



PI ALPHA UNIVERSITY

CHAPTER

2

Analyzing Transactions



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Standard-Setting Environment

- **Generally Accepted Accounting Principles (GAAP)**
 - A set of rules and practices
 - Having substantial authoritative support, and
 - That the accounting profession recognizes as a general guide for financial reporting purposes
 - Determined by standard-setting bodies

Standard-Setting Bodies

United States

- Securities and Exchange Commission (SEC)
- Financial Accounting Standards Board (FASB)
- Public Company Accounting Oversight Board (PCAOB)

International

- International Financial Reporting Standards (IFRS)
 - International Accounting Standards Board (IASB)

Over 115
countries use I
FRS



Standard-Setting Environment

Review Question

Generally accepted accounting principles are:

- a. a set of standards and rules that are recognized as a general guide for financial reporting.
- b. usually established by the Internal Revenue Service.
- c. the guidelines used to resolve ethical dilemmas.
- d. fundamental truths that can be derived from the laws of nature.



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Standard-Setting Environment

Review Question Answer

Generally accepted accounting principles are:

- a. **Answer:** a set of standards and rules that are recognized as a general guide for financial reporting.
- b. usually established by the Internal Revenue Service.
- c. the guidelines used to resolve ethical dilemmas.
- d. fundamental truths that can be derived from the laws of nature.



Qualities of Useful Information

- FASB states
 - Useful information should possess two fundamental qualities
 - **Relevance** and
 - **Faithful representation**
 - **Materiality**
 - A company-specific aspect
 - An item is material when its **size** makes it likely to influence the decision of an investor or creditor.



Relevance and Faithful Representation

Relevance

- Makes a difference in a business decision
- Provides information that has **predictive value**
- Has **confirmatory value**, confirms or corrects prior expectations

Faithful Representation

- Information accurately depicts what really happened
- Information must be
 - **Complete** (nothing important has been omitted)
 - **Neutral** (not biased toward one position or another)
 - **Free from error**



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Enhancing Qualities of Useful Information

Comparability results when different companies use the same accounting principles.

Information is **verifiable** if independent observers, using the same methods, obtain similar results.

Information has the quality of **understandability** if it is presented in a clear and concise fashion.

Consistency means that a company uses the same accounting principles and methods from year to year.

For accounting information to have relevance, it must be **timely**.

Assumptions in Financial Reporting (1 of 2)

Monetary Unit Assumption

Requires that only those things that can be expressed in money are included in the accounting records

Economic Entity Assumption

States that every economic entity can be separately identified and accounted for



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Assumptions in Financial Reporting (2 of 2)

Periodicity Assumption

States that the life of a business can be divided into artificial time periods.

Going Concern Assumption

The business will remain in operation for the foreseeable future.

Measurement Principles

Historical Cost

- Dictates companies record assets at cost
- Also called the cost principle

Fair Value

- Indicates that assets and liabilities should be reported at fair value

Full Disclosure Principle

- Requires disclosure of all circumstances and events that would make a difference to financial statement users

Cost Constraint

Accounting standard-setters weigh

- The cost that companies will incur to provide the information

Against

- The benefit that financial statement users will gain from having the information available.



Do It! 3: Financial Accounting Concepts and Principles (1 of 4)

The following items guide the FASB when it creates accounting standards.

Relevance

Faithful representation

Comparability

Consistency

Monetary unit assumption

Economic entity assumption

Periodicity assumption

Going concern assumption

Historical cost principle

Full disclosure principle

Materiality

Accounting Transactions

Transactions

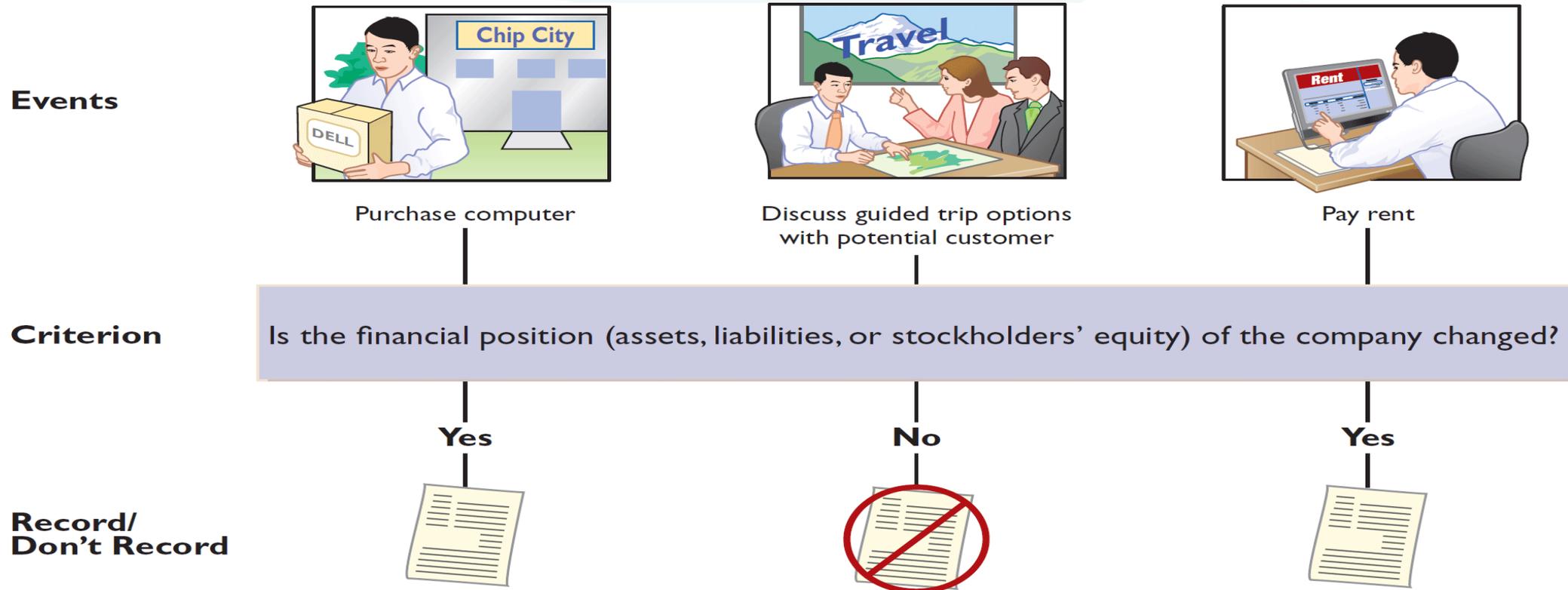
- Are economic events that require recording in the financial statements
- Not all activities require transactions
- Assets, liabilities, or stockholders' equity items change as a result of an economic event
- Have a **dual effect** on the accounting equation



