PRINCIPLES OF ACCOUNTING

CHAPTER 4

COMPLETING THE ACCOUNTING CYCLE

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Chapter Introduction

The accounting cycle begins when a business transaction occurs and continues until the financial records are prepared for the next accounting period. Completing the cycle involves:

- Reviewing account balances
- Recording adjustments
- Preparing financial statements
- Closing temporary accounts
- Preparing a post-closing trial balance
- Beginning the next accounting period

Why This Chapter Matters

A business may have correctly recorded and adjusted its transactions but still need to:

- Organize adjusted balances
- Prepare formal financial statements
- Transfer net income to owner’s capital
- Remove temporary-account balances
- Verify permanent-account balances
- Prepare the ledger for the next period

From Chapter 3 to Chapter 4

Chapter 3 focused on

- Accrual accounting
- Adjusting entries
- Adjusted account balances
- Adjusted trial balance

Chapter 4 focuses on

- Work-sheet preparation
- Financial-statement preparation
- Closing entries
- Post-closing trial balance
- The complete accounting cycle

Central Accounting Question

How are adjusted ledger balances converted into financial statements, and how are the accounts prepared for the next accounting period?

Learning Objectives

By the end of this chapter, students will be able to:

1. Explain the purpose and stages of the accounting cycle.
2. Describe the flow of accounting information.
3. Prepare an accounting work sheet.
4. Extend adjusted balances to the appropriate work-sheet columns.
5. Determine net income or net loss from a work sheet.
6. Prepare financial statements from adjusted balances.
7. Distinguish temporary and permanent accounts.
8. Prepare and post closing entries.
9. Prepare a post-closing trial balance.
10. Explain how the accounting cycle begins again.

Chapter Roadmap

1. Accounting-cycle overview
2. Flow of accounting information
3. Accounting work sheet
4. Financial statements
5. Classified balance sheet
6. Temporary and permanent accounts
7. Closing process
8. Post-closing trial balance
9. Complete accounting cycle
10. Practical exercise

Opening Reflection

At December 31, a business has:

Fees Earned	**ETB 500,000**
Total expenses	**ETB 380,000**
Owner, Drawing	**ETB 40,000**
Owner, Capital	**ETB 600,000**

Questions

- What is net income?
- Which accounts must be closed?
- What is the updated capital balance?
- Which accounts continue into the next period?

SECTION 1

The Accounting Cycle

What Is the Accounting Cycle?

The accounting cycle is the sequence of procedures used to:

- Analyze transactions
- Record transactions
- Adjust accounts
- Prepare financial statements
- Close temporary accounts
- Prepare records for the next period

Why It Is Called a Cycle

The process is continuous.

End of one period

- Financial statements are prepared.
- Temporary accounts are closed.

Beginning of the next period

- Permanent balances continue.
- New transactions are recorded.
- The cycle starts again.

Main Accounting-Cycle Stages

1. Analyze transactions
2. Journalize transactions
3. Post to the ledger
4. Prepare an unadjusted trial balance
5. Gather adjustment information
6. Journalize and post adjusting entries
7. Prepare an adjusted trial balance
8. Prepare financial statements
9. Journalize and post closing entries
10. Prepare a post-closing trial balance

Optional Step — The Work Sheet

A work sheet may be prepared before the financial statements. It helps organize:

- Unadjusted balances
- Adjustments
- Adjusted balances
- Income-statement accounts
- Balance-sheet accounts

mportant: the work sheet is an internal accounting tool, not a formal financial statement.

Flow of Accounting Information

Source Documents
↓
Journal
↓
Ledger
↓
Unadjusted Trial Balance
↓
Adjusting Entries

Adjusted Trial Balance
↓
Financial Statements
↓
Closing Entries
↓
Post-Closing Trial Balance

Unadjusted Trial Balance

The unadjusted trial balance lists account balances before adjustments. It helps verify that:

Total Debits = Total Credits

However, some balances may still be incomplete or outdated.

Adjusting Entries

Adjusting entries recognize:

- Prepaid expenses consumed
- Supplies used
- Depreciation
- Unearned revenue earned
- Accrued revenue
- Accrued expenses

They ensure that revenue and expenses are assigned to the correct accounting period.

