

## UNIT .2 THE ACCOUNTING CYCLE

### 2.1 INTRODUCTION

In unit 1, you have learned the relationship between the accounting equation and business transactions. Every business transaction affects the elements of the accounting equation. This accounting procedure will be discussed in detail. *The different and interrelated stages of the accounting cycle will be presented.* The chapter is lengthy, but essential for the remaining chapters in this course and other accounting courses. Therefore, you are advised to study the chapter carefully.

### 2.2 NATURE OF AN ACCOUNT

In order to provide the necessary information to users, accountants maintain separate records on each element of the financial statements. For example, to report the balance for cash at the end of a year, a record regarding cash should be kept. The record includes beginning cash balance, cash payments & cash collections during the period. This record is called an **account**.

**Definition:** 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'.

#### **Example**

| Title |        |
|-------|--------|
| Debit | Credit |
| Dr    | Cr     |

### 2.3 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.

The five groups of account are discussed below

**1. 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.

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. 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.

**3. 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.

**4. 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.

**5. 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 from customers (revenue) the Hotel has pay salary to the employees (expense).

Example of expenses: Salary, insurance, depreciation, supplies, utilities, rent etc.

## 2.4 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**. Look at the following chart of accounts of Bati Transport.

### Bati Transport

#### Chart of Accounts

| <u>Asset</u>                             | <u>Account number</u> |
|------------------------------------------|-----------------------|
| Cash-----                                | 11                    |
| Accounts Receivable-----                 | 12                    |
| Supplies-----                            | 13                    |
| Prepaid Insurance-----                   | 14                    |
| Equipment-----                           | 15                    |
| Accumulated Depreciation -Equipment----- | 16                    |

|                                       |    |
|---------------------------------------|----|
| Truck-----                            | 17 |
| Accumulated depreciation – Truck----- | 18 |

### **Liabilities**

|                       |    |
|-----------------------|----|
| Accounts Payable----- | 21 |
| Notes Payable-----    | 22 |

### **Owners Equity**

|                          |    |
|--------------------------|----|
| Yimer Adam, Capital----- | 31 |
| Yimer Adam Drawing-----  | 32 |
| Income Summary-----      | 33 |

### **Revenue**

|                     |    |
|---------------------|----|
| Service income----- | 41 |
|---------------------|----|

### **Expense**

|                            |    |
|----------------------------|----|
| Salaries Expense -----     | 51 |
| Rent Expense -----         | 52 |
| Utilities Expense-----     | 53 |
| Supplies Expense-----      | 54 |
| Insurance Expense-----     | 55 |
| Maintenance Expense-----   | 56 |
| Depreciation Expense-----  | 57 |
| Truck Expense-----         | 58 |
| Miscellaneous expense----- | 59 |

In the chart of accounts, the asset accounts are listed according to their liquidity. Liquidity is the ease with which an asset can be converted in to cash. Cash is the most liquid asset so it is listed first. Accounts other than cash will be listed in their frequency of use or in alphabetical order.

The account number is a code to identify accounts. The number could be a two digit, three digit or more digits. In the above example a three – digits code is used.

When the chart of accounts is prepared in an organization we say the ledger is opened.

## 2.5 RULES OF DEBITS AND CREDITS

As shown above every account has three parts. These parts are discussed below:

**Title** - The name of the account. This is written at the top of the account.

**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.

An account may increase or decrease on the debit side or on the credit side depending on the nature of the account. In general, accounts appearing on the left hand side of the accounting equation increase on their left side (Dr. side) and decrease on their right side (Cr. Side); whereas accounts on the right side of the equation increase on their right side and decrease on their left side.

