Chapter 2[1]

Accounting for Business Transactions & Journalizing

Learning Objectives

- Explain the steps involved in processing transactions, in their proper sequence.
- Provide examples of source documents for a cash disbursement, cash receipt, sale and purchase.
- Describe an account, journal, ledger and chart of accounts.
- Provide examples of accounts in a chart of accounts and how they are used to summarize and record transactions.
- Analyze the impact of transactions on individual accounts and financial statements.
- Provide examples of cash-based transactions.
- Provide examples of noncash-based or accrual-based transactions.
- Provide examples of transactions including both cash and accruals.
- Record a variety of transactions in a journal or original book of entry.
- Post entries to the ledger or general ledger.
- Explain the usefulness of a trial balance.
- Prepare financial statements.
- Compute the debt ratio and describe its usefulness in analyzing financial information.

[1] Acknowledgement: An earlier version of this chapter was provided to all accounting faculty on October 31, 2014, for review notes, comments, and recommendations for improvement. Work on this text began in early 2014. The completion of this text was made possible through a spring 2015 sabbatical from West Chester University.

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Professor Halsey is also very active in legal academic and professional organizations. He is past President of the Mid-Atlantic Academy of Legal Studies in Business (MAALSB) and he has been Editor-In-Chief of the *Atlantic Law Journal* since 2009. He has also served on the West Chester Borough Planning Commission.

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Professor Belak worked in industry as a financial analyst and senior financial analyst and for a firm preparing individual and business federal and state tax returns. She is a member of the Pennsylvania Institute of Certified Public Accountants (PICPA) and the Association of Certified Fraud Examiners (ACFE). Professor Belak has returned to her alma mater to teach Managerial Accounting, Fraud Examination for Managers, and Governmental and Not-For-Profit Accounting. Her research interests involve topics related to Fraud Examination and Tax. She has published in the *Pennsylvania CPA Journal* and *Journal of Business Case Studies*.

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DHS Ebola preparedness failings detailed in hearing Everett Rosenfeld Friday, 24 Oct 2014 | 12:20 PM ETCNBC.com

Growing health threat: Ebola in NYC. A doctor in New York City has tested positive for Ebola after recently treating patients with the virus in Guinea.

Several federal preparedness errors, ***including poor record keeping and missing supplies*** (emphasis added), were outlined Friday at a House Oversight and Government Reform Committee hearing on Ebola.

Analyzing and Recording

Accounting is a process that identifies and produces financial statements from business transactions. These transactions must be organized, in some fashion, using a systematic, rational and methodical approach.

The accounting process begins when transactions are analyzed. Then, these transactions are recorded in a journal (original book of entry) and posted in a ledger, before a trial balance is prepared and financial statements can be produced.

Analyze Transactions → **Record in Journal** → **Post in Ledger** → **Prepare Trial Balance**

Source Documents

Source documents might be available in hard copy or electronic form:

- A check is an example of a source document for a cash disbursement.
- A deposit slip is an example of a source document for a cash receipt.
- A sales invoice, whether the sale was for cash, credit, or a mixture of both, is an example of a source document for a sales or revenue transaction.
- A bill from a supplier, whether paid in cash, provided on credit, or a mixture of both, is an example of a source document for a purchase or cost of goods sold or some expense transaction.

These examples are summarized, below:

Transaction	Source Document Example
Cash disbursement	check
Cash receipt	deposit slip
Sales or revenue	sales invoice
Cost of goods sold or purchase or expense	bills from suppliers

Cash disbursements and cash receipts are eventually confirmed by an external source or source document, when the firm receives its bank statement. Sales and purchase invoices are often prepared in multiple copies or electronically, where the sales invoice represents an internal source document and the purchase order represents an internal source document. The latter is supported by and can be matched to a bill or external source document from the supplier at some later date.

Account Analysis

An account is provided for each asset, liability, equity, revenue, and expense item. Transactions occurring within and affecting an account are summarized for financial statement presentation. Prior to summarizing these transactions, each account is analyzed.

