**Step 8 Part 1 Script**

Slide 1: Welcome to the Step 8 video presentation. I decided to split this step into two parts. In this first part, we’ll look at the closing process with some numbers other than those we’ve been using to learn how the closing process works. In the second part, we’ll return to the numbers we’ve been using in steps 1 through 7 and apply what we learn in part 1.

If you wish to work along, you can print out the Step 8 (Part1) blank t-accounts.

Slide 2: Before we get to the closing process specifics, we need to distinguish between two types of accounts – temporary and permanent.

Assume a company’s accounting period starts on January first and ends on December 31st. If there is 1,000,000 of revenue on December 31st, we know that on January 1st, that account will have a zero balance – a new accounting period starts. On the other hand, if the company owes the bank 500,000 on December 31st, they still owe that amount on January 1st. This demonstrates the difference between the two account types.

Temporary accounts collect information during and accounting period. Examples of temporary accounts are Revenue, Expense and Dividend accounts.

Permanent accounts collect information across accounting periods. Examples are Assets, Liabilities and Equity accounts.

The closing process is concerned with making temporary accounts have zero balances and are ready to collect information in the new accounting period. Equally important, the closing process transfers earnings from the Income Statement to the Equity section of the Balance Sheet.

Slide 3: Here we see the four steps of the closing process. The first step is to close out credit balances in our Revenue accounts to an account called Income Summary (This is the most temporary of the temporary accounts – it’s only used during the closing process).

The next step is to close out debit balances in expense accounts to Income Summary.

Next, we close out Income Summary to Retained Earnings.

The fourth step in the closing process is to close Distributions to Retained Earnings.

Slide 4: As mentioned earlier, these actions pretty much accomplish what we see in the Statement of Retained Earnings. The difference between Revenue and Expenses is transferred from Income Summary to Retained Earnings – this is the “plus Net Income” line on the statement. Then, the last step of the closing process takes care of the “less distributions” part of the statement. Next, I want to look at two different cases we encounter when closing – where we have profit and where we have a loss.

Slide 5: Here, we look at the case where the company has earned a profit – there is an excess of Revenues over Expenses, and we have a credit balance in Income Summary at Step 3. We debit Income Summary to close it out and credit Retained Earnings - -this makes sense, as we are increasing an equity account and we do that with credits.

Slide 6: Here, we can see the ledgers after closing for the accounts involved, as well as the Income and Retained Earnings Statements. We can see that the statement tells us that Ending Retained Earnings should be $6,000, and that’s exactly the number we see in the ledger. Also, all the temporary account ledgers have zero balances.

Slide 7: Here, we look at the case where the company has recorded a loss – there is an excess of Expenses over Revenues, and we have a debit balance in Income Summary at Step 3. We credit Income Summary to close it out and debit Retained Earnings - -this makes sense, as we are decreasing an equity account and we do that with debits.

Slide 8: Here, we can see the ledgers after closing for the accounts involved, as well as the Income and Retained Earnings Statements. We can see that the statement tells us that Ending Retained Earnings should be $2,000, and that’s exactly the number we see in the ledger. Also, all the temporary account ledgers have zero balances.

Slide 9: This is just a side-by-side view of the two situations we encountered in this presentation. In the unlikely event that we break even – Revenues equal Expenses – there would be no transfer in Step 3 of the closing process…

Slide 10: Now that we have learned about the closing process, in Step 8 (part 2), we will take the financial statements we created in Step 7 and close the temporary accounts and transfer Net Income to Retained Earnings.