

## CHAPTER 2

### ACCOUNTING FOR BUSINESS TRANSACTIONS

| <b><u>Related Assignment Materials</u></b>   |                                |                       |   |  |   |
|--|--------------------------------|-----------------------|---|--|---|
| <i>Student Learning Objectives</i>   | <i>Questions</i>               | <i>Quick Studies*</i> | <i>Exercises*</i>                       | <i>Problems*</i>   | <i>AA and BTN</i>   |
| <b>Conceptual objectives:</b>  |                                |                       |   |  |   |
| C1. Explain the steps in processing transactions and the role of source documents. | 3, 6, 9                        | 2-1                   | 2-1                                     | 2-6  | BTN 2-1, BTN 2-2, BTN 2-4, BTN 2-7                          |
| C2. Describe an account and its use in recording transactions.                     | 1, 2, 14                       | 2-2                   | 2-2                                     | 2-5  | BTN 2-2, BTN 2-4  |
| C3. Describe a ledger and a chart of accounts.                                     |                                | 2-3                   | 2-3, 2-16                               | 2-1, 2-2, 2-3, 2-4, 2-6, GL: 2-4, 2-5, 2-6, 2-7                    |   |
| C4. Define <i>debits</i> and <i>credits</i> and explain double-entry accounting.   | 7                              | 2-4, 2-5, 2-10        | 2-4                                     | 2-1, 2-2, 2-3, GL: 2-4, 2-5, 2-6                                   | BTN 2-4   |
| <b>Analytical objectives:</b>  |                                |                       |   |  |   |
| A1. Analyze the impact of transactions on accounts and financial statements.       |                                | 2-7                   | 2-5, 2-6, 2-9, 2-13, 2-15, 2-20         | 2-1, 2-2, 2-3, 2-4, 2-5, 2-6, SP, GL: 2-2, 2-4, 2-5, 2-6, 2-7, 2-8 | AA 2-1, AA 2-2, BTN 2-2, BTN 2-3, BTN 2-4, BTN 2-5, BTN 2-6 |
| A2. Compute the debt ratio and describe its use in analyzing financial condition.  |                                | 2-15                  | 2-22                                    | 2-5  | AA 2-1, AA 2-2, AA 2-3, BTN: 2-5, BTN 2-6                   |
| <b>Procedural objectives:</b>  |                                |                       |   |  |   |
| P1. Record transactions in a journal and post entries to a ledger.                 | 4, 5                           | 2-6, 2-11             | 2-7, 2-11, 2-12, 2-14, 2-19, 2-21, 2-23 | 2-1, 2-2, 2-3, 2-4, SP, GL: 2-1, 2-3, 2-4, 2-5, 2-6, 2-7, 2-8      |   |
| P2. Prepare and explain the use of a trial balance.                                | 8                              | 2-8                   | 2-8, 2-10, 2-20, 2-21                   | 2-1, 2-2, 2-3, 2-4, 2-6, SP, GL: 2-4, 2-5, 2-6, 2-7, 2-8           |   |
| P3. Prepare financial statements from business transactions.                       | 10, 11, 12, 13, 15, 16, 17, 18 | 2-9, 2-12, 2-13, 2-14 | 2-16, 2-17, 2-18, 2-19                  | 2-7, ES-1, ES-2  | BTN 2-2, BTN 2-5, BTM 2-6                                   |

*\*See additional information on next page that pertains to these quick studies, exercises, and problems.*

*SP refers to the Serial Problem*

*AA refers to Accounting Analysis*

*BTN refers to Beyond the Numbers*

*GL refers to General Ledger Problems*

*Questions with Guided Example videos*

## **Additional Information on Related Assignment Material**

*See Chapter 1 of the Instructor's Resource Manual for more information on materials for this text available in Connect.*

### **Connect**

Available on the instructor's course-specific website, Connect:

- All numerical Quick Studies, all Exercises and Problems Set A.
  - Connect also provides algorithmic versions for Quick Study, Exercises, and Problems.
- General Ledger Problems
- Excel Simulations
- LearnSmart/SmartBook

### **Hints/Guided Examples**

Please note that the Guided Examples are labeled as "Hints" in Connect assignments. The animated PowerPoints without the video and audio functions for the Guided Examples are also available in the Connect Instructor Library and Exercise Presentations. **These are indicated in the Related Assignment Materials grid on page 1 in blue bold font.**

