PRINCIPLES OF ACCOUNTING

Chapter two

ACCOUNTING CYCLE

SECTION TWO

ACCOUNTING CYCLE:

- is the sequence of accounting procedures of a fiscal period.
- Annual accounting period adopted by an enterprise is known as ***fiscal Year***.
- Fiscal year ordinarily begin with the first day of a particular month selected and end on the last day of the twelfth month.

BASIC PHASES IN ACCOUNTING CYCLE

1. Transactions are analyzed and recorded in the journal,
2. Transactions are posted to the ledger,
3. Trial balance is prepared, data needed to adjust the accounts are assembled, and the worksheet is completed,
4. Financial statements are prepared,

BASIC PHASES IN ACCOUNTING CYCLE

5. Adjusting and closing entries are journalized,
6. Adjusting and closing entries are posted to the ledger,
7. Post-closing trial balance is prepared,
8. Reversing certain adjusting entries (optional)

The Account

- accounting systems are designed to show the increases and decreases in each accounting equation element as a separate record.
- This record is called an **account**.
- An account, in its simplest form, has three parts.

1. A **title**, which is the name of the accounting equation element recorded in the account.eg. Cash

The Account cont..

2. A space for recording increases in the amount of the element.
3. A space for recording decreases in the amount of the element .

Title of the Account

Left or debt side	Right or credit

Classification of Accounts

- Accounts in the ledger are customarily listed in the order, in which they appear in financial statements and classified according to common characteristics.

1. Balance sheet accounts are classified as assets, liabilities and owner's equity.
2. Income statement accounts are classified as revenues or expenses.

Balance sheet accounts

Assets:

- Any physical thing (tangible) or right (intangible) that has a monetary value is to a business or individual is its asset.
- It divided into

Current Assets, Plant Assets, and Intangible Assets

Balance sheet accounts cont...

- **Current Assets:** Are assets that may reasonably be expected to be realized in cash or sold or used up usually within one year or less

-It include: Cash, Accounts Receivable, Inventories, Prepaid Rents, Supplies, etc.

Balance sheet accounts cont...

- **Plant Assets Are** Tangible assets used in the businesses, which are of a permanent or relatively fixed nature

-It include: Equipment, Machinery, buildings, Land, vehicles, etc.

-With the exception of land, such assets gradually wear out or otherwise lose their usefulness with the passage of time and this process is known as depreciation.

Balance sheet accounts ont...

- **Intangible Assets** Are Nonphysical things controlled by the business.

-It include: Goodwill, Patents, Copyrights, Trademarks, etc.

Balance sheet accounts ont...

❖Liabilities

- are debts owed to outsiders (creditors) and are frequently described on the balance sheet by titles that include the word “payable”.
- Categories are

✓ **Current Liabilities** and

✓ **Long term liabilities**

Balance sheet accounts ont...

- **Current Liabilities**: Liabilities that will be due within a short time (usually one year or less) and that are to be paid out of current assets
- include: Accounts payable, Notes payable, Salaries payable, Taxes payable, etc.
- **Long-term Liabilities:** Liabilities that will not be due for a comparatively long time (usually more than one year)
- include: Notes payable (long-term), Mortgage payables, etc.

Balance sheet accounts ont...

Owner's Equity

- is the residual claim against the business after the total liabilities are deducted.
- For a corporation, owner's Equity is frequently called *Stockholder's equity* or *shareholder's equity*.

Income statement accounts

❖ **Revenues:**

- are the gross increases in owner's Equity as a result of the sale of merchandise, the performance of services for customer or a client,
- the rental of property,
- the lending of money, and
- other business and professional activities.

Income statement accounts cont...

- sources of revenue include:
  - professional fees,
  - commission’s revenue;
  - interest income.

Income statement accounts cont...

Expenses

- Are Costs that have been consumed in the process of producing revenue are expired costs or expenses.
- The number of expense categories and individual expense accounts maintained in the ledger varies with the nature and the size of the business.

Chart of Accounts

- A listing of the accounts in a ledger
- The order of items (accounts) in the chart of accounts should agree with the order of the items in the balance sheet and the income statement.
- The accounts are numbered to permit indexing and also for use as references.

Chart of Accounts

- For most simple (small) business organization it has two digits:

-The first digit indicates the major division of the ledger in which the account is placed.

-Accounts beginning with

1 represent asset,

2 liabilities,

3 owner’s equity and drawing,

4 Revenue and

5 expenses.

