# Manage the Finance

Handout 2

Accounting Cycle

THE ACCOUNTING CYCLE

Accountants work through a cycle called the Accounting Cycle.

A manager does not need to go into great depth in terms of understanding the accounting behind the financials; however, it does help to have a basic idea of where the numbers are coming from.

The accounting profession is made up of various degrees of qualifications. You get accountants, chartered accountants, financial accountants, management accountants, auditors and bookkeepers.

The Accounting Cycle is illustrated:
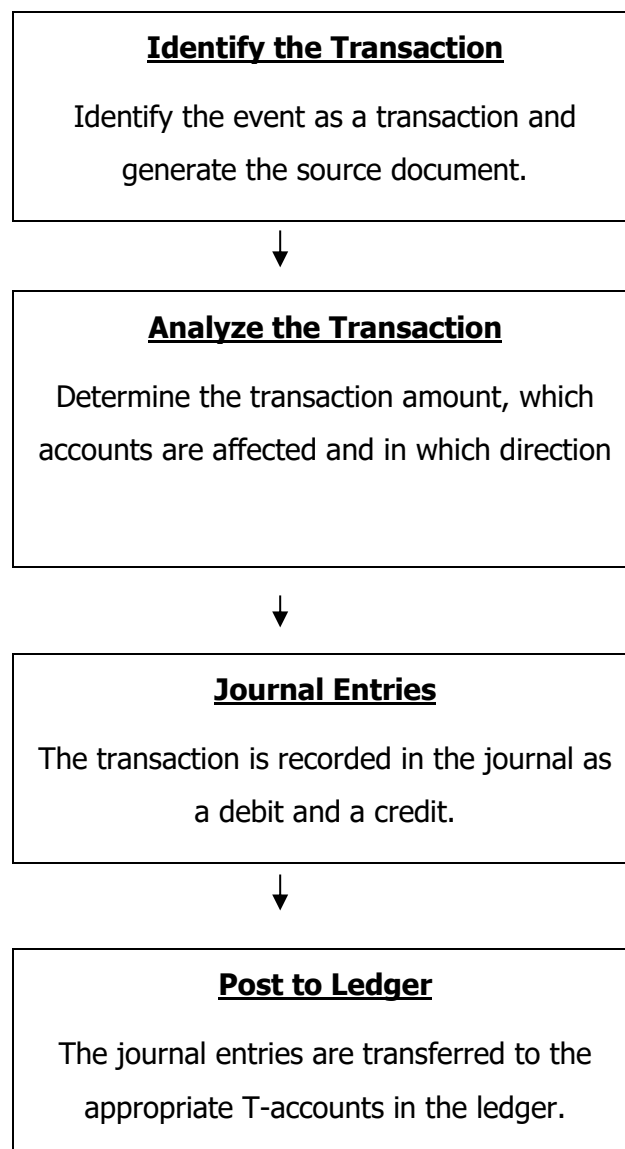
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┌─────────────────────────────────────┐
│      Identify the Transaction        │
│                                      │
│   Identify the event as a transaction│
│    and generate the source document. │
└─────────────────────────────────────┘
                  ↓
┌─────────────────────────────────────┐
│       Analyze the Transaction        │
│                                      │
│   Determine the transaction amount,  │
│   which accounts are affected and in │
│           which direction            │
└─────────────────────────────────────┘
                  ↓
┌─────────────────────────────────────┐
│           Journal Entries            │
│                                      │
│  The transaction is recorded in the  │
│   journal as a debit and a credit.   │
└─────────────────────────────────────┘
                  ↓
┌─────────────────────────────────────┐
│            Post to Ledger            │
│                                      │
│   The journal entries are transferred│
│   to the appropriate T-accounts in   │
│             the ledger.              │
└─────────────────────────────────────┘
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Trial Balance

A trial balance is calculated to verify that the sum of the debits is equal to the some of the credits

↓

Adjusting entries

Adjusting entries are made for accrued and deferred items. The entries are journalised and posted to the T-accounts in the ledger.