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Transaction Identification Process

Are the following events recorded in the accounting records?





Analyzing Transactions (12)

- The process of identifying the specific effects of economic events on the accounting equation

Basic Accounting Equation

$$\boxed{\text{Assets}} = \boxed{\text{Liabilities}} + \boxed{\text{Stockholders' Equity}}$$



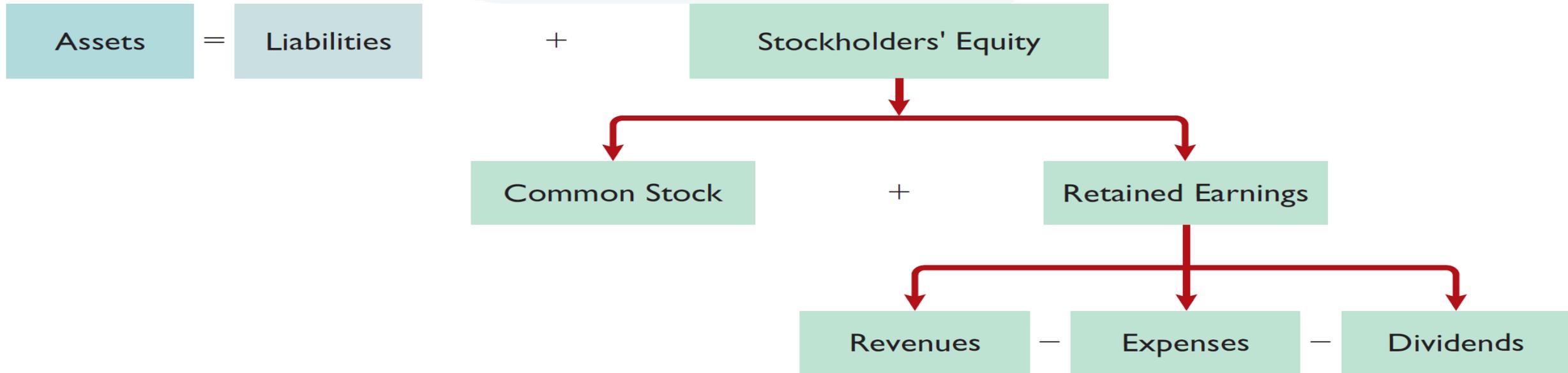
Accounting Equation Effects

- Accounting equation **must always balance**
- Each transaction has a **dual effect** on the equation
- If an asset is increased, there must be a corresponding
 - Decrease in another asset, or
 - Increase in a specific liability, or
 - Increase in stockholders' equity.



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Expanded Accounting Equation





Analyzing Transactions (2 of 12)

Event 1. Investment of Cash by Stockholders. On October 1, cash of \$10,000 is invested in Sierra Corporation by investors in exchange for \$10,000 of common stock.

CASH FLOW	BALANCE SHEET							INCOME STATEMENT				
	Assets	=	Liabilities	+	Stockholders' Equity							
					Retained Earnings							
	Cash	=			Common Stock	+	Rev.	-	Exp.	-	Div.	
↑ \$10,000	(1) +\$10,000	=			+\$10,000							No effect



Analyzing Transactions

Event 2. Note Issued in Exchange for Cash. On October 1, Sierra borrowed \$5,000 from Castle Bank by signing a 3-month, 12%, \$5,000 note payable.

CASH FLOW
↑ \$5,000

BALANCE SHEET	
Assets	Liabilities + Stockholders' Equity
	Retained Earnings
	Rev. - Exp. - Div.
Cash	Notes Payable + Common Stock
\$10,000	\$10,000
(2) +5,000	+ \$5,000
\$15,000	\$5,000 + \$10,000
	\$15,000

INCOME STATEMENT
No effect



Analyzing Transactions

Event 3. Purchase of Equipment for Cash. On October 2, Sierra purchased equipment by paying \$5,000 cash to Superior Equipment Sales Co.

CASH FLOW	BALANCE SHEET										INCOME STATEMENT
	Assets		=	Liabilities	+	Stockholders' Equity					
	Cash	+ Equip-ment	=	Notes Payable	+	Common Stock	Retained Earnings				
			=		+		Rev.	-	Exp.	-	Div.
	\$15,000		=	\$5,000	+	\$10,000					
↓ \$5,000	(3) -5,000	+5,000	=		+						
	\$10,000	+ \$5,000	=	\$5,000	+	\$10,000					
	\$15,000			\$15,000							
											No effect



Analyzing Transactions (5 of 12)

Event 4. Receipt of Cash in Advance from Customer. On October 2, Sierra received a \$1,200 cash in advance from R. Knox, a client.

CASH FLOW		BALANCE SHEET							INCOME STATEMENT									
		Assets		=	Liabilities		+	Stockholders' Equity										
		Cash	Equip-ment	=	Notes Pay.	Unearned Serv. Rev.	+	Common Stock	Retained Earnings									
				=			+		Rev.	-	Exp.	-	Div.					
↑ \$1,200		\$10,000	+	\$5,000	=	\$5,000	+	\$10,000						No effect				
		(4) +1,200																
		\$11,200	+	\$5,000	=	\$5,000	+	\$1,200	+	\$10,000								
		\$16,200			\$16,200													



Analyzing Transactions (6 of 12)

Event 5. Services Performed for Cash. On October 3, Sierra received \$10,000 in cash from Copa Company for guide services performed.

