Accounting 2303 Resource #2

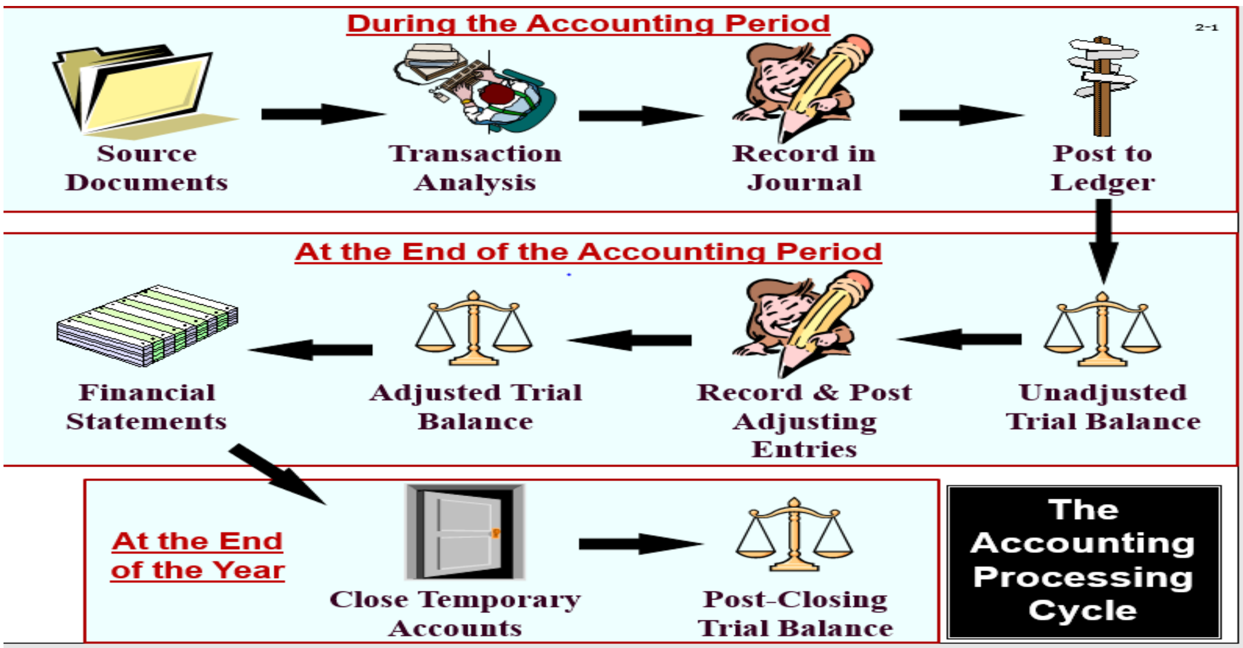
Chapter 3 Part 2- Closing Entries and Accounting Ratios

Hello everyone! This week the resource will be walking through closing entries and accounting ratios. Additionally, I will be providing Accounting group tutoring sessions from 6:30-7:30pm on Tuesdays over Microsoft Teams each week. If you would like to attend those sessions or want to schedule a 1-on-1 appointment with one of our fantastic accounting tutors, please visit www.baylor.edu/tutoring to make an appointment!

-Jerry

Brief Recap:

Over the past three weeks, you have been journeying through the accounting life cycle. You have made initial entries, posted them to the ledger, and made adjusting entries. This cycle is illustrated by the following flowchart:



(Source: Pearson Education 2015)

As you can see, after making adjusting entries, we also need to close out temporary accounts with closing journal entries to end the accounting processing cycle.

Questions:

What are closing entries and how do they work?

A: Closing entries close the temporary accounts and prepare the books for the beginning of the next accounting cycle. Generally, these entries take place at the end of the year.

Temporary Accounts: These are accounts that are tied to a specific period of time. These accounts include revenue accounts, expense accounts, and dividend accounts.

(Note: Temporary Accounts do not include **Permanent Accounts** such as assets, liabilities, and stockholder's equity)

To close the temporary accounts, we do three things (in order):

1. Debit each revenue account for its account balance and credit the sum of all of these balances to Retained Earnings
2. Credit every expense account for its balance and debit the sum of these balances to retained earnings
3. Credit the Dividends account for its balance and debit the retained earnings account with that same number

The Retained Earnings T-Account should look something like this when you are done closing the temporary accounts:

Retained Earnings

		Beginning balance	18,800
Expenses	4,600	Revenues	7,500
Dividends	3,200		
		Ending balance	18,500

(Source: Pearson Education 2015)

The following video is another great explanation of the closing entries: https://www.youtube.com/watch?v=oCJEW4T2xuk

What are the accounting ratios and what do they measure?

Accounting ratios are a quick way to measure the health of a business using the information provided to us in the financial statements

Ratios:

Net Working Capital: This ratio measures a company's ability to pay off current debts with the current assets on hand (another word for this concept is operating liquidity)

The formula is as follows: **Total Current Assets-Total Current Liability=Net Working Capital**

Current Ratio:

Another way of measuring operating liquidity

Formula: **Total Current Assets/Total Current Liabilities**

Companies Generally want a ratio falling between 1.2-1.5

Debt Ratio:

Reveals what portion of the company's assets are funded by debt

Also measures ability to pay current and long-term debts

Lower debt ratio is better

Formula: **Total Liabilities/Total Assets**

See the following videos about the accounting ratios:

Current Ratio: https://www.youtube.com/watch?v=sWWnsvuQ3kk&feature=youtu.be

Net Working Capital: https://www.youtube.com/watch?v=EovKfDwRt9Q&feature=youtu.be

Debt Ratio: https://www.youtube.com/watch?v=zeZOjxK-908&feature=youtu.be

Examples:

Closing Entries:

Assume Baylor Had the Following Balances in the following accounts at the end of the year. Perform the closing entries

Cash: $100,000

Accounts Payable: $50,000

Service Revenue: $80,000

Rent Exp $50,000

Utilities Exp: $4,000

Dividends $5,000

Retained Earnings: $5,000

1st JE:

DR: Service Revenue: $80,000

CR: Retained Earnings: $80,000

2nd JE:

DR: Retained Earnings $54,000 (Rent + Utilities)

CR: Utilities Exp $4,000

CR: Rent Exp $50,000

3rd JE:

DR: Retained Earnings: $5,000

CR: Dividends $5,000

Accounting Ratios:

Given the following amounts calculate the company's net working capital, current ratio, and debt ratio

Current assets $50,000

Current liabilities $25,000

Long-term assets $70,000

Long-term liabilities $35,000

Total revenues $30,000

Total expenses $20,000

Current Ratio:

Total Current Assets/Total Current Liabilities

$50,000/$25,000= 2 (or 2:1)

Networking Capital:

Total Current Assets-Total Current Liability

$50,000-$25,000= $25,000

Debt Ratio:

Total Liabilities/Total Assets

($25,000+$35,000)/($70,000+$50,000)= .5 (or 1:2)

Works Cited:

Edspira.com

Financial Accounting by Harrison, Horngren, and Thomas, 12th Edition, Prentice Hall via Pearson Education 2015