Adjusted Trial Balance

The adjusted trial balance is prepared after adjusting entries are posted. It contains the balances used to prepare:

- Income statement
- Statement of owner's equity
- Balance sheet
- Other financial reports

Financial Statements

Financial statements summarize:

Financial performance

- Revenue
- Expenses
- Net income or net loss

Financial position

- Assets
- Liabilities
- Owner’s equity

Changes in equity

- Investments
- Net income or loss
- Withdrawals

The Closing Process

The closing process:

- Transfers temporary-account balances
- Updates the owner’s capital account
- Reduces temporary accounts to zero
- Prepares the accounts for the next period

Post-Closing Trial Balance

The post-closing trial balance:

- Is prepared after closing entries
- Contains only permanent accounts
- Verifies equality of debit and credit balances
- Confirms that temporary accounts were closed

SECTION 2

The Accounting Work Sheet

What Is an Accounting Work Sheet?

An accounting work sheet is a multi-column accounting document used to organize information for:

- Adjusting entries
- Adjusted balances
- Financial-statement preparation
- Closing-process planning

Purpose of the Work Sheet

The work sheet helps accountants:

- Identify required adjustments
- Verify adjusted balances
- Separate income-statement accounts
- Separate balance-sheet accounts
- Calculate net income or net loss
- Reduce financial-statement preparation errors

A Work Sheet Is Not a Journal

A work-sheet adjustment does not automatically update the ledger. Adjusting entries must still be:

1. Journalized
2. Posted to the ledger

The work sheet supports the accounting process but does not replace formal records.

A Work Sheet Is Not a Financial Statement

The work sheet is:

- Prepared for internal use
- Not normally distributed externally
- Not a substitute for formal financial statements
- Not part of the general ledger

Main Work-Sheet Columns

A common work sheet contains five pairs of debit and credit columns:

1. Unadjusted Trial Balance
2. Adjustments
3. Adjusted Trial Balance
4. Income Statement
5. Balance Sheet

Work-Sheet Structure

Every account title is carried across five pairs of debit and credit columns.

Account	Unadjusted Trial Balance	Adjustments	Adjusted Trial Balance	Income Statement	Balance Sheet
Column pair	Dr. / Cr.	Dr. / Cr.	Dr. / Cr.	Dr. / Cr.	Dr. / Cr.
Cash	Dr.	—	Dr.	—	Dr.
Fees Earned	Cr.	—	Cr.	Cr.	—
Supplies Expense	Dr.	Dr.	Dr.	Dr.	—
Owner, Drawing	Dr.	—	Dr.	—	Dr.

Revenue and expense balances extend to the Income Statement columns; all other balances extend to the Balance Sheet columns.

Work-Sheet Heading

The heading normally contains:

1. Name of the business
2. Title: Work Sheet
3. Accounting period covered

EXAMPLE

Bright Consulting
Work Sheet
For the Year Ended December 31, 2026

Step 1 — Enter Account Titles

List the accounts in ledger order:

1. Assets
2. Liabilities
3. Owner’s capital
4. Owner’s drawing
5. Revenue
6. Expenses

Additional accounts needed for adjustments may also be added.

Step 2 — Enter Unadjusted Balances

Transfer the account balances from the unadjusted trial balance into the work-sheet columns.

CONTROL CHECK

Unadjusted Debit Total = Unadjusted Credit Total

Step 3 — Enter Adjustments

Record each adjustment in the Adjustments columns. Examples:

- Supplies used
- Insurance expired
- Depreciation
- Accrued wages
- Accrued fees
- Unearned revenue earned

Each adjustment must have equal debits and credits.

Adjustment Reference Letters

Adjustments may be identified using letters:

Supplies used	**(a)**
Insurance expired	**(b)**
Depreciation	**(c)**
Wages accrued	**(d)**
Revenue accrued	**(e)**

The letters help link related debit and credit amounts.

Step 4 — Calculate Adjusted Balances

Combine the unadjusted balance and the adjustment.

Same-side adjustment

- Add the amounts.

Opposite-side adjustment

- Subtract the smaller amount from the larger amount.

Adjusted Balance Example — Supplies

Unadjusted Supplies	**ETB 20,000 Dr**
Less: adjustment for supplies used	**ETB 14,000 Cr**
Adjusted Supplies balance	**ETB 6,000 Dr**

Enter the resulting balance in the appropriate adjusted trial-balance column.