CASH FLOW		BALANCE SHEET								INCOME STATEMENT							
		Assets		=	Liabilities		+	Stockholders' Equity									
		Cash	+	Equip-ment	=	Notes Pay.	+	Unearned Serv. Rev.	+	Common Stock	Retained Earnings						
										Rev.	-	Exp.	-	Div.			
	↑ \$10,000	\$11,200	+	\$5,000	=	\$5,000	+	\$1,200	+	\$10,000							
	(5) +10,000	\$21,200	+	\$5,000	=	\$5,000	+	\$1,200	+	\$10,000	+	\$10,000					
		\$26,200				\$26,200											
																	Service Revenue



Analyzing Transactions

Event 6. Payment of Rent. On October 3, Sierra Corporation paid its office rent for the month of October in cash, \$900.

CASH FLOW		BALANCE SHEET								INCOME STATEMENT	
		Assets		=	Liabilities		+	Stockholders' Equity			
								Retained Earnings			
		Cash	Equip- ment	=	Notes Pay.	Unearned Serv. Rev.	+	Common Stock	Rev.	Exp.	Div.
	↓ \$900	\$21,200	+ \$5,000	=	\$5,000	+ \$1,200	+	\$10,000	\$10,000	—	—
	(6)	−900								−\$900	
		\$20,300	+ \$5,000	=	\$5,000	+ \$1,200	+	\$10,000	\$10,000	—	\$900
		\$25,300						\$25,300			
											Rent Expense



Analyzing Transactions (8 of 12)

Event 7. Purchase of Insurance Policy for Cash. On October 4, Sierra paid \$600 for a one-year insurance policy that will expire next year on September 30.

CASH FLOW		BALANCE SHEET										INCOME STATEMENT						
		Assets			=	Liabilities		+	Stockholders' Equity									
		Cash	Prepaid Insurance	Equip-ment	=	Notes Pay.	Unearned Serv. Rev.	+	Common Stock	Retained Earnings								
					=			+		Rev.	–	Exp.	–	Div.				
	↓ \$600	\$20,300		+ \$5,000	=	\$5,000	+ \$1,200	+	\$10,000	+ \$10,000	–	\$900			No effect			
(7)		–600	+\$600		=													
		\$19,700	+ \$600	+ \$5,000	=	\$5,000	+ \$1,200	+	\$10,000	+ \$10,000	–	\$900						
			\$25,300						\$25,300									



Analyzing Transactions (9 of 12)

Event 8. Purchase of Supplies on Account. On October 5, Sierra purchased an estimated three months of supplies on account from Aero Supply for \$2,500.

CASH FLOW	BALANCE SHEET											INCOME STATEMENT		
	Assets				=	Liabilities			+	Stockholders' Equity				
										Retained Earnings				
	Cash	+ Supplies	+ Prep'd. Insur.	+ Equip-ment	=	Notes Pay.	+ Accounts Payable	+ Unearned Serv. Rev.	+ Common Stock	+ Rev.	- Exp.	- Div.		
No effect	\$19,700		+ \$600	+ \$5,000	=	\$5,000		+ \$1,200	+ \$10,000	+ \$10,000	- \$900		No effect	
		+\$2,500					+\$2,500							
	\$19,700	+ \$2,500	+ \$600	+ \$5,000	=	\$5,000	+ \$2,500	+ \$1,200	+ \$10,000	+ \$10,000	- \$900			
	\$27,800					\$27,800								



Analyzing Transactions

Event 9. Hiring of New Employees. On October 9, Sierra hired four new employees to begin work on October 15.

CASH FLOW		BALANCE SHEET										INCOME STATEMENT				
		Assets				=	Liabilities			+	Stockholders' Equity					
		Cash	Supplies	Prepd. Insur.	Equip-ment	=	Notes Pay.	Accounts Payable	Unearned Serv. Rev.	+	Common Stock	Retained Earnings				
						=				+		Rev.	-	Exp.	-	Div.
		\$19,700		\$600	\$5,000	=	\$5,000		\$1,200	+	\$10,000	\$10,000	-	\$900		
			+\$2,500					+\$2,500								
No effect		\$19,700	\$2,500	\$600	\$5,000	=	\$5,000	\$2,500	\$1,200	+	\$10,000	\$10,000	-	\$900		
		\$27,800					\$27,800									
		(8)														
		No effect														

An accounting transaction has not occurred.



Analyzing Transactions (11 of 12)

Event 10. Payment of Dividend. On October 20, Sierra paid a \$500 dividend.

CASH FLOW		BALANCE SHEET										INCOME STATEMENT					
		Assets				=	Liabilities			+	Stockholders' Equity						
		Cash	Sup- plies	Prepd. Insur.	Equip- ment	=	Notes Pay.	Accts. Pay.	Unearned Serv. Rev.	+	Common Stock	Retained Earnings					
						=				+	Rev.	-	Exp.	-	Div.		
	↓ \$500	\$19,700	\$2,500	\$600	\$5,000	=	\$5,000	\$2,500	\$1,200	+	\$10,000	+	\$10,000	-	\$900	-	
	(10)	-500				=				+							-500
		\$19,200	\$2,500	\$600	\$5,000	=	\$5,000	\$2,500	\$1,200	+	\$10,000	+	\$10,000	-	\$900	-	\$500
		\$27,300									\$27,300						
		No effect															



Do It! 1: Transaction Analysis

A tabular analysis of the transactions for the month of August is shown below. Describe each transaction.

