

Financial Accounting



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Sixth Edition



Chapter 02

Analyzing and Recording Transactions

Conceptual Learning Objectives

- C1: Explain the steps in processing transactions.
- C2: Describe an account and its use in recording transactions.
- C3: Describe a ledger and a chart of accounts.
- C4: Define *debits* and *credits* and explain double-entry accounting.

[Analytical Learning Objectives]

- A1:** Analyze the impact of transactions on accounts and financial statements.
- A2:** Compute the debt ratio and describe its use in analyzing financial condition.

Procedural Learning Objectives

- P1:** Record transactions in a journal and post entries to a ledger.
- P2:** Prepare and explain the use of a trial balance.
- P3:** Prepare financial statements from business transactions.

Analyzing and Recording Process

C1

Exchanges of economic consideration between two parties.



External Transactions
occur between the
organization and an
outside party.



Internal Transactions
occur within the
organization.

Analyzing and Recording Process

C1



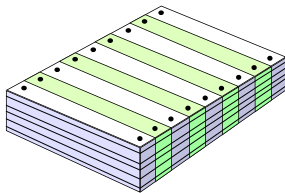
Analyze each transaction and event from **source documents**



Record relevant transactions and events in a **journal**

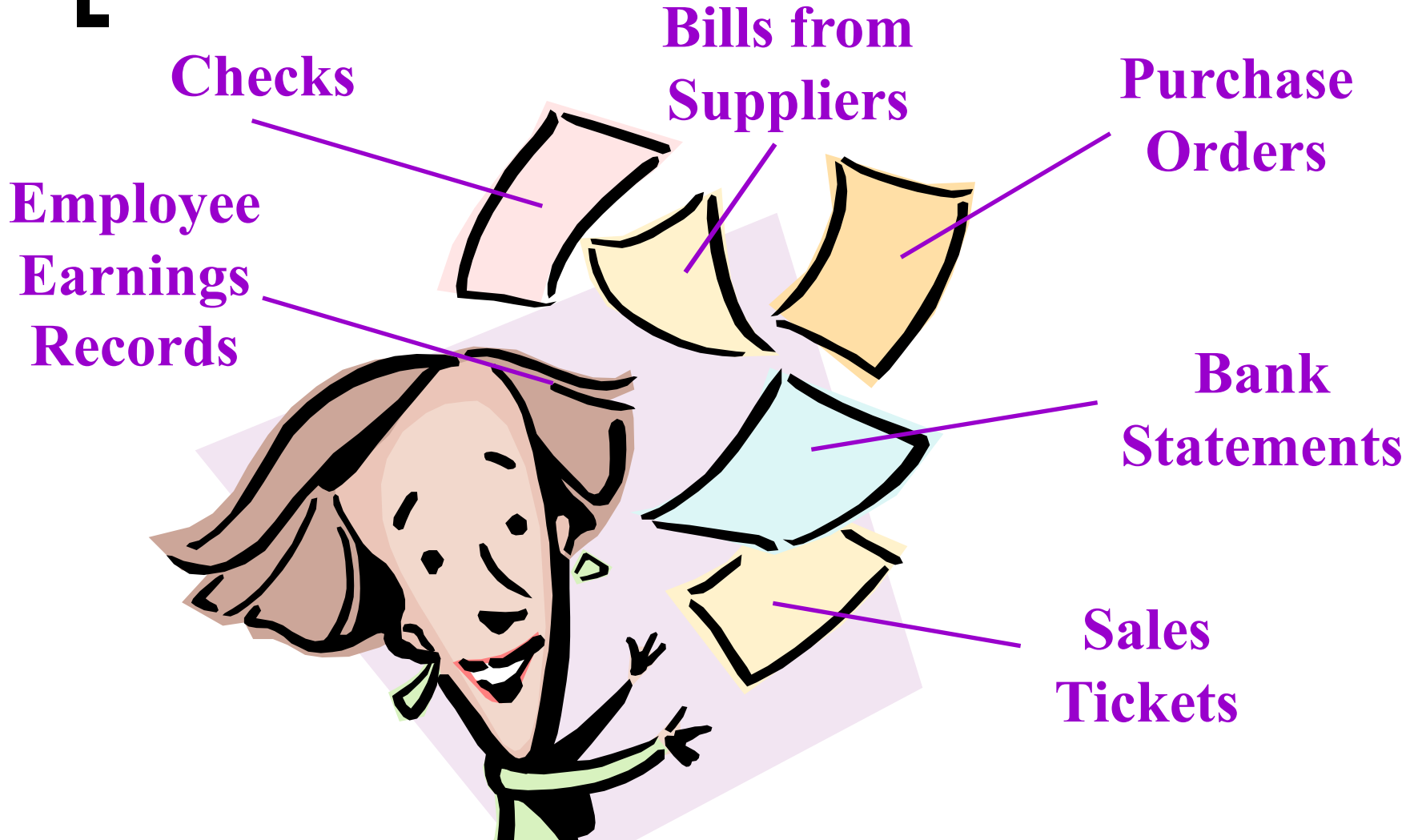


Post journal information to **ledger accounts**



Prepare and analyze the **trial balance**

Source Documents



The Account and its Analysis

An **account** is a record of increases and decreases in a specific asset, liability, equity, revenue, or expense item.

The **general ledger** is a record containing all accounts used by the company.

