

## Accounting Cycle and Accounting Equation

The accounting cycle is a systematic process used by businesses to identify, analyze, and record accounting events. This cycle ensures that financial statements are accurate, complete, and prepared in a timely manner. The accounting cycle typically consists of several steps that are repeated in each accounting period.

### Steps in the Accounting Cycle

#### 1. Identify Transactions:

Activity: Identify all economic events or transactions that affect the financial position of the business.

Example: Sales, purchases, receipts, and payments.

#### 2. Record Transactions in the Journal:

Activity: Record each transaction as a journal entry in the general journal, using the double-entry accounting method.

Example: When a business sells goods for cash, the journal entry would debit Cash and credit Sales Revenue.

#### 3. Post Journal Entries to the Ledger:

Activity: Transfer the journal entries to the general ledger accounts to update the balances.

Example: Posting the cash sale to the Cash account and the Sales Revenue account in the ledger.

#### 4. Prepare an Unadjusted Trial Balance:

Activity: List all the ledger accounts with their balances to check that debits equal credits.

Example: Summarize the balances of all accounts to create an unadjusted trial balance.

#### 5. Adjust Entries:

Activity: Make adjusting entries for accrued and deferred items to ensure revenues and expenses are recognized in the correct period.

Example: Adjusting for accrued salaries or prepaid expenses.

#### 6. Prepare an Adjusted Trial Balance:

Activity: List all accounts after adjusting entries to verify that debits still equal credits.

Example: Summarize the adjusted balances to create an adjusted trial balance.

#### 7. Prepare Financial Statements:

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- Activity: Use the adjusted trial balance to prepare the financial statements.
- Income Statement: Shows revenue and expenses to calculate net income.
- Balance Sheet: Shows assets, liabilities, and equity.
- Cash Flow Statement: Shows inflows and outflows of cash.
- Statement of Owner's Equity: Shows changes in equity.
- Example: Using the adjusted balances, prepare the income statement, balance sheet, cash flow statement, and statement of owner's equity.

**8. Close Temporary Accounts:**

Activity: Close revenue, expense, and withdrawal accounts to the Owner's Equity account to prepare for the next accounting period.

Example: Transferring net income to retained earnings and closing revenue and expense accounts.

**9. Prepare a Post-Closing Trial Balance:**

Activity: List all permanent accounts and their balances after closing entries to ensure that debits equal credits.

Example: Summarize the balances of permanent accounts to create a post-closing trial balance.

**Source Documents**

Definition:

A source document is the original record that contains the details necessary to substantiate a transaction entered into an accounting system. These documents provide the evidence and supporting information needed to verify and record financial transactions accurately.

**Types of Source Documents**

1. Invoices:

- Issued by sellers to buyers, detailing goods or services provided, prices, quantities, and terms of payment.
- Example: An invoice from a supplier for raw materials purchased.

2. Receipts:

- Issued by sellers to acknowledge receipt of payment from buyers.
- Example: A cash register receipt for a retail purchase.

3. Purchase Orders:

- Issued by buyers to sellers, indicating the items they intend to purchase and the agreed terms.



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- Example: A purchase order sent to a supplier for office supplies.
- 4. Credit Notes:
  - Issued by sellers to buyers, indicating a reduction in the amount owed due to returns or allowances.
  - Example: A credit note for returned defective products.
- 5. Debit Notes:
  - Issued by buyers to sellers to request a credit note for returned goods or services.
  - Example: A debit note sent to a supplier for overcharged items.
- 6. Checks or Cheques:
  - Written orders directing a bank to pay a specific amount from the writer's account to the named recipient.
  - Example: A check issued to a vendor for services rendered.
- 7. Bank Statements:
  - Issued by banks, showing all transactions in a business's bank account over a specific period.
  - Example: A monthly bank statement detailing deposits, withdrawals, and bank charges.
- 8. Sales Orders:
  - Issued by sellers to confirm a buyer's purchase order.
  - Example: A sales order confirmation sent to a customer.
- 9. Delivery Notes:
  - Issued by sellers to accompany delivered goods, detailing items delivered and their quantities.
  - Example: A delivery note for shipped products.
- 10. Expense Reports:
  - Submitted by employees to claim reimbursement for business expenses incurred.
  - Example: An expense report for travel and accommodation costs.



