Guide 1: The Accounting Cycle

Accounting Equation, Debits & Credits, Journal Entries, T-Accounts, Trial Balance, Adjusting Entries, Closing Entries, Financial Statements

Watch These Videos With This Guide

Topic	Video
ACCOUNTING BASICS: a Guide to (Almost) Everything	https://youtu.be/yYX4bvQSqbo (14 min)
Debits & Credits Explained	https://youtu.be/VhwZ9t2b3Zk (14 min)
A Complete Guide to Adjusting Entries	https://youtu.be/mrJdVh5MmKI (32 min)
CLOSING ENTRIES: Everything You Need To Know	https://youtu.be/e1z2lpdQyGQ (13 min)

The Accounting Equation – The Only Rule You Need

$$\boxed{\textbf{Assets} = \textbf{Liabilities} + \textbf{Owner's Equity}}$$

This is not just a formula. This is the structure that holds all of accounting together. Every single entry you make must keep this balanced.

Term	What It Means in Business
Assets	Everything the business owns that has value. Cash in the bank, equipment, buildings, inventory, money customers owe you (accounts receivable).
Liabilities	Everything the business owes to others. Bank loans, money owed to suppliers (accounts payable), taxes owed, salaries owed to employees.
Owner's Equity	What belongs to the owners. What's left after subtracting liabilities from assets. This is the net worth of the business.

Think of it this way: Everything the business has (Assets) was paid for either by borrowing money (Liabilities) or by the owners putting money in (Equity). So Assets must always equal Liabilities + Equity.

Real example: You start a business by putting $10,000 of your own cash into a bank account.

- The business now has $10,000 in cash (Asset)
- Nobody loaned the business anything, so Liabilities = $0
- The owner contributed $10,000, so Equity = $10,000
- $10,000 = $0 + $10,000. The equation balances.

Debits and Credits – What They Actually Mean

Most people get confused because banks use these words differently. Here's the truth:

The Simple Rule

Debit (Dr) = Left side of the accounting equation.
Credit (Cr) = Right side of the accounting equation.

The accounting equation is: **Assets = Liabilities + Equity**

So:

- **Assets** are on the LEFT. They increase when you DEBIT them.
- **Liabilities** are on the RIGHT. They increase when you CREDIT them.
- **Equity** is on the RIGHT. It increases when you CREDIT it.

That's all. The entire system comes from this one idea.

Account Type	Increases With	Decreases With
Assets	Debit	Credit
Liabilities	Credit	Debit
Owner's Equity	Credit	Debit
Revenue	Credit	Debit
Expenses	Debit	Credit
Dividends / Drawings	Debit	Credit

Why Revenue and Expenses Work This Way

Revenue increases Equity. Equity is on the RIGHT side (Credit increases). So Revenue increases with CREDIT.

Expenses decrease Equity. Since Equity increases with Credit, the opposite (decreasing) happens with Debit. So Expenses increase with DEBIT.

Dividends also decrease Equity. So Dividends increase with DEBIT.

A Quick Memory Aid

Accounts that increase with Debit: Assets, Drawings/Dividends, Expenses.
Think: "A-D-E" = Assets, Drawings, Expenses all increase on Debit.

Everything else (Liabilities, Equity, Revenue) increases on Credit.

Why Does Your Bank Account Say "Credit" When You Deposit Money?

When you deposit money into your bank account, your bank statement shows it as a "credit." That's because from the **bank's** perspective, your deposit is a liability – the bank owes that money back to you. Liabilities increase with credit. So the bank credits your account.

But from **your business's** perspective, the cash in the bank is an **asset**. On your books, you **debit** Cash to show that your asset increased.

Perspective	Account Type	Entry
The bank's books	Your account = Liability	Credit
Your business books	Cash = Asset	Debit

The Golden Rule

Every journal entry must have:

1. At least one debit
2. At least one credit
3. Total debits = Total credits

Journal Entries – How to Record Transactions

Every time a business does something that affects its finances, it records a journal entry. The format is always:

Date	Account	Amount
	Account being debited	$XX
	Account being credited	$XX

The debited account is listed first (left), the credited account is indented below (right).