<u>Assets</u>		=	<u>Liabilities</u>	+	<u>Stockholders' Equity</u>		
<u>Cash</u>	+ <u>Equipment</u>	=	<u>Accounts Payable</u>	+	<u>Common Stock</u>	+ <u>Retained Earnings</u>	
						<u>Revenue</u>	- <u>Expenses</u>
1. +\$25,000		=			+\$25,000		
2.	+\$7,000	=	+\$7,000				
3. +8,000		=				+\$8,000	
4. -850		=					-\$850
<u>\$32,150</u>	+ <u>\$7,000</u>	=	<u>\$7,000</u>	+	<u>\$25,000</u>	+ <u>\$8,000</u>	- <u>\$850</u>
\$39,150						\$39,150	

Service Revenue
Rent Expense

1. Company issued shares of stock for \$25,000 cash.
2. Company purchased \$7,000 of equipment on account.
3. Company received \$8,000 cash in exchange for services performed.
4. Company paid \$850 for this month's rent.



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Accounts, Debits, and Credits

- **An account** is an individual accounting record of increases and decreases in a specific asset, liability, stockholder's equity, revenue, or expense item
- A T-Account consists of
 - 1) the title of the account,
 - 2) a left or debit side, and
 - 3) a right or credit side

Debits and Credits (1 of 2)

If **Debits** are **greater than Credits**, the account will have a **debit balance**.

Account Name		
	Debit / Dr.	Credit / Cr.
Transaction #1	10,000	3,000
Transaction #3	8,000	
Balance	15,000	

Transaction #2

Debits and Credits (2 of 2)

If **Credits** are **greater than Debits**, the account will have a **credit balance**.

Account Name		
	Debit / Dr.	Credit / Cr.
Transaction #1	10,000	3,000
		8,000
Balance		1,000

Transaction #2
Transaction #3

Debit and Credit Procedures

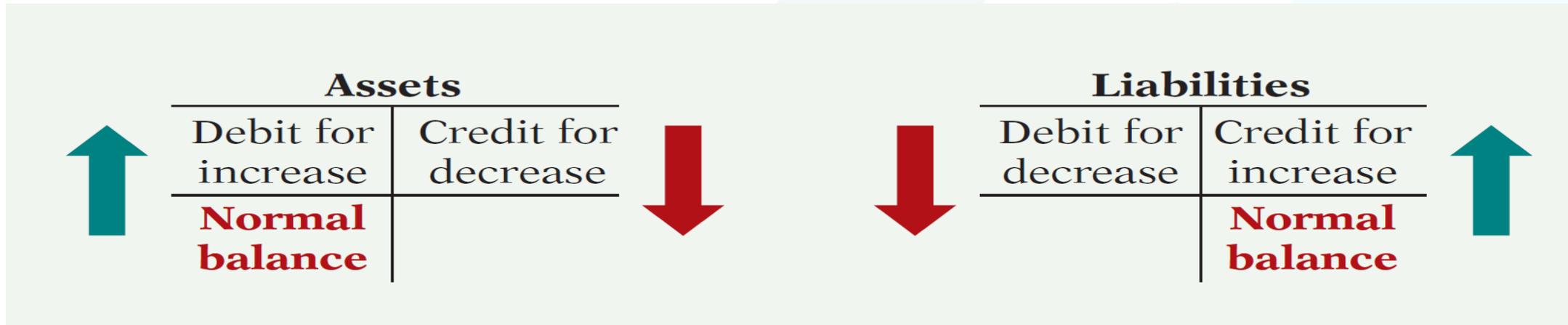
- Each transaction must affect two or more accounts, at least one debit and one credit
- Equality of debits and credits is the basis for **double-entry system**
- Debits **must** equal credits



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Procedures for Assets and Liabilities

- **Asset accounts** → Debits should exceed credits
- **Liability accounts** → Credits should exceed debits



HELPFUL HINT

The normal balance is the side where increases in the account are recorded.

Procedures for Stockholders' Equity (1 of 2)

- **Investments by stockholders and revenues earned** increase stockholders' equity accounts as credits
- **Dividends and expenses incurred** decrease stockholder's equity with debits

Common Stock	
Debit for decrease	Credit for increase
	Normal balance

Retained Earnings	
Debit for decrease	Credit for increase
	Normal balance

Dividends	
Debit for increase	Credit for decrease
Normal balance	



Investor Insight Chicago Cubs

Keeping Score

The **Chicago Cubs** baseball team has these major revenue and expense accounts:

Revenues	Expenses
Admissions (ticket sales)	Players' salaries
Concessions	Administrative salaries
Television and radio	Travel
Advertising	Ballpark maintenance

Do you think that the **Chicago Bears** football team would be likely to have the same major revenue and expense accounts as the Cubs?



Using Accounts to Record Transactions

- Accounting systems are designed to show the increases and decreases in each accounting equation element as a separate record. This record is called an **account**.

Assets and Liabilities

- **Assets** are resources owned by the business entity.

- Some examples of assets are:

- Cash
- Supplies
- Accounts receivable
- Buildings

- **Liabilities** are debts owed to outsiders (creditors).

- Some examples of liabilities are:

- Accounts payable
- Notes payable
- Wages payable

Owner's Equity

- **Owner's equity** is the owner's right to the assets of the business after all liabilities have been paid. For a proprietorship, the owner's equity is represented by the balance of the owner's **capital account**.
- A **drawing** account represents the amount of withdrawals made by the owner.



Revenues and Expenses

- **Revenues** are increases in assets and owner's equity as a result of selling services or products to customers.
 - Some examples of revenues are:
 - Fees earned
 - Commissions revenue
 - Rent revenue
- The using up of assets or consuming services in the process of generating revenues results in **expenses**.
 - Some examples of expenses are:
 - Wages expense
 - Rent expense
 - Miscellaneous expense



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Double-Entry Accounting System

- All businesses use what is called the **double-entry accounting system**. This system is based on the accounting equation and requires:
 - Every business transaction to be recorded in at least two accounts.
 - The total debits recorded for each transaction to be equal to the total credits recorded.
- The double-entry accounting system has specific **rules of debit and credit** for recording transactions in the accounts.



