

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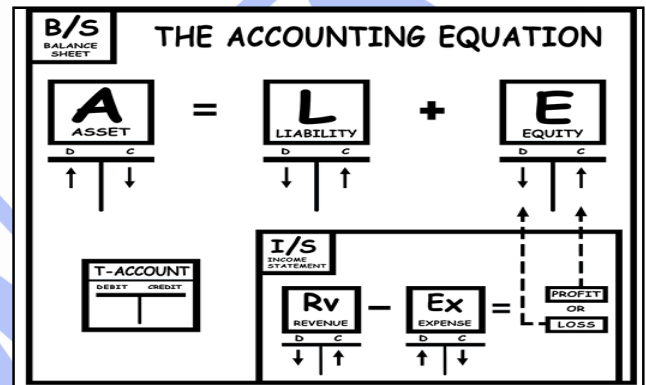
- Activity: Use the adjusted trial balance to prepare the financial statements.
- Income Statement: Shows revenue and expenses to calculate net income.
- Balance Sheet: Shows assets, liabilities, and equity.
- Cash Flow Statement: Shows inflows and outflows of cash.
- Statement of Owner's Equity: Shows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

**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**

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.

**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.

The Account	
Debit Side	Credit Side

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- 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.
  - 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)

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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

- Revenue:** Revenue in accounting means the receipt of a recurring (regular) nature from any defined source.
- Goods:** Anything which is kept in business for resale or anything in which business deals.
- Sale:** The Term SALES is used only for the sales of those goods which are purchased for resale purposes.
- Purchase:** The Term PURCHASE is used only for purchase of those goods, in which business deals.
- Stock (Inventory):** The Term Stock includes the value of those goods which are lying unsold at the end of an accounting period.
  - Opening stock
  - Closing stock
- 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.
- Receivables:** Amount due from debtors and bills receivables (B/R) is jointly termed as 'Receivables' or 'Account Receivables'.
- 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.
- 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:
- Started business with cash ₹ 70,000.
  - Credit purchase of goods ₹ 18,000.
  - Payment made to creditors .

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- (iv) Purchase of machinery for cash ₹ 20,000.  
(v) Depreciation on machinery ₹ 2,000.

Solution:  
The solution for this question is as follows:

S. No.	Transaction	Assets				=	Liabilities (Rs)	+	Capital (Rs)
		Cash (Rs)	+	Stock (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		=	0		70,000
(v)	Depreciation on Machinery Rs 2,000	32,000	+	18,000	+				70,000 (2,000) (Depreciation)
		32,000	+	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 ₹ 1,00,000.
- (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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