C2

The Account and Its Analysis

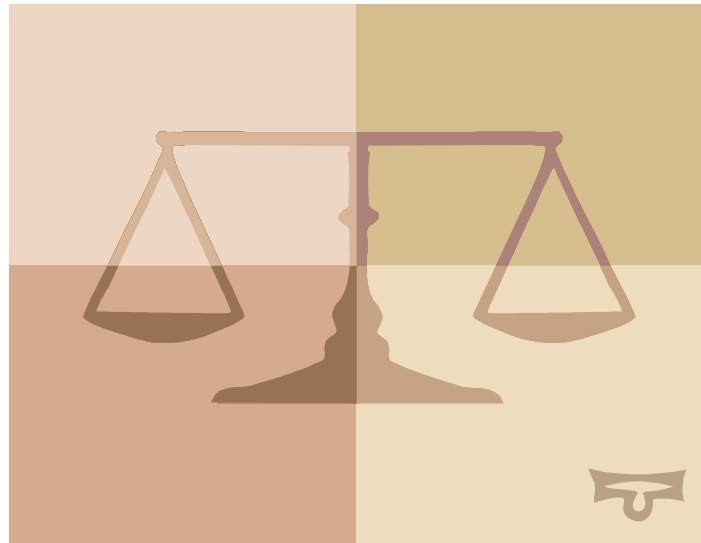
**Asset
Accounts**

=

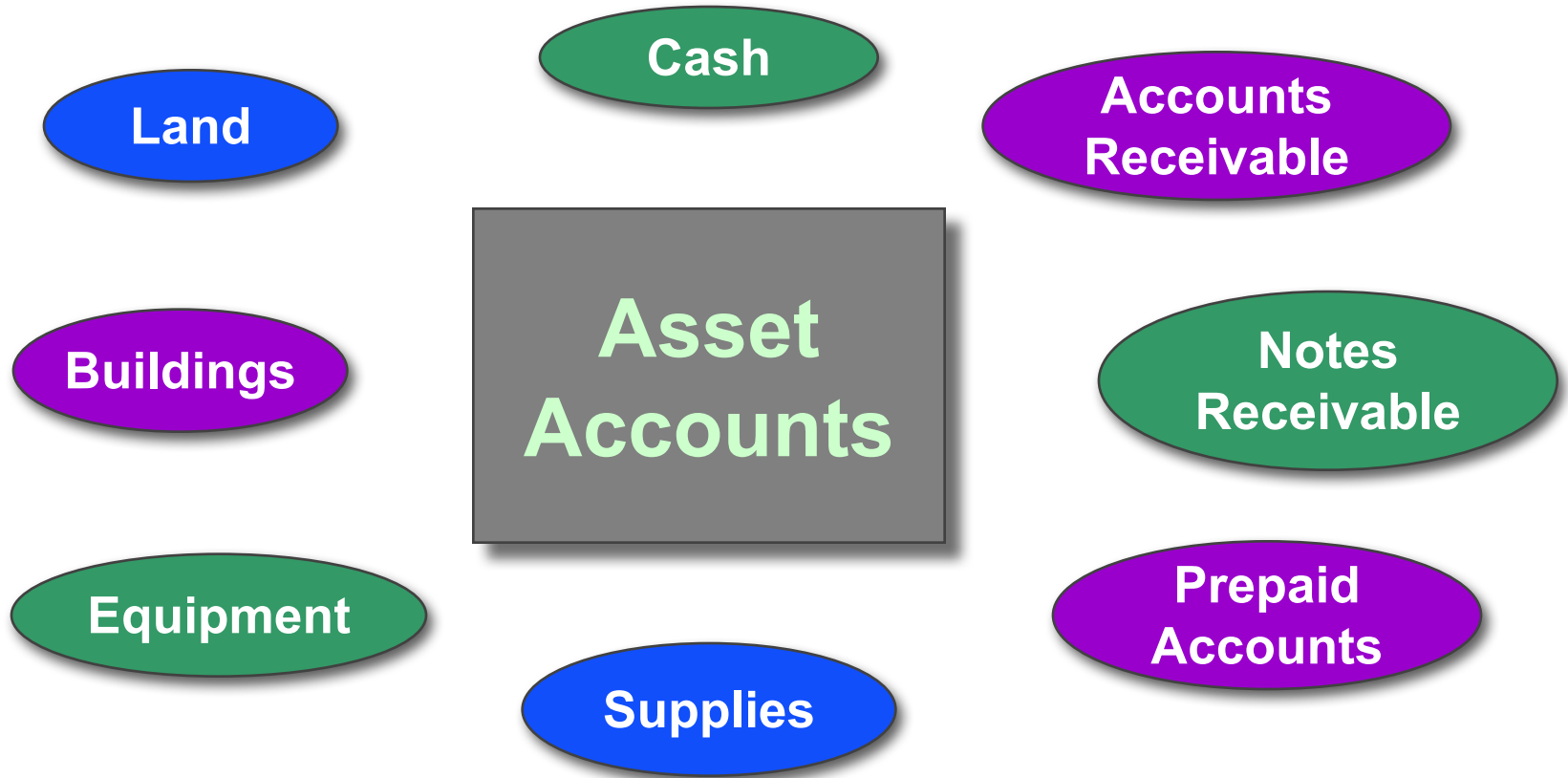
**Liability
Accounts**

+

**Equity
Accounts**



Asset Accounts





Liability Accounts

**Accounts
Payable**

**Notes
Payable**

**Liability
Accounts**

**Accrued
Liabilities**

**Unearned
Revenue**

Equity Accounts

Common
Stock

Retained
Earnings

Dividends

