

THEME: CLOSING THE BOOKS

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ACCOUNTING TERM: Support Document

A support document is one that verifies that the ending balance of a general ledger (GL) account is accurate. For example, the supporting document for the GL Cash account is the Bank Reconciliation.

FEATURE ARTICLE: Closing The Books

Thank God for computers! Before computers, when accountants closed the books, they had to write a series of journal entries reversing all the revenue and expense accounts in order to record the net profit or loss at the end of the year into the appropriate equity account, i.e., Owner's Equity for a sole proprietorship; Retained Earnings for a corporation; and Partnership Capital Accounts for partnerships. Nowadays, the computer completes that function with the stroke of a key.

As you may already be aware, each year the Profit & Loss (P&L) Statement has to be cleared to allow the new year's figures to be entered. If you look closely at your Balance Sheet, you will see that the Net Profit or Loss figure found on your P&L Statement is also located in the Equity section. Therefore, that number has to be closed into another account that accumulates and stores all the prior year's earnings. Once the books are closed at year-end, then they are opened and ready for the new year's activity.

Here is what your P&L Statement and the Equity section of your Balance Sheet looks like before closing:

P&L

Revenue	10,000
Expense	<u><5,000></u>
Net Profit	\$ 5,000

Equity

Net Profit or Loss	\$5,000
Owner's Equity	0

This is what your computer does for you using T-Accounts:

(a) = Before Closing (b) = After Closing

<u>Revenue Accounts</u>	Less	<u>Expense Accounts</u>	=	<u>Net Profit or Loss</u>
(b) 10,000 10,000 (a)		(a) 5,000 5,000 (b)		(b) 5,000 5,000 (a)
0		0		0

Owner's Equity (or Retained Earnings, or Partner's Capital Accounts)
| 5,000 (b)

Before this process takes place, it is prudent to verify that the ending balances on the Balance Sheet and certain key accounts on the Profit & Loss Statement are accurate. It's best to approach this task systematically, starting at the top of the Balance Sheet. Print out a Trial Balance, which is a document that lists all the active GL accounts with their ending balances. I recommend setting up a file folder and labeling it something like "Year End Documentation 20XX". Two-hole punch the folder and use a fastener to hold the documents in place. The Trial Balance, as of 12/31/XX with the date of printing, will always be the top document.

Usually your first account to verify will be Cash. Start at the top of the Trial Balance and work your way down. Here is a list of some typical supporting documents:

<u>GL Account</u>	<u>Supporting Document</u>
Cash	Bank Reconciliation
Accounts Receivable (A/R)	A/R Ageing Report (summary)
Inventory	Summary of physical inventory report
Employee Advance	List of employees and amounts
Fixed Assets	Fixed Asset Report
Accumulated Depreciation	Depreciation Schedule
Goodwill (etc)	Amortization Schedule
Accounts Payable (A/P)	A/P Ageing Report (summary)
Payroll Taxes Payable	Payroll Tax Forms
Sales Tax Payable	Sales Tax Form
Notes Payable	Amortization Schedule
Capital Contributions	Summary list, amounts and dates
Miscellaneous Expense	List of items included
Interest Expense	Summary interest paid by note, etc.
Interest Income	Bank Statement
Depreciation	Depreciation Schedule
Amortization	Amortization Schedule
Taxes Paid	List of Federal and State Taxes paid

Other P&L accounts, such as: Sales Revenue, Rent, Utilities, etc., that already have checks written and invoices supporting those payments, should be in a file. But, remember to apply what is called “The Test of Reasonableness” to those balances. For instance, if you pay \$1,000 a month for rent, then \$12,000 should be the Rent balance. If you see \$14,500 in the Rent account, it might be wise to review all the entries posted to that account. (Hint: Use the Detail General Ledger Report)

As you go through each GL account, you will find that there are certain adjustments that need to be made to correct the account balances. You do this through adjusting general journal entries. Once this is done and the journal entries are posted to the general ledger, you will need to rerun the Trial Balance. This is why it is important to keep track of the date on the Trial Balance. You don’t want to get the latest version mixed up with an earlier one. Once you have run the final Trial Balance, then file all the supporting documentation under it in the same order as found on the first Trial Balance.

QUESTION: Is There A Technique For Referencing Support Documents?

Yes, and it works great. Your supporting documentation relates directly to certain GL accounts, therefore you don’t want to be searching all over the place trying to match the balances. It is called the “Going to” and “Coming from” referencing system. Each ending balance found on the supporting documents is referenced to the Trial Balance by writing TB.1 (or TB.2, whichever is appropriate) on the right side of the number. This indicates the number is “going to” the Trial Balance. On the Trial Balance, where that number is found, you would place the reference page BR.1 (Bank Reconciliation, page 1) on the left side of the number, indicating the number is “coming from” the supporting document BR.1. The following is an example from my *Accounting for Non-Accountants* online course:

BE HAIR NOW, INC.				
TRIAL BALANCE FOR PERIOD ENDING 12/31/XX				
ACCOUNTS 1010 THRU 9560				
ACCOUNT	DESCRIPTION		DEBIT	CREDIT
Current Assets				
1010	Cash-in-Bank	BR-1	\$ 3,747.18	
1020	Petty Cash	PC-1	50.00	
1030	Cash-in-Bank MMK	BR-2	18,957.80	
1250	Notes Receivable	NR-1	913.29	
Etc.				TB.1

Notice that TB.1 represents page one of the Trial Balance. The references BR-1 (Bank Reconciliation, page 1), PC-1 (Petty Cash, page 1), BR-2 (Bank Reconciliation, page 2), and NR-1 (Notes Receivable, page 1) are on the left side of the balances indicating “coming from” the support documents. All pages, including the Trial Balance should have these page references written on the bottom right hand side of the page. You can even add an index page that lists all the support documents and their respective page numbers if you feel so inclined. The index page should be located on top of the Trial Balance in the folder.

When you thumb through the folder you can easily find the page and match the number. Want to have some fun? Whip this file folder out in front of an auditor and watch how he/she gains immediate respect for you.

TIP: How To Distribute Net Profit or Loss To Partner’s Capital Accounts.

Here’s the problem. Your computer does a great job of closing the books, except it doesn’t know how to distribute the Net Profit or Loss amongst the partners. Only you know that. Most accounting software programs require that you indicate which “single” account you want the Net Profit or Loss closed into, such as Owner’s Equity or Retained Earnings. When you set up the partnership books in a software program you should use a transitional account. I call that account, “Partners Clearing”.

At the end of the year, the computer closes the Net Profit or Loss into the Partners Clearing account. At this point, you have to write a general journal entry removing the figure from Partners’ Clearing and distributing it to the Partners’ Capital accounts according to the partners’ percentage of ownership or by whatever percentage has been designated in the partnership agreement. Your journal entry might look something like this, if the Net Profit was \$9,000 and there were three partners with equal ownership:

DESCRIPTION	DEBIT	CREDIT
Partners Clearing	9,000	
Partner 1 - Capital		3,000
Partner 2 - Capital		3,000
Partner 3- Capital		3,000

Sometimes you have to trick the computer to get it to do what you want. But first, understanding how accounting works is a big help.

John W. Day, MBA is the author of two courses in accounting basics: Real Life Accounting for Non-Accountants (20-hr online) and The HEART of Accounting (4-hr PDF). Visit his website at <http://www.reallifeaccounting.com> to download his FREE e-book pertaining to small business accounting and his monthly newsletter on accounting issues. Ask John questions directly on his Accounting for Non-Accountants blog.