### **Need-to-Know Videos**

| LO         | Need-to-Know | Title                   | Time |
|------------|--------------|-------------------------|------|
| C1, C2, C3 | 2-1          | Classifying Accounts    | 1:34 |
| C4         | 2-2          | Normal Account Balance  | 2:54 |
| P1, A1     | 2-3          | Recording Transactions  | 1:54 |
| P2         | 2-4          | Preparing Trial Balance | 2:01 |

### **Concept Overview Videos**

Each video is paired with a Knowledge Check question.

| LO | Title  | Time |
|----|--|------|
| C1 | Explain the steps in processing transactions and the role of source documents. |      |
|    | Source Documents   | 0:58 |
| C2 | Describe an account and its use in recording transactions.                     |      |
|    | Types of Accounts  | 0:52 |
|    | Asset Accounts   | 3:48 |
|    | Liability Accounts   | 2:35 |
|    | Equity Accounts  | 1:29 |
|    | Decision Insights  | 0:14 |
| C3 | Describe a ledger and a chart of accounts.                                     |      |
|    | Chart of Accounts  | 1:45 |
|    | Ledger   | 0:25 |
| C4 | Define <i>debits</i> and <i>credits</i> and explain double-entry accounting.   |      |
|    | T-accounts   | 0:54 |

|    |   |      |
|----|---|------|
|    | Double-Entry Accounting   | 0:47 |
|    | Normal Balance Rules  | 1:33 |
|    | Normal Balance - Equity   | 0:43 |
| A1 | Analyze the impact of transactions on accounts and financial statements.      |      |
|    | Receive Investment by Owner   | 1:00 |
|    | Purchase Equipment for Cash   | 0:46 |
|    | Purchase Supplies for Cash  | 0:32 |
|    | Providing Services for Cash   | 0:32 |
|    | Payment of Expense on Credit  | 0:34 |
|    | Payment of Accounts Payable   | 0:43 |
| A2 | Compute the debt ratio and describe its use in analyzing financial condition. |      |
|    | Financial Statement Data  | 1:25 |
|    | Debt Ratio  | 1:13 |
| P1 | Record transactions in a journal and post entries to a ledger.                |      |
|    | Accounting Process  | 0:20 |
|    | Journalizing Transactions   | 1:30 |
|    | Posting Journal Entries to Ledger Accounts: General Procedures                | 1:37 |
|    | Post Entries to Ledger Accounts: Four step Process                            | 0:48 |
| P2 | Prepare and explain the use of a trial balance.                               |      |
|    | Trial Balance   | 1:33 |
|    | Trial Balance – Searching for Errors  | 1:04 |
| P3 | Prepare financial statements from business transactions.                      |      |
|    | Preparing Financial Statements  | 2:01 |
|    | How Financial Statements Link   | 1:10 |

## **Synopsis of Chapter Revisions**

NEW opener—Fitbit and entrepreneurial assignment.

New visual for process to get from transactions to financial statements.

New layout on four types of accounts that determine equity.

Improved presentation of “Double-Entry System” section.

Updated Apple data for NTK 2-4.

Updated debt ratio analysis using Costco and Walmart.

New Cheat Sheet reinforces chapter content.

Added four new Quick Studies.

Added three new Exercises.

Added new analysis assignments: Company Analysis, Comparative Analysis, and Global Analysis.

## **Chapter Outline**

**I. Basis of Financial Statements**—process to go from transactions and events to financial statements includes the following:

1. Identify each transaction and event from source documents, which identify and describe transactions and events entering the accounting process.
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.

A. Source Documents—identify and describe transactions and events entering the accounting system.

## **II. The “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.
  - a. Accounts Receivable—promises of payment from customers.
  - b. 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* or *owner’s 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).

## **III. Ledger and Chart of Accounts**

1. The *general ledger* or *ledger* (referred to as the *books*) is a collection of all accounts and their balances for an accounting system.
2. The *chart of accounts* is a list of all accounts in the ledger with their identification numbers.

## **IV. 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 Credit

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*.
- B. 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.
    - a. *Assets* are on the *left side* of the equation; therefore, the left, or *debit*, side is the normal balance for assets.
    - b. *Liabilities and equities* 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. Withdrawals 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.