The above general rule will be expanded as follows

| <u><b>Debit</b></u>      | <u><b>Credit</b></u>     |
|--------------------------|--------------------------|
| -Increase in assets      | -Decrease in assets      |
| -Increase in expenses    | -Decrease in expenses    |
| -Decrease in capital     | -Increase in Capital     |
| -Decrease in liabilities | -Increase in liabilities |
| -Decrease in revenue     | -Increase in revenue.    |

## 2.6 JOURNALIZING BUSINESS TRANSACTIONS

When a business transaction takes place, **source documents** will be obtained and recorded. 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**.

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.

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      |         |                        |     |         |    |         |    |
| Mon<br>th | da<br>y | Debited account title  |     | XX<br>X | XX |         |    |
|           |         | Credited account title |     |         |    | X<br>XX | XX |
|           |         | Explanation            |     |         |    |         |    |

There are also other types of Journals like, known as **special journals** that are used to record specific types of transactions. The cash Journal, for instance, is used to record only transactions affecting cash. The

General Journal is used for illustrations in this chapter. Special journals are discussed in unit 5.

### **Steps in Journalizing a Transaction**

The following steps should be followed in recording a transaction in the journal.

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.

Each one set of debits and credits for a transaction is called a ***journal entry***.

In recording a business transaction answer the following questions based on the transaction to be recorded may help you.

- 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.

Example. On January 10, 2003 Tamget P.L.C paid Birr 6,000 to its employees as a salary for the first week of the year.

This business transaction will be analyzed and recorded as follows.

- a) Which accounts are affected? Answer: Cash and Salary Expense.
- b) Is each account increased or decreased? Answer: cash is decreased and salary expense is increased.

- c) Which account is debited and which is credited? Answer: Salary Expense is debited because increase in expenses is recorded on the debit side. And cash is credited because decrease in assets is recorded on the debit side.
- d) Prepare the complete Journal entry.

|      |   |                   |  |     |    |     |   |
|------|---|-------------------|--|-----|----|-----|---|
| 2003 |   | Description       |  |     |    |     |   |
| Jan. | 1 | Salary expense    |  | 600 | 00 |     |   |
|      | 0 |                   |  | 0   |    |     |   |
|      |   | Cash              |  |     |    | 600 | 0 |
|      |   |                   |  |     |    | 0   | 0 |
|      |   | Payment of salary |  |     |    |     |   |

Note: A **journal entry** is the complete presentation of the record in the journal..

### ***Illustration***

To illustrate the complete accounting cycle, we will consider the following list of selected transactions. The transactions were completed by Bati Transport in the month of January 2003.

January 1. Ato yimer took Birr 450,000 from his personal savings and deposited it in the name of Bati transport.

January 2. Bati Transport purchased two used trucks for Birr 150,000 each, on cash.

January 4. Bati Transport received a check for Birr 650 for services given to Alem

Trading.

January 4. Received an invoice for truck expenses Birr 90.

January 11. Paid Birr 600 for Awash Insurance Company to buy an insurance policy for its trucks.

January 16. Ato Yimer issued a check for Birr 9,400 to the workers as a salary for

Two weeks.

January 20. Bati trading Billed Muradu Supermarket for goods transported from

Djibouti to Gondar Birr 2,650

January 21. Ato Yimer wrote a check for birr 450 to have one of the trucks repainted

January 21. Bati trading purchased stationary materials and other supplies of Birr 740 on

account

January 22. Office equipment of Birr 11,600 is bought on account.

January 23. Purchased an additional truck for Birr 250,000 paying birr 100,000 in cash

and issuing a note for the difference.

January 23. Recorded services billed to customers on account birr 14,600.

January 25. Received cash from customers on account Birr 15,000.

January 27. The owner withdrew Birr 500 in cash for his personal use.

January 28. Paid Birr 9,400 to workers as a salary for the last two weeks of the month.

\*January 30. Paid telephone expense of Birr 95 and electric expenses of Birr 125 for the

month.

January 30. Paid other miscellaneous expenses Birr 50.

January 31. Paid Birr 4,000 as a rent for a building used for office space.

