Debits	Credits
Bank	520.51	–	520.51	–
Accounts Receivable	18 475.00	–	18 475.00	–
Supplies	526.00	–	526.00	–
Prepaid Insurance	4 070.00	–	4 070.00	–
Furniture & Equipment	4 196.00	–	4 196.00	–
Automotive Equipment	54 600.00	–	54 600.00	–
Accounts Payable	–	3 336.00	–	3 336.00
Bank Loan	–	25 000.00	–	25 000.00
Unearned Revenue	–	6 000.00	–	6 000.00
HST Payable	–	1 240.00	–	1 240.00
HST Recoverable	720.00	–	720.00	–
January 1 Capital	–	28 895.42	–	47 531.51
P. Marshall, Drawings	42 000.00	–	0.00	–
Shipping Revenue	–	207 821.00	–	0.00
Bank Charges Expense	3 500.00	–	0.00	–
Insurance Expense	2 494.00	–	0.00	–
Miscellaneous Expense	2 036.65	–	0.00	–
Rent Expense	24 000.00	–	0.00	–
Telephone Expense	2 045.00	–	0.00	–
Supplies Expense	954.90	–	0.00	–
Truck Expense	42 447.16	–	0.00	–
Utilities Expense	3 750.00	–	0.00	–
Wages Expense	65 957.20	–	0.00	–
	<u>275 292.42</u>	<u>272 292.42</u>	<u>83 107.51</u>	<u>83 107.51</u>

Figure 8.10

The trial balances for Global Logistics on the last day of one fiscal period and on the first day of the next fiscal period

Real Accounts (Permanent) - have balances that continue into the next fiscal period. All asset, liability, as well as the owner's capital are permanent accounts.

Nominal Accounts (Temporary) - have balances that do not continue into the next fiscal period. All revenue, expense, as well as owner's drawings are temporary accounts and they begin the next fiscal period with a balance of zero.

Income Summary

Closing/Clearing an Account means to make it have a balance of zero.

Comparing Income Statements

Global Logistics Income Statement 01/01/20-4 to 12/31/20-4		Global Logistics Income Statement 01/01/20-5 to 01/01/20-5	
REVENUE		REVENUE	
REVENUE		REVENUE	
Shipping Revenue	207 821.00	Shipping Revenue	0.00
Total Revenue	<u>207 821.00</u>	Total Revenue	<u>0.00</u>
TOTAL REVENUE	<u>207 821.00</u>	TOTAL REVENUE	<u>0.00</u>
EXPENSE		EXPENSE	
Operating Expenses		Operating Expenses	
Bank Charges Expense	3 500.00	Bank Charges Expense	0.00
Insurance Expense	2 494.00	Insurance Expense	0.00
Miscellaneous Expense	2 036.65	Miscellaneous Expense	0.00
Rent Expense	24 000.00	Rent Expense	0.00
Telephone Expense	2 045.00	Telephone Expense	0.00
Supplies Expense	954.90	Supplies Expense	0.00
Truck Expense	42 447.16	Truck Expense	0.00
Utilities Expense	3 750.00	Utilities Expense	0.00
Wages Expense	65 957.20	Wages Expense	0.00
Total Operating Expenses	<u>147 184.91</u>	Total Operating Expenses	<u>0.00</u>
TOTAL EXPENSE	<u>147 184.91</u>	TOTAL EXPENSE	<u>0.00</u>
NET INCOME	<u>60 636.09</u>	NET INCOME	<u>0.00</u>

Figure 8.11

The income statements for Global Logistics on two consecutive days. One summarizes the financial performance for one year. The other is reset to start the process again.

Comparing Balance Sheets

It is also helpful to compare the balance sheets for the same two consecutive days. Figure 8.12 shows two partial balance sheets for Global Logistics. Notice the equity section of the December 31st balance sheet on the left. It reveals a variation of the equity equation you learned in Chapter 5 (Beginning Capital for the year, minus Drawings, plus Net Income, equals Ending Capital). On the right, the ending capital from the previous day becomes the beginning capital for a brand new year starting on January 1st.