All accounts are separately summarized in a ledger or general ledger. All of this information, including the general ledger, can be stored in paper or electronic form, or a combination of both. Detailed account information is recorded in the general ledger, where all accounts used by a firm are summarized in what is called a chart of accounts. The accounts used by a firm are classified into three general categories, as follows:

ASSETS = LIABILITIES + EQUITY

Assets

Assets are economic resources owned and/or controlled by a firm, and expected to produce future benefits. Example of assets and their definitions are summarized below. They are presented in order of liquidity, where the most liquid asset, cash, is the most liquid and listed first, as follows:

ASSETS
Cash
Accounts receivable
Notes receivable
Prepaid expenses
Supplies
Equipment
Buildings
Land

- **Cash** accounts represent balances in a firm's bank accounts. A firm may have more than one account. Cash includes coins, money orders, checks, savings accounts, and checking accounts.
- **Accounts receivable** evolve from credit sales to a customer or client. They are increased by credit sales to customers and decreased when the customer makes a payment or payments. Separate accounts must be maintained for each customer to

keep track of the amount of credit extended to each customer and the payments made and the balance due from each customer.

- **Notes receivable** usually evolve from a promissory note. Notes receivable may be interest bearing or non-interest bearing and short-term or long-term.
- **Prepaid expenses** represent prepayments. Examples include prepaid insurance premiums and prepaid rent. As these prepayments expire or are consumed, through the passage of time, they are converted from their asset status to an expense. Until consumed, these prepayments are correctly classified as and considered assets. For example, assume that you pay six months of car insurance in January 1. One-sixth of this prepayment is an expense for January; one-sixth of this prepayment is an expense for February; and so on, until this prepaid asset is completely consumed (or expensed) through June.
- **Supplies** remain assets until consumed and expensed. There may be more than one category of supplies, and they would be accounted for separately. For example, office supplies and work shop supplies would be accounted for in separate accounts.
- **Equipment** represents a long-lived asset that wears out over time. As was the case for supplies, we might have more than one category or classification of equipment. For example, office equipment and work shop equipment would be accounted for in separate accounts. Regardless of the type of equipment, as it wears out, we will record an expense known as depreciation expense.
- **Buildings** also represent an asset that wears out over time. Again, as the building deteriorates or wears out, we will record an expense known as depreciation expense.
- **Land** is an asset that does <u>not</u> wear out over time. Because land does not wear out, we do not have to record any wear or depreciation for land. Since land does not wear out or depreciate and buildings do depreciate, we record land and buildings in separate accounts.

Liabilities

Liabilities are claims by creditors against assets and/or economic resources <u>owed</u> by a firm and requiring transfers to others. Examples of liabilities, where the most liquid liability is that claim against assets that is expected to be paid first, follow:

LIABILITIES
Accounts payable
Notes payable
Unearned revenues
Accrued liabilities

- **Accounts payable**, like accounts receivable, evolve from credit purchases, however, in this case, the firm is recording the account payable for a customer or client. This account is increased by credit purchases and decreased when a payment or payments are made. Separate accounts must be maintained for each

creditor to keep track of the amount of credit extended and the payments made and the balance due to each supplier.
- **Notes payable**, again, usually evolve from a promissory note. Notes payable may be interest bearing or non-interest bearing and short-term or long-term.
- **Unearned revenues** represent a liability until the amount, received in advance, is earned. When earned, unearned revenue is converted from its liability status to revenue.
- **Accrued liabilities** represent amounts owed, but not yet paid. They include wages payable, taxes payable, interest payable, and other payables. These amounts are determined at the end of each accounting period by conducting an account analysis.

Assets and Liabilities

By now, you may have noticed some logical connections between certain asset and liability accounts.

- An account receivable on your firm's books represents an account payable on another firm's books. The reverse is also true.
- The same may be said for notes receivable and notes payable.
- In the case of prepaid expenses, your prepaid rent is unearned rent for another firm or entity. Again, the reverse is true. Prepaid expenses and unearned revenues might apply to a variety of revenue and expense items, and are not confined to insurance and rent.

ASSETS	LIABILITIES
Accounts receivable	**Accounts payable**
Notes receivable	**Notes payable**
Prepaid expenses	**Unearned revenues**

If assets are amounts you <u>own</u> and liabilities are amounts you <u>owe</u>, we must account for the difference between these measures. In accounting, this difference is referred to as equity, and can be presented, as follows:

ASSETS – LIABILITIES = EQUITY

and

ASSETS = LIABILITIES + EQUITY

Equity

The owner of a firm has a claim on the net assets (assets minus liabilities) or equity of the firm. Equity is also referred to as *stockholders' equity*, *shareholders' equity*, or *owners' equity*. It is the residual interest in a business.