Adjusted Balance Example — Wages Expense

Unadjusted Wages Expense	ETB 80,000
Add: accrued wages adjustment	ETB 10,000
Adjusted Wages Expense	**ETB 90,000**

Adjusted Trial-Balance Check

After calculating all adjusted balances, Adjusted Debit Total must equal Adjusted Credit Total. If the columns are unequal, review:

- Calculations
- Adjustment transfers
- Debit and credit classifications
- Account balances

Step 5 — Extend Income-Statement Accounts

Transfer these adjusted balances to the Income Statement columns.

Accounts extended

- Revenue accounts
- Expense accounts

Typical placement

- Revenue → Income Statement credit
- Expenses → Income Statement debit

Step 6 — Extend Balance-Sheet Accounts

Transfer these adjusted balances to the Balance Sheet columns.

Accounts extended	Typical placement
• Assets • Liabilities • Owner’s capital • Owner’s drawing	• Asset and drawing balances → Debit • Liability and capital balances → Credit

Why Drawing Goes to the Balance-Sheet Columns

Owner's Drawing is not an expense. It:

- Does not affect net income
- Reduces owner's equity
- Is closed directly to the capital account

Therefore, it is extended to the Balance Sheet debit column.

Income-Statement Column Totals

Add both Income Statement columns and compare the totals.

Add

- Income Statement debit column
- Income Statement credit column

The difference represents

- Net income, or
- Net loss

Determining Net Income

When Income Statement Credits > Income Statement Debits

the business has net income.

$$\textbf{Net Income} = \textbf{Revenue} - \textbf{Expenses}$$

Net-Income Work-Sheet Entry

Net income is entered in two columns, which balances both column pairs.

Income Statement

- Entered in the debit column

Balance Sheet

- Entered in the credit column

Why Net Income Balances the Columns

Net income increases owner’s equity, so it is added to the Balance Sheet credit column alongside capital.

- Income Statement debit and credit columns become equal
- Balance Sheet debit and credit columns become equal
- The work sheet is proved before statements are prepared

Determining Net Loss

When Income Statement Debits > Income Statement Credits

the business has a net loss.

Net Loss = Expenses – Revenue

Net-Loss Work-Sheet Entry

Net loss decreases owner’s equity, so it is entered opposite to net income.

Income Statement

- Entered in the credit column

Balance Sheet

- Entered in the debit column

Work-Sheet Net-Income Example

Income Statement credits	**ETB 500,000**
Income Statement debits	**ETB 380,000**
Net income	**ETB 120,000**

Final Work-Sheet Verification

After entering net income or net loss, both column pairs must agree.

Income Statement columns

- Debits = Credits

Balance Sheet columns

- Debits = Credits

Limitations of a Work Sheet

A balanced work sheet does not prove that:

- Every transaction was recorded
- Correct accounts were used
- All adjustments were identified
- Fraud did not occur
- Estimates are accurate

Professional judgement and internal control remain necessary.

SECTION 3

Preparing Financial Statements

Financial-Statement Sequence

Financial statements are normally prepared in this order:

1. Income Statement
2. Statement of Owner’s Equity
3. Balance Sheet
4. Statement of Cash Flows

The results of one statement may be needed for the next.

The Income Statement

The Income Statement reports the following for a specified accounting period:

- Revenue
- Expenses
- Net income or net loss

Income-Statement Example

Bright Consulting — Income Statement — For the Year Ended December 31, 2026

Item	ETB
Fees Earned	500,000
Wages Expense	(200,000)
Rent Expense	(70,000)
Supplies Expense	(45,000)
Depreciation Expense	(35,000)
Other Expenses	(30,000)
Net Income	**120,000**

Statement of Owner’s Equity

The Statement of Owner’s Equity reports changes in capital resulting from:

- Beginning capital
- Additional owner investment
- Net income or net loss
- Owner withdrawals

Owner's-Equity Formula

Ending capital is calculated as follows:

Beginning capital	+
Owner investment	+
Net income (or net loss)	+ / −
Owner withdrawals	−
Ending capital	**=**

Statement of Owner's Equity Example

Item	ETB
Beginning capital	600,000
Add: Additional investment	50,000
Add: Net income	120,000
Subtotal	**770,000**
Less: Owner withdrawals	(40,000)
Ending capital	**730,000**

The Balance Sheet

The Balance Sheet reports the following at a specific date:

Assets	Liabilities	Owner's equity

Assets = Liabilities + Owner's Equity

Classified Balance Sheet

A classified balance sheet organizes accounts into meaningful sections.