Equity
Accounts

Revenues

Expenses

C3

The Account and Its Analysis

Assets

=

Liabilities

+

Equity

+

**Common
Stock**

-

Dividends

+

Revenues

-

Expenses

Ledger and Chart of Accounts

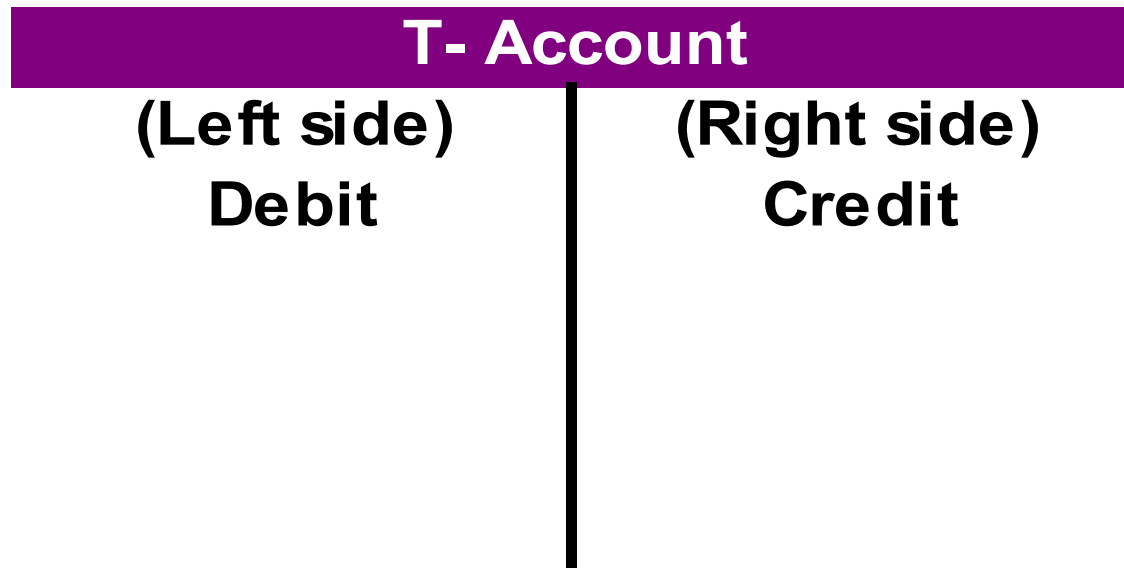
The **ledger** is a collection of all accounts for an information system. A company's size and diversity of operations affect the number of accounts needed.