Worked Problem 1: Recording Common Transactions

Record these January transactions for a new service business:

Jan 1	Owner invested $50,000 cash
Jan 3	Paid $12,000 for equipment
Jan 5	Borrowed $20,000 from bank
Jan 8	Performed services for $8,000 cash
Jan 12	Paid $2,000 for January rent
Jan 15	Purchased $1,500 of supplies on credit
Jan 20	Billed a client $4,000 for services
Jan 25	Collected $2,500 from that client
Jan 28	Paid $1,500 for the supplies bought on Jan 15
Jan 31	Paid $1,000 dividend to owner

Solution:

Date	Account Title	Dr/Cr	Amount
Jan 1	Cash	Dr	$50,000
	Owner's Capital	Cr	$50,000
	(Owner invested cash in the business)		
Jan 3	Equipment	Dr	$12,000
	Cash	Cr	$12,000
	(Purchased equipment with cash)		
Jan 5	Cash	Dr	$20,000
	Bank Loan Payable	Cr	$20,000
	(Borrowed money from the bank)		
Jan 8	Cash	Dr	$8,000
	Service Revenue	Cr	$8,000
	(Performed services and collected cash)		
Jan 12	Rent Expense	Dr	$2,000
	Cash	Cr	$2,000
	(Paid January rent)		
Jan 15	Supplies	Dr	$1,500
	Accounts Payable	Cr	$1,500
	(Bought supplies on credit)		
Jan 20	Accounts Receivable	Dr	$4,000
	Service Revenue	Cr	$4,000
	(Performed services on credit)		
Jan 25	Cash	Dr	$2,500
	Accounts Receivable	Cr	$2,500
	(Collected cash from customer billed Jan 20)		
Jan 28	Accounts Payable	Dr	$1,500
	Cash	Cr	$1,500
	(Paid supplier for supplies bought Jan 15)		
Jan 31	Owner's Drawings	Dr	$1,000
	Cash	Cr	$1,000
	(Owner withdrew cash for personal use)		

T-Accounts – Visualizing Account Balances

A T-account is shaped like the letter "T." Debits go on the left side, credits go on the right side. The ending balance is found by subtracting total credits from total debits.

Cash T-Account

Debit (+)		Credit (−)
Beginning: $0		
Jan 1: Owner investment	$50,000	
Jan 5: Bank loan	$20,000	
Jan 8: Service revenue	$8,000	
Jan 25: Collected AR	$2,500	
		Jan 3: Equipment
$12,000		
		Jan 12: Rent
$2,000		
		Jan 28: Paid supplier
$1,500		
		Jan 31: Owner withdrawal
$1,000		
Total debits	$80,500	Total credits
$16,500		
Ending balance: $80,500 − $16,500 = **$64,000 Dr**		

Since Cash is an Asset, its normal balance is Debit. The $64,000 Dr means the company has $64,000 in cash.

Trial Balance – Checking Your Work

After recording all entries and posting to T-accounts, you prepare a trial balance. This is simply a list of every account and its ending balance. You sum all debit balances and all credit balances. They must be equal.

Trial Balance from Problem 1:

Account	Debit	Credit
Cash	$64,000	
Accounts Receivable	$1,500	
Supplies	$1,500	
Equipment	$12,000	
Accounts Payable		$0
Bank Loan Payable		$20,000
Owner's Capital		$50,000
Owner's Drawings	$1,000	
Service Revenue		$12,000
Rent Expense	$2,000	
Total	**$82,000**	**$82,000**

The trial balances at $82,000. This means our entries are mathematically correct (but not necessarily right – we could have put something in the wrong account).

