Chapter 8 – Recording Adjusting and Closing Entries for a Service Business

Service businesses prepare a worksheet at the end of each fiscal period to summarize the general ledger information needed to prepare financial statements.

Concept: Accounting Period Cycle – Changes in financial information are reported for a specific period of time in the form of financial statements

Concept: Adequate Disclosure – When financial statements contain all information necessary t understand a business's financial condition

8-1 ADJUSTING ENTRIES

1. Adjustments are analyzed and planned on a worksheet
   a. They must be journalized in order to poste them to the general ledger accounts
2. **Adjusting Entries** – journal entries recorded to update general ledger accounts at the end of a fiscal period
3. Recorded on the next journal page following the page on which the last daily transactions for the month are recorded
   a. They are entered in the General Debit and General Credit columns
4. There are usually two adjusting entries: one to adjust supplies and one to adjust prepaid insurance
5. Information needed to journalize the adjusting entries are found in the Adjustment column of the worksheet
6. Write adjusting entries in the Account Title column before the first adjusting entry

8-2 CLOSING ENTRIES

1. **Permanent Accounts** – accounts used to accumulate information from one fiscal period to the next
   a. These are referred to as real accounts
   b. Assets, liabilities, and the owner's capital account
   c. The ending balances for one fiscal period are the beginning balances for the next fiscal period
2. **Temporary Accounts** – accounts used to accumulate information until it is transferred to the owner's capital account
   a. These are referred to as nominal accounts
   b. Revenue, expense, owner's drawing account, income summary
   c. They show changes in the owner's capital for a single fiscal period
   d. At the end of a fiscal period, the balances of temporary accounts are summarized and transferred to the owner's capital account
   e. The temporary accounts begin a new fiscal period with zero balances
3. **Closing Entries** – journal entries used to prepare temporary accounts for the new fiscal period
   a. Temporary account balances must be reduced to zero at the end of each fiscal period. This prepares the temporary accounts for recording information about the next fiscal period. Otherwise, the amounts for the next fiscal period would be added to amounts for previous fiscal periods.
   b. Concept – Matching Expenses with Revenue – the revenue earned and the expenses incurred to earn that revenue are reported in the same fiscal period
   c. To close a temporary account, an amount equal to its balance is recorded in the account on the side opposite the balance side
   d. When a temporary account is closed, the closing entry must have equal debits and credits

e. **Income summary** is used to put the matching amounts into
   i. Income summary is a unique account because it doesn't have a normal balance side
   ii. The balance of this account is determined by the amounts posted to the account at the end of a fiscal period
   iii. When revenue is greater than total expenses (net income), the income summary account has a credit balance
   iv. When total expenses is greater than revenue (net loss), the income summary account has a debit balance
   v. Because income summary is a temporary account, it must be closed at the end of the fiscal period. The balance (net income or net loss) goes into the owner's capital account

f. There are usually four closing entries for a service business
   i. An entry to close income statement accounts with credit balances – **REVENUE**
   ii. An entry to close income statement accounts with debit balances – **EXPENSES**
   iii. An entry to transfer net income or net loss into the capital account and close the **INCOME SUMMARY** account
   iv. An entry to close the owner's **DRAWING** account

<u>8-3 POST-CLOSING TRIAL BALANCE</u>

1. As the last step in the Accounting Cycle – the ledger account total debits must equal the total credits
2. **Post-closing trial balance** – a trial balance prepared after the closing entries are posted
3. Only general ledger accounts with balances are included on a post-closing trial balance
   a. This would include only the permanent accounts (assets, liabilities and owner's capital account)
4. The temporary accounts (revenue, expenses, and income summary) are closed and have zero balances therefore they do not appear on a post-closing trial balance

<u>THE ACCOUNTING CYCLE FOR A SERVICE BUSINESS</u>

1. Analyze transactions from source documents into debit and credit parts
2. Journalize transactions from information on the source documents
3. Post transactions into the general ledger
4. Prepare a worksheet from the information in the general ledger
5. Prepare financial statements (income statement and balance sheet) from the worksheet
6. Journalize adjusting and closing entries from the worksheet
7. Post adjusting and closing entries to the general ledger
8. Prepare a post-closing trial balance using the general ledger