Balance Sheet Accounts

- The debit and credit rules for balance sheet accounts are as follows:

Balance Sheet Accounts							
ASSETS Asset Accounts		=	LIABILITIES Liability Accounts		+	OWNER'S EQUITY Owner's Equity Accounts	
Debit for increases (+)	Credit for decreases (-)		Debit for decreases (-)	Credit for increases (+)		Debit for decreases (-)	Credit for increases (+)



Income Statement Accounts

- The debit and credit rules for income statement accounts are based on their relationship with owner's equity.

Income Statement Accounts			
Revenue Accounts		Expense Accounts	
Debit for decreases (-)	Credit for increases (+)	Debit for increases (+)	Credit for decreases (-)

Owner Withdrawals

- The debit and credit rules for recording owner withdrawals are based on the effect of owner withdrawals on owner's equity.

Drawing Account	
Debit for increases (+)	Credit for decreases (-)

Normal Balances

- The sum of the increases in an account is usually equal to or greater than the sum of the decreases in the account. Thus, the **normal balance of an account** is either a debit or a credit depending on whether increases in the account are recorded as debits or credits.

Journalizing

(slide 1 of 2)

- A transaction is initially entered in a record called a **journal**.
- Transactions are recorded in the journal using the following steps:
 - Step 1. The date of the transaction is entered in the Date column.
 - Step 2. The title of the account to be debited is recorded in the left-hand margin under the Description column, and the amount to be debited is entered in the Debit column.
 - Step 3. The title of the account to be credited is listed below and to the right of the debited account title, and the amount to be credited is entered in the Credit column.
 - Step 4. A brief description may be entered below the credited account.
 - Step 5. The Post. Ref. (Posting Reference) column is left blank when the journal entry is initially recorded. This column is used later when the journal entry amounts are transferred to the accounts in the ledger.

Journalizing

(slide 2 of 2)

- The process of recording a transaction in the journal is called **journalizing**.
- The entry in the journal is called a **journal entry**.

The General Journal

- Transactions are recorded in chronological order in a **journal** before they are transferred to the accounts.
- The journal contributes to the recording process because it:
 1. Discloses the **complete effect of a transaction**
 2. Provides a **chronological record** of transactions
 3. Helps to **prevent or locate errors** because the debit and credit amounts can be readily compared

Journalizing

- The process of entering transaction data in the journal

Illustration: Presented below is information related to Sierra Corporation.

October 1, Sierra issued common stock in exchange for \$10,000 cash.

October 1, Sierra borrowed \$5,000 by signing a note.

October 2, Sierra purchased equipment for \$5,000.

Journalize these transactions.



Journalize Stock Issued for Cash

October 1, Sierra issued common stock in exchange for \$10,000 cash.

<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Stockholders' Equity</u>
<u>Cash</u>	=			<u>Common Stock</u>
+\$10,000	=			+\$10,000
				Issued stock

GENERAL JOURNAL

Date	Account Titles and Explanations	Debit	Credit
2022			
Oct. 1	Cash	10,000	
	Common Stock		10,000



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Journalize Purchase of Equipment

October 2, Sierra purchased equipment for \$5,000.

<u>Assets</u>		=	<u>Liabilities</u>	+	<u>Stockholders' Equity</u>
Cash	+	Equipment	=		
-\$5,000		+\$5,000	=		

GENERAL JOURNAL

Date	Account Titles and Explanations	Debit	Credit
2022			
Oct. 2	Equipment	5,000	
	Cash		5,000



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Summary of Journal Entries

GENERAL JOURNAL

Date	Account Titles and Explanations	Debit	Credit
2022			
Oct. 1	Cash	10,000	
	Common Stock		10,000
	(Issued stock for cash)		
1	Cash	5,000	
	Notes Payable		5,000
	(Issued 3-month, 12% note payable for cash)		
2	Equipment	5,000	
	Cash		5,000
	(Purchased equipment for cash)		



Do It! 3: Journal Entries (1 of 2)

The following events occurred during the first month of business of Hair It Is Inc., Kate Browne's beauty salon:

1. Issued common stock to shareholders in exchange for \$20,000 cash.
2. Purchased \$4,800 of equipment on account (to be paid in 30 days).
3. Interviewed three people for the position of stylist.

The three activities are recorded as presented on the next slide.

The Ledger

The **ledger** is comprised of the entire group of accounts maintained by a company.