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**Responsibilities of Book Keeper:**

1. Identifying the transactions of financial nature
2. Measuring the identified transactions in terms of money
3. Recording the measured transactions in JOURNAL-A Book Of Prime Entry.
4. Classifying them into Ledger, also known as LEDGER POSTING

**Uses of Accounting information:**

1. Provides complete and systematic record
2. Information regarding profit and loss
3. Evidence in legal matters
4. Helpful in raising loans
5. Helpful in prevention and detection of errors and frauds.

**Users of Accounting Information:**

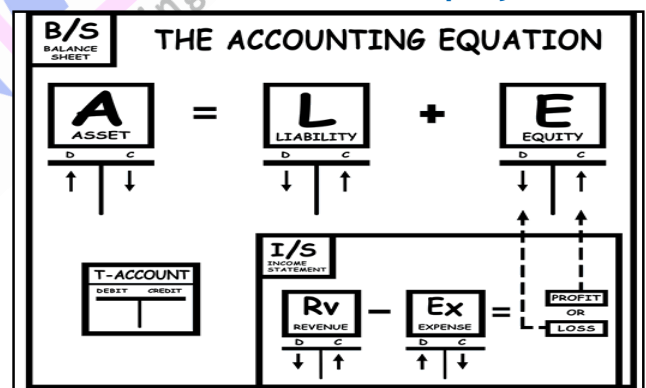
1. Owners
2. Investors
3. Employees
4. Government
5. Public
6. Banks

**Accounting Equation**

The accounting equation is the foundational principle of the double-entry accounting system. It states that the total assets of a business are always equal to the sum of its liabilities and owner's equity. This equation ensures that the balance sheet remains balanced.

**Accounting Equation: Assets = Liabilities + Owner's Equity**

- **Assets:** Resources owned by the business that provide future economic benefits.
- **Liabilities:** Obligations of the business; amounts the business owes to creditors.
- **Owner's Equity:** The residual interest in the assets of the business after deducting liabilities. It includes capital contributed by the owner and retained earnings.



**Concept of Debit and Credit**

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In the double-entry accounting system, every financial transaction affects at least two accounts, and each transaction is recorded with a debit and a credit entry. This system ensures the accounting equation remains balanced.

The Account	
Debit Side	Credit Side

**Debit (Dr.):**

- Refers to the left side of an account.
- Increases in assets and expenses.
- Decreases in liabilities, equity, and revenue.

**Credit (Cr.):**

- Refers to the right side of an account.
- Increases in liabilities, equity, and revenue.
- Decreases in assets and expenses.

**Detailed Explanation**

**Assets:**

- Increase with debits.
- Decrease with credits.
- Example: Purchasing office equipment for cash.
  - Debit: Office Equipment (increase in asset)
  - Credit: Cash (decrease in asset)

**Liabilities:**

- Increase with credits.
- Decrease with debits.
- Example: Taking a loan from a bank.
  - Debit: Cash (increase in asset)
  - Credit: Loan Payable (increase in liability)

**Owner's Equity:**

- Increase with credits (e.g., investments by owner, retained earnings).
- Decrease with debits (e.g., owner's withdrawals, dividends).
- Example: Owner invests cash into the business.
  - Debit: Cash (increase in asset)
  - Credit: Owner's Equity (increase in equity)

**Revenue:**

- Increase with credits.
- Decrease with debits (generally not applicable as revenues typically increase).
- Example: Providing services for cash.