Accrual Accounting – Why Adjusting Entries Exist

There are two ways to do accounting:

Cash basis: Record revenue when cash arrives. Record expenses when cash leaves. Simple, but doesn't show the true picture of how the business performed.

Accrual basis: Record revenue when it is **earned** (work done, goods delivered). Record expenses when they are **incurred** (benefit received). Cash may come or go later.

Example: In December, a company does $10,000 of work for a client but doesn't get paid until January. Under cash basis, that $10,000 is January revenue. Under accrual basis, it's December revenue – because the work was done in December.

Why accrual is required: GAAP (Generally Accepted Accounting Principles) requires accrual accounting because it gives a truer picture of how a business actually performed.

Adjusting entries are the journal entries made at the end of an accounting period to convert the books from cash basis to accrual basis. They ensure that revenues and expenses are recorded in the correct period.

The Six Adjusting Entries – P-U-A-A-D-S

There are exactly six types of adjusting entries. Think of them as fixing what happened during the year so the financial statements are accurate.

Type	When It Happens	The Adjusting Entry
Prepaid Expense	Paid cash early, using it up over time	Dr Expense / Cr Prepaid Asset
Unearned Revenue	Got cash early, earning it over time	Dr Unearned Liability / Cr Revenue
Accrued Expense	Used something but haven't paid yet	Dr Expense / Cr Payable
Accrued Revenue	Earned money but haven't billed yet	Dr Receivable / Cr Revenue
Depreciation	Long-term asset wearing out over years	Dr Depreciation Exp / Cr Accum Depr
Supplies	Bought supplies, used some up	Dr Supplies Expense / Cr Supplies

Prepaid Expense – Paid First, Used Later

Example: On October 1, a company pays \$12,000 for a 2-year insurance policy. The company's year ends December 31.

During October to December (3 months), the insurance coverage is being used up. Since the policy covers 24 months, the amount used is 3/24.

Adjusting entry: $3/24 \times \$12{,}000 = \$1{,}500$.
Dr Insurance Expense \$1,500 / Cr Prepaid Insurance \$1,500

After this entry: Insurance Expense on the income statement = \$1,500 (the cost of insurance used this year). Prepaid Insurance on the balance sheet = \$10,500 (remaining coverage for future years).

Unearned Revenue – Received First, Earned Later

Example: On November 1, a magazine company receives \$6,000 for 6 months of subscriptions.

From November to December (2 months), the company has earned the right to keep some of that money. Since the subscription covers 6 months, the amount earned is 2/6.

Adjusting entry: $2/6 \times \$6{,}000 = \$2{,}000$.
Dr Unearned Revenue \$2,000 / Cr Subscription Revenue \$2,000

After this entry: Subscription Revenue = \$2,000 (earned this year). Unearned Revenue (liability) = \$4,000 (still owed to customers).

Accrued Expense – Used It, Haven't Paid Yet

Example: Employees earn \$5,000 in wages during December 28-31. They will be paid on January 5.

The company has already received the benefit of the employees' work. The expense belongs in December, even though cash hasn't left yet.

Adjusting entry:
Dr Salaries Expense \$5,000 / Cr Salaries Payable \$5,000

On payday (January 5), the company will reverse the payable and record the cash payment.

Accrued Revenue – Earned It, Haven't Collected Yet

Example: A consulting firm completed \$3,000 of work in December. The client will be billed in January.

The company has already earned the revenue. It belongs in December, even though the customer hasn't paid yet.

Adjusting entry:
Dr Accounts Receivable \$3,000 / Cr Service Revenue \$3,000

When the customer pays later: Dr Cash / Cr Accounts Receivable (no revenue – it was already recorded).

Depreciation – Spreading Out the Cost of Long-Term Assets

When a company buys equipment, it doesn't expense the full cost in one year. Instead, it spreads the cost over the equipment's useful life.

Example: Equipment cost \$60,000, expected to last 10 years, with \$0 value at the end.