Equity is increased by revenues and decreased by expenses. Therefore, equity is increased by net income and decreased by net loss, as follows:

	Revenues	**Revenues**
less:	**Expenses**	**Expenses**
equals:	**Net Income**	**Net Loss**

The above equation can be expanded:

ASSETS = LIABILITIES + EQUITY (REVENUES – EXPENSES)

and

ASSETS = LIABILITIES + EQUITY (NET INCOME/(LOSS))

Dividends are paid to shareholders out of earnings or net income. This is an asset distribution to shareholders, as follows:

ASSETS = LIABILITIES + EQUITY (NET INCOME – DIVIDENDS)

Ledger and Chart of Accounts

The listing of all accounts and their balances is called a *ledger* or *general ledger* (GL). The *chart of accounts* lists all general ledger accounts, where a number is assigned to each account in a firm's chart of accounts.

A firm's chart of accounts lists the assets, liabilities, equities, revenues and expenses. It is a common practice for assets to be listed as 100s, liabilities as 200s, equities as 300s, revenues as 400s, and expenses as 500s and/or 600s. An illustration follows:

100	**Cash**
105	**Accounts receivable**
115	**Notes receivable**
125	**Prepaid expenses**
135	**Supplies**
140	**Equipment**
150	**Buildings**
160	**Land**
205	**Accounts payable**
215	**Notes payable**
225	**Unearned revenues**
235	**Accrued liabilities**
300	**Common stock**
310	**Retained earnings**
320	**Dividends**
400	**Revenue**
515	**Salaries expense**
525	**Rent expense**
535	**Supplies expense**
545	**Utilities expense**

It is helpful to assign account numbers in some fashion or pattern that makes it easier for the user to learn the chart of accounts and associate related account numbers. For example, note that supplies (135) and supplies expense (535) have the same account number suffix. Also, note that a similar pattern has been developed for accounts receivable (105) and accounts payable (235), as well as notes receivable (115) and notes payable (215).

Debits and Credits

A *T-account* represents a ledger or general ledger account. It has a left or debit side and a right or credit side. Debits are abbreviated as Dr or DR. Credits are abbreviated as Cr or CR.

Account Title	
Debit	Credit

Debits and credits do not mean increase or decrease. Whether a debit or credit is an increase or decrease depends on the account. Debits increase assets and expenses. Credits increase liabilities, equity and revenues.

Double-Entry Accounting

Double-entry accounting is used to maintain the accounting equation. Debits must always equal credits. If debits equal credits for each individual transaction, debits will equal credits in aggregate.

The T-accounts for assets, liabilities and equity are produced, below, where you should note that debits increase (+) assets and credits increase (+) liabilities and equity accounts. Alternatively, credits decrease (-) assets and debits decrease (-) liabilities and equity accounts.

Assets		=	Liabilities		+	Equity	
Debit	Credit		Debit	Credit		Debit	Credit
+	-		-	+		-	+

Typical (or normal) balances for assets are debits and typical (or normal) balances for liabilities and equity accounts are credits, as follows:

Assets		=	Liabilities		+	Equity	
Debit				Credit			Credit

Alternatively, debits can be shown to equal credits, as follows:

Assets	=	Liabilities	+	Equity
Debits	=	Credits	+	Credits

The above can be expanded to include revenues and expenses, where revenues are increased with credits and expenses are increased with debits, as follows:

Assets		=	Liabilities		+	Equity	
Debit	Credit		Debit	Credit		Debit	Credit
+	-		-	+		-	+

Revenues		-	Expenses	
Debit	Credit		Debit	Credit
-	+		+	-

Revenues are increased with credits. Expenses are increased with debits.

- If revenues are greater than expenses, the firm generates net income or net credit. Net income <u>increases</u> equity (see the above).
- If revenues are lower than expenses, the firm generates net loss or net debit. Net loss <u>decreases</u> equity (see the above).