## **V. Analyzing and Processing Transactions**

### **A. 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.

## VI. Trial Balance

- A. 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.
- B. The trial balance tests for the equality of the debit and credit account balances as required by double-entry accounting.
- C. Preparing a Trial Balance: three steps to prepare a trial balance are as follows:
  - 1. List each account and its amount (from the ledger).
  - 2. Compute the total of debit balances and the total of credit balances.
  - 3. 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.**

- D. Presentation Issues
  - 1. Dollar signs are not used in journals and ledgers, but do appear in financial statements and other reports such as trial balances.
  - 2. Usual practice on statements is to put dollar signs before only the first and last numbers in each column.
  - 3. Commas are optional except for financial reports, where they are always used.
  - 4. Companies commonly round amounts in reports to the nearest dollar, or even to a higher level.
  - 5. Double rule the final total(s) on the financial statements.

## 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.

## Chapter 2 Alternate Demonstration Problem

Record the following transactions of Speedy Computer Service, owned by Bill Smith, for the month of March 2019.

Mar 1. Bill Smith invested \$3,000 cash in exchange for common stock to start the business.

15. Bill provided services and received cash amounting to \$5,400 from customers.

16. Purchased supplies on account, \$100.

17. Paid for gas and oil, \$800.

18. Paid salaries, \$5,000.

21. Provided service on credit, \$600.

28. Bill provided services and received cash amounting to \$6,000.

29. Paid for truck and equipment rental, \$2,500.

30. Speedy Computer Service paid cash dividends of \$2,000 to the owner.

Required:

1. Record the above transactions in general journal form.
2. Prepare a trial balance after posting the entries to T-accounts (you can make your own T-accounts).
3. Prepare an income statement from trial balance.
4. Prepare a statement of retained earnings from the trial balance and income statement.
5. Prepare a balance sheet using the trial balance totals and the statement of retained earnings.
6. Explain why the company's cash balance does not agree with net income.

**Chapter 2 Solution: Alternate Demonstration Problem****GENERAL JOURNAL**

| <b>DATE</b>    | <b>ACCOUNT TITLES AND EXPLANATION</b> | <b>PR</b> | <b>DEBIT</b> |          |           | <b>CREDIT</b> |          |           |
|----------------|---------------------------------------|-----------|--------------|----------|-----------|---------------|----------|-----------|
| <b>March 1</b> | <b>Cash</b>                           |           | <b>3</b>     | <b>0</b> | <b>00</b> |               |          |           |
|                | <b>Common Stock</b>                   |           |              |          |           | <b>3</b>      | <b>0</b> | <b>00</b> |
|                |                                       |           |              |          |           |               |          |           |
| <b>15</b>      | <b>Cash</b>                           |           | <b>5</b>     | <b>4</b> | <b>00</b> |               |          |           |
|                | <b>Service Fees Earned</b>            |           |              |          |           | <b>5</b>      | <b>4</b> | <b>00</b> |
|                |                                       |           |              |          |           |               |          |           |
| <b>16</b>      | <b>Supplies</b>                       |           | <b>1</b>     | <b>0</b> | <b>00</b> |               |          |           |
|                | <b>Accounts Payable</b>               |           |              |          |           | <b>1</b>      | <b>0</b> | <b>00</b> |
|                |                                       |           |              |          |           |               |          |           |
| <b>17</b>      | <b>Gas and Oil Expense</b>            |           | <b>8</b>     | <b>0</b> | <b>00</b> |               |          |           |
|                | <b>Cash</b>                           |           |              |          |           | <b>8</b>      | <b>0</b> | <b>00</b> |
|                |                                       |           |              |          |           |               |          |           |
| <b>18</b>      | <b>Salaries Expense</b>               |           | <b>5</b>     | <b>0</b> | <b>00</b> |               |          |           |
|                | <b>Cash</b>                           |           |              |          |           | <b>5</b>      | <b>0</b> | <b>00</b> |
|                |                                       |           |              |          |           |               |          |           |
| <b>21</b>      | <b>Accounts Receivable</b>            |           | <b>6</b>     | <b>0</b> | <b>00</b> |               |          |           |
|                | <b>Service Fees Earned</b>            |           |              |          |           | <b>6</b>      | <b>0</b> | <b>00</b> |
|                |                                       |           |              |          |           |               |          |           |
| <b>28</b>      | <b>Cash</b>                           |           | <b>6</b>     | <b>0</b> | <b>00</b> |               |          |           |
|                | <b>Service Fees Earned</b>            |           |              |          |           | <b>6</b>      | <b>0</b> | <b>00</b> |
|                |                                       |           |              |          |           |               |          |           |
| <b>29</b>      | <b>Equipment Rental Expense</b>       |           | <b>2</b>     | <b>5</b> | <b>00</b> |               |          |           |
|                | <b>Cash</b>                           |           |              |          |           | <b>2</b>      | <b>5</b> | <b>00</b> |
|                |                                       |           |              |          |           |               |          |           |
| <b>30</b>      | <b>Dividends</b>                      |           | <b>2</b>     | <b>0</b> | <b>00</b> |               |          |           |
|                | <b>Cash</b>                           |           |              |          |           | <b>2</b>      | <b>0</b> | <b>00</b> |