Annual depreciation = \$60,000 / 10 = \$6,000.

Adjusting entry:

Dr Depreciation Expense $6,000 / Cr Accumulated Depreciation $6,000

Important: Accumulated Depreciation is not an expense account. It's a **contra-asset** – it sits on the balance sheet right below the Equipment account and subtracts from it. If Equipment is $60,000 and Accumulated Depreciation is $6,000, the equipment's book value is $54,000.

Supplies – Tracking What You've Used

Example: The company had $2,000 of supplies at the start. At year-end, a physical count shows $500 remaining.

Used during the year = $2,000 - $500 = $1,500.

Adjusting entry:
Dr Supplies Expense $1,500 / Cr Supplies $1,500

After this entry: Supplies Expense = $1,500 (used up). Supplies asset = $500 (still on hand).

Worked Problem 2: The Full Adjustment Cycle

Here is the unadjusted trial balance for XYZ Company at December 31:

Account	**Debit**	**Credit**
Cash	$15,000	
Accounts Receivable	$8,000	
Prepaid Insurance	$6,000	
Equipment	$50,000	
Accumulated Depreciation		$5,000
Accounts Payable		$4,000
Unearned Revenue		$3,000
Common Shares		$40,000
Retained Earnings		$12,000
Service Revenue		$25,000
Salaries Expense	$8,000	
Rent Expense	$2,000	
Total	**$89,000**	**$89,000**

Adjusting information:

1. $3,000 of the Prepaid Insurance has expired (been used up).
2. Annual depreciation is $5,000.
3. $1,000 of the Unearned Revenue has been earned. Employees have earned $2,000 that hasn't been paid yet.

Step 1: Record the adjusting entries.

#	Account	Dr/Cr	Amount
1	Insurance Expense	Dr	$3,000
	Prepaid Insurance	Cr	$3,000
2	Depreciation Expense	Dr	$5,000
	Accumulated Depreciation	Cr	$5,000
3	Unearned Revenue	Dr	$1,000
	Service Revenue	Cr	$1,000
4	Salaries Expense	Dr	$2,000
	Salaries Payable	Cr	$2,000

Step 2: Prepare the Adjusted Trial Balance.

Account	Debit	Credit
Cash	\$15,000	
Accounts Receivable	\$8,000	
Prepaid Insurance (\$6K − \$3K)	\$3,000	
Equipment	\$50,000	
Accum. Depreciation (\$5K + \$5K)		\$10,000
Accounts Payable		\$4,000
Salaries Payable (new)		\$2,000
Unearned Revenue (\$3K − \$1K)		\$2,000
Common Shares		\$40,000
Retained Earnings		\$12,000
Service Revenue (\$25K + \$1K)		\$26,000
Salaries Expense (\$8K + \$2K)	\$10,000	
Rent Expense	\$2,000	
Insurance Expense (new)	\$3,000	
Depreciation Expense (new)	\$5,000	
Total	**\$96,000**	**\$96,000**

Step 3: Prepare financial statements.

Income Statement (for the year ending Dec 31):

Revenue:	
Service Revenue	\$26,000
Expenses:	
Salaries Expense	\$10,000
Rent Expense	\$2,000
Insurance Expense	\$3,000
Depreciation Expense	\$5,000
Total Expenses	(\$20,000)
Net Income **\$6,000**	

Statement of Retained Earnings:

Beginning Retained Earnings	\$12,000
+ Net Income	\$6,000
− Dividends	\$0
Ending Retained Earnings	**\$18,000**

Balance Sheet (at December 31):

Assets	
Cash	\$15,000
Accounts Receivable	\$8,000
Prepaid Insurance	\$3,000
Equipment	\$50,000
Less: Accum. Depr.	(\$10,000)
Equipment, net	\$40,000
Total Assets	**\$66,000**

Liabilities	
Accounts Payable	\$4,000
Salaries Payable	\$2,000
Unearned Revenue	\$2,000
Total Liabilities	\$8,000
Equity	
Common Shares	\$40,000
Retained Earnings	\$18,000
Total Equity	\$58,000
Total Liab. + Equity	**\$66,000**

Closing Entries

After preparing financial statements, temporary accounts (Revenue, Expenses, Dividends) must be closed to zero. Only permanent accounts (Assets, Liabilities, Equity) carry forward.