Global Logistics Balance Sheet As at 12/31/20-4		Global Logistics Balance Sheet As at 01/01/20-5	
ASSET		ASSET	
Current Assets		Current Assets	
Bank	520.51	Bank	520.51
Accounts Receivable	18,475.00	Accounts Receivable	18,475.00
Supplies	500.00	Supplies	500.00
Accounts Payable	3,336.00	Accounts Payable	3,336.00
Bank Loan	25,000.00	Bank Loan	25,000.00
Unearned Revenue	6,000.00	Unearned Revenue	6,000.00
HST Payable	1,240.00	HST Payable	1,240.00
HST Recoverable	-720.00	HST Recoverable	-720.00
HST Owed	520.00	HST Owed	520.00
Total Current Liabilities	<u>34,856.00</u>	Total Current Liabilities	<u>34,856.00</u>
TOTAL LIABILITY	<u>34,856.00</u>	TOTAL LIABILITY	<u>34,856.00</u>
EQUITY		EQUITY	
P. Marshall, Capital		P. Marshall, Capital	
January 1 Capital	28,895.42	January 1 Capital	47,531.51
P. Marshall, Drawings	-42,000.00	P. Marshall, Drawings	0.00
Current Earnings	60,636.09	Current Earnings	0.00
December 31 Capital	<u>47,531.51</u>	January 01 Capital	<u>47,531.51</u>
TOTAL EQUITY	<u>47,531.51</u>	TOTAL EQUITY	<u>47,531.51</u>
LIABILITIES AND EQUITY	<u>82,387.51</u>	LIABILITIES AND EQUITY	<u>82,387.51</u>

Figure 8.12

Two balance sheets a day apart for Global Logistics

Preparing the Closing Journal Entries

The proper way to change a ledger account balance is through a journal entry. Since the closing process requires many account balances to change, it follows that various closing journal entries are needed.

All of the necessary amounts for the closing journal entries exist in one place on the worksheet. There is no single way that closing entries must be recorded. This text uses a four-step approach to the closing entries. Figure 8.13 (on the next page) is the worksheet for Global Logistics. The amounts for the four closing steps are clearly identified. **REID**

Global Logistics		Worksheet				Year Ended Dec. 31, 20-4			
ACCOUNTS	TRIAL BALANCE		ADJUSTMENTS		INCOME STATEMENTS		BALANCE SHEET		
	Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr	
Bank	52051						52051		
Accounts Receivable	18475						18475		
Supplies	1480			① 95490			526		
Prepaid Insurance	6564			② 2494					
Furniture & Equipment	4196						4196		
Automotive Equipment	54600						54600		
Accounts Payable		2510		③ 826				3336	
Bank Loan		25000						25000	
HST Payable		1240						1240	
HST Recoverable							720		
P. Marshall, Capital		2889542						2889542	
P. Marshall, Drawings	42000						42000		
Shipping Revenue		213821	④ 6000			207821	100		
Bank Charges Expense	3500				3500				
Miscellaneous Expense	195165		⑧ 85		203665				
Rent Expense	24000				24000				
Telephone Expense	1800		③ 245		2045				
Truck Expense	4244716		③ 496		4244716				
Utilities Expense	3756				3750				
Wage Expense	6595720				6595720				
	27146642	27146642							
Supplies Expense			① 95490		95490				
Insurance Expense			② 2494		2494				
Unearned Revenue				④ 6000				6000	
			1027490	1027490	14718491	207821		12510751	
Net Income					6063609			6063609	
					207821	207821		12510751	

Closing Entry No. 1—Revenues (Page 293)

The first closing entry deals with revenue. One of your goals in closing is to reset nominal or temporary accounts to zero. Shipping Revenue is a nominal account. Since the credit balance of Shipping Revenue in Figure 8.13 is \$207 821, all you need to do is enter the opposite amount. In other words, to bring the balance of Shipping Revenue to zero, journalize a debit of \$207 821.

What about the credit portion of this journal entry? To which account should it be allocated? The capital account is a logical choice. After all, revenue entries came from the capital account when we expanded the ledger in Chapter 5. Now, at year-end, it makes sense to return the final balance of those revenue entries back to capital.

Instead of directly crediting the capital account, however, many accountants take an intermediate step by creating a temporary equity account called **Income Summary**, which is used to record debit and credit amounts during the closing process.

closed as well

As the name suggests, Income Summary will summarize revenue and expense amounts in one ledger account. This ledger account will then reveal the amount of net income or loss, which accountants can conveniently transfer to the capital account.

The first closing entry for Global Logistics appears in Figure 8.14 below.

