Closing Entries

by Sophia

WHAT'S COVERED

This tutorial will cover the topic of closing entries and how they are used.

Our discussion breaks down as follows:

1. Closing Entries

A **closing entry** is an entry made at the end of an accounting period that is used to close out a temporary account. You may recall that **temporary accounts** are those accounts whose balances are closed at the end of an accounting period and reopened at the beginning of the next period.

Now, where are these closing entries made? Well, closing entries are made in the general journal, and the general journal gets posted to the general ledger.

As mentioned in the definition, the accounts that get closed are the temporary accounts--not the permanent accounts. The temporary accounts comprise the revenues and expenses, which we will discuss in more detail in the next section. There is also another account that needs to get closed: the drawing account or the owner draw account. The **drawing account** is an account that keeps a record of money taken out of the business by its owner or owners. This means that any time an owner or some of the owners pull money out of the business, it gets tracked in the drawing account.

HINT

It is important to note that a C Corp does not have a drawing account.

So, why are closing entries made? Well, temporary accounts are closed to ensure accurate reporting. Those temporary accounts are period-based accounts, so they track specific activity for a given period. Temporary accounts are reopened for the following period so that they can report activity for only one specific period.

TERMS TO KNOW

Closing Entry

An entry made at the end of an accounting period that is used to close out a temporary account.

Temporary Accounts

Accounts whose balances are closed at the end of an accounting period and reopened at the beginning of the next period.

Drawing Account

An account that keeps a record of money taken out of the business by its owner or owners.

2. Objectives of Closing Entries

The purpose of closing the accounting system is to determine net income or net loss. This is achieved through closing the temporary accounts, which, as mentioned, are those accounts whose balances are closed at the end of an accounting period and reopened at the beginning of the next period.

The temporary accounts reflect **revenue**, which is earnings from interest or from the sale of goods or services, and **expense**, which is costs associated with operating or maintaining a company. These accounts are closed to determine net income or loss; think of this as hitting the reset button.

Once net income or loss is determined, through closing the temporary accounts and effectively hitting the reset button, that net income or loss must be transferred to equity.

TERMS TO KNOW

Revenue

Earnings from interest or from the sale of goods or services.

Expenses

Costs associated with operating or maintaining a company.

3. Closing Procedure

Next, let's look at the specific procedure for making closing entries, utilizing what is called the REDI method. Temporary account groups are closed by processing netting journal entries on their unnatural balance side. Now, netting refers to looking at the total balance of the account, whether it's debit or credit, and recording a closing entry for that amount to the opposite side.

EXAMPLE Suppose you have an account with a current debit balance. Through netting, you would book an entry for that same amount to the opposite side so that the account nets to zero.

The REDI method refers to the following process :

Revenues.
Expenses.
Drawings.
Income Summary.

First, we close out our revenues. Then we move onto expenses. Drawings is the next type of temporary account we need to close. Now, where do all those go? Those go to income summary.

So we close our revenues, our expenses, and our drawings to the income summary, which then gets closed to our retained earnings.

SUMMARY

Today we learned about **closing entries**, which are entries made at the end of an accounting period that is used to close out a temporary account. Remember, temporary accounts are those accounts whose balances are closed at the end of an accounting period and reopened at the beginning of the next period. The types of temporary accounts that need to be closed out are revenues, expenses, and the owner's drawing accounts.

We also learned about the **objectives of closing entries**. The purpose of closing the accounting system is to determine net income or net loss. Once net income or loss is determined, through closing the temporary accounts and effectively hitting the reset button, that net income or loss must be transferred to equity. Lastly, we learned about the **closing procedure**, using the REDI method--Revenues, Expenses, Drawings, all closed to the Income Summary.

Source: Adapted from Sophia instructor Evan McLaughlin.

TERMS TO KNOW

Closing Entry
An entry made at the end of an accounting period that is used to close out a temporary account.

Drawing Account
An account that keeps a record of money taken out of the business by its owner or owners.

Expenses
Costs associated with operating or maintaining a company.

Revenue
Earnings from interest or from the sale of goods or services.

Temporary Accounts
Accounts whose balances are closed at the end of an accounting period and reopened at the beginning of the next period.