Net income (NI) increases equity and net losses (NL) decrease equity, as follows:

Assets		=	Liabilities		+	Equity	
Debit	Credit		Debit	Credit		Debit	Credit
+	-		-	+		-	+
						Net Loss	Net Income

Assets, liabilities and equity are balance sheet accounts. Revenues and expenses are income statement accounts. These financial statements are described later in the chapter.

Other accounts also impact the equity account.

Profitable firms may decide to pay dividends to stockholders or those with an equity interest in the firm. These dividends are paid from profits or net income, as follows:

Assets		=	Liabilities		+	Equity	
Debit	Credit		Debit	Credit		Debit	Credit
+	-		-	+		-	+
						Dividends	Net Income

An Illustration Focusing on Equity Transactions
To illustrate the impact of a variety of transactions on the equity account, assume that a new firm is formed with a cash-based capital contribution of $5,000. Cash of $5,000 is deposited in the firm's newly formed checking account, and $5,000 of common stock is issued, as follows:

Assets		=	Liabilities		+	Equity	
$5,000							$5,000

Assets are increase by $5,000 cash. This is a debit. Equity is increased by $5,000 for the issuance of common stock, which represents *contributed capital*. This is a credit. Debits equal credits and assets equal liabilities plus equity.

Assume that $4,000 in revenues and $3,000 in expenses are generated during the first month of operations. This results in net income of $1,000 for the period. Net income results in an increase in net assets, the details of which are not presented, but will be explained later in the chapter. For now, focus in the fact that debits equal credits, Assets equals liabilities and equity, and the impact on the equity account, as follows:

Assets		=	Liabilities		+	Equity	
$5,000							$5,000
1,000							1,000

Revenues		-	Expenses	
	$4,000		$3,000	

Finally, assume that this profitable firm decides to pay $500 to equity owners in the form of a cash payment of dividends, as follows:

Assets		=	Liabilities		+	Equity	
$5,000							$5,000
1,000							1,000
	$500					$500	
$5,500							$5,500

To summarize, focusing on the equity account, common stock or contributed capital was issued to form and capitalize the firm, Net Income was generated during the first month or period of operations, and some portion of this net income was distributed to common stock holders in the form of cash. Equity was increased with contributed capital, increased by net income for the period, and decreased as dividends were paid to common stock holders, as follows:

Assets		=	Liabilities		+	Equity	
							Common Stock or Contributed Capital
							Net Income
						Dividends	

Journalizing and Posting Transactions

Accounting and accounting systems process transactions. This chapter began with the following, four step process:

Analyze Transactions → **Record in Journal** → **Post in Ledger** → **Prepare Trial Balance**

Journalizing

A journal is *an original book of entry*, where like transactions are summarized, monthly.

A cash receipts journal is used to record cash received and a cash disbursements journal is used to record cash disbursed. If you have ever had a checking account, simply imagine keeping a separate check register or "grossing up" the "net" subtotals to these cash transactions, separately, for (1) cash receipts and (2) cash disbursements. Cash receipts (debits to cash) are deposits or electronic transfers into the checking accounting. Cash disbursements (credits to cash) are checks written or electric or automatic transfers from the checking account. Separate, monthly cash disbursements and cash receipts journals are maintained for each checking account.

Of course, some transactions do not involve cash. A sale might be made on account or on credit and a purchase might be made on account or on credit. For credit sales, a (3) sales journal is used. For credit purchases, a (4) purchases journal is used. These separate journals result in credits to sales and debits to purchases, and are also maintained on a monthly basis.

Finally, for those transactions that do not involve the use of a (1) cash receipt, (2) cash disbursement, (3) credit sale, or (4) credit purchase, a (5) general journal is used. All accounting texts use the general journal entry format to illustrate the impact of the mechanics of debits and credits on accounts included in the firm's chart of accounts and, ultimately, used by the firm to produce financial statements. This chapter will introduce the use of the general journal entry format.

Each and every month, all of the (1) cash receipts, (2) cash disbursements, (3) credit sales, (4) credit purchases, and (5) general journal entries for the month are summarized or totaled and posted to the general ledger. This process is referred to as posting.

Analyzing Transactions from Chapter 1
Below is a summary of the transactions from Chapter 1.