These transactions are journalised as follows:

| Date         | Description           | Debit   | Credit  |
|--------------|-----------------------|---------|---------|
| 2003<br>Jan. | Cash<br>Yimer Capital | 450,000 | 450,000 |

|    |                                                                          |         |                    |
|----|--------------------------------------------------------------------------|---------|--------------------|
| 1  | To record investment by owner                                            |         |                    |
| 2  | Truck<br>Cash<br>Purchase of trucks                                      | 300,000 | 300,000            |
| 4  | Cash<br>Service Income<br>Cash received from customers                   | 650     | 650                |
| 4  | Truck Expenses<br>Accounts Payable<br>Service received in advance        | 90      | 90                 |
| 11 | Prepaid Insurance<br>Cash<br>Purchase of insurance policy                | 600     | 600                |
| 6  | Salary Expense<br>Cash<br>Payment of salary                              | 9,400   | 9,400              |
| 0  | Accounts Receivable<br>Service Income<br>Provision of service            | 2,650   | 2,650              |
| 21 | Truck Expense<br>Cash<br>Cash paid to repaint truck                      | 450     | 450                |
| 21 | Supplies<br>Accounts Payable<br>Purchase of supplies of account          | 740     | 740                |
| 22 | Office Equipment<br>Accounts Payable<br>Purchase of equipment            | 11,600  | 11,600             |
| 23 | Truck<br>Cash<br>Notes Payable<br>Purchase of truck                      | 250,000 | 100,000<br>150,000 |
| 23 | Accounts Receivable<br>Service Income<br>Provision of service on account | 14,600  | 14,600             |
| 25 | Cash<br>Accounts Receivable<br>Collection of cash                        | 15,000  | 15,000             |

|    |                                                                    |       |       |
|----|--------------------------------------------------------------------|-------|-------|
| 27 | Drawings<br>Cash<br>Owner withdrawals                              | 500   | 500   |
| 28 | Salary Expense<br>Cash<br>Payment of salary                        | 9,400 | 9,400 |
| 30 | Utilities Expense<br>Cash<br>Payment for telephone,<br>electricity | 220   | 220   |
| 30 | Miscellaneous Expenses<br>Cash<br>Payment for various<br>expenses  | 50    | 50    |
| 31 | Rent Expense<br>Cash<br>Payment of Rent                            | 4,000 | 4,000 |

## 2.7 POSTING FROM THE JOURNAL TO THE LEDGER

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**.

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.

### ***The two-column account:***

Account \_\_\_\_\_ Account number \_\_\_\_\_

| Date | Item | P.<br>R | Debit | Date | Item | P.<br>R | Credit |
|------|------|---------|-------|------|------|---------|--------|
|      |      |         |       |      |      |         |        |

### ***The four-column account:***

AccountAccount number

| Date |  | Item | P.<br>R | Debit |  | Credit |  | Balance |  |        |  |
|------|--|------|---------|-------|--|--------|--|---------|--|--------|--|
|      |  |      |         |       |  |        |  | Debit   |  | Credit |  |
|      |  |      |         |       |  |        |  |         |  |        |  |

***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.

Note. The P.R Column is used for reference purposes. The P.R column of the journal shows whether the entry is posted and the account to which it is posted. In the account, the P.R Column shows the Journal page number from which the entry was brought.

The group of accounts used by an organization is called **ledger**.

**Illustration.** As mentioned above, to illustrate the posting process the four column account is used and the entries to the cash account are posted as follows.

