

3.2: Define and Describe the Initial Steps in the Accounting Cycle

The **accounting cycle** is a step-by-step process to record business activities and events to keep financial records up to date. The process occurs over one accounting period and will begin the cycle again in the following period. A **period** is one operating cycle of a business, which could be a month, quarter, or year. Review the accounting cycle in Figure 3.2.1.

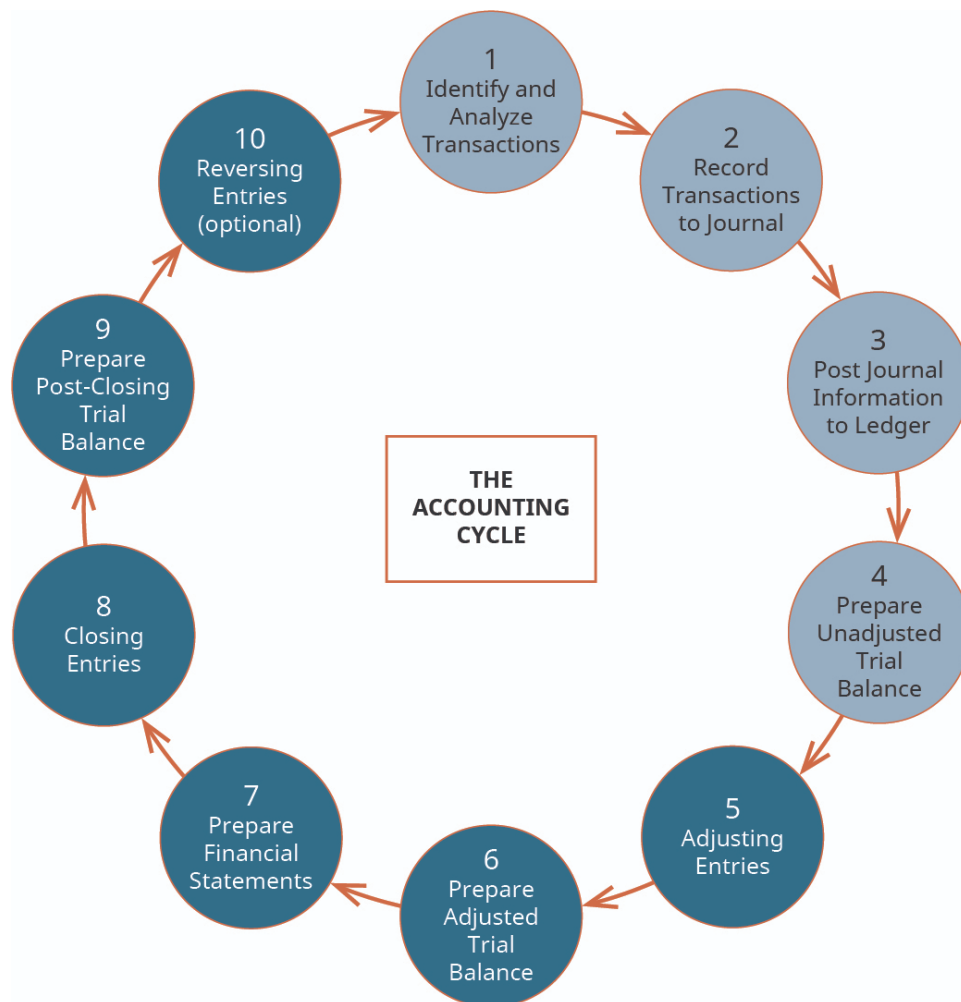


Figure 3.2.1: The Accounting Cycle. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

As you can see, the cycle begins with identifying and analyzing transactions and culminates in reversing entries. The entire cycle is meant to keep financial data organized and easily accessible to both internal and external users of information. In this chapter, we focus on the first four steps in the accounting cycle: identify and analyze transactions, record transactions to a journal, post journal information to a ledger, and prepare an unadjusted trial balance.

Ethical Considerations: Turning Hacked Gift Card Accounts into Cash

Gift cards are a great way for a company to presell its products and to create cash flow. One of the problems with gift cards is that fraudsters are using the retailer's weak internal controls to defraud the retailer's customers. A fraudster can hack into autoloading gift cards and drain a customer's bank account by buying new, physical gift cards through the autoloading gift card account. This is a real problem, and an internal control to reduce this type of fraud is to use a double verification system for the transfer of money from a bank account to reloadable gift card account. Accountants can help their organization limit gift card fraud by reviewing their company's internal controls over the gift card process.

A simple explanation of this fraud is that a fraudster will gain access to an individual's email account through phishing or by other means, such as a fraudster putting a key logger on a public computer or in a corrupted public Wi-Fi. The individual uses the same password for the reloadable gift card as his or her email account, and the fraudster will see emails about the gift card. The fraudster contacts the retailer posing as the individual, and the retailer creates an in-store gift card redemption code, and

the fraudster or his or her accomplice will go to the store posing as the individual and buy physical gift cards with the redemption code. The customer's bank account will be drained, and the customer will be upset. In another gift card fraud, the individual's credit card is stolen and used to buy physical gift cards from a retailer. This type of fraud causes problems for the retailer, for the retailer's reputation is damaged through the implementation of poor internal controls.