The **chart of accounts** is a list of all accounts and includes an identifying number for each account.

101	Cash	319	Dividends
106	Accounts receivable	403	Consulting revenues
126	Supplies	406	Rental revenue
128	Prepaid insurance	622	Salaries expense
167	Equipment	637	Insurance expense
201	Accounts payable	640	Rent expense
236	Unearned revenue	652	Supplies expense
307	Common stock	690	Utilities expense
318	Retained earnings		

Debits and Credits

A T-account represents a ledger account and is a tool used to understand the effects of one or more transactions.



C4

Double-Entry Accounting

Assets

=

Liabilities

+

Equity

ASSETS



Debit
+



Credit
-

LIABILITIES



Debit
-



Credit
+

EQUITIES



Debit
-



Credit
+

C4

Double-Entry Accounting

Equity

**Common
Stock**

-

Dividends

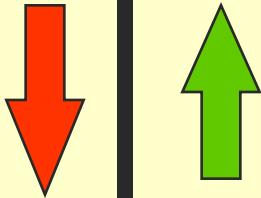
+

Revenues

-

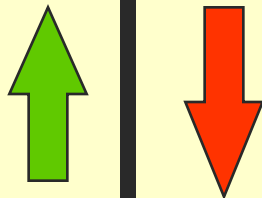
Expenses

Stock



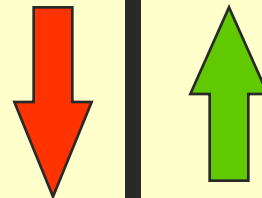
Debit -
Credit +

Dividends



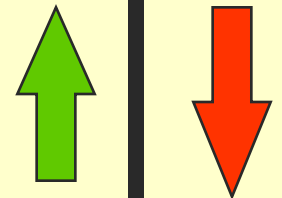
Debit +
Credit -

Revenues



Debit -
Credit +

Expenses



Debit +
Credit -

Double-Entry Accounting

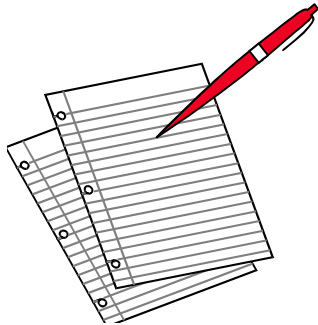
An account balance is the difference between the increases and decreases in an account.

Notice the T-Account

Cash			
Investment by owner for stock	30,000	Purchase of supplies	2,500
Consulting services revenues earned	4,200	Purchase of equipment	26,000
Collection of accounts receivable	1,900	Payment of rent	1,000
		Payment of salary	700
		Payment of accounts payable	900
		Payment of cash dividend	200
Total increases	36,100	Total decreases	31,300
Balance	4,800		

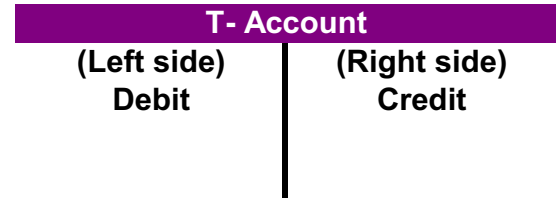
Journalizing and Posting Transactions

P1



Step 1: Analyze transactions and source documents.