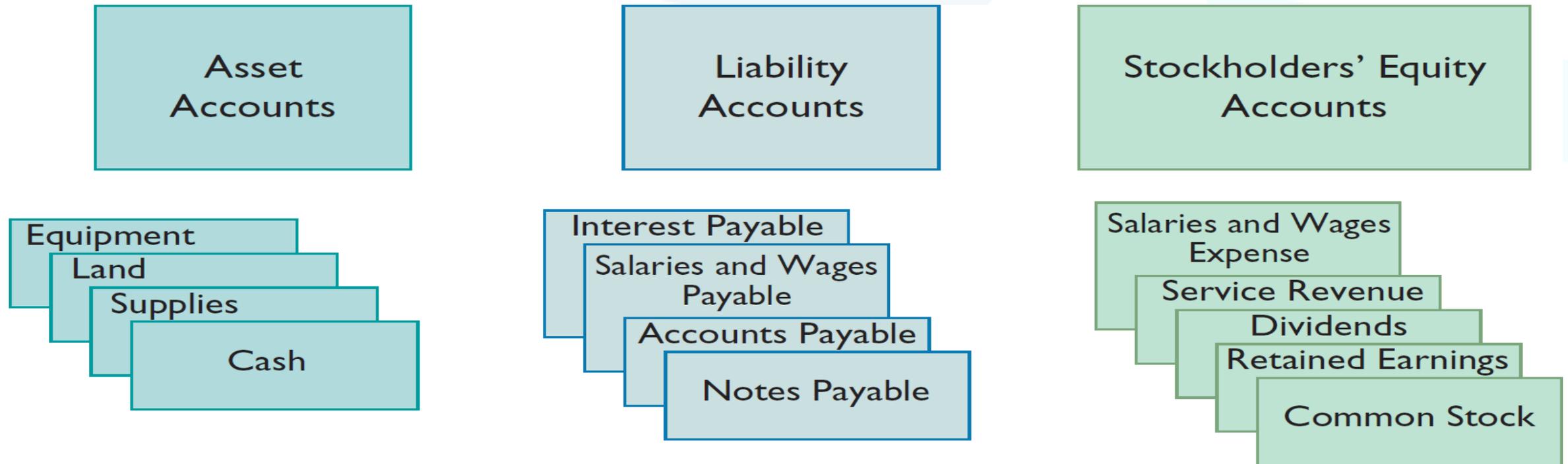


Chart of Accounts

Accounts in **Red** are used in this chapter.

Assets

Cash
Accounts Receivable
Supplies
Prepaid Insurance
Equipment
 Accumulated Depreciation—Equipment

Liabilities

Notes Payable
Accounts Payable
 Interest Payable
Unearned Service Revenue
 Salaries and Wages Payable

Stockholders' Equity

Common Stock
Retained Earnings
Dividends
 Income Summary

Revenues

Service Revenue

Expenses

Salaries and Wages Expense
 Supplies Expense
Rent Expense
 Insurance Expense
 Interest Expense
 Depreciation Expense

Posting

Posting involves these steps:

1. In the ledger, enter in the appropriate columns of the debited account(s) the date and debit amount shown in the journal.
2. In the ledger, enter in the appropriate columns of the credited account(s) the date and credit amount shown in the journal.

Posting

Review Question

Posting:

- a. normally occurs before journalizing.
- b. transfers ledger transaction data to the journal.
- c. is an optional step in the recording process.
- d. transfers journal entries to ledger accounts.

Posting

Review Question Answer

Posting:

- a. normally occurs before journalizing.
- b. transfers ledger transaction data to the journal.
- c. is an optional step in the recording process.
- d. **Answer:** transfers journal entries to ledger accounts.



Recording Process Illustrated (1 of 12)

Steps in the Recording Process

1. Determine what type of account is involved.
2. Determine what items increased or decreased and by how much.
3. Translate the increases and decreases into debits and credits.



Recording Process Illustrated (3 of 12)

Event 2

On October 1, Sierra borrows cash of \$5,000 by signing a 3-month, 12%, \$5,000 note payable.

Basic Analysis

The asset Cash is increased \$5,000; the liability Notes Payable is increased \$5,000.

Equation Analysis

$$\begin{array}{r}
 \text{Assets} \\
 \hline
 \text{Cash} \\
 \hline
 +\$5,000 \\
 (2)
 \end{array}
 =
 \begin{array}{r}
 \text{Liabilities} \\
 \hline
 \text{Notes Payable} \\
 \hline
 +\$5,000
 \end{array}
 +
 \begin{array}{r}
 \text{Stockholders' Equity}
 \end{array}$$

Debit–Credit Analysis

Debits increase assets: debit Cash \$5,000.
Credits increase liabilities: credit Notes Payable \$5,000.

Journal Entry

Oct. 1	Cash	5,000	
	Notes Payable (Issued 3-month, 12% note payable for cash)		5,000

Posting to Ledger

Cash	
Oct. 1	10,000
1	5,000

Notes Payable	
Oct. 1	5,000



Recording Process Illustrated (4 of 12)

Event 3

On October 2, Sierra used \$5,000 cash to purchase equipment.

Basic Analysis

The asset Equipment is increased \$5,000; the asset Cash is decreased \$5,000.

Equation Analysis

$$\begin{array}{r}
 \text{Assets} \\
 \hline
 \text{Cash} \quad + \quad \text{Equipment} \\
 \hline
 (3) \quad -\$5,000 \quad +\$5,000
 \end{array}
 =
 \begin{array}{r}
 \text{Liabilities} \\
 \hline
 \end{array}
 +
 \begin{array}{r}
 \text{Stockholders' Equity} \\
 \hline
 \end{array}$$

Debit–Credit Analysis

Debits increase assets: debit Equipment \$5,000.
Credits decrease assets: credit Cash \$5,000.

Journal Entry

Oct. 2	Equipment			5,000					
	Cash						5,000		
	(Purchased equipment for cash)								

Posting to Ledger

Cash				Equipment			
Oct. 1	10,000	Oct. 2	5,000	Oct. 2	5,000		
1	5,000						



Recording Process Illustrated (5 of 12)

Event 4 On October 2, Sierra received a \$1,200 cash advance from R. Knox, a client, for guide services for multi-day trips that are expected to be completed in the future.

Basic Analysis The asset Cash is increased \$1,200; the liability Unearned Service Revenue is increased \$1,200 because the service has not been performed yet. That is, when an advance payment is received, unearned revenue (a liability) should be recorded in order to recognize the obligation that exists (see **Helpful Hint**).

Equation Analysis

	<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Stockholders' Equity</u>
	Cash	=	Unearned Serv. Rev.		
(4)	+\$1,200		+\$1,200		

Debit–Credit Analysis

Debits increase assets: debit Cash \$1,200.
Credits increase liabilities: credit Unearned Service Revenue \$1,200.

Journal Entry

	Oct. 2	Cash			
		Unearned Service Revenue (Received advance from R. Knox for future services)	1,200	1,200	

Posting to Ledger

Cash				Unearned Service Revenue			
Oct. 1	10,000	Oct. 2	5,000			Oct. 2	1,200
1	5,000						
2	1,200						



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Recording Process Illustrated (6 of 12)

Event 5

On October 3, Sierra received \$10,000 in cash from Copa Company for guide services performed in October.