Chart of Accounts

- The second digit indicates the position of the account with in its division.
- A numbering system of this type has the advantage of permitting the later insertion of new accounts in their proper sequence without disturbing the other account numbers.

Example of Chart of accounts for Net Solution

Balance Sheet Accounts	Income Statement Accounts
1. Assets	4. Revenue
11 Cash	41 Fees Earned
12 Accounts Receivable	5. Expenses
14 Supplies	51 Wages Expense
15 Prepaid Insurance	52 Rent Expense
17 Land	54 Utilities Expense
18 Office Equipment	55 Supplies Expense
2. Liabilities	59 Miscellaneous Expense
21 Accounts Payable	
23 Unearned Rent	
3. Owner's Equity	
31. Chris Clark, Capital	

Rule of Debit and Credit

- If every transaction is recorded with equal debits and credits, then the sum of all the debits to the accounts must equal with the sum of all the credits.
- Amounts entered on the left side of an account are called **debits**.
- right side of an account are called **credits**.

Rule of Debit and Credit

- Increases in assets must be entered on the left or debit side, and decreases in assets must be entered on the right or credit side.
- increases in liabilities must be entered on the right or credit side, and decreases in liabilities must be entered on the left or debit side.

Rule of Debit and Credit

BalanceSheet Account

Assets = Liability + Owners' Equity

Asset Accounts = Liability Accounts + Owners' Equity

Dr For cr for Dr For (-) cr for (+) Dr For (-) cr for (+)

Increase (+) (-)

-a credit balance in an asset account such as Land or a debit balance in a liability account such as wages payable would indicate errors in recording

Rule of Debit and Credit

- The cash account, for example, will have a credit balance when a company has overdrawn its bank balance (i.e., written a “bad” check).
- This rule of debit and credit is known as the **General Rule of debit and Credit or the balance sheet rule.**

Rule of Debit and Credit

- It is derived from the basic accounting equation and it is a rule for the three elements of the accounting equation.

Rule of Debit and Credit

Income Statement Account

Revenue		**Expense**	
Dr for	cr for	Dr for	cr for
_____			

Owner Withdrawals

- The debit and credit rules for recording owner withdrawals are based on the effect of owner withdrawals on owner's equity.
- Since owner's withdrawals decrease owner's equity, the owner's drawing account is increased by debits.
- Likewise, the owner's drawing account is decreased by credits.

Normal Balances

- the **normal balance of an account** is either a debit or credit depending on whether increases in the account are recorded as debits or credits.
- Eg. since asset accounts are increased with debits, asset accounts normally have debit balances.

-liability accounts normally have credit balances.

Errors in recording

- a credit balance in the office equipment account could result only from an error.

  -This is because a business cannot have more decreases than increases of office equipment.

- On the other hand, a debit balance in an accounts payable account could result from an overpayment.

Normal Balances

		Increase	Decrease	Normal Balance
Assets		Debit	Credit	Debit
Liabilities		Credit	Debit	Credit
Owner’s Equity	Stock Holder’s Equity			
Capital	Capital Stock	Credit	Debit	Credit
	Retained Earning	Credit	Debit	Credit
Drawing	Dividend	Debit	Credit	Debit
Revenue		Credit	Debit	Credit
Expense		Debit	Credit	Debit

Journalizing and Posting Transactions

- Journal is the accounting record in which a transaction is initially recorded.
- The journal is therefore, referred to as “the book of original entry” because all the information first recorded on the journal.
- The process of recording transactions in a journal is called **journalizing.**
- The recording process begins with the transaction.

Journalizing and Posting Transactions

- **Business documents**, such as a sales slip, a check, a bill, or a cash register tape, provide evidence of the transaction.
- The company analyzes this evidence to determine the transaction's effects on specific accounts.
- The company then enters the transaction in

Journalizing and Posting Transactions

- **kinds of source documents:**

-The *bank deposit ticket :* is the document that shows the amount of cash received by the business, and the capital account shows the net investment of the owner,

-The *purchase invoice:* is the source document that tells the business how much and when to pay the vendor

-*The sales invoice:* is the source document that tells the business how much revenue to record.

Journalizing and Posting Transactions

- The flow of accounting data from the time a transaction occurs to its recording in the ledger

1. Business Transaction Occurs
2. Business Document Prepared
3. Entry Recorded In Journal
4. Entry Posted To Ledger

Journalizing and Posting Transactions

- the transactions are entered in chronological order in a journal.