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$



Step 2: Apply double-entry accounting

ACCOUNT NAME:		ACCOUNT No.			
Date	Description	PR	Debit	Credit	Balance

Step 4: Post entry to ledger

GENERAL JOURNAL			Page 123	
Date	Description	Post. Ref.	Debit	Credit

Step 3: Record journal entry

Journalizing Transactions

① Transaction Date

② Titles of Affected Accounts

GENERAL JOURNAL					Page 1
Date	Account Titles and Explanations	PR	Debit	Credit	
2011					
Dec. 1	Cash		30,000		
	Common stock			30,000	
	<i>Investment by shareholders</i>				

④ Transaction explanation

③ Dollar amount of debits and credits

Balance Column Account

T-accounts are useful illustrations, but **balance column accounts** are used in practice.

CASH		ACCOUNT No. 101			
Date	Explanation	PR	Debit	Credit	Balance
2011					
Dec. 1	Initial investment		30,000		30,000
Dec. 2	Purchased supplies			2,500	27,500
Dec. 3	Purchased equipment			26,000	1,500
Dec. 10	Collection from customer		4,200		5,700

Posting Journal Entries

GENERAL JOURNAL					Page 1
Date	Account Titles and Explanation		PR	Debit	Credit
2011					
Dec. 1	Cash			30,000	
		Common stock			30,000
		<i>Investment by shareholders</i>			

- 1 Identify the debit account in ledger.

CASH		ACCOUNT No.		101	
Date	Explanation	PR	Debit	Credit	Balance
2011					

Posting Journal Entries

P1 →

GENERAL JOURNAL					Page 1
Date	Account Titles and Explanation	PR	Debit	Credit	
2011					
Dec. 1	Cash		30,000		
	Common stock			30,000	
	<i>Investment by shareholders</i>				

2 Enter the date.

CASH		ACCOUNT No. 101			
Date	Explanation	PR	Debit	Credit	Balance
2011					
Dec. 1					

Posting Journal Entries

P1

GENERAL JOURNAL				Page 1	
Date	Account Titles & Explanations		PR	Debit	Credit
2011					
Dec. 1	Cash			30,000	
		Common stock			30,000
		<i>Investment by shareholders</i>			

3 Enter the amount and description.

CASH			ACCOUNT No.		101
Date	Explanation	PR	Debit	Credit	Balance
2011					
Dec. 1			30,000		

Posting Journal Entries

P1

GENERAL JOURNAL					Page 1
Date	Account Titles and Explanation		PR	Debit	Credit
2011					
Dec. 1	Cash			30,000	
		Common stock			30,000
		<i>Investment by shareholders</i>			

4 Enter the journal reference.

CASH		ACCOUNT No.		101	
Date	Explanation	PR	Debit	Credit	Balance
2011					
Dec. 1		G1	30,000		

Posting Journal Entries

P1

GENERAL JOURNAL					Page 1
Date	Account Titles & Explanations		PR	Debit	Credit
2011					
Dec. 1	Cash			30,000	
		Common stock			30,000
		<i>Investment by shareholders</i>			

5 Compute the balance.

CASH			ACCOUNT No. 101		
Date	Explanation	PR	Debit	Credit	Balance
2011					
Dec. 1		G1	30,000		30,000

Posting Journal Entries

P1

GENERAL JOURNAL					Page 1
Date	Account Titles and Explanation		PR	Debit	Credit
2011					
Dec. 1	Cash		101	30,000	
		Common stock			30,000
		<i>Investment by shareholders</i>			

6

Enter the ledger reference.

CASH

ACCOUNT No.

101

Date	Explanation	PR	Debit	Credit	Balance
2011					
Dec. 1		G1	30,000		30,000

Analyzing Transactions

<i>Transaction:</i>	Shareholder invested \$30,000 in FastForward on Dec. 1.
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Analysis:

Assets	=	Liabilities	+	Equity
Cash				Common Stock
30,000				30,000

Double entry:

(1)	Cash	101	30,000	
	Common stock	301		30,000

Posting:

	Cash	101	Common Stock	301
(1)	30,000		(1)	30,000

Analyzing Transactions

Transaction: FastForward purchases supplies by paying \$2,500 cash.

Analysis:

Assets		=	Liabilities	+	Equity
Cash	Supplies				Common Stock
(2,500)	2,500				

Double entry:

(2)	Supplies	126	2,500	
	Cash	101		2,500

Posting:

	Supplies	126	Cash	101
(2)	2,500		(1) 30,000	(2) 2,500

Analyzing Transactions

A1

Transaction: FastForward purchases equipment by paying \$26,000 cash.

