

Steps to the Accounting Cycle

The term, accounting cycle, refers to the steps involved in accounting for all of the business activities during an accounting period.

These steps are repeated each reporting period.

There are ten steps to the accounting cycle. We will go through each one in detail later. But let's review the basics. Step one begins with analyze transactions. Step two – journalize. Step three – Post. Step four – prepare unadjusted trial balance. Step five – adjust. Step six – prepare adjusted trial balance. Seven – prepare financial statements. Step eight – close. Step nine – Prepare a post-closing trial balance and Step Ten – Reverse.

It's important that you realize when the steps occur. Steps 1 through 3 occur often throughout the accounting time period.

Steps four through 10 occur only at the end of the accounting period.

The accounting process begins with analyzing transactions. The company first looks at the source documents which describe the transactions and events. Source documents can be either hard copy or electronic. Some examples of source documents include bank statements, checks, and purchase orders.

After analyzing the transactions, events and source documents, the company is now ready to complete step 2, journalize. When the company journalizes the accountant applies the rules of double-entry accounting. Remember that double-entry accounting means that each transaction must be recorded in at least two accounts or that the debits must equal the credits.

After applying the rules of debits and credits, the accountant should then record the transactions in a journal, or journalize. A journal is a complete record of each transaction. It's easy to remember, because journal entry has the word journal in it!

The third step in the accounting cycle is to post. This sounds complicated but it's actually very easy. Posting involves transferring information from the journal to the ledger. A ledger is simply a collection of all accounts – it shows all of the number detail about a company's accounts.

In this posting example, notice how the journal entry that includes a debit to cash and credit to common stock is posted to the ledger with a debit of \$25,000 in the cash account and a credit of \$25,000 in the common stock account. When we post, we are simply transferring the debits and credits from the journal to the ledger.

To verify that the companies debits equals the credits, an unadjusted trial balance is prepared. A trial balance is a list of all accounts and their balances at a point in time. This is the fourth step of the

accounting cycle. The information used in a trial balance comes from the ledger. The account balances from the ledger is used to create the trial balance. We call this trial balance an unadjusted trial balance because it is prepared before the adjusting entries.

Here's an example of the trial balance, notice how the account balances are listed in the appropriate debit and credit column. The purpose of the trial balance is to verify that the debits equal the credits. It does not guarantee that no errors were made.

The fifth step in the accounting cycle is to prepare adjusting entries. Adjusting entries involve bringing an asset or liability account balance to its proper amount and updating the corresponding revenue or expense account.

Adjusting entries are recorded in the general journal and then posted to the ledger. All adjusting entries are made at the end of the accounting time period.

After the adjusting entries have been posted, the accountant prepares another trial balance. This trial balance is called the adjusted trial balance because it is prepared AFTER the adjusting entries. This trial balance is used to verify that the debits equal the credits and also is used to prepare the financial statements.

Now that the adjusted trial balance has been prepared the next step is to prepare the financial statements.

The financial statements must be prepared in a very specific order. The order for the financial statements is: income statement, statement of retained earnings, balance sheet, and then statement of cash flows.

This order is important because information provided in the income statement is used in the statement of retained earnings, and information from the statement of retained earnings is used in the balance sheet.

Step eight in the accounting cycle is to prepare the closing entries. Closing entries are prepared after the financial statements are completed. The purpose of closing entries is to prepare the accounts for recording transactions and events for the next period. The accountant is now getting the books ready for next year!

Step nine, and for many companies the last step in the accounting cycle, is to prepare a post-closing trial balance.

A post-closing trial balance should only contain the debit and credit balance for permanent accounts, because these are the only accounts that are remaining after the closing process.

Once again the purpose of this trial balance is to ensure that the debits equal the credits and that all temporary accounts have a zero balance.

For many companies this is the last step in the accounting cycle, the company is now ready to start the new accounting period.

However, some companies, complete one more step in the accounting cycle, step 10, or reversing entries.

Reversing entries are optional. These entries reverse certain adjustments in the next period.

For most of you, reversing entries will not be covered by your accounting instructor.

We have now gone through and discussed each of the steps to the accounting cycle. Remember, that there are ten steps to the accounting cycle.

Step one begins with analyze transactions. Step two – journalize. Step three – Post. Step four – prepare unadjusted trial balance. Step five – adjust. Step six – prepare adjusted trial balance. Seven – prepare financial statements. Step eight – close. Step nine – Prepare a post-closing trial balance and Step Ten – Reverse.