Account CashAccount Number

| Date |    | Item | P.R | Debit  |    | Credit |    | Balance |    |        |  |
|------|----|------|-----|--------|----|--------|----|---------|----|--------|--|
|      |    |      |     |        |    |        |    | Debit   |    | Credit |  |
| 200  |    |      |     | 450,00 | 00 |        |    | 450,00  | 00 |        |  |
| 3    | 1  |      |     | 0      |    |        |    | 0       |    |        |  |
| Jan  |    |      |     |        |    |        |    |         |    |        |  |
|      | 2  |      |     |        |    | 300,00 | 00 | 150,00  | 00 |        |  |
|      |    |      |     |        |    | 0      |    | 0       |    |        |  |
|      | 4  |      |     | 650    | 00 |        |    | 150,65  | 00 |        |  |
|      |    |      |     |        |    |        |    | 0       |    |        |  |
|      | 11 |      |     |        |    | 600    | 00 | 15005   | 00 |        |  |
|      |    |      |     |        |    |        |    | 0       |    |        |  |
|      | 16 |      |     |        |    | 9,400  | 00 | 14065   | 00 |        |  |
|      |    |      |     |        |    |        |    | 0       |    |        |  |

|  |    |  |  |        |    |             |    |            |    |  |  |
|--|----|--|--|--------|----|-------------|----|------------|----|--|--|
|  | 21 |  |  |        |    | 450         | 00 | 14020<br>0 | 00 |  |  |
|  | 23 |  |  |        |    | 100,00<br>0 | 00 | 40200      | 00 |  |  |
|  | 25 |  |  | 15,000 | 00 |             |    | 55200      | 00 |  |  |
|  | 27 |  |  |        |    | 500         | 00 | 54200      | 00 |  |  |
|  | 28 |  |  |        |    | 9,400       | 00 | 45300      | 00 |  |  |
|  | 30 |  |  |        |    | 220         | 00 | 45,080     | 00 |  |  |
|  | 30 |  |  |        |    | 50          | 00 | 45,030     | 00 |  |  |
|  | 31 |  |  |        |    | 4,000       | 00 | 41,030     | 00 |  |  |
|  |    |  |  |        |    |             |    |            |    |  |  |

**Note.** The item column is usually left blank. In some cases the word balance is written when the account is carried foreword to a new page.

## 2.8 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.

The trial balance for our illustration, Bati Transport is presented bellow. The amounts are taken from the balances of the accounts after all the transactions have been posted. Therefore, after posting the above transactions, you should get the final balances shown on the trial balance in the end.

### Bati Transport Trial Balance January 31, 2003

|                     |         |    |        |    |
|---------------------|---------|----|--------|----|
| Cash                | 41,030  | 00 |        |    |
| Accounts Receivable | 2,250   | 00 |        |    |
| Supplies            | 740     | 00 |        |    |
| Prepaid Insurance   | 600     | 00 |        |    |
| Office equipment    | 11,600  | 00 |        |    |
| Truck               | 550,000 | 00 |        |    |
| Accounts payable    |         |    | 12,430 | 00 |

|                       |                |           |                |           |
|-----------------------|----------------|-----------|----------------|-----------|
| Notes payable         |                |           | 150,000        | 00        |
| Yimer capital         |                |           | 450,000        | 00        |
| Yimer drawing         | 500            | 00        |                |           |
| Service income        |                |           | 17,900         | 00        |
| Salary expense        | 18,800         | 00        |                |           |
| Rent expense          | 4,000          | 00        |                |           |
| Utilities expense     | 220            | 00        |                |           |
| Maintenance expense   | 450            | 00        |                |           |
| Truuck expense        | 90             | 00        |                |           |
| Miscellaneous expense | 50             | 00        |                |           |
| Total                 | <u>630,330</u> | <u>00</u> | <u>630,330</u> | <u>00</u> |

### 2.8.1 Proof Provided by the Trial Balance

The trial balance debit totals and credit totals are equal implies that the accounting work is more likely to be free from any one or more of the following errors.