				A	**=**	**L**	**+**	**E**			
	Cash	AR	Supplies	PP&E	=	AP	+	CS	Dividends	Revenues	Expenses
(1)	+$50,000				=		+	+$50,000			
(2)	-$5,000		+$5,000		=		+				
	+$45,000		+$5,000		=		+	+$50,000			
(3)	-$35,000			+$35,000	=		+				
	+$10,000		+$5,000	+$35,000	=		+	+$50,000			
(4)	-$5,000		+$15,000		=	+$10,000	+				
	+$5,000		+$20,000	+$35,000	=	+$10,000	+	+$50,000			
(5)	+$5,000	+$5,000			=		+			+$10,000	
	+$10,000	+$5,000	+$20,000	+$35,000	=	+$10,000	+	+$50,000		+$10,000	
(6)	-$4,000				=		+				-$4,000
	+$6,000	+$5,000	+$20,000	+$35,000	=	+$10,000	+	+$50.000		+$10,000	-$4,000
(7)	+$12,500	-$5,000			=		+			+$7,500	
	+$18,500	$0	+$20,000	+$35,000	=	+$10,000	+	+$50,000		+17,500	-$4,000
(8)	-$15,000				=	-$10,000	+		-$5,000		
	+$3,500	$0	+$20,000	+$35,000	+	$0	+	+$50,000	-$5,000	+$17,500	-$4,000

Note that all of these transactions involved cash. Therefore, all of these transactions could be more efficiently summarized in a (1) cash receipt journal and a (2) cash disbursements journal, as follows:

CASH RECEIPTS JOURNAL

	DR	DR/(CR)	CR	CR
Account	#100	#105	#300	#400
		Accounts	Common	
	Cash	Receivable	Stock	Revenues
(1)	$50,000		$50,000	
(5)	$5,000	$5,000		$10,000
(7)	$12,500	($5,000)		$7,500
Totals	$67,500	$0	$50,000	$17,500

There were 3 cash receipts during the period. Each and every single cash receipt involves a debit to the cash account. First, the checking account was initially established when $50,000 was deposited and used to issue common stock. Second, a sale involving cash was made, however, this $10,000 sale involved $5,000 in cash and $5,000 on account (an accounts receivable was established when credit was extended to the customer or client). Third, the accounts receivable of $5,000 was received

CASH DISBURSEMENTS JOURNAL

	CR	DR	DR	CR/(DR)	DR	DR	DR
Account	#100	#135	#140	#205	#320	#515	#525
			[PP&E]	Accounts		[Expenses]	[Expenses]
	Cash	Supplies	Equipment	Payable	Dividend	Salary	Rent
(2)	$5,000	$5,000					
(3)	$35,000		$35,000				
(4)	$5,000	$15,000		$10,000			
(6)	$4,000					$1,500	$2,500
(8)	$15,000			($10,000)	$5,000		
Totals	$64,000	$20,000	$35,000	$0	$5,000	$1,500	$2,500

There were 5 cash disbursements during the period. Each and every single cash disbursement involved a credit to the cash account. First, supplies were purchased at a cost of $5,000. Second, equipment was purchase at a cost of $35,000. Third, $15,000 in supplies was purchased with a $5,000 cash down payment and the remaining $10,000 owed to the supplier. The supplier extended credit to the firm. Fourth, salary ($1,500) and rent ($2,500) were paid, at a total cost of $4,000. Fifth and finally, a $15,000 cash disbursement was made to completely pay the accounts payable from item (4), the third cash disbursement in the above cash disbursements journal, and a $5,000 dividend.

Identify & Analyze

(1) The owner makes an investment of $50,000 to form his or her corporation and receives common stock.

			A	**=**	**L**	**+**	**E**			
Cash	AR	Supplies	PP&E	=	AP	+	CS	Dividends	Revenues	Expenses
+$50,000				=		+	+$50,000			

Record

Below is the transaction, presented in general journal form:

Cash	**$50,000**	
Common Stock		**$50,000**

Post

Below are the accounts in the general ledger that each component of the transaction will be posted to:

Cash = Liabilities + Common Stock

Cash			Liabilities			Common Stock	
$50,000		=			+		$50,000

Revenues - Expenses

Notes:

Identify & Analyze

(2) The corporation purchases supplies for a cash payment of $5,000.