Analysis:

Assets		=	Liabilities	+	Equity
Cash	Equipment				Common Stock
(26,000)	26,000				

Double entry:

(3)	Equipment	167	26,000	
	Cash	101		26,000

Posting:

Equipment		167	Cash		101
(3)	26,000		(1)	30,000	(2) 2,500
					(3) 26,000

Analyzing Transactions

Transaction: FastForward purchases \$7,100 of supplies on credit.

Analysis:

Assets	=	Liabilities	+	Equity
Supplies		Accounts Payable		Common Stock
7,100		7,100		

Double entry:

(4)	Supplies	126	7,100	
	Accounts payable	201		7,100

Posting:

	Supplies	126	Accounts Payable	201
(2)	26,000			(4) 7,100
(4)	7,100			

A1

Analyzing Transactions

Transaction: FastForward provides consulting services and immediately collects \$4,200 cash.

Analysis:

Assets	=	Liabilities	+	Equity
Cash 4,200				Revenue 4,200

Double entry:

(5)	Cash	101	4,200	
	Consulting Revenue	403		4,200

Posting:

Consulting Revenue	403	Cash	101
(5)	4,200	(1)	30,000
		(5)	4,200
		(2)	2,500
		(3)	26,000

P2

Trial Balance

FastFoward Trial Balance December 31, 2011

	<i>Debits</i>	<i>Credits</i>
Cash	\$ 4,350	
Accounts receivable	-	
Supplies	9,720	
Prepaid Insurance	2,400	
Equipment	26,000	
Accounts payable		\$ 6,200
Unearned consulting revenue		3,000
Common stock		30,000
Dividends	200	
Consulting revenue		5,800
Rental revenue		300
Salaries expense	1,400	
Rent expense	1,000	
Utilities expense	230	
Total	\$ 45,300	\$ 45,300

After processing its remaining transactions for December, FastForward's trial balance is prepared.

The trial balance lists all account balances in the general ledger. If the books are in balance, the total debits will equal the total credits.

Six Steps for Searching for and Correcting Errors

If the trial balance does not balance, the error(s) must be found and corrected.

① Verify that the trial balance columns are correctly added.

② Verify that account balances are correctly entered from the ledger.

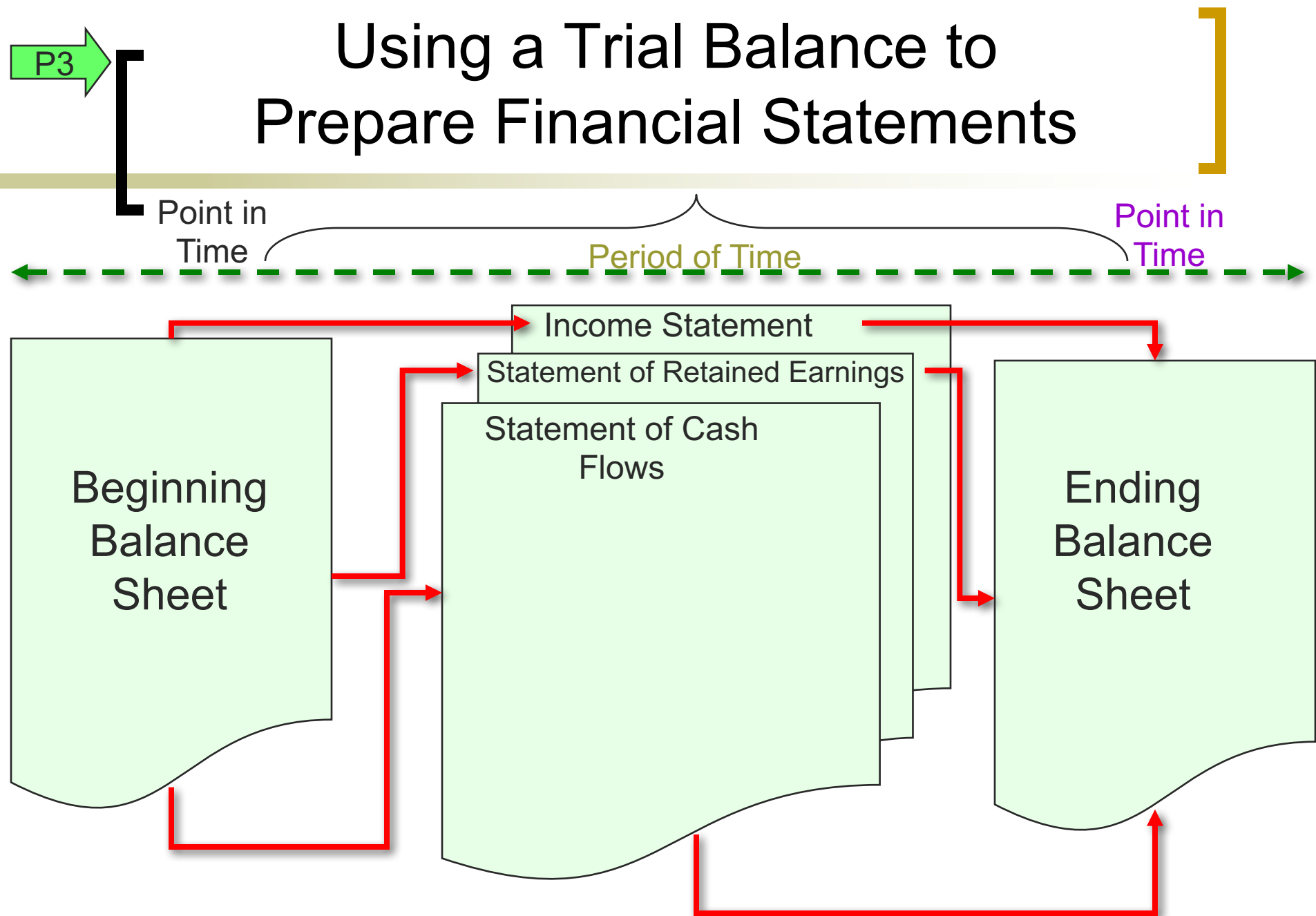
③ See whether a debit (or credit) balance is mistakenly listed as a credit (or debit).