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- Debit: Cash (increase in asset)
- Credit: Service Revenue (increase in revenue)

**Expenses:**

- Increase with debits.
- Decrease with credits (generally not applicable as expenses typically increase).
- Example: Paying for utilities.
  - Debit: Utilities Expense (increase in expense)
  - Credit: Cash (decrease in asset)

**Debit and Credit concept with respect to following five accounting terminology:**

	Increase	Decrease
Asset	Debit	Credit
Liability	Credit	Debit
Income/Revenue	Credit	Debit
Expense	Debit	Credit
Equity/Capital	Credit	Debit

**Accounting Terminology**

1. **Revenue:** Revenue in accounting means the receipt of a recurring (regular) nature from any defined source.
2. **Goods:** Anything which is kept in business for resale or anything in which business deals.
3. **Sale:** The Term SALES is used only for the sales of those goods which are purchased for resale purposes.
4. **Purchase:** The Term PURCHASE is used only for purchase of those goods, in which business deals.
5. **Stock (Inventory):** The Term Stock includes the value of those goods which are lying unsold at the end of an accounting period.
  - (a) Opening stock
  - (b) Closing stock
6. **Debtors:** The term DEBTORS represents those persons or firms to whom goods have been sold on credit and payment has not been received from them.
7. **Receivables:** Amount due from debtors and bills receivables (B/R) is jointly termed as 'Receivables' or 'Account Receivables'.

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8. **Creditors:** The Term CREDITORS represents those persons or firms from whom goods have been purchased or services procured on credit and payment has not been made to them.

9. **Payables:** Amount Due to creditors and for Bills Payable (B/P) is jointly termed as 'Payables' Or 'Account Payables'.

Solved Example: Accounting Equation

**Ques:** Prepare an Accounting Equation on the basis of the following transactions:

- (i) Started business with cash ₹ 70,000.
- (ii) Credit purchase of goods ₹ 18,000.
- (iii) Payment made to creditors .
- (iv) Purchase of machinery for cash ₹ 20,000.
- (v) Depreciation on machinery ₹ 2,000.



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Solution:  
The solution for this question is as follows:

S. No.	Transaction	Assets					=	Liabilities	+	Capital
		Cash (Rs)	+	Stock (Rs)	+	Machinery (Rs)		(Rs)		(Rs)
(i)	Started business with Cash Rs 70,000	70,000								70,000
(ii)	Credit purchase of goods Rs 18,000	70,000		18,000			=	18,000		70,000
(iii)	Payment made to creditor Rs 18,000	70,000 (18,000)	+	18,000			=	18,000 (18,000)	+	70,000 0
(iv)	Purchase of Machinery for Cash Rs 20,000	52,000 (20,000)	+	18,000		20,000	=	0		70,000
(v)	Depreciation on Machinery Rs 2,000	32,000	+	18,000	+	20,000 (2,000)	=			70,000 (2,000) (Depreciation)
		32,000	+	18,000	+	18,000	=			68,000

Assets = 32,000 + 18,000 + 18,000 = Rs 68,000  
Liabilities = NIL  
Capital = Rs 68,000

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Assignment

Ques 1: Show the effect of the following transactions as in Accounting Equation:

- (i) Started business with cash ₹ 60,000.
- (ii) Purchased Furniture for ₹ 5000
- (iii) Purchase goods for ₹ 10000
- (iv) Rent received ₹ 2,000.
- (v) Amount withdrawn ₹ 5,000.

Ques 2: Prove that the Accounting Equation is satisfied in all the following transactions of Sameer Goel:

- (i) Started business with cash ₹ 10,000.
- (ii) Purchased machinery ₹ 50000
- (iii) Purchased goods for cash ₹ 5,000 and credit ₹ 2,000.
- (iv) Sold goods for cash ₹ 8,000 costing ₹ 4,000.
- (v) Paid salary ₹ 450
- (vi) Bought motorcycle for personal use ₹ 3,000.

Ques 3: Raghunath had the following transactions in an accounting year:

- (i) Commenced business with cash ₹ 50,000.
- (ii) Paid into bank ₹ 10,000.
- (iii) Purchased goods for cash ₹ 20,000 and credit ₹ 30,000.
- (iv) Sold goods for cash ₹ 40,000 costing ₹ 30,000.
- (v) Rent paid ₹ 500.
- (vi) Bought furniture ₹ 5,000 on credit.
- (vii) Bought refrigerator for personal use ₹ 5,000.
- (ix) Purchased motorcycle for cash ₹ 20,000.

Create an Accounting Equation to show the effect of the above

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