1. Error in preparing the trial balance including
  - Addition error
  - The amount of an account balance was in correctly listed on the trial balance
  - A debit balance was recorded as a credit or vice versa
  - A balance was entirely omitted.
2. Error in posting, including
  - An erroneous amount was posted to the account.
  - A debit amount was posted as a credit or vice versa
  - A debit or credit posting was omitted

### 2.8.2 Limitations of the Trial Balance

The trial balance amounts are equal doesn't mean that the accounting work is free from error. That is, there are errors that may take place without affecting the trial balance totals. Some examples are mentioned below:

- Failure to record a transaction or to post a transaction

- Recording the same erroneous amount for both the debit and the credit parts of a transaction.
- Recording the same transaction more than once.
- Posting part of a transaction to the correct side but the wrong account.

Note: All these errors have the same affect (increasing or decreasing) on the debit totals and credit totals

## 2.9 ADJUSTMENTS

All the transactions recorded above in the journalizing step are the result of daily transactions. Other transactions result from the passage of time or from the internal operations of the business. For example, insurance premiums are paid for a certain period of time and expire during that time period. Another example is office supplies such as paper, pens & pencils.

At the end of the period the balances in accounts such as supplies and prepaid insurance must be brought up to date. The supplies account balance, for example, must be credited by the consumed part of the supplies, debiting supplies expense.

Example. Stationary materials totaling Birr 1,900.00 were purchased and recorded during the year. At the end of the year, only Birr 150 of the supplies is left in hand.

The adjusting entry prepared at the end of the year to adjust the supplies account will be

|      |                  |  |  |       |  |
|------|------------------|--|--|-------|--|
| 1990 | Supplies expense |  |  | 1,750 |  |
|------|------------------|--|--|-------|--|

|       |          |  |  |  |       |
|-------|----------|--|--|--|-------|
| Dec31 | Supplies |  |  |  | 1,750 |
|-------|----------|--|--|--|-------|

**Note:** 1. Adjustments are dated as the last day of the year.

2. The accounting year here - we assume, runs from January 1-December 31.

Additional examples on adjustments will be given below under the topic 'worksheet'

### 2.9.1 The Accrual Basis and the Cash Basis of Accounting

1. ***The cash basis of accounting*** - In this basis of accounting revenues are reported in the period in which cash is received and expenses are reported in the period in which cash is paid. Net income will, therefore, be the difference between the cash receipts (Revenues) and cash payments (expenses). This method will be used by organizations that have very few receivables and payables. For most businesses, however, the cash basis is not an acceptable method.
2. ***The accrual basis of accounting*** - Under this method revenues are reported in the period in which they are earned, and expenses are reported in the period in which they are incurred. For example, revenue will be recognized as services are provided to customers or goods sold and not when cash is collected. Most organizations use this method of accounting and we will apply this method in this course.

### 2.9.2 The Matching Principle

We have discussed three concepts and principles in accounting in unit one. Now we will see one more principle, the matching principle. This principle states that the expense of a period have to be matched with the revenue of that period regardless of when payment is made. In order to do this, the accrual basis of accounting requires the use of an adjusting

process at the end of the period so that revenues and expenses of the period will be determined properly.

## **2.10 WORKSHEET FOR FINANCIAL STATEMENTS**

Most of the data required to prepare the accounting reports (financial statements) is now gathered. The data will now be presented in a convenient form. The worksheet is a large columnar sheet prepared to arrange in a convenient form all the accounting data required to prepare financial statements. The worksheet has a heading and a body.

The heading has three parts:

- i) Name of the Organization
- ii) Name of the form (worksheet)
- iii) Period of time covered.

The body contains five main parts each of them with two main columns.

These parts are

- 1. The trial balance
- 2. The adjustment
- 3. The adjusted trial balance
- 4. The income statement
- 5. The balance sheet.

The worksheet for Bati Transport is given below. The five parts of the body are discussed as follows. You are advised to read and understand the discussions before you look at the respective columns of the worksheet.

