Case Study: Merchandising, Adjusting, and Closing

by Sophia

WHAT'S COVERED

This tutorial will cover the preparation of closing entries in the context of a case study, using a hypothetical merchandising company.

Our discussion breaks down as follows:

1. Case Study: Legacy Clothing

The subject company for our case study is called Legacy Clothing. Legacy Clothing is a sole proprietorship, which is a company that is owned by a single individual, and where that individual and the business are legally treated as the same.

The purpose of Legacy Clothing as a business is to own and operate clothing/merchandise stores. It is similar to a department store chain, selling men's, women's, and children's clothing and other related items. Legacy Clothing has locations throughout Washington, DC, and they have a staff of 50 people employed in their stores.

Legacy Clothing	
Type of company	Sole proprietorship
Business purpose	Own and operate clothing/merchandise stores
Business location(s)	Washington, D.C. Staff of 50 people

Legacy Clothing needs to perform closing procedures to have accurate reporting. They need to close out their temporary or period-based accounts and reset for the next period, which allows them to track activity for individual periods.

Once those temporary, period-based accounts are closed, Legacy Clothing can transfer that net income or loss into cumulative equity. Then, they can reopen those temporary accounts and reset for the following period, to report activity for one specific period.

2. Case Study: Closing Entries

Now, let's look at identifying and creating closing entries for Legacy Clothing. The starting point is going to be the adjusted trial balance, noting that we've already gone through and prepared our financial statements. Now that those are completed, we need to take our adjusted trial balance and prepare the closing entries for Legacy Clothing.

ADJUSTED TRIAL BALANCE		
Accounts	Dr.	Cr.
Sales		990,000
Sales Returns and Allowances	30,000	
Sales Discounts	15,000	
Purchases	163,000	
Purchase Returns and Allowances		10,000
Purchase Discounts		5,000
Freight-in	5,000	
Salaries Expense	360,000	
Advertising Expense	10,000	
Rent Expense	50,000	
Interest Expense	20,000	
Depreciation Expense: Buildings	15,000	
Insurance Expense	6,000	
Supplies Expense	2,500	

It is important to note that in this example, we are only looking at those closing entries that are unique to a merchandising company. Any company, whether it is merchandising-related or service-related, is going to have to close out temporary accounts such as revenues and operating expenses. However, our focus today is on those temporary accounts that are unique to a merchandising company, outlined in red above.

Let's take a look to see how this will look in the closing entry.

CLOSING ENTRIES				
Date	Account Title	Ref	Debit	Credit
12/31/12	Income Summary	7999	30,000	
	Sales Returns and Allowances	7501		30,000
12/31/12	Income Summary	7999	15,000	
	Sales Discounts	7502		15,000
12/31/12	Income Summary	7999	163,000	
	Purchases	7600		163,000
12/31/12	Purchase Returns and Allowances	7601	10,000	
	Income Summary	7999		10,000
12/31/12	Purchase Discounts	7602	5,000	
	Income Summary	7999		5,000
12/31/12	Income Summary	7999	5,000	
	Freight-In	7603		5,000

The first accounts that we need to close out are our sales returns and allowances, and our sales discounts. Notice that they are being closed out with credits. This is because they have natural debit balances, because they reduce our sales; they are contra-revenue accounts.

Next, we can close out our purchases account. The purchases account needs to be closed out with a credit. After we've closed purchases, we can close our purchase returns and allowances, as well as our purchase discounts. As you can see, our purchase returns and allowances and purchase discounts are being closed out with debits. This is because they have natural credit balances, as they are a reduction of our purchases.

The last account that we need to close out for Legacy Clothing is the freight-in account, which represents the cost to ship those goods to us. We close out freight-in with a credit because it's an expense, so it will have a natural debit balance.

In conclusion, these are the closing entries that need to be made for a merchandising company, to close out the temporary accounts that are unique to that type of business.

SUMMARY

Today we introduced our **case study** company called **Legacy Clothing**, that is in the business of owning and operating multiple department store locations, selling men's, women's, and children's clothing and other related items. We looked at an **example of preparing closing entries** for our subject company, starting with the adjusted trial balance, and moving through closing all of the temporary accounts--revenue and expense accounts, discounts, returns, and allowances.

Source: Adapted from Sophia instructor Evan McLaughlin.