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Adjusted Trial Balance

A new trial balance is calculated after making the adjusting entries.

↓

Financial Statements

The financial statements are prepared.

Let us work through each step of the cycle: -

Step One:

Identify the Transaction
Identify the event as a transaction and generate the *source document*.

Transactions will include things like purchases, making a sale and issuing credit. Source documents are the documents that show proof of the transaction. Source documents include things like invoices, receipts, cheque counterfoils and credit notes.

Step Two:

Analyze the Transaction
Determine the transaction amount, which accounts are affected and in which direction.

The transaction amount will be the amount in Rands of the purchase or sale etc. Accountants will then enter the transaction amount into the *accounts*. Accounts are the opened for each element of a financial statement and all the transaction amounts that apply to that particular item is recorded in the relevant account. Accounts are divided into two symmetrical sections called *debits* and *credits*. The debit section is shown on the left-hand side and the credit section is shown on the right-hand side.

The side on which the transaction is captured depends on whether the transaction increases or decreases the particular asset or liability or income or expense. For example, if there was increase in the asset account, the entry would be recorded on the debit side of the account. If the asset had decreased, the entry would be recorded on the credit side of the account.

Which side of the accounts need to be debited and which side of the accounts need to be credited can often be confusing to the non-accountant. For the purposes of this course, it is not essential for you to grasp accounting concepts in detail, however some examples of debits and credits are shown in the tables below:

Table depicting examples of debits and credits for expenses and incomes:

Debits (usually expenses)	Credits (usually incomes)
Cost of sales	Sales
Wages	Rent income
Water and electricity	Interest on a fixed deposit
Salaries	Discount received
Telephone	Bad debt recovered
Stationery	Provision of bad debt
Depreciation	Profit on sale of assets
Interest paid	Interest received

Table depicting examples of debits and credits for assets and liabilities:

Debits (usually assets)	Credits (usually liabilities)
Fixed assets such as land, buildings, vehicles and equipment	Long term liabilities such as non-current loans.
Financial assets such as fixed deposits, fixed investments and any other deposits.	Current liabilities such as overdrafts and income received in advance.
Current assets such as inventory or prepaid expenses.	Dividends or distributions to members.

Accountants follow what is called "*The Double Entry Rule*". An accounting equation must always balance, so a transaction always affects two elements at the same time. One element will be debited, and one element will be credited.

Let us look at a couple of very basic accounting examples:

Example 1

- On the 11th January 2009, wages were paid to an employee by the name of Andrew Smith in the amount of R500.

The wages account would be debited by R500 and the bank account would be credited by R500 at the same time, in line with the double entry rule.

Example 2

- On the 12th January 2009, the organisation received an amount of R350 from a customer for services that were rendered.

The bank account would be debited by R350 and the services rendered account would be credited by R350 at the same time in line with the double entry rule.

Step Three:

Journal Entries

The transaction is recorded in the _journal_ as a debit and a credit.

Once the accountant knows which accounts to debit and which accounts to credit, the records are made in the _books of first entry_ or _Journals_. The examples used in Step two are shown as journal entries below:

THEMBA'S CLOTHING

General journal for January 2009

Date		Debit	Credit
11/01/2009	Dr Wages	R500	
	Cr Bank		R500
12/01/2009	Dr Bank	R350	
	Cr Services Rendered		R350

Step Four

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Post to Ledger

The journal entries are transferred to the appropriate T-accounts in the *ledger*.

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The ledger is simply a summary of the transactions that were recorded in the journals. The example from Step two and Step three are shown in a simple ledger below. *CPJ* stands for "Cash Purchases Journal" and *CRJ* stands for "Cash Receipts Journal."