			A	=	L	+	E			
Cash	AR	Supplies	PP&E	=	AP	+	CS	Dividends	Revenues	Expenses
-$5,000		+$5,000		=		+				

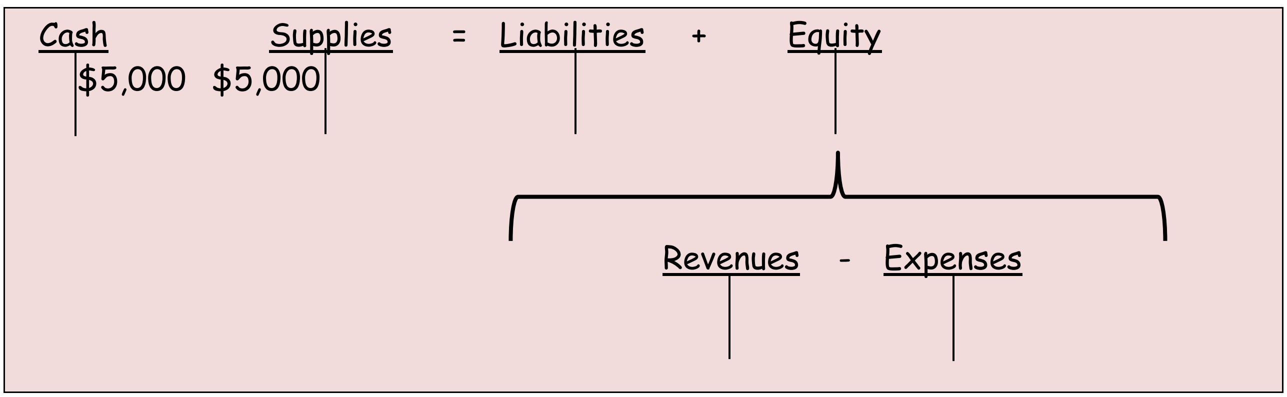
Record

Below is the transaction, presented in general journal form:

Supplies	**$5,000**	
Cash		**$5,000**

Post

Below are the accounts in the general ledger that each component of the transaction will be posted to:



Notes:

Identify & Analyze

(3) The corporation pays cash for equipment purchased at a cost of $35,000.

			A	=	L	+	E			
Cash	AR	Supplies	PP&E	=	AP	+	CS	Dividends	Revenues	Expenses
-$35,000			+$35,000	=		+				

Record

Below is the transaction, presented in general journal form:

Equipment	**$35,000**	
Cash		**$35,000**

Post

Below are the accounts in the general ledger that each component of the transaction will be posted to:

Cash		Equipment		=	Liabilities		+	Equity	
	$35,000	$35,000							

Revenues - Expenses

Notes:

Identify & Analyze

(4) The corporation purchases additional supplies with a down payment of $5,000 in cash and $10,000 on credit.

			A	**=**	**L**	**+**	**E**			
Cash	AR	Supplies	PP&E	=	AP	+	CS	Dividends	Revenues	Expenses
-$5,000		+$15,000		=	+$10,000	+				

Record

Below is the transaction, presented in general journal form:

Supplies	**$15,000**	
Cash		**$5,000**
Accounts payable		**10,000**

Post

Below are the accounts in the general ledger that each component of the transaction will be posted to:

Cash | $5,000 $15,000 | Supplies = Accounts payable | $10,000 + Equity

Revenues - Expenses

Notes:

Identify & Analyze

(5) The corporation completes professional services for $10,000, where $5,000 was paid immediately and the remaining $5,000 is due within 30 days.

			A	=	L	+	E			
Cash	AR	Supplies	PP&E	=	AP	+	CS	Dividends	Revenues	Expenses
+$5,000	+$5,000			=		+			+$10,000	

Record

Below is the transaction, presented in general journal form:

Cash	$5,000	
Accounts receivable	5,000	
Revenue		$10,000

Post

Below are the accounts in the general ledger that each component of the transaction will be posted to:

Cash | Accounts receivable = Liabilities + Equity

Cash: $5,000 (debit)

Accounts receivable: $5,000 (debit)

Liabilities

Equity

Revenues - Expenses

Revenues: $10,000 (credit)

Expenses

Notes: ______________________________

Identify & Analyze

(6) The corporation pays $2,500 monthly rent expense and $1,500 monthly salary expense in cash. If each of these expenses had been paid separately, with two separate checks, a stronger audit trial would be established and available for later review and this practice would provide for stronger internal control. The corporation agrees to apply this preferred practice for future disbursements.