**Speedy Computer Service****Trial Balance****March 31, 2019**

|                                 |            |              |           |                  |              |           |
|---------------------------------|------------|--------------|-----------|------------------|--------------|-----------|
| <b>Cash</b>                     | <b>4</b>   | <b>1 0 0</b> | <b>00</b> |                  |              |           |
| <b>Accounts Receivable</b>      |            | <b>6 0 0</b> | <b>00</b> |                  |              |           |
| <b>Supplies</b>                 |            | <b>1 0 0</b> | <b>00</b> |                  |              |           |
| <b>Accounts Payable</b>         |            |              |           |                  | <b>1 0 0</b> | <b>00</b> |
| <b>Common Stock</b>             |            |              |           | <b>3 0 0 0</b>   | <b>00</b>    |           |
| <b>Dividends</b>                | <b>2</b>   | <b>0 0 0</b> | <b>00</b> |                  |              |           |
| <b>Service Fees Earned</b>      |            |              |           | <b>1 2 0 0 0</b> | <b>00</b>    |           |
| <b>Gas &amp; Oil Expense</b>    |            | <b>8 0 0</b> | <b>00</b> |                  |              |           |
| <b>Equipment Rental Expense</b> | <b>2</b>   | <b>5 0 0</b> | <b>00</b> |                  |              |           |
| <b>Salaries Expense</b>         | <b>5</b>   | <b>0 0 0</b> | <b>00</b> |                  |              |           |
| <b>Totals</b>                   | <b>1 5</b> | <b>1 0 0</b> | <b>00</b> | <b>1 5</b>       | <b>1 0 0</b> | <b>00</b> |
|                                 |            |              |           |                  |              |           |
|                                 |            |              |           |                  |              |           |
|                                 |            |              |           |                  |              |           |
|                                 |            |              |           |                  |              |           |

3.

**Speedy Computer Service****Income Statement****For the month ended March 31, 2019**

|                                       |                        |
|---------------------------------------|------------------------|
| <b>Fees Earned .....</b>              | <b>\$12,000</b>        |
| <b>Expenses:</b>                      |                        |
| <b>Equipment Rental Expense .....</b> | <b>\$2,500</b>         |
| <b>Gas &amp; Oil Expense .....</b>    | <b>800</b>             |
| <b>Salary Expense .....</b>           | <b><u>5,000</u></b>    |
| <b>Total expenses .....</b>           | <b><u>8,300</u></b>    |
| <b>Net income .....</b>               | <b><u>\$ 3,700</u></b> |

4. **Speedy Computer Service**  
**Statement of Retained Earnings**  
**For the month ended March 31, 2019**

|                          |                |
|--------------------------|----------------|
| Beginning Owner's Equity | \$0            |
| Add: Net Income          | <u>3,700</u>   |
| Total                    | 3,700          |
| Less: Dividends          | <u>2,000</u>   |
| Ending Owner's Equity    | <u>\$1,700</u> |

5. **Speedy Computer Service**  
**Balance Sheet**  
**March 31, 2019**

| Assets                |                | Liabilities and Owner's Equity |                |
|-----------------------|----------------|--------------------------------|----------------|
| Cash.....             | \$4,100        | Accounts payable .....         | \$ 100         |
| Accts Receivable..... | 600            | Common Stock.....              | <u>3,000</u>   |
|                       |                | Ending Retained Earnings..     | <u>1,700</u>   |
| Supplies .....        | <u>100</u>     | Total liabilities and          |                |
|                       |                | equity .....                   | <u>\$4,800</u> |
| Total Assets .....    | <u>\$4,800</u> |                                |                |

6. First, note that Common stock (\$3,000) and Dividends (\$2,000) affect the cash balance but do not affect the amount of net income earned during the period. Also, revenues in the amount of \$600 (March 21) are reflected in net income, but have not yet been collected. As such, these revenues did not impact the cash balance.