**Bati Transport**  
**Work Sheet**  
**For the month ended Jan.31,2003**

|    | Account Title         | Trial Balance  |                | Adjustment  |             | Adjusted Trial balance |                | Income statement |              | Balance sheet  |                |
|----|-----------------------|----------------|----------------|-------------|-------------|------------------------|----------------|------------------|--------------|----------------|----------------|
| 1  | Cash                  | 41,030         |                |             |             | 41,030                 |                |                  |              | 41,030         |                |
| 2  | Accounts receivable   | 2,250          |                | ©7,400      |             | 9,650                  |                |                  |              | 9,650          |                |
| 3  | Supplies              | 740            |                |             | (a)340      | 400                    |                |                  |              | 400            |                |
| 4  | Prepaid Insurance     | 600            |                |             | (b)450      | 150                    |                |                  |              | 150            |                |
| 5  | Office equipment      | 11,600         |                |             |             | 11,600                 |                |                  |              | 11,600         |                |
| 6  | Truck                 | 550,000        |                |             |             | 550,000                |                |                  |              | 550,000        |                |
| 7  | Accounts payable      |                | 12,430         |             |             |                        | 12,430         |                  |              |                | 12,430         |
| 8  | Notes payable         |                | 150,000        |             |             |                        | 150,000        |                  |              |                | 150,000        |
| 9  | Yimer Capital         |                | 450,000        |             |             |                        | 450,000        |                  |              |                | 450,000        |
| 10 | Yimer drawing         | 500            |                |             |             | 500                    |                |                  |              | 500            |                |
| 11 | Service income        |                | 17,900         |             | ©7,400      |                        | 25,300         |                  | 25300        |                |                |
| 12 | Salary expense        | 18,800         |                |             |             | 18,800                 |                | 18,800           |              |                |                |
| 13 | Rent expense          | 4,000          |                |             |             | 4,000                  |                | 4,000            |              |                |                |
| 14 | Utilities expense     | 220            |                |             |             | 220                    |                | 220              |              |                |                |
| 15 | Maintenance expense   | 450            |                |             |             | 450                    |                | 450              |              |                |                |
| 16 | Truck expense         | 90             |                |             |             | 90                     |                | 90               |              |                |                |
| 17 | Miscellaneous Expense | 50             |                |             |             | 50                     |                | 50               |              |                |                |
| 18 |                       | <u>630,330</u> | <u>630,330</u> |             |             |                        |                |                  |              |                |                |
| 19 | Supplies expense      |                |                | (a)340      |             | 340                    |                | 340              |              |                |                |
| 20 | Insurance expense     |                |                | (b)450      |             | 450                    |                | 450              |              |                |                |
| 21 |                       |                |                | <u>7290</u> | <u>7290</u> | <u>636,830</u>         | <u>636,830</u> |                  |              |                |                |
| 22 | Net income            |                |                |             |             |                        |                |                  |              |                |                |
| 23 |                       |                |                |             |             |                        |                | <u>25300</u>     | <u>25300</u> | <u>613,330</u> | <u>613,330</u> |
|    |                       |                |                |             |             |                        |                |                  |              |                |                |

**1. The trial balance column** - this is the same trial balance we have prepared before. The trial balance column of the work sheet can be brought direct from the ledger or from a separate trial balance.

**2. The Adjustment column** - As mentioned previously, some account balances have to be adjusted at the end of the year.

The accounts in the ledger of our illustration that require adjustment and the adjusting entry for the accounts are presented below.

**a) Supplies** – The supplies account has a debit balance of Birr 740. The cost of supplies in hand on July 31 is determined to be Birr 400. The following adjusting entry is required to bring the balance of the account up to date:

|                       |     |
|-----------------------|-----|
| Supplies expense..... | 340 |
| Supplies.....         | 340 |

**b) Prepaid insurance** – Analysis of the policy showed that three – fourth of the policy is expired. That is only Birr 150 of the policy is applicable to future periods. The adjusting entry to transfer the expired part of the insurance to expense will be.

|                         |     |
|-------------------------|-----|
| Insurance expense ..... | 450 |
| Prepaid insurance.....  | 450 |

**c) Service Income** – At the end of the month unbilled fees for services performed to clients totaled Birr 7,400.

This amount refers to an income earned but to be collected in the future. The journal entry to record it will be

|                          |       |
|--------------------------|-------|
| Accounts receivable..... | 7,400 |
| Service income.....      | 7,400 |

All the above adjusting entries will be inserted in the adjustment column of the worksheet in front of the accounts affected.

