**Chapter 4 Closing the Books, Accounting Cycle and Classified B/S**

**Closing the Books**

When a company prepares the month-end F/S, the I/S and the SOE are prepared for a specific period of time such as the Month Ended XX 2016 and the B/S is prepared as of a specific date. The I/S and SOE can be compared to a video whereas the B/S is a snapshot of the company’s financial position as of a specific date. The accounts related to the I/S and SOE must be zeroed out or “closed” in order to accumulate the information for the next, upcoming period. These accounts are temporary accounts or “nominal” accounts. Therefore, all income/revenue accounts, expense accounts, and withdrawal accounts will be closed. They will be closed to the owner’s equity balance or owner’s capital account. This makes sense given what we know about the expanded accounting equation because these accounts are part of the owner’s equity. The owner’s equity or capital account is not closed because it is a B/S account. B/S accounts do not close; they are permanent. For example, if F/S are prepared as of Dec 31, 2015, the next day you will still have cash, accounts receivable, prepaids, equipment, accounts payable, accruals and owner’s equity. These items will still exist whereas the I/S and SOE accounts are used to separate the different types of transactions that affect owner’s equity.

In the accounting cycle, we prepare financial statements from the adjusted trial balance. We prepare the income statement first, then the statement of owner’s equity, and then the balance sheet. Through this process, we update ending owner’s equity. Now, this update of the accumulation of owner’s wealth should also be reflected on the books of the company. Therefore, we will close out income statement and statement of owner’s equity accounts to owner’s equity in order to update it.

However, accounting conventions do not use a direct route to close these accounts to owner’s equity. An intermediary account “Income Summary” will be used to close out the income statement accounts.

The next several pages will demonstrate how we will accomplish this. To avoid confusion, we will want to maintain two T-accounts in order to close the books properly. These two T-Accounts are the Income Summary and the Owner’s Capital account. Follow these steps and use the T-Accounts.

I will explain the steps and then show you the explanation.

Steps to close the nominal or temporary accounts

1. Debit all revenue accounts and credit Income Summary for the total of all revenues.
2. Credit all expense accounts and debit Income Summary for the total of all expenses.
3. Balance the income summary account in a T Account form
   1. Deduct the smaller amount from the larger amount
      1. If it is a credit (normal) balance, then debit Income Summary for this amount and credit Owner’s Capital for the same amount.
      2. If it is a debit balance (loss), then credit Income Summary for this amount and debit Owner’s Capital for the same amount.
4. Credit the Withdrawal account for the balance in Withdrawals and debit Owner’s Capital for the same amount. – You are decreasing Owner’s Capital
5. Prepare the post-closing trial balance, only balance sheet accounts (permanent) accounts should be on the post-closing trial balance. There should be no balances in withdrawals, revenue or expense accounts.







Part 2 of the lecture notes walks through these transactions using a power point with a page-by-page description. In the post lecture, I narrate these slides if you wish to watch that as well to help you understand.

**The Accounting Cycle**

There are nine steps to the accounting cycle:

1. Analyze business transactions
   1. Done throughout the month
2. Journalize entries in the general journal
   1. Done throughout the month
3. Post the journal entries to the general ledger (T-Accounts)
   1. Done throughout the month
4. Prepare the unadjusted trial balance
   1. End of accounting cycle
5. Prepare and post the adjusting journal entries
   1. End of accounting cycle
6. Prepare the adjusted trial balance
   1. End of accounting cycle
7. Prepare the financial statements
   1. End of accounting cycle
8. Prepare and post the closing entries
   1. End of accounting cycle
9. Prepare the post-closing trial balance
   1. End of accounting cycle

**Classified Balance Sheet**

What differentiates current from long-term assets or liabilities depends upon the operating cycle of a company. An operating cycle is defined as the average time it takes to sell a product or a service to a customer, sell it for cash or on account, and collect from a customer OR a year **whichever is longer**. For almost all companies a year is longer, so current and long-term is divided by what used up or paid off within one year. We assume a year cutoff for this course.

**Assets Liabilities**

**Current Assets Current Liabilities**

Cash Accounts Payable

Accounts Receivable Current maturities of long-term debt

Inventory Taxes payable

Prepaid Assets Salaries and Wages payble

**Long-Term Assets Long-Term Liabilities**

Long-Term Investments Long-Term Debt

Property, Plant and Equipment Bonds

Accumulated Depreciation

Intangible Assets **Owner’s Equity or Capital**