Step	Entry
1. Close Revenue	Dr Service Revenue \$26,000 / Cr Income Summary \$26,000
2. Close Expenses	Dr Income Summary \$20,000 / Cr each expense account
3. Close Income Summary	Dr Income Summary \$6,000 / Cr Retained Earnings \$6,000
4. Close Dividends	Dr Retained Earnings / Cr Dividends (if any declared)

After closing: All revenue and expense accounts = \$0. Retained Earnings = \$18,000. The post-closing trial balance lists only permanent accounts.

Practice Problems – Exam Style

Problem A: Journal Entries and Trial Balance (12 marks)

Record these transactions for August, then prepare a trial balance:

Aug 1	Owner invested \$30,000 cash
Aug 3	Purchased equipment for \$15,000 cash
Aug 5	Performed services for \$6,000 cash
Aug 10	Paid \$1,200 rent
Aug 15	Billed client \$4,000 for services
Aug 20	Received \$2,500 from that client
Aug 25	Paid \$800 for utilities
Aug 31	Owner withdrew \$1,000

Solution

Journal entries:

Date	Account	Dr/Cr	Amount
Aug 1	Cash	Dr	\$30,000
	Owner's Capital	Cr	\$30,000
Aug 3	Equipment	Dr	\$15,000
	Cash	Cr	\$15,000
Aug 5	Cash	Dr	\$6,000
	Service Revenue	Cr	\$6,000
Aug 10	Rent Expense	Dr	\$1,200
	Cash	Cr	\$1,200
Aug 15	Accounts Receivable	Dr	\$4,000
	Service Revenue	Cr	\$4,000
Aug 20	Cash	Dr	\$2,500
	Accounts Receivable	Cr	\$2,500
Aug 25	Utilities Expense	Dr	\$800
	Cash	Cr	\$800
Aug 31	Owner's Drawings	Dr	\$1,000
	Cash	Cr	\$1,000

Trial balance:

Account	Dr	Cr
Cash	\$20,500	
Accounts Receivable	\$1,500	
Equipment	\$15,000	
Owner's Capital		\$30,000
Owner's Drawings	\$1,000	
Service Revenue		\$10,000
Rent Expense	\$1,200	
Utilities Expense	\$800	
Total	**\$40,000**	**\$40,000**

Problem B: Adjusting Entries (8 marks)

Prepare adjusting entries at December 31:

1. Supplies account shows \$4,000. A physical count shows \$1,200 left.
2. Equipment costing \$48,000, 8-year life, \$0 residual. Record annual depreciation.
3. Received \$9,000 on Nov 1 for 6 months of service. Two months have been earned.
4. Employees earned \$3,500 in the last week of December, unpaid.

Solution:

1. Used = \$4,000 − \$1,200 = \$2,800. **Dr Supplies Expense \$2,800 / Cr Supplies \$2,800**
2. Annual = \$48,000 / 8 = \$6,000. **Dr Depreciation Exp \$6,000 / Cr Accum Depr \$6,000**
3. Earned = $2/6 \times$ \$9,000 = \$3,000. **Dr Unearned Revenue \$3,000 / Cr Revenue \$3,000**
4. **Dr Salaries Expense \$3,500 / Cr Salaries Payable \$3,500**

Problem C: Closing Entries (4 marks)

From the adjusted TB, prepare closing entries: Service Revenue \$45,000; Salaries Exp \$22,000; Rent Exp \$8,000; Insurance Exp \$3,000; Dividends \$4,000.

