What is the Accounting Cycle?

The **accounting cycle** is the complete, repeatable sequence of steps a business follows each accounting period (monthly, quarterly, or annually) to record transactions, prepare accurate financial statements, and reset temporary accounts for the next period. It ensures that financial information moves from raw evidence (vouchers/receipts) to organized reports (Income Statement, Balance Sheet, Cash Flow Statement) in a systematic, auditable way.

Identify and analyze transactions
Every cycle begins when an event with financial impact occurs—sales, purchases, expenses, collections, borrowings, etc. Source documents (invoices, cash memos, bank statements, payroll records) provide objective evidence. The accountant decides which accounts are affected and in what direction (debit/credit).

1. **Journalize in the General Journal**
   Each transaction is recorded chronologically as a **journal entry** using the **double-entry** system: at least one debit equals at least one credit. A proper entry includes the date, accounts and amounts, brief narration, and reference numbers for traceability. This creates the first structured record of the period's activity.

2. **Post to the Ledger (T-accounts)**
   Journal entries are transferred (posted) to the **General Ledger**, which groups transactions by account (Cash, Sales, Rent Expense, Accounts Payable, etc.). Posting creates running balances for each account and enables easy look-up of totals when preparing the trial balance. Subsidiary ledgers (e.g., receivables by customer) may also be updated.

3. **Prepare the Unadjusted Trial Balance (UTB)**
   The ledger's ending balances are listed in a **trial balance** to test mechanical accuracy: total debits must equal total credits. If they don't, errors like transposition, omission, or misposting are investigated. Note: equality of totals does not guarantee absence of errors in classification or omission.

4. **Record Adjusting Entries (Accrual & Deferral adjustments)**
   At period-end, accountants record **adjusting entries** to comply with accrual principles and matching:

   - **Accruals:** expenses incurred but not yet paid (wages payable), revenues earned but not yet billed (interest receivable).

   - **Deferrals:** prepaid expenses consumed (insurance, rent), unearned revenue now earned (advance fees).

- **Estimates/valuation:** depreciation, amortization, expected credit losses (allowance for doubtful debts).

  Adjustments ensure revenues and expenses reflect the correct period.

5. **Adjusted Trial Balance (ATB)**
   After adjustments are posted, a new trial balance is prepared. The **ATB** provides the most reliable account balances for preparing financial statements. Again, debits must equal credits.

6. **Prepare Financial Statements**
   Using the ATB, statements are compiled in logical order:
   i) **Income Statement** (or Statement of Profit and Loss): measures performance (revenues – expenses = profit/loss).
   ii) **Statement of Changes in Equity/Retained Earnings:** reconciles opening to closing equity considering profit and distributions.
   iii) **Balance Sheet**: presents assets, liabilities, and equity at period end.
   iv) **Cash Flow Statement**: classifies cash movements into operating, investing, and financing activities.
   Notes and schedules provide policies, assumptions, and detailed breakdowns.

7. **Closing Entries**
   Temporary (nominal) accounts—revenues, expenses, gains, losses, drawings/dividends—are **closed** to retained earnings (or capital) so they reset to zero for the next period. Permanent (real) accounts—assets, liabilities, equity—carry forward.

8. **Post-Closing Trial Balance**
   Prepared after closing to verify that only permanent accounts remain with non-zero balances and that debits still equal credits. It becomes the opening position for the next cycle.

9. **Reversing Entries (optional, at start of next period)**
   Certain adjusting entries (e.g., accrued expenses/revenues) may be **reversed** on the first day of the new period to simplify routine transaction recording. This step is optional but commonly used for efficiency.