Posting Transactions

- The amounts of the debits and the credits in the journal are then transferred to the accounts in a ledger.
- This process of transferring the amounts of the debits and credits from the journal to the accounts in the ledger is known as Posting.

Two – Column Journal

- **Analysis steps**

1. Determine; account(s) affected.
2. Determine, whether the affected account increases or decreases.
3. determine whether the effect (increase or decrease) should be recorded as debits or credits by using the rule of debits and credits.

Two – Column Journal

- The process of recording a transaction in a two-column journal is summarized as follow:
  - **Recording steps:**

1. Record the date:
2. Record the debit
3. Record the credit
4. Write an explanation

Two – Column Journal

- **note that:**
  - All transactions are recorded only in terms of debits and credits to specific accounts,
  - Titles of accounts used in the entries should be the same as the titles of accounts in ledger,
  - The line following an entry is left blank in order to clearly separate each entry,
  - Each one set of debits and credits for a transaction is called a journal entry.

Two – Column Journal

- The significant of journal recording process:

- It discloses in one place the **complete effects of a transaction**;
- it provides a **chronological record** of transactions;
- it helps to **prevent or locate errors** because the debit and credit amounts for each entry can be easily compared

Two – Column Journal

- Eg. (a) on November 1 was to deposit Br.25, 000 in a bank account in the name of Net Solutions. The effect of this transaction on the balance sheet is to increase assets (Cash) and owner’s equity (Chris Clark, Capital) by Br.25, 000.

Two – Column Journal

Date		Description	P.R.	Debit	Credit
2010					
Nov.	1	Cash		25,000	
		Chris Clark, Capital			25,000
		Invested cash in Net Solution			

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.

The standard form of two column account (Journal)

Date		Description	Post Ref.	Debit	Credit
Year					
Month	Day				
		Debited Account title			
		Credited Account title			
		Explanation			

The standard form of Four – Column account (Ledger)

- **Account: ___ Account No: _____**

	Date		Item	Post Ref.	Debit	Credit	balance	
							Debit	Credit

advantages of the four column account form

1. Only a single date column is required, with each debit and credit appearing in its chronological order,
2. The debit or credit nature of an account balance is more easily determined and more prominently displayed in the account,
3. Having immediately adjacent debit and credit columns makes it easier to examine the data in an account.

Steps in Posting

1. Record the date and amount of Dr. and Cr. entry to the account,
2. Insert journal page number in the P.R (Posting Reference) column of the account, Insert the account number in the P.R (Posting Reference) of the journal.

Transactions

- Mar 1, 1990. Ann Hill operated a photographic business her home on a part –time basis.
- She decided to move to rented quarters as of March 1 and to devote full time the business which was to be known as Hill photographic studio.

- The following assets were invested in the enterprise;
  - cash, 3500,
  - accounts Receivable 950
  - supplies 1200; and
  - photographic equipment 15000.
  - There were no liabilities transferred to the business.

- March 1. Paid 2400 on a rental contract the payment representing three months’ rent of quarters for the studio.
- March 4. Purchased additional photographic equipment on account for 2500
- March 5. Received 850 from customers in payment of their accounts

- March 6. Paid 125 for a newspaper advertisement – Advertising expense considered as miscellaneous expense by Ann Hill.
- March 10. Paid 500 for the debt as a result of March 4 transactions.
- March 13. Paid receptionist 575 for two weeks' salary

- March 16. Received 1,980 from sale of service
- March 20. Paid 650 for supplies purchase
- March 27. Paid 575 receptionists for two weeks’ salary
- March 31. Paid 69 for telephone bill for the month

- March 31. Paid 175 for electric bill for the month
- March 31. Received 1870 from sales of service
- March 31. Make sales on account for 1,675.
- March 31. Hill withdrew 1500 for her personal use.

- The business decides that Advertising expense, Electric expense, and telephone expense are classified as miscellaneous expense.

- **Required**: Journalize and Post the above transaction.

