Chapter 2

The Accounting Cycle FOR SERVICE RENDERING BUSINESS ENTERPRISES

Contents

- Describe the nature, types and charts of accounts
- State the rules of debit and credit
- Journalizing business transactions
- Post business transactions
- Prepare trial balance

2.1 Nature of an account

- An account is a subdivision under the three elements of the accounting equation used to record the changes over a single element in the financial statements.
- An account has three parts, Title, Debit, and credit.
- For illustration purposes an account can be represented in the form of capital letter ‘T’.

2.1 Classifications of accounts

- Accounts are classified into five: assets, liabilities, capital, revenue and, expenses.
- The first three are called balance sheet accounts and the other two are called income Statement accounts.
- Balance Sheet accounts are those reported on the balance sheet at the end of the reporting period and Income Statement accounts are reported on the Income Statement.

2.1 Classifications of accounts

- Assets: Resources owned by a business or individual are called assets.
- Assets could be tangible or intangible. Tangible assets are assets having physical existence, like cash, land, computer, stationery materials. Intangible assets do not have physical existence. Example: Goodwill, Copyright, patent right.

2.1 Classifications of accounts

- On the balance sheet assets are classified into two current assets and non – current assets.
- Current Assets – are those assets, which can be used, sold, or converted into cash within one accounting year. Example: cash, supplies, prepayments, receivables etc.

- Non-current Asset: All assets other than current assets are called non-current assets. Example: land, patent right, office equipment, vehicles.

2.1 Classifications of accounts

- Liabilities: Creditors' claims to the assets of a business; amounts owed to creditors are called liabilities. Like assets, liabilities are classified in to two as current liabilities and non – current liabilities
- Current liabilities: The liabilities that are payable within the next (one) accounting year are known as current liability. Example: Accounts Payable, Rent Payable, Salary Payable.

- Non – Current Liabilities: Debts that are not required to be paid within the next accounting period. Example long term notes payable.

2.1 Classifications of accounts

- Capital: The excess of the assets of a business over its liabilities is referred to as capital. It is the equity of the owner in the business.
- Revenue: Are increases in owner's equity resulting from the main operations of the business. Examples of revenue accounts are sales, interest income, tuition fee, and sales commission.

2.1 Classifications of accounts

- Expenses: are decreases in owner's equity in the process of earning revenue. For example, a hotel has to pay salary to its workers for the services rendered to clients in order to get the income form customers (revenue) the Hotel has to pay salary to the employees (expense).
- Example of expenses: Salary, insurance, depreciation, supplies, utilities, rent etc.

2.1 Chart of accounts

- The number and name of accounts used by an organization depends on the nature of its operation.
- The list of accounts used by an organization and their codes is called the chart of accounts.

2.2 Rules of debits and credits

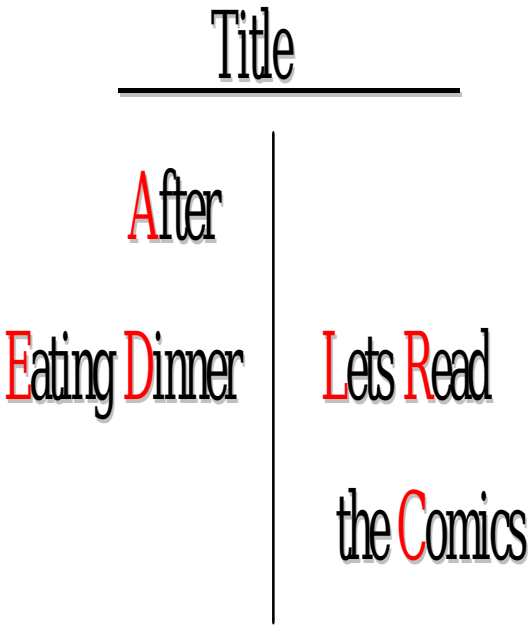
- Debit is the left hand side of an account
- Debit is abbreviated as ‘Dr.’. When an amount is entered on the left side of an account we say the account is debited or charged.
- Credit – is the right hand side of an account.
- Credit is abbreviated as Cr. An account is said to be credited when an amount is entered on the right hand side of the account.

2.2 Rules of debits and credits

The above general rule will be expanded as follows

Debit	Credit
-Increase in assets	-Decrease in assets
-Increase in expenses	-Decrease in expenses
-Decrease in capital	-Increase in Liabilities
-Decrease in liabilities	-Increase in liabilities
-Decrease in revenue	-Increase in revenue.

2.2 Rules of debits and credits



2.3 Journalizing business transactions

- The accounting record in which a transaction is initially recorded is known as a journal. The journal is therefore referred to as "The book of original entry".
- The process of recording a business transaction in the accounting record is called journalizing.

2.3 Journalizing business transactions

- The Journal commonly used to record all types of transactions is the General Journal. This Journal includes the following parts, entered step by step.

1. The date of the transaction
2. The title of the account debited
3. The title of the account credited
4. The amount of debit and credit
5. Brief explanation of the entry or reference to the source document.

2.3 Journalizing business transactions

- General Journal

Look at the following General Journal and notice where each of the above information is found.

Journal page_____

Date		Description	P.R	Debit		Credit	
Year							
Month	day	Debited account title		XXX	XX		
		Credited account title				X XX	XX
		Explanation					

2.3 Journalizing business transactions

- Steps in Journalizing a Transaction

1. Record the date - Insert the year, the month, and the date as shown above.

2. Record the Debit- Insert the account debited in the description column and the amount of debit in the debit column.

3. Record the credit- Insert the account credited below the debited account and indented to the right in the description column and the amount of credit in the credit column.

4. Explanation- Write a brief explanation or reference to source document in the description column, when necessary.

2.3 Journalizing business transactions

- In recording a business transaction answer the following questions:

a) Which accounts are affected?

b) Is each account increased or decreased?

c) Which account is debited and which is credited?

d) Prepare the complete journal entry.

2.4 Posting

- After the information about a business transaction has been journalized, that information is transferred to the specific accounts affected by each transaction. This process of transferring the information is called posting.
- The group of accounts used by an organization is called ledger.
- An account could be of two types; the two-column account and the four-column account. We will use the four-column account for our illustration. The two forms of accounts are given below.

2.4 Posting

- Types of accounts

The two-column account:

Account_____ Account number_____

Date		Item	P.R	Debit		Date		Item	P.R	Credit	

The four-column account:

Account_____ Account number_____

Date		Item	P.R	Debit		Credit		Balance			
								Debit		Credit	

2.4 Posting

- The steps in posting are given below:

1. Record the date and amount of Dr. and Cr. Entry to the account
2. Insert the Journal page number in the P.R (Post Reference) column of the account.
3. Insert the account number in the P.R column of the journal.

2.5 The trial balance

- After the posting phase is completed, we have to verify the equality of the debit and credit balances. This is done through the use of the 'Trial Balance'.
- A trial balance is a two column listing of the accounts in the ledger and their balance to make sure that the total of debit balances equals the total of credit balances.

Chapter Illustration

By taking the transactions of Omo Company

- Record the transactions in a journal
- Post them in the accounts
- Prepare trial balance
- Prepare financial statements

End of Chapter 2