chapter 2

Accounting for business transactions

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| Chapter Outline | | | |
| 1. **Basis of Financial Statements** 2. The process to go from transactions and events to financial statements includes the following: | | | | | |
| 1. Identify each transaction and event from source documents. 2. Analyze each transaction and event using the accounting equation. 3. Record relevant transactions and events in a journal. 4. Post journal information to ledger accounts. 5. Prepare and analyze the trial balance and financial statements. 6. Source Documents—identify and describe transactions and events entering the accounting system. | | | | |
| C. “Account” Underlying Financial Statements | | | |
| An *account* is a record of increases and decreases in a specific asset, liability, equity, revenue, or expense. Account categories include: | | | |
| 1. *Assets—*resources owned or controlled by a company that have future economic benefit. Examples include Cash, Accounts Receivable, Note Receivable, Prepaid Expenses, Prepaid Insurance, Supplies, Store Supplies, Equipment, Buildings, and Land. 2. Accounts Receivable—promises of payment from customers. 3. Prepaid accounts—assets from prepayments of future expenses expected to be incurred in future accounting periods.   2. *Liabilities—*claims by creditors against assets, which means they are obligations to transfer assets or provide products or services to others. Examples include Accounts Payable, Note Payable, Unearned Revenues, and Accrued Liabilities. | | | | | |
| a. Accounts Payable—promises to pay later, usually arising from purchase of inventory or other assets.  b. Notes Payable—written promissory note to pay a future amount.  c. Unearned revenue—revenue collected before it is earned/ before services or goods are provided.  d. Accrued liabilities—amounts owed that are not yet paid. | | | | | |
| 3. *Equity*—an owner’s claim on a company’s assets is called *equity, stockholders’ equity* or *shareholders’ equity*. Examples include Common Stock, Dividends (decreases equity), Revenues from providing goods or services; i.e., Sales, Fees Earned, (increases equity), and Expenses from assets or services used in operation; i.e., Supplies Expense, (decreases equity).  D. Ledger and Chart of Accounts  1. The *ledger* or general *ledger* is a collection of all accounts and their balances.  2. The *chart of accounts* is a list of all accounts in the ledger with their identification numbers. | | |
| **III. Double-Entry Accounting** | | |
| Double-entry accounting demands the accounting equation remain in balance. This means that for each transaction (1) at least two accounts are involved with at least one debit and one credit and (2) total amount debited must equal the total amount credited. | | |
| A. Debits and Credits  1. A *T-account* represents a ledger account and is used to understand the effects of one or more transactions. It is shaped like the letter T with the account title on top. | | |
| 2. The *left* side of an account is called the *debit* side. A debit is an entry on the left side of an account.  3. The *right* side of an account is called the *credit* side. A credit is an entry on the right side of an account. | | |
| 4. Accounts are *assigned balance sides* based on their classification or type.  5. To *increase* an account, an amount is placed on the *balance side,* and to *decrease* an account, the amount is placed on the *side opposite its assigned balance side*. | | |
| 6. The *account balance* is the difference between the total debits and the total credits recorded in that account. When total debits exceed total credits, the account has a *debit balance*. When total credits exceed total debits, the account has a *credit balance*. When total debits equal total credits, the account has a *zero balance*. | | |
| 1. Double-Entry System**—**requires that each transaction affect, and be recorded in, at least two accounts. The total debits must equal the total credits for each transaction. | | |
| 1. The assignment of balance sides (debit or credit) follows the accounting equation. | | |
| 1. *Assets* are on the *left side* of the equation; therefore, the left, or *debit,* side is the normal balance for assets. 2. *Liabilities and equities (Common stock* and *retained earnings)* are on the *right side;* therefore, the right, or *credit*, side is the normal balance for liabilities and equity.   c. *Dividends, revenues, and expenses* really are changes in equity, but it is necessary to set up temporary accounts for each of these items to accumulate data for statements. Dividends and expense accounts really represent decreases in equity; therefore, they are assigned debit balances. *Revenue* accounts really represent increases in equity; therefore, they are assigned credit balances. | | |
| **IV. Analyzing and Processing Transactions**   1. Journalizing and Posting Transactions   Four steps in processing transactions are as follows:  1. Identify transactions and source documents.  2. Analyze transactions using the accounting equation. Apply double-entry accounting to determine account to be debited and credited.  3. Record journal entry—recorded chronologically. A journal gives us a complete record of each transaction in one place.  a. A *General Journal* is the most flexible type of journal because it can be used to record any type of transaction.  b. When a transaction is recorded in the General Journal, it is called a *journal entry*. A journal entry that affects more than two accounts is called a compound journal entry.  c. Each journal entry must contain equal debits and credits.  4. Post entry to ledger—process of transferring entries from the journal to the ledger.  a.Debits are posted as debit, and credits as credits to the accounts identified in the journal entry. | | |
| b. Actual accounting systems use *balance column accounts* rather than T‑accounts in the ledger.  c. A *balance column account* has debit and credit columns for recording entries and a third column for showing the balance of the account after each entry is posted.  Note: Refer to the 16 basic transactions in the textbook for an illustration of analyzing, journalizing, and posting. | |
| **V. Trial Balance** |
| 1. A *trial balance* is a list of all ledger accounts and their balances (either debit or credit) at a point in time. Account balances are reported in their appropriate debit or credit columns of the trial balance. 2. The trial balance tests for the equality of the debit and credit account balances as required by double-entry accounting. 3. Preparing a Trial Balance: three steps to prepare a trial balance are as follows: 4. List each account and its amount (from the ledger) in the trial balance. 5. Compute the total of debit balances and the total of credit balances. 6. Verify (prove) total debit balances equal total credit balances.   D. Searching for Errors: when a trial balance does not balance, an error has occurred and must be corrected. Follow these steps: | |
| 1. Verify that the trial balance columns are correctly added. 2. Verify that account balances are accurately entered from the ledger. 3. See whether a debit (or credit) balance is mistakenly listed in the trial balance 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 the original journal entry has equal debits and credits.   **Note:** **Any errors must be located and corrected before preparing the financial statements. Financial statements prepared from the trial balance are actually *unadjusted* statements. The purpose, content and format for each statement was presented in Chapter 1. The next chapter will address adjustments.** | |
| 1. Presentation Issues 2. Dollar signs are not used in journals and ledgers but do appear in financial statements and other reports such as trial balances. 3. Usual practice on statements is to put dollar signs before only the first and last numbers in each column. | |
| **VI. Decision Analysis**—**Debt Ratio**  A. Companies finance their assets with either liabilities or equity.  B. A company that finances a relatively large portion of its assets with liabilities has a high degree of financial leverage (greater risk).  C. The debt ratio describes the relationship between a company's liabilities and assets. It is calculated as total liabilities divided by total assets.  D. The debt ratio tells us how much (what percentage) of the assets are financed by creditors (nonowners), or liability financing. The higher this ratio, the more risk a company faces, because liabilities must be repaid and often require regular interest payments. | |