Basic Analysis

The asset Cash is increased \$10,000; the revenue Service Revenue is increased \$10,000.

Equation Analysis

	<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Stockholders' Equity</u>
	Cash	=			Revenues
(5)	+\$10,000				+\$10,000 Service Revenue

Debit-Credit Analysis

Debits increase assets: debit Cash \$10,000.
Credits increase revenues: credit Service Revenue \$10,000.

Journal Entry

	Oct. 3	
	Cash	10,000
	Service Revenue (Received cash for services performed)	10,000

Posting to Ledger

Cash				Service Revenue	
Oct. 1	10,000	Oct. 2	5,000		
1	5,000				
2	1,200				
3	10,000			Oct. 3	10,000



Recording Process Illustrated (8 of 12)

Event 7 On October 4, Sierra paid \$600 for a 1-year insurance policy that will expire next year on September 30.

Basic Analysis The asset Cash is decreased \$600. Payments of expenses that will benefit more than one accounting period are identified as prepaid expenses or prepayments. When a payment is made, an asset account is debited in order to show the service or benefit that will be received in the future. Therefore, the asset Prepaid Insurance is increased \$600.

Equation Analysis

	<u>Assets</u>		=	<u>Liabilities</u>	+	<u>Stockholders' Equity</u>
	Cash	+ Prepaid Insurance				
(7)	-\$600	+\$600				

Debit-Credit Analysis Debits increase assets: debit Prepaid Insurance \$600.
Credits decrease assets: credit Cash \$600.

Journal Entry

Oct. 4	Prepaid Insurance	600	
	Cash		600
	(Paid 1-year policy; effective date October 1)		

Posting to Ledger

Cash				Prepaid Insurance	
Oct. 1	10,000	Oct. 2	5,000	Oct. 4	600
1	5,000	3	900		
2	1,200	4	600		
3	10,000				



Recording Process Illustrated (9 of 12)

Event 8 On October 5, Sierra purchased an estimated 3 months of supplies on account from Aero Supply for \$2,500.

Basic Analysis The asset Supplies is increased \$2,500; the liability Accounts Payable is increased \$2,500.

Equation Analysis

<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Stockholders' Equity</u>
Supplies	=	Accounts Payable		
+\$2,500		+\$2,500		

(8)

Debit-Credit Analysis

Debits increase assets: debit Supplies \$2,500.
Credits increase liabilities: credit Accounts Payable \$2,500.

Journal Entry

Oct. 5	Supplies	2,500	
	Accounts Payable		2,500
	(Purchased supplies on account from Aero Supply)		

Posting to Ledger

Supplies			Accounts Payable		
Oct. 5	2,500			Oct. 5	2,500



Recording Process Illustrated (10 of 12)

Event 9

On October 9, Sierra hired four employees to begin work on October 15. Each employee will receive a weekly salary of \$500 for a 5-day work week, payable every 2 weeks—first payment made on October 26.

Basic Analysis

An accounting transaction has not occurred. There is only an agreement that the employees will begin work on October 15. Thus, a debit–credit analysis is not needed because there is no accounting entry. (See transaction of October 26 (Event II) for first payment.)



Recording Process Illustrated (11 of 12)

Event 10

On October 20, Sierra paid a \$500 cash dividend to stockholders.

Basic Analysis

The Dividends account is increased \$500; the asset Cash is decreased \$500.

Equation Analysis

$$\begin{array}{r}
 \text{Assets} \\
 \hline
 \text{Cash} \\
 -\$500 \\
 \hline
 \text{(10)}
 \end{array}
 =
 \begin{array}{r}
 \text{Liabilities} \\
 \hline
 \text{---} \\
 \hline
 \text{---}
 \end{array}
 +
 \begin{array}{r}
 \text{Stockholders' Equity} \\
 \hline
 \text{Dividends} \\
 -\$500 \\
 \hline
 \text{---}
 \end{array}$$

Debit-Credit Analysis

Debits increase dividends: debit Dividends \$500.
Credits decrease assets: credit Cash \$500.

Journal Entry

Oct. 20	Dividends			500			
	Cash					500	
	(Declared and paid a cash dividend)						

Posting to Ledger

Cash				Dividends	
Oct. 1	10,000	Oct. 2	5,000	Oct. 20	500
1	5,000	3	900		
2	1,200	4	600		
3	10,000	20	500		

Journalizing Summary

GENERAL JOURNAL

Date	Account Titles and Explanations	Debit	Credit
2022			
Oct. 1	Cash	10,000	
	Common Stock		10,000
	(Issued stock for cash)		
1	Cash	5,000	
	Notes Payable		5,000
	(Issued 3-month, 12% note payable for cash)		
2	Equipment	5,000	
	Cash		5,000
	(Purchased equipment for cash)		



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المنصورة
(2014)

Journalizing Summary

GENERAL JOURNAL

Date	Account Titles and Explanations	Debit	Credit
2022			
Oct. 2	Cash	1,200	
	Unearned Service Revenue		1,200
	(Received advance from R. Knox for future services)		
3	Cash	10,000	
	Service Revenue		10,000
	(Received cash for services performed)		
3	Rent Expense	900	
	Cash		900
	(Paid cash for October office rent)		



جامعة
منصورة
(3 of 4)

Journalizing Summary

GENERAL JOURNAL

Date	Account Titles and Explanations	Debit	Credit
2022			
Oct. 4	Prepaid Insurance	600	
	Cash		600
	(Paid 1-year policy; effective date October 1)		
5	Supplies	2,500	
	Accounts Payable		2,500
	(Purchased supplies on account from Aero Supply)		
20	Dividends	500	
	Cash		500
	(Declared and paid a cash dividend)		



جامعة
المنصورة
(4 of 4)