④ Recompute each account balance in the ledger.

⑤ Verify that each journal entry is properly posted.

⑥ Verify that each original journal entry has equal debits and credits.

Using a Trial Balance to Prepare Financial Statements





Income Statement



FASTFORWARD
Income Statement
For the Month Ended December 31, 2011

Revenues:

Consulting revenue	\$ 5,800	
Rental revenue	300	
Total revenues	<u> </u>	\$ 6,100

Expenses:

Salaries expense	1,400	
Rent expense	1,000	
Utilities expense	230	
Total expenses	<u> </u>	<u>2,630</u>
Net income		<u><u>\$ 3,470</u></u>

Statement of Retained Earnings

FASTFORWARD	
Statement of Retained Earnings	
For the Month Ended December 31, 2011	
Balance, 12/1/11	\$ -
Net income for December	3,470
	3,470
Less: Dividends	(200)
Balance, 12/31/11	\$ 3,270

FASTFORWARD		
Income Statement		
For the Month Ended December 31, 2011		
Revenues:		
Consulting revenue	\$ 5,800	
Rental revenue	300	
Total revenues		\$ 6,100
Expenses:		
Rent expense	1,000	
Salaries expense	1,400	
Utilities expense	230	
Total expenses		2,630
Net income		\$ 3,470

Balance Sheet

FASTFORWARD

Statement of Retained Earnings For the Month Ended December 31, 2011

Balance, 12/1/11	\$ -
Net income for December	3,470
	<u>3,470</u>
Less: Dividends	200
Balance, 12/31/11	<u><u>\$ 3,270</u></u>

FASTFORWARD

Balance Sheet December 31, 2011

Assets	
Cash	\$ 4,350
Supplies	9,720
Prepaid insurance	2,400
Equipment	26,000
Total assets	<u><u>\$ 42,470</u></u>
Liabilities	
Accounts payable	\$ 6,200
Unearned revenue	3,000
Total liabilities	<u><u>9,200</u></u>
Equity	
Common stock	30,000
Retained earnings	3,270
Total equity	<u><u>33,270</u></u>
Total liabilities and equity	<u><u>\$ 42,470</u></u>

Debt Ratio

- Describes the relationship between the amounts of the company's liabilities and assets.

$$\text{Debt Ratio} = \frac{\text{Total Liabilities}}{\text{Total Assets}}$$

- Helps to assess the risk that a company will fail to pay its debts.

End of Chapter 02

