Bookkeeping 101: The Ceterus Way

What are retained earnings?

Retained earnings are the cumulative earnings or losses of the business since it began operations.

When does the account get updated and how?

At the end of the year, all balances from the income statement are closed (adjusted to $0). The net amount from these balances is also known as net income (loss). This amount is transferred to retained earnings. If you look at your profit and loss statement on January 1, before any transactions take place, you will see that your profit and loss statement has nothing but 0's. This indicates that the income statement has been closed out for the previous year, with the net amount being recorded to retained earnings.

Let's take a look at an example. First let's assume a business had $10,000 in revenue for the year and $5,000 in expenses. This business would then have net income of $5,000. At the end of the year, the revenue and expense accounts need to be closed out or adjusted to $0. This is done to ensure the new year starts at $0. To accomplish this, you would need to post the following journal entry.

Account	Debit	Credit	Explanation
Revenue	10,000		To close the revenue account
Operating Expenses		5,000	To close the operating expense account
Retained Earnings		5,000	To transfer net income to the balance sheet

After posting this journal entry, the revenue and expense accounts would be $0. Retained earnings would increase by $5,000 because the business had net income of $5,000 this year.