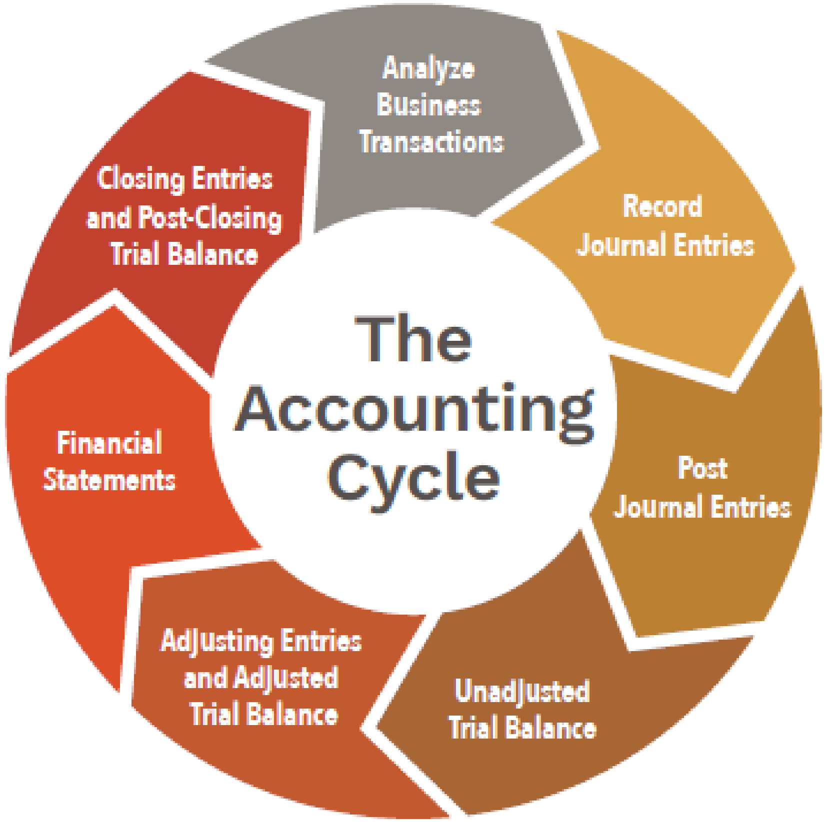
2 The Accounting Cycle

LABYRINTH LEARNING®

LEARNING OBJECTIVES

- Explain the concept of posting journal entries
- Identify the purpose of a trial balance
- Distinguish between adjusting entries and closing entries
- Discuss the four primary financial statements

The Accounting Cycle



- **Step 1:** Analyze business transactions
- **Step 2:** Record journal entries
- **Step 3:** Post journal entries
- **Step 4:** Unadjusted trial balance
- **Step 5:** Adjusting entries and adjusted trial balance
- **Step 6:** Financial statements
- **Step 7:** Closing entries and post-closing trial balance

Source Documents

- **Invoice:** A bill for goods or services
- **Check:** Provides information regarding payment from a customer or to a supplier
- **Bank statement:** Outlines monthly bank activity
- **Purchase order:** Sent to the seller to indicate a desire to purchase items
- **Sales order:** Prepared by the seller upon receipt of a purchase order

Generally Accepted Accounting Principles

- **Cost principle:** Every asset must be recorded at the amount paid for the item.
- **Time-period principle:** Accounting activity may be expressed over a specific period of time.
- **Revenue principle:** Revenue must be recorded in the period in which it is earned.
- **Matching principle:** Expenses must be recorded in the same period as the revenue they generated.

Generally Accepted Accounting Principles (cont.)

- **Monetary unit principle:** Balances, shown in U.S. dollars or other applicable local currency, can be used to express company performance.
- **Full disclosure principle:** Public companies must disclose all pertinent information.

Potential Account Balance Errors

- An amount was incorrectly copied from a source document.
- A transaction was recorded using the wrong account.
- Digit transposition (such as $250 instead of $520)
- The omission of a transaction.
- The recording of a single transaction multiple times.

Accrual Basis of Accounting

- Revenues are recorded when they're earned, regardless of when cash changes hands.
- Expenses are recorded when they're incurred, regardless of when cash changes hands.
- This accounting basis:
  - is compliant with GAAP
  - requires adjusting entries

Cash Basis of Accounting

- Revenues are recorded when cash changes hands, regardless of when they are earned.
- Expenses are recorded when cash changes hands, regardless of when they are incurred.
- This accounting basis:
  - is not compliant with GAAP
  - eliminates the need for adjusting entries

Financial Statements

- **Income statement:** This displays ending balances for all revenue and expense accounts.
- **Statement of owner's equity:** This is a reconciliation summarizing activity related to owner's equity.
- **Balance sheet:** This displays all asset, liability, and owner's equity account balances.
- **Statement of cash flows:** This summarizes all uses and sources of cash.

Financial Statement Users

- **Internal users:** Work with the company
  - Finance professionals
  - Marketing professionals
  - Internal auditors
- **External users:** Work outside the company
  - Potential investors
  - Governmental agencies
  - Potential lenders

Permanent Accounts

The ending balance for one year becomes the beginning balance for the subsequent year.

- Asset accounts
- Liability accounts
- Owner's capital account

Temporary Accounts

The ending balance is closed to the owner’s capital account. Begin each period with a $0 balance.

- Revenue accounts
- Expense accounts
- Owner’s withdrawal account