Dr. (+)		(Wages)		1			(Cr. (-)
Date	Details	Folio	R	Date	Details	Folio	R
11-01-2009	Cash	CPJ	500				

Dr. (+)		(Bank)			B1		(Cr. (-)
Date	Details	Folio	R	Date	Details	Folio	R
11-01-2009	Services rendered	CPJ	350	11-01-2009	Wages	CPJ	500
		c/d	150				
	Balance		**500**				**500**
				01-02-2009	2009 Balance	b/d	150

Dr. (+)		(Services Rendered)			I2		(Cr. (-)
Date	Details	Folio	R	Date	Details	Folio	R
				11-01	2009 Bank	CRJ	350

Step Five:

> **Trial Balance**
>
> A *trial balance* is calculated to verify that the sum of the debits is equal to the some of the credits

A trial balance is a list of all the balances of the accounts that were depicted in the general ledger. The trial balance can be used to confirm that the total of accounts with debit balances still equals the total of the accounts with credit balances. The example as carried over from Step four is shown below:

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Trial balance as at 31 January 2009

	Folio	Debit R	Credit R
Balance Sheet Section			
Bank	B1		150
Income Statement Section			
Wages	I1	500	
Services Rendered	I2		350
		500	500

Step Six:

```
          Adjusting entries

 Adjusting entries are made for accrued
    and deferred items. The entries are
 journalised and posted to the T-accounts
             in the ledger.
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In accounting, adjustments are made at the end of the financial year to reflect any transactions that did not appear in the source documents. These adjustments are made for the sake of accuracy. Adjusting entries would need to be made in the journal and the ledger.

For example, let us say that wages were incorrectly entered at R500, and the correct amount was actually R450. Let us also so that one of the tenants in the building (S Tato) owed R1200 for rent for the month, but she paid R1800 and this entry was not recorded. The adjustments would need to be reflected in the journal and ledger as follows:

THEMBA'S CLOTHING: General journal for January 2009

No	Detail	Debit	Credit
1.	Dr. Bank	500	
	Cr. Wages		500
	(Correction of error)		
2.	Wages	450	
	Bank		450
	(Current amount for wages)		
3.	Rent Paid	1200	
	Bank		1200
4.	Pre-paid expenses	600	
	Rent Paid		600

General Ledger

Dr. (+)			(Wages) B1				(Cr. (-)
Date	Details	Folio	R	Date	Details	Folio	R
11-01-2009	Bank		500	11-01-2009	Bank		500
	Bank		450	30-01-2009	Balance c/f		450
			950				950
01-02-2009	Balance b/d		450				

Dr. (+)	(Bank) B2						(Cr. (-)
Date	Details	Folio	R	Date	Details	Folio	R
11-01-2009	Wages		500	11-01-2009	Wages		500
					Wages		450
	Balance c/f		1650	21-01-2009	Rent		1200
	Bank		2150				2150
				01/02/2009	Balance b/d		1650

Dr. (+)	(Rent) B3						(Cr. (-)
Date	Details	Folio	R	Date	Details	Folio	R
21-01-2009	Bank		1200	21-01-2009	Pre-paid Expenses		600
				30/01/2009	Balance c/f		600
			1200				1200
01/02/2009	Balance b/d		600				

Dr. (+)	(Pre-paid Expenses) B4						(Cr. (-)
Date	Details	Folio	R	Date	Details	Folio	R
	Rent		600				

Step Seven:

<table>
<tr><td><u>Adjusted Trial Balance</u>

A new trial balance is calculated after making the adjusting entries.</td></tr>
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Once the adjustments have been made, a new trial balance has to be drawn up. The example is depicted below:

THEMBA'S CLOTHING

Adjustment trial balance as at 31 January 2009

Details	Folio	Debit: R	Credit: R
Wages	B1	450	
Bank	B2		1650
Rent	B3	600	
Prepaid Expenses	B4	600	
		1 650	1 650

Step Eight:

<table>
<tr><td><u>Financial Statements</u>

The financial statements are prepared.</td></tr>
</table>

The financial statements are then prepared from the trial balance.