Journalizing Summary

GENERAL JOURNAL

Date	Account Titles and Explanations	Debit	Credit
2022			
Oct. 26	Salaries and Wages Expense	4,000	
	Cash		4,000
	(Paid salaries to date)		

Posting Summary



General Ledger

Cash				Unearned Service Revenue			
Oct. 1	10,000	Oct. 2	5,000		Oct. 2	1,200	
1	5,000	3	900		Bal.	1,200	
2	1,200	4	600				
3	10,000	20	500				
		26	4,000				
Bal.	15,200						
Supplies				Common Stock			
Oct. 5	2,500				Oct. 1	10,000	
Bal.	2,500				Bal.	10,000	
Prepaid Insurance				Dividends			
Oct. 4	600			Oct. 20	500		
Bal.	600			Bal.	500		
Equipment				Service Revenue			
Oct. 2	5,000				Oct. 3	10,000	
Bal.	5,000				Bal.	10,000	
Notes Payable				Salaries and Wages Expense			
		Oct. 1	5,000	Oct. 26	4,000		
		Bal.	5,000	Bal.	4,000		
Accounts Payable				Rent Expense			
		Oct. 5	2,500	Oct. 3	900		
		Bal.	2,500	Bal.	900		

Do It! 4: Posting (1 of 2)



Selected transactions from the journal of Faital Inc. during its first month of operations are presented below. Post these transactions to T-accounts.

GENERAL JOURNAL

Date	Account Titles	Debit	Credit
July 1	Cash	30,000	
	Common Stock		30,000
9	Accounts Receivable	6,000	
	Service Revenue		6,000
24	Cash	4,000	
	Accounts Receivable		4,000

Do It! 4: Posting (2 of 2)



GENERAL JOURNAL

Date	Account Titles	Debit	Credit
July 1	Cash	30,000	
	Common Stock		30,000
9	Accounts Receivable	6,000	
	Service Revenue		6,000
24	Cash	4,000	
	Accounts Receivable		4,000

Cash

July 1	30,000	
24	4,000	

Accounts Receivable

July 9	6,000	July 24	4,000
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Common Stock

	July 1	30,000
--	--------	--------

Service Revenue

	July 9	6,000
--	--------	-------

Unearned Revenue

- The liability created by receiving the cash in advance of providing the service is called **unearned revenue**.

Accounts Receivable

- When a business agrees that a customer may pay for services provided at a later date, an **account receivable** is created.
- An account receivable is a claim against the customer.
- An account receivable is an asset, and the revenue is earned even though no cash has been received.

Nature of a Trial Balance

- A list of accounts and their balances at a given time
- Accounts are listed in the order in which they appear in the ledger
 - Assets, liabilities, stockholders' equity, revenues, and expenses
- Purpose is to prove that debits equal credits
- May uncover errors in journalizing and posting
- Useful in the preparation of financial statements

Trial Balance

- (Slide 1 of 2) The equality of debits and credits in the ledger should be proven at the end of each accounting period by preparing a **trial balance**.
- The steps in preparing a trial balance are as follows:
 - Step 1. List the name of the company, the title of the trial balance, and the date the trial balance is prepared.
 - Step 2. List the accounts from the ledger, and enter their debit or credit balance in the Debit or Credit column of the trial balance.
 - Step 3. Total the Debit and Credit columns of the trial balance.
 - Step 4. Verify that the total of the Debit column equals the total of the Credit column.

Trial Balance



Sierra Corporation
Trial Balance
October 31, 2022

	<u>Debit</u>	<u>Credit</u>
Cash	\$15,200	
Supplies	2,500	
Prepaid Insurance	600	
Equipment	5,000	
Notes Payable		\$ 5,000
Accounts Payable		2,500
Unearned Service Revenue		1,200
Common Stock		10,000
Dividends	500	
Service Revenue		10,000
Salaries and Wages Expense	4,000	
Rent Expense	<u>900</u>	
	<u>\$28,700</u>	<u>\$28,700</u>



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منصورة

Limitations of a Trial Balance

The trial balance may balance even when

- a transaction is not journalized
- a correct journal entry is not posted
- a journal entry is posted twice
- incorrect accounts are used in journalizing or posting, or
- offsetting errors are made in recording the amount of a transaction.

Do It! 5: Trial Balance



The following accounts come from the ledger of SnowGo Corporation at December 31, 2022.

Equipment	\$88,000	Common Stock	\$20,000
Dividends	8,000	Salaries and Wages Payable	2,000
Accounts Payable	22,000	Notes Payable (due in 3 months)	19,000
Salaries and Wages Expense	42,000	Utilities Expense	3,000
Accounts Receivable	4,000	Prepaid Insurance	6,000
Service Revenue	95,000	Cash	7,000

Prepare a trial balance in good form.

Do It! 5: Trial Balance



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SnowGo Corporation

Trial Balance

December 31, 2022

	Debit	Credit
Cash	\$ 7,000	
Accounts Receivable	4,000	
Prepaid Insurance	6,000	
Equipment	88,000	
Notes Payable		\$ 19,000
Accounts Payable		22,000
Salaries and Wages Payable		2,000
Common Stock		20,000
Dividends	8,000	
Service Revenue		95,000
Utilities Expense	3,000	
Salaries and Wages Expense	42,000	
	<u>\$158,000</u>	<u>\$158,000</u>



Errors Affecting the Trial Balance

- A **transposition** occurs when the order of the digits is copied incorrectly, such as writing \$542 as \$452 or \$524.
- In a **slide**, the entire number is copied incorrectly one or more spaces to the right or the left, such as writing \$542.00 as \$54.20 or \$97.50 as \$975.00.



Errors Not Affecting the Trial Balance

- Errors that do not cause the trial balance totals to be unequal may be discovered when preparing the trial balance or may be indicated by an unusual account balance. For example, since a business cannot have “negative” supplies, a credit balance in the supplies account indicates an error has occurred.
- If an error has already been journalized and posted to the ledger, a **correcting journal entry** is normally prepared.