**Note** – The letters a, b & c are used to cross-reference the debits and credits to help future review of the worksheet.

**3. The Adjusted Trial Balance Column** – The accounts that require adjustment are now adjusted. Transferring the trial balance column

amounts combined with the adjustment column amounts will complete the adjusted trial balance column of the worksheet.

**4. The income statement and the balance sheet columns** - Transfer the income statement account balances (revenue & expenses) to the income statement and balance sheet account balances (Asset, Liability & owners equity) to the balance sheet columns. Note that what we have to transfer is the adjusted trial balance column amounts, to the corresponding columns.

Look at the 22<sup>nd</sup> row. It shows the net income for the month and it is added to the two columns (Income statement Dr. and balance sheet cr.) as a balancing figure.

## **2.11 FINANCIAL STATEMENT PREPARATION**

After the work sheet is completed financial statements could be prepared easily. In chapter one we have discussed four basic financial statements prepared by most organizations. Here, we will prepare three of these statements for Bati Transport from the worksheet.

**1. Income statement** all the data required to prepare the income statement is brought  
from the worksheet.

### **Bati Transport**

#### **Income statement**

**For the month ended. Jan 31, 2003**

Service Income .....Birr 25,300

Operating expenses

Salary expense.....Birr 18,800

Rent “.....4,000

Maintenance expense ..... 450

Insurance “.....450

|                              |         |               |
|------------------------------|---------|---------------|
| Supplies                     | " ..... | 340           |
| Utilities                    | " ..... | 220           |
| Truck                        | " ..... | .90           |
| Miscellaneous                | " ..... | 50            |
| Total operating expense..... |         | <u>24,400</u> |
| Net Income.....              | Birr    | 900           |

**2. Statement of owner's equity** - This statement shows the beginning balance of capital and the changes that affected it.

The balance of the owners equity account (Yimer capital) in the worksheet may not be the beginning one. Therefore, the ledger has to be reviewed to see if there was an additional investment during the period or not. In our illustration there is no additional investment.

**Bati Transport**  
**Statement of Owner's equity**  
**For the month ended January 31, 2003**

|                                      |            |
|--------------------------------------|------------|
| Yimer capital January 1, 2003.....   | Birr       |
| 450,000                              |            |
| Net income for the month.....        | birr 900   |
| <u>Less: Withdrawal.....</u>         | <u>500</u> |
| <u>400</u>                           |            |
| Yimer capital, January 31, 2003..... | Birr       |
| 450,400                              |            |

**3. Balance sheet** - The data to prepare this statement will be taken from the worksheet and the other financial statements. Note that assets and liabilities are classified as current and non - current.

**Bati Transport**  
**Balance sheet**

**January 31, 2003**

**Assets**

**Current Assets:**

|                           |              |             |
|---------------------------|--------------|-------------|
| Cash.....                 | Birr 41, 030 |             |
| Accounts Receivable.....  | 9,650        |             |
| Supplies.....             | 400          |             |
| Prepaid insurance.....    | <u>150</u>   |             |
| Total current assets..... |              | Birr 51,230 |

**Plant Asset (None-Current Assets):**

|                       |                |                     |
|-----------------------|----------------|---------------------|
| Office equipment..... | Birr 110,600   |                     |
| Truck.....            | <u>550,000</u> | <u>561,600</u>      |
| Total asset.....      |                | Birr <u>612,830</u> |

