ACCOUNTING BASICS

Chapter 4 — Completing the Accounting Cycle

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1 · Temporary vs. permanent accounts

At the end of a period, after the statements are done, one job remains: close the books. To understand it you first have to split every account into two families. Some accounts measure ONE period and must reset to zero before the next; others carry their balances forward forever.

Temporary (nominal) accounts: Revenues, expenses, and the owner's drawings. They measure a single period, so they are reset to zero at period end. Income Summary is temporary too.

Permanent (real) accounts: Assets, liabilities, and owner's capital — the balance-sheet accounts. Their balances roll forward into the next period; they are never closed.

A quick test: if it appears on the income statement (or it's Drawings), it's temporary and gets closed. If it appears on the balance sheet, it's permanent and stays. That single split is what the whole chapter turns on.

2 · Why we close the books

Closing entries do two things at once. First, they zero out every temporary account so the new period starts fresh — otherwise this year's revenue would pile on top of last year's. Second, they move the period's net income (or loss) and the owner's drawings into Owner's Capital, so the permanent capital account ends up exactly where the owner's-equity statement said it should.

Income Summary: A temporary account used only during closing. Revenues and expenses are funneled into it; its balance then equals net income (a credit) or net loss (a debit), which is transferred to Owner's Capital.

Think of Income Summary as a holding pen: you herd all the revenues and expenses into it, see what's left (the profit), then push that profit out to the owner's capital and empty the pen.

3 · The worksheet: an optional organizing tool

Many accountants pull the whole period together on a worksheet before writing the formal statements — a multi-column sheet that flows the numbers from the trial balance all the way to the finished statements. It is optional (a scratchpad, never part of the ledger), but it makes the logic of completing the cycle visible.

Worksheet: A multi-column form with five column-pairs — Trial Balance, Adjustments, Adjusted Trial Balance, Income Statement, and Balance Sheet — used to organize the data for the financial statements. It is a working tool, not a permanent accounting record.

You carry each account across the sheet: start with the trial balance, enter the adjustments, combine them into the adjusted trial balance, then EXTEND every account to the correct statement columns — revenues and expenses to the Income Statement columns; assets, liabilities, capital, and drawings to the Balance Sheet columns.

Net income appears twice. Total the Income Statement columns. If revenues (credit) of $24,000 exceed expenses (debit) of $18,000, the $6,000 net income is written into the Income Statement DEBIT column to balance it — and into the Balance Sheet CREDIT column, because profit increases equity. Both pairs of columns then balance. (A net loss goes the other way: Income Statement credit and Balance Sheet debit.)

4 · The four closing entries

Closing is always the same four steps, in this order. Take Brookfield Services, which had $48,000 of Service Revenue; expenses of $22,000 salaries, $6,000 rent, $3,500 supplies, $4,500 depreciation, and $2,000 utilities (total $38,000); and $5,000 of owner's drawings.

- 1) Close revenues: debit each revenue for its balance, credit Income Summary. Here: debit Service Revenue $48,000, credit Income Summary $48,000.
- 2) Close expenses: debit Income Summary for the total, credit each expense. Here: debit Income Summary $38,000, credit the five expenses for $38,000 total.
- 3) Close Income Summary to capital: its balance is now $48,000 - $38,000 = $10,000 credit (net income). Debit Income Summary $10,000, credit Owner's Capital $10,000.
- 4) Close drawings: debit Owner's Capital $5,000, credit Owner's Drawings $5,000. Drawings never touch Income Summary — they close straight to capital.

After all four, every revenue, expense, drawing, and Income Summary sits at zero, and Owner's Capital has absorbed the $10,000 profit and the $5,000 withdrawal.

5 · Net income vs. net loss

Step 3 flips direction depending on whether the business made money. After you close revenues and expenses, look at the Income Summary balance.

- Net income (a credit balance in Income Summary): debit Income Summary, credit Owner's Capital — profit raises capital.
- Net loss (a debit balance in Income Summary): debit Owner's Capital, credit Income Summary — a loss reduces capital.

A net loss. If revenues were $30,000 and expenses $34,000, Income Summary carries a $4,000 debit (a loss). Close it with: debit Owner's Capital $4,000, credit Income Summary $4,000.