Solution:

1. Dr Service Revenue \$45,000 / Cr Income Summary \$45,000
2. Dr Income Summary \$33,000 / Cr Salaries \$22,000 / Cr Rent \$8,000 / Cr Insurance \$3,000
3. Dr Income Summary \$12,000 / Cr Retained Earnings \$12,000
4. Dr Retained Earnings \$4,000 / Cr Dividends \$4,000

Practice MCQs

1. **A company pays \$24,000 for a 2-year insurance policy on July 1. The December 31 adjusting entry is:**
   (a) Dr Insurance Exp \$24,000 / Cr Prepaid \$24,000
   (b) Dr Insurance Exp \$6,000 / Cr Prepaid \$6,000
   (c) Dr Prepaid \$6,000 / Cr Insurance Exp \$6,000
   (d) Dr Insurance Exp \$12,000 / Cr Prepaid \$12,000
   Answer: (b) 6 months used out of 24 = $6/24 \times$ \$24,000 = \$6,000. Insurance coverage used = expense.

2. **A law firm receives \$18,000 on Dec 1 for 6 months of legal services. The December 31 adjusting entry is:**
   (a) Dr Cash \$18,000 / Cr Revenue \$18,000
   (b) Dr Unearned Revenue \$3,000 / Cr Revenue \$3,000
   (c) Dr Revenue \$3,000 / Cr Unearned Revenue \$3,000
   (d) Dr Unearned Revenue \$18,000 / Cr Revenue \$18,000
   Answer: (b) One month earned (Dec) out of six = \$3,000. Shift from liability to revenue.

3. **Employees earned \$12,000 in the last week of December, to be paid in January. The December 31 entry:**

(a) Dr Salaries Payable / Cr Cash
(b) Dr Salaries Expense / Cr Salaries Payable
(c) Dr Salaries Expense / Cr Cash
(d) No entry needed

Answer: (b) The expense was incurred in December. Record it now, pay later.

4. **Which account is NEVER closed at year-end?**
(a) Service Revenue
(b) Salaries Expense
(c) Cash
(d) Dividends

Answer: (c) Cash is a permanent balance sheet account. Revenue, expense, and dividends are temporary accounts.

5. **Beginning Retained Earnings = $100K, Net Income = $50K, Dividends = $10K. Ending RE = ?**
(a) $50K
(b) $150K
(c) $140K
(d) $160K

Answer: (c) $100K + $50K − $10K = $140K.

6. **If prepaid insurance was not adjusted at year-end, what is the effect?**
(a) Expenses overstated, NI understated, Assets understated
(b) Expenses understated, NI overstated, Assets overstated
(c) Expenses understated, NI overstated, Assets understated
(d) Expenses overstated, NI overstated, Assets overstated

Answer: (b) No adjusting entry means the expense wasn't recorded (understated), so net income is higher (overstated), and the prepaid asset is still on the books (overstated).

7. **Accumulated Depreciation is classified as:**
(a) A liability
(b) A contra-asset account
(c) An expense account
(d) Part of shareholders' equity

Answer: (b) It's subtracted from the related asset on the balance sheet. Normal credit balance.

8. **Equipment cost $80K, residual value $8K, 10-year life. Year 1 straight-line depreciation?**
(a) $8,000
(b) $7,200
(c) $10,000
(d) $80,000

Answer: (b) ($80,000 − $8,000) / 10 = $7,200.

9. **The purpose of closing entries is to:**
(a) Record all transactions for the period
(b) Zero out temporary accounts so the next period starts fresh
(c) Adjust the cash balance
(d) Prepare the bank reconciliation

Answer: (b) Revenue, expense, and dividend accounts must start each year at zero.

10. **Unearned Revenue is classified as:**

(a) An asset
(b) A liability
(c) Revenue
(d) An expense

Answer: (b) You received cash but haven't earned it yet. You owe the customer service or product – that's a liability.