Assets

- Current assets
- Long-term assets

Liabilities

- Current liabilities
- Long-term liabilities

Owner's Equity

- Owner's capital

Current Assets

Current assets are expected to be converted into cash, sold or consumed within one year or the operating cycle.

Characteristics	Examples
• Converted into cash • Sold • Consumed within the operating cycle	• Cash • Accounts receivable • Supplies • Prepaid insurance • Short-term investments

Long-Term Assets

Long-term assets support operations for more than one accounting period. Examples:

- Land
- Buildings
- Equipment
- Vehicles
- Furniture
- Intangible assets

Current Liabilities

Current liabilities are expected to be paid within one year or the operating cycle. Examples:

- Accounts payable
- Wages payable
- Interest payable
- Unearned revenue
- Short-term notes payable

Long-Term Liabilities

Long-term liabilities are obligations not due within the next year. Examples:

- Long-term loans payable
- Mortgage payable
- Long-term notes payable
- Long-term lease obligations

Classified Balance-Sheet Example

Assets

Item	ETB
Current assets	330,000
Property and equipment, net	900,000
Total assets	**1,230,000**

Liabilities and Owner's Equity

Item	ETB
Current liabilities	180,000
Long-term liabilities	320,000
Owner's capital	730,000
Total liabilities and equity	**1,230,000**

Relationship among the Statements

Income Statement

Produces net income or net loss.

Statement of Owner’s Equity

Uses net income or net loss to calculate ending capital.

Balance Sheet

Reports ending capital as part of owner’s equity.

SECTION 4

Closing the Accounts

Why Accounts Are Closed

Closing entries are prepared to:

- Transfer temporary balances
- Update owner’s capital
- Set temporary accounts to zero
- Separate one accounting period from the next
- Prevent current and prior-period amounts from being combined

Temporary Accounts

Temporary accounts accumulate information for one accounting period. They include:

- Revenue accounts
- Expense accounts
- Income Summary
- Owner's Drawing

Their balances are closed at the end of the period.

Permanent Accounts

Permanent accounts continue from one accounting period to the next. They include:

- Assets
- Liabilities
- Owner’s capital

Their ending balances become the next period’s beginning balances.

Temporary versus Permanent Accounts

Temporary Accounts	Permanent Accounts
Revenue	Assets
Expenses	Liabilities
Drawing	Owner’s capital
Income Summary	—
Closed to zero	**Carried forward**

The Income Summary Account

Income Summary is a temporary account used during the closing process. It is used to:

- Collect revenue balances
- Collect expense balances
- Determine net income or net loss
- Transfer the result to owner's capital

t does not appear in the financial statements.

The Four Closing Entries

1. Close revenue accounts to Income Summary.
2. Close expense accounts to Income Summary.
3. Close Income Summary to Owner’s Capital.
4. Close Owner’s Drawing to Owner’s Capital.

Closing Entry 1 — Revenue

Assume Fees Earned has a credit balance of ETB 500,000.

Account	Debit	Credit
Fees Earned	500,000	
Income Summary		500,000

Result: Fees Earned becomes zero.

Closing Entry 2 — Expenses

Assume total expenses are ETB 380,000.

Account	Debit	Credit
Income Summary	380,000	
Wages Expense		200,000
Rent Expense		70,000
Supplies Expense		45,000
Depreciation Expense		35,000
Other Expenses		30,000

Income Summary after Closing Revenue and Expenses

Income Summary credits	**ETB 500,000**
Income Summary debits	**ETB 380,000**
Credit balance	**ETB 120,000**

The credit balance represents net income.

Closing Entry 3 — Net Income

Account	Debit	Credit
Income Summary	120,000	
Owner, Capital		120,000

Income Summary becomes zero and capital increases by net income.

Closing a Net Loss

When expenses exceed revenue, Income Summary has a debit balance.

Account	Debit	Credit
Owner, Capital	XXX	
Income Summary		XXX

A net loss decreases owner's capital.

Closing Entry 4 — Drawing

Assume Owner, Drawing has a debit balance of ETB 40,000.

Account	Debit	Credit
Owner, Capital	40,000	
Owner, Drawing		40,000

Drawing is closed directly to Capital, not to Income Summary.