6 · The post-closing trial balance

Once the closing entries are posted, you prepare one last trial balance — the post-closing trial balance. Because every temporary account is now zero, it lists ONLY the permanent accounts: assets, liabilities, and the updated Owner's Capital. Its job is to prove the ledger still balances as the new period begins.

Post-closing trial balance: A trial balance taken after closing. It contains only permanent (balance-sheet) accounts, and its debit and credit columns must still be equal.

For Brookfield, the post-closing columns total $76,500 each. You will not see Service Revenue or any expense there — they've all been closed to zero.

7 · The complete accounting cycle

Closing is the next-to-last step of the full accounting cycle — the repeating sequence a business runs every period. Knowing the order matters, because each step feeds the next.

- 1) Analyze transactions. 2) Journalize them. 3) Post to the ledger.
- 4) Prepare a trial balance. 5) Journalize and post adjusting entries. 6) Prepare an adjusted trial balance.
- 7) Prepare the financial statements. 8) Journalize and post closing entries. 9) Prepare a post-closing trial balance.

Steps 1–3 happen throughout the period; steps 4–9 happen at period end. The optional worksheet is a tool that helps with steps 5–7, and reversing entries (an appendix topic) are an optional extra at the very start of the next cycle.

8 · Correcting entries

Sometimes a transaction was journalized wrong and posted before anyone noticed. A correcting entry fixes it. Unlike adjusting entries — which are planned and happen every period end — correcting entries are unplanned, made whenever an error is found, and can involve any combination of accounts.

A correcting entry. A $300 cash collection for services performed was wrongly recorded as a debit to Cash and a credit to Accounts Receivable — but the work was done this period, so it should have credited Service Revenue. The correction: debit Accounts Receivable $300, credit Service Revenue $300, which cancels the wrong credit and records the right one.

The trick is to compare the wrong entry with the correct entry and book whatever difference gets you from one to the other. When only the amount is wrong, correct just the difference — a $760 purchase recorded as $670 needs a $90 correction, not a full re-entry.

9 · The classified balance sheet

Completing the cycle also means presenting the balance sheet properly. A classified balance sheet groups accounts into standard categories so readers can judge liquidity at a glance, rather than listing everything in one long column.

- Current assets — cash and things that become cash or are used up within a year (or the operating cycle): Cash, Accounts Receivable, Supplies, Prepaid Insurance.
- Long-term investments — assets held for years and not used in day-to-day operations: long-term stock or bond investments, and land held for future use.
- Property, plant & equipment — long-lived assets used in operations, like Equipment, Buildings, and Land in use, shown at cost LESS accumulated depreciation (net book value).
- Intangible assets — long-lived assets with no physical form: patents, copyrights, trademarks, and goodwill.
- Current liabilities — obligations due within a year: Accounts Payable, Salaries Payable, Unearned Revenue, and the current portion of notes payable.
- Long-term liabilities — obligations due beyond a year, such as a long-term Notes Payable or a mortgage payable.
- Owner's equity — the ending Owner's Capital after closing.

Brookfield's classified balance sheet. Current assets $31,500 + property, plant & equipment $36,000 (Equipment $45,000 - accumulated depreciation $9,000) = total assets $67,500. That equals current liabilities $10,500 + long-term liabilities $12,000 + Owner's Capital $45,000. Assets = liabilities + equity, and the cycle is complete.

10 · Reversing entries (an optional appendix)

Some businesses add one more optional step at the very start of the next period: a reversing entry. It simply reverses a prior-period accrual adjusting entry so the next routine cash entry can be recorded normally, without splitting it between two periods.

> **Reversing an accrued salary.** At Dec 31 you accrued $1,800 of salaries: debit Salaries and Wages Expense $1,800, credit Salaries and Wages Payable $1,800. On Jan 1 you reverse it: debit Salaries and Wages Payable $1,800, credit Salaries and Wages Expense $1,800. Now when payday comes, you simply debit Salaries and Wages Expense for the whole payroll — no special split required.

Reversing entries are purely a convenience. They never change net income, they only ever reverse accruals, and they are entirely optional.