Solutions

Journalizing: Two -Column/General Journal/

General Journal

Date		Description	P.R	Debit		Credit	
1990 March	1	Cash Accounts Receivable Supplies Photographic Equipment Ann Hill, Capital		3500 950 1200 15000	00 00 00 00	 20650	 00
	1	Prepaid Rent Cash		2400	00	2400	00
	4	Photographic Equipment Accounts payable		2500	00	2500	00
	5	Cash Accounts Receivable		850	00	850	00

Date		Description	P.R	Debit		Credit	
	6	Miscellaneous Expense Cash		125	00	125	00
	10	Accounts payable Cash		500	00	500	00
	13	Salary Expense Cash		575	00	575	00
	16	Cash Sale		1980	00	1980	00
	20	Supplies Cash		650	00	650	00
	27	Salary Expense Cash		575	00	575	00

Date		Description	P.R	Debit		Credit	
	31	Miscellaneous Expense		69	00		
		Cash				69	00
	31	Miscellaneous Expense		175	00		
		Cash				175	00
	31	Cash		1870	00		
		Sales				1870	00
	31	Accounts Receivable		1675	00		
		Sales				1675	00
	31	Ann Hill Drawing		1500	00		
		Cash				1500	00

These Journal Entries are posted to the accounts in the accounts in the ledger as follow:

- **Account: Cash**

Date		Item	P.R	Debit		Credit		balance			
								Debit		Credit	
1990 March	1		1	3500	00			3500	00		
	1		1			2400	00	1100	00		
	5		1	850	00			1950	00		
	6		1			125	00	1825	00		
	10		1			500	00	1325	00		
	13		1			575	00	750	00		
	16		1	1980	00			2730	00		

These Journal Entries are posted to the accounts in the accounts in the ledger as follow cont.…

Date	Item	P.R	Debit	Credit	balance	
					Debit	Credit
20		1		650 00	2080 00	
27		1		557 00	1505 00	
31		1		69 00	1436 00	
31		1		175 00	1261 00	
31		1	1870 00		3131 00	

Trial Balance

- Errors may occur in posting debits and credits from the journal to the ledger.
- One way to detect such errors is by preparing a trial balance.
- The trial balance verifies this equality.

steps in preparing a trial balance

- Step 1: List the name of the company, the title of the trial balance, and the date the trial balance is prepared,
- Step 2: List the accounts from the ledger and enter their debit or credit balance in the Debit or Credit column of the trial balance,
- Step 3: Total the Debit and Credit columns of the trial balance,
- Step 4: Verify that the total of the Debit column equals the total of the Credit column.

Hill Photographic Studio
Trial Balance
March 31, 1990

	Debit	Credit
Cash	1,631	
Accounts Receivable	1,775	
Supplies	1,850	
Prepaid Rent	2,400	
Photographic Equipment	17,500	
Accounts payable		2,000
Ann Hill, Capital		20,650

Hill Photographic Studio
Trial Balance
March 31, 1990

	Debit	Credit
Ann Hill, Drawing	1,500	
Sales		5,525
Salary Expense	1,150	
Miscellaneous Expense	369	
total	28,175	28,175

Posting the Transaction

- Receivable:

1990 March	1	dr=950	bal=950
	5	cr=850	bal=100
	31	dr=1675	bal=1775

- **Supplies:**

1990 March	1	dr=1200	bal=1200
	20	dr=650	bal=1850

Prepaid Rent:

1990 March	1	dr=2400	bal=2400

Photographic Equipment:

1990 March	1	dr=15000	bal=15000
	4	dr=2500	bal=17500

- Before a trial balance is prepared, each account balance in the ledger must be determined.
- the balance of each account appears in the balance column on the same line as the last posting to the account.

Errors Affecting the Trial Balance

- If the trial balance totals are not equal, an error has occurred. In this case, the error must be found and corrected.

Proof provided by trial Balance

- The trial balance does not provide complete proof of the accuracy of the ledger.
- It indicates only that the debits and the credits are equal.
- If the two totals of a trial balance are not equal it is probably due to one or more of the following types of errors:

1. Error in preparing the trial balance , such as:

a. One of the columns of the trial balance was incorrectly added,

b. The amount of an account balance was incorrectly recorded on the trial balance,

c. A debit balance was recorded on a trial balance as a credit or vice- versa, or a balance was omitted entirely.

2. Error in determining the account balances, such as:

a. A balance was incorrectly computed,

b. A balance was entered in the wrong balance column.

3. Errors in recording a transaction in the ledger, such as:

a. An erroneous amount was posted to the account

b. A debit entry was posted as a credit or vice versa

c. A debit or credit posting was omitted

- Among the types of errors that will not cause an inequality in the trial balance totals are :

1. Failure to record a transaction or to post a transaction,
2. Recording the same erroneous amount for both debit and credit part of a transaction,
3. Recording a single transaction more than once,
4. Posting a part of a transaction correctly as a debit or credit but to the wrong account.

END OF CHAPTER TWO

THANK YOU