**Liabilities**

**Current liabilities**

|                       |             |
|-----------------------|-------------|
| Accounts payable..... | Birr 12,430 |
|-----------------------|-------------|

**Non-current liabilities**

|                        |                |
|------------------------|----------------|
| Notes payable.....     | <u>150,000</u> |
| Total liabilities..... | Birr 162,430   |

**Owner's equity**

|                                        |                     |
|----------------------------------------|---------------------|
| Ato Yimer Capital.....                 | <u>450,400</u>      |
| Total liability and owners equity..... | Birr <u>612,830</u> |

## 2.12 THE CLOSING PROCESS

Some of the accounts in the ledger are temporary accounts used to classify and summarize the transactions affecting capital (owners'

equity). These accounts will be closed after financial statements are prepared. That is, their balances will be transferred to the Capital account. The temporary accounts that have to be closed are revenue, expense and withdrawal accounts.

### **Steps in closing:**

1. ***Closing revenue accounts*** - Debit each revenue account by its balance and credit the 'Income Summary' account by the total revenue for the period.

*Note:* Income summary is an account used to close revenue and expense accounts. This account will immediately be closed to the capital account at the end of the closing process.

2. ***Closing expense accounts*** - Debit the income summary account by the total of expenses for the period and credit each expense account by its balance.
3. ***Closing the income summary account*** - Income summary will be closed to the capital account. The balance of his account depends on the nature of operation; credit if result is profit and debit if result is loss.
4. ***Closing Withdrawal*** - Debit the owners equity account by the total of drawings for the period and credit the drawing account.

The temporary accounts of Bati transport are closed as follows.

|         |                     |        |
|---------|---------------------|--------|
| 2003    | Income summary..... | 25,300 |
| January | Service income..... | 25,300 |
| 31      | Closing revenue     |        |
| 31      | Salary expense..... | 18,800 |
|         | rent expense.....   | 4,000  |

|                            |        |
|----------------------------|--------|
| Maintenance expense.....   | 450    |
| Insurance expense.....     | 450    |
| Supplies expense.....      | 340    |
| Utilities expense.....     | 220    |
| Truck expense .....        | 90     |
| Miscellaneous expense..... | 50     |
| Income expense.....        | 24,400 |
| Closing expenses           |        |

|            |                        |     |
|------------|------------------------|-----|
| 2003       | Income summary.....    | 900 |
| January 31 | Yemer Capital.....     | 900 |
|            | Closing income summary |     |
| 31         | Yimer capital.....     | 500 |
|            | Yimer drowing.....     | 500 |
|            | Closing with drowal    |     |

The above closing entries have transferred the balance of the temporary accounts to the permanent capital account.

### 2.13 POST CLOSING TRIAL BALANCE

After the closing entries have been journalized and posted, a trial balance is prepared to prove the equality of the general ledger *before recording the new year's transactions*. It should be noted that this trial balance includes only balance sheet accounts. This is because the temporary income statement accounts are closed during the closing process. This trial balance is called the ***post - closing trial balance***.

In practice the ledger balance after closing may be checked by a simple calculator print out rather than a formal trial balance. The post closing trial balance for Bait Transport is presented below.

#### **Bati Transport**

**Post - Closing trial balance**  
**Jan 31, 2003**

|                           |                     |                     |
|---------------------------|---------------------|---------------------|
| Cash.....                 | Birr 41,030         |                     |
| Accounts Receivable ..... | 9,650               |                     |
| Supplies.....             | 400                 |                     |
| Prepaid insurance.....    | 150                 |                     |
| Office equipment.....     | 11,600              |                     |
| Truck.....                | 550,000             |                     |
| Accounts payable.....     |                     | Birr 12,430         |
| Nots payable.....         |                     | 150,000             |
| Yimer capital.....        |                     | <u>450,400</u>      |
| Total.....                | Birr <u>612,830</u> | Birr <u>612,830</u> |