Figure 8.14

The first closing entry to clear the revenue account

GENERAL JOURNAL					PAGE 42				
DATE	PARTICULARS	P.R.	DEBIT			CREDIT			
Dec 20-4 31	Shipping Revenue		207	821	-				
	* Income Summary					207	821	-	
	To close the 2004 balance of revenue								

① Dr. Revenue
Cr Income Summary

Closing Entry No. 3—Income (or Loss) (Page 294)

The amount for the third closing journal entry is also found on the worksheet. Before preparing the third closing entry, it is helpful to examine the income summary account. If the first two closing journal entries for Global Logistics were posted, the Income Summary account would look like Figure 8.16.

If Income Summary had a debit balance—which would represent a net loss—it would need a credit entry to bring it to zero.

Ledger Account

ACCOUNT		Income Summary			NO. 399	
DATE	PARTICULARS	P.R.	DEBIT	CREDIT	Dr/Cr	BALANCE
20-4 Dec 31	Total Revenue	J42		207 821 -	Cr	207 821 -
31	Total Expenses	J42	147 184 91		Cr	60 636 09
	Net Income					

Figure 8.16

The Income Summary account after the second closing entry is posted

You can now see why Income Summary is an appropriate name for this account. In an account format, total expenses are subtracted from total revenue to produce the account balance. In this example, the account balance is a credit because revenues (credits) are greater than expenses (debits). This account balance, therefore, represents the net income figure.

Income summary is a temporary account and must also be closed at year-end. If the account has a credit balance, it needs a debit entry to clear it, as shown below in Figure 8.17.

General Journal

31	Income Summary		60 636 09		
	P. Marshall, Capital			60 636 09	
	To close the Income Summary account and transfer the net income to capital				

Figure 8.17

The third closing entry for Global Logistics

The owner's capital is the companion account in this third closing entry. This makes perfect sense. Recall the equity equation you learned back in Chapter 5. Net Income was added to Beginning Capital. The journal entry in Figure 8.17 accomplishes the same mathematical outcome in the ledger of Global Logistics.

Net Income

③ (1) Dr. Income Summary

Cr. Capital

Net Loss

(1) Dr. Capital

Cr. Income Summary

Post-Closing Trial Balance

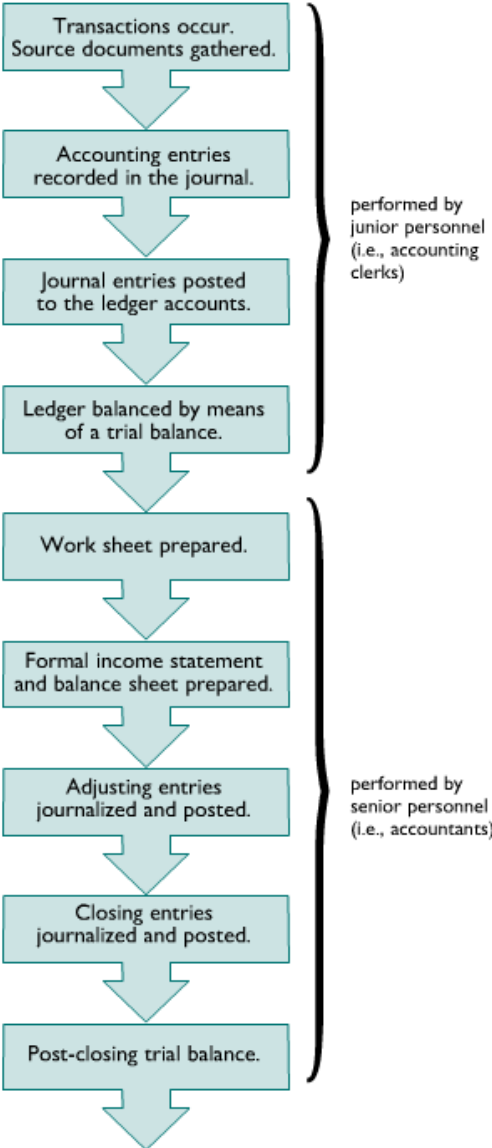
The accuracy of the ledger must be checked after you have finished journalizing and posting the adjusting and closing entries. This is done by taking off the **post-closing trial balance**.

The post-closing trial balance for Global Logistics is shown on the right side of Figure 8.10 on page 290. If that trial balance had been prepared manually, zero balance accounts would not have been listed. The last account listed would have been the capital account.

Complete Accounting Cycle

You now understand that accounting is cyclical in nature. In a manual system, the post-closing trial balance is the final step in the accounting cycle. Figure 8.20 below shows the major steps in the accounting cycle that occur every fiscal year.

Figure 8.20
The complete accounting cycle for a manual accounting system



Homework

Section 8.3 on page 297