SECTION 5

Post-Closing Trial Balance and Chapter Close

Post-Closing Trial Balance

The post-closing trial balance is prepared after closing entries are journalized and posted.

It contains only

- Assets
- Liabilities
- Owner's capital

It should not contain

- Revenue
- Expenses
- Drawing
- Income Summary

Purpose of the Post-Closing Trial Balance

- Verify that total debits equal total credits
- Confirm temporary accounts were closed
- Verify permanent-account balances
- Prepare the ledger for the next period

Practical Exercise — Adjusted Balances (1 of 2)

Bright Consulting — permanent accounts.

Account	Debit	Credit
Cash	220,000	
Accounts Receivable	80,000	
Supplies	30,000	
Equipment	500,000	
Accumulated Depreciation		50,000
Accounts Payable		70,000
Wages Payable		20,000
Owner, Capital		450,000

Practical Exercise — Adjusted Balances (2 of 2)

Bright Consulting — temporary accounts.

Account	Debit	Credit
Owner, Drawing	40,000	
Fees Earned		500,000
Wages Expense	200,000	
Rent Expense	70,000	
Supplies Expense	45,000	
Depreciation Expense	35,000	
Other Expenses	30,000	

Practical Exercise — Requirements

Using the adjusted balances provided:

1. Calculate net income.
2. Prepare the closing entries.
3. Calculate the ending capital balance.
4. Prepare the post-closing trial balance.

Solution 1 — Net Income

Total expenses = 200,000 + 70,000 + 45,000 + 35,000 + 30,000

Fees Earned	**ETB 500,000**
Total expenses	**ETB 380,000**
Net income	**ETB 120,000**

Solution 2 — Closing Entries

Close revenue

Fees Earned 500,000 Dr / Income Summary 500,000 Cr

Close expenses

Income Summary 380,000 Dr / Expense accounts 380,000 Cr

Close net income

Income Summary 120,000 Dr / Owner, Capital 120,000 Cr

Close drawing

Owner, Capital 40,000 Dr / Owner, Drawing 40,000 Cr

Solution 3 — Ending Capital

Ending capital = Beginning capital + Net income − Withdrawals

Owner, Capital (adjusted)	**ETB 450,000**
Add: Net income	**ETB 120,000**
Less: Owner withdrawals	**ETB 40,000**
Ending capital	**ETB 530,000**

Solution 4 — Post-Closing Trial Balance

Account	Debit	Credit
Cash	220,000	
Accounts Receivable	80,000	
Supplies	30,000	
Equipment	500,000	
Accumulated Depreciation		50,000
Accounts Payable		70,000
Wages Payable		20,000
Owner, Capital		530,000
Total	**830,000**	**670,000**

Important Review Point

The provided adjusted balances do not produce a balanced post-closing trial balance. This indicates that one or more permanent-account balances, or the original adjusted trial-balance data, are incomplete.

Difference: 830,000 – 670,000 = ETB 160,000

The post-closing trial balance should never be forced to balance by inserting an unsupported amount. The accountant must investigate the difference before finalising the accounting cycle.

Chapter Summary — Cycle and Work Sheet

- The accounting cycle organizes transaction recording and reporting.
- A work sheet helps organize adjustments and financial-statement information.
- The work sheet is optional and is not a formal accounting record.
- Adjusted revenue and expense balances go to the Income Statement columns.
- Asset, liability, capital and drawing balances go to the Balance Sheet columns.
- Net income increases owner’s equity; net loss decreases it.

Chapter Summary — Statements and Closing

- Financial statements are prepared from adjusted balances.
- Temporary accounts relate to one accounting period.
- Permanent accounts continue into future periods.
- Closing entries transfer temporary balances to owner’s capital.
- The post-closing trial balance contains only permanent accounts.
- A balanced post-closing trial balance supports — but does not guarantee — accuracy.

Accounting-Cycle Summary

1. Analyze
2. Journalize
3. Post
4. Unadjusted Trial Balance
5. Adjust
6. Adjusted Trial Balance
7. Financial Statements
8. Close
9. Post-Closing Trial Balance
10. Begin New Period

Key Message

Completing the accounting cycle transforms adjusted account balances into financial statements and prepares the accounting records for a new reporting period.

THANK YOU

Questions and Discussion

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The accounting cycle is complete only when financial statements have been prepared, temporary accounts have been closed and permanent balances have been verified for the next accounting period.