Does the fraudster use the fraudulently acquired gift cards? No, there is an entire market for selling gift cards on **Craigslist**, just go look and see how easy it is to buy discounted gift cards on **Craigslist**. Also, there are companies such as **cardcash.com** and **cardhub.com** that buy and resell gift cards. The fraudster just sells the gift cards, and the retailer has no idea it is redeeming fraudulently acquired gift cards. Through the implementation of proper internal controls, the accountant can help limit this fraud and protect his or her employer's reputation.

First Four Steps in the Accounting Cycle

The first four steps in the accounting cycle are (1) identify and analyze transactions, (2) record transactions to a journal, (3) post journal information to a ledger, and (4) prepare an unadjusted trial balance. We begin by introducing the steps and their related documentation.



Figure 3.2.2: Accounting Cycle. The first four steps in the accounting cycle. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

These first four steps set the foundation for the recording process.

Step 1. Identifying and analyzing transactions is the first step in the process. This takes information from original sources or activities and translates that information into usable financial data. An **original source** is a traceable record of information that contributes to the creation of a business transaction. For example, a sales invoice is considered an original source. Activities would include paying an employee, selling products, providing a service, collecting cash, borrowing money, and issuing stock to company owners. Once the original source has been identified, the company will analyze the information to see how it influences financial records.

Let's say that Mark Summers of Supreme Cleaners provides cleaning services to a customer. He generates an invoice for \$200, the amount the customer owes, so he can be paid for the service. This sales receipt contains information such as how much the customer owes, payment terms, and dates. This sales receipt is an original source containing financial information that creates a business transaction for the company.

Step 2. The second step in the process is recording transactions to a journal. This takes analyzed data from step 1 and organizes it into a comprehensive record of every company transaction. A **transaction** is a business activity or event that has an effect on financial information presented on financial statements. The information to record a transaction comes from an original source. A **journal** (also known as the book of original entry or general journal) is a record of all transactions.

For example, in the previous transaction, Supreme Cleaners had the invoice for \$200. Mark Summers needs to record this \$200 in his financial records. He needs to choose what accounts represent this transaction, whether or not this transaction will increase or decreases the accounts, and how that impacts the accounting equation before he can record the transaction in his journal. He needs to do this process for every transaction occurring during the period.

Figure 3.2.3 includes information such as the date of the transaction, the accounts required in the journal entry, and columns for debits and credits.

GENERAL JOURNAL			
Date	Account Title	Debit	Credit

Figure 3.2.3: General Journal. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

Step 3. The third step in the process is posting journal information to a ledger. **Posting** takes all transactions from the journal during a period and moves the information to a general ledger, or ledger. As you've learned, account balances can be represented visually in the form of T-accounts.

Returning to Supreme Cleaners, Mark identified the accounts needed to represent the \$200 sale and recorded them in his journal. He will then take the account information and move it to his general ledger. All of the accounts he used during the period will be shown on the general ledger, not only those accounts impacted by the \$200 sale.

Accounts Receivable		Cleaning Revenue	
Debit	Credit	Debit	Credit
Jan. 1	\$200		Jan. 1
			\$200
	Bal \$200		Bal \$200

Figure 3.2.4: General Ledger in T-Account Form. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

Step 4. The fourth step in the process is to prepare an unadjusted trial balance. This step takes information from the general ledger and transfers it onto a document showing all account balances, and ensuring that debits and credits for the period balance (debit and credit totals are equal).

Mark Summers from Supreme Cleaners needs to organize all of his accounts and their balances, including the \$200 sale, onto a trial balance. He also needs to ensure his debits and credits are balanced at the culmination of this step.

SUPREME CLEAN Trial Balance April 30, 2018		
Account Title	Debit	Credit
Cash	XXX	
Accounts receivable	XXX	
Office supplies	XXX	
Prepaid insurance	XXX	
Equipment	XXX	
Accounts payable		XXX
Unearned cleaning revenue		XXX
Common stock		XXX
Dividends	XXX	
Cleaning revenue		XXX
Gas expense	XXX	
Advertising expense	XXX	
	<u>XXX</u>	<u>XXX</u>

Figure 3.2.5: Unadjusted Trial Balance. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

It is important to note that recording the entire process requires strong attention to detail. Any mistakes early on in the process can lead to incorrect reporting information on financial statements. If this occurs, accountants may have to go all the way back to the beginning of the process to find their error. Make sure that as you complete each step, you are careful and really take the time to

understand how to record information and why you are recording it. In the next section, you will learn how the accounting equation is used to analyze transactions.

Concepts in Practice: Forensic Accounting

Ever dream about working for the Federal Bureau of Investigation (FBI)? As a forensic accountant, that dream might just be possible. A forensic accountant investigates financial crimes, such as tax evasion, insider trading, and embezzlement, among other things. Forensic accountants review financial records looking for clues to bring about charges against potential criminals. They consider every part of the accounting cycle, including original source documents, looking through journal entries, general ledgers, and financial statements. They may even be asked to testify to their findings in a court of law.

To be a successful forensic accountant, one must be detailed, organized, and naturally inquisitive. This position will need to retrace the steps a suspect may have taken to cover up fraudulent financial activities. Understanding how a company operates can help identify fraudulent activities that veer from the company's position. Some of the best forensic accountants have put away major criminals such as Al Capone, Bernie Madoff, Ken Lay, and Ivan Boesky.

Link to Learning

A tool that can be helpful to businesses looking for an easier way to view their accounting processes is to have drillable financial statements. This feature can be found in several software systems, allowing companies to go through the accounting cycle from transaction entry to financial statement construction. Read this [Journal of Accountancy column on drillable financial statements](#) to learn more.

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