			A	**=**	**L**	**+**	**E**			
Cash	AR	Supplies	PP&E	=	AP	+	CS	Dividends	Revenues	Expenses
-$4,000				=		+				-$4,000

Record

Below is the transaction, presented in general journal form:

Rent expense	**$2,500**	
Salary expense	**$1,500**	
Cash		**$4,000**

Post

Below are the accounts in the general ledger that each component of the transaction will be posted to:

Cash = Liabilities + Equity

Cash: | $4,000

Revenues - Rent expenses Salary expense

Rent expenses: $2,500 |

Salary expense: $1,500 |

Notes: ______________________________

Identify & Analyze

(7) The corporation completes professional services for $7,500 received in cash. The corporation also receives the $5,000 balance (see item (5)) from a prior engagement.

			A	=	L	+	E			
Cash	AR	Supplies	PP&E	=	AP	+	CS	Dividends	Revenues	Expenses
+$12,500	-$5,000			=		+			+$7,500	

Record

Below is the transaction, presented in general journal form:

Cash	$12,500	
Accounts receivable		$5,000
Revenue		7,500

Post

Below are the accounts in the general ledger that each component of the transaction will be posted to:

Cash		Accounts receivable		=	Liabilities		+	Equity	
$12,500			$5,000						

Revenues		-	Expenses	
	$7,500			

Notes:

Identify & Analyze

(8) The corporation pays the $10,000 trade account payable (AP) (see item (4)) and declares and pays a dividend of $5,000.

			A	=	L	+	E			
Cash	AR	Supplies	PP&E	=	AP	+	CS	Dividends	Revenues	Expenses
-$15,000				=	-$10,000	+		-$5,000		

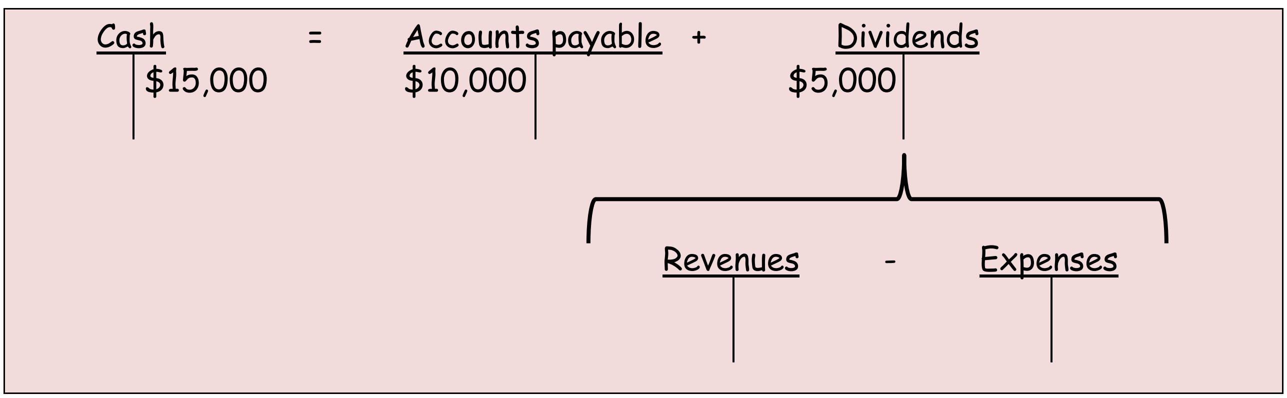
Record

Below is the transaction, presented in general journal form:

Accounts payable	$10,000	
Dividends	5,000	
Cash		$15,000

Post

Below are the accounts in the general ledger that each component of the transaction will be posted to:



Notes:

The below summarizes all of the above transactions in a general ledger or T-Account form, which was not produced or provided in Chapter 1. Note that all balances are double underlined and assets = liabilities + owners' equity (or debits = credits), as follows:

Assets = **Liabilities** + **Equity**

Assets

#100 **Cash**

(1) $50,000	(2) $5,000
(5) $5,000	(3) $35,000
(7) $12,500	(4) $5,000
	(6) $4,000
	(8) $15,000
Bal. $2,500	

#105 **Accounts Receivable**

(5) $50,000	(7) $5,000
Bal. $-0-	

#135 **Supplies**

(2) $50,000	
(7) $15,000	
Bal. $20,000	

#140 **Equipment**

(3) $35,000	
Bal. $35,000	

Liabilities

#205 **Accounts Payable**

	(4) $10,000
(8) $10,000	
Bal. $-0-	

Equity

#300 **Common Stock**

	(1) $50,000
	Bal. $50,000

#320 **Dividends**

(8) $5,000	
Bal. $5,000	

#400 **Revenues**

	(5) $10,000
	(7) $7,500
	Bal. $17,500

#515 **Salary Expense**

(6) $1,500	
Bal. $1,500	

#525 **Rent Expense**

(6) $2,500	
Bal. $2,500	

Assets	=	Liabilities	+	Equity
$58,500		$-0-		$58,500

Recall that this same data and fact patterns were used and presented in Chapter 1, as follows:

	A	=	L	+	E
Cash	$3,500				
AR	$0				
Supplies	$20,000				
PP&E	$35,000				
AP			$0		
CS					$50,000
Dividends					-$5,000
Revenues					$17,500
Expenses					-$4,000
	$58,500	=	$0	+	$58,500

Alternatively, the same data and fact patterns can be summarized and organized by debit and credit, in the traditional *trial balance* format, as follows:

Soltis Corporation
Trial Balance
For the Month Ended December 31, 2013

	Debit	Credit
Cash	$3,500	
Accounts receivable	$0	
Supplies	$20,000	
Property, plant & equipment	$35,000	
Accounts payable		$0
Common stock		$50,000
Dividends	$5,000	
Revenues		$17,500
Salary expense	$1,500	
Rent expense	$2,500	
Totals	$67,500	$67,500

The above trial balance is used to confirm that debits equal credits. Notice that the trial balance follows the same sequence as the chart of accounts, provided earlier in this chapter. It is reproduced below:

100	Cash
105	Accounts receivable
115	Notes receivable
125	Prepaid expenses
135	Supplies
140	Equipment
150	Buildings
160	Land
205	Accounts payable
215	Notes payable
225	Unearned revenues
235	Accrued liabilities
300	Common stock
310	Retained earnings
320	Dividends
400	Revenue
515	Salaries expense
525	Rent expense
535	Supplies expense
545	Utilities expense

The Soltis Corporation had a zero balance for accounts receivable and accounts payable at the end of the first month of operations. Quite a few accounts in the above chart of accounts were not used during this first month of operations.

Revenue, expense and the dividends account will have to be closed out to retained earnings, so some adjustments will be made to the format trial balance, after the income statement is prepared. Revenue and expense accounts are referred to as *temporary* or *nominal* accounts, since they are closed (or zeroed) out to an income summary account, and, eventually, to a retained earnings account at the end of each accounting period. The dividends account is a *contra equity* account, and is also closed out to the retained earnings account at the end of each accounting period.

The income statement is presented below, in a slightly expanded form from that originally presented in Chapter 1:

Soltis Corporation
Income Statement
For the Month Ended December 31, 2013

Revenues		$17,500
Expenses:		
Salary expense	$1,500	
Rent expense	2,500	$4,000
Net Income		$13,500

The income statement has been prepared, so the revenue and expense accounts can be closed out to the income summary account to reflect the zero beginning balances in these temporary or nominal accounts for the next period or month of operations, as follows:

Income summary	$4,000	
Salary expense		$1,500
Rent expense		$2,500

Revenue	$17,500	
Income summary		$17,500

The income summary account, now, summarizes income. Net income was $13,500 for the period. However, recall that $5,000 of these "earnings" was paid out in dividends. Therefore, only $8,500 was retained, as originally presented in Chapter 1, and as follows:

Soltis Corporation
Statement of Retained Earnings
For the Month Ended December 31, 2013

	Retained Earnings, Beginning	$0
plus:	Net Income	$13,500
		$13,500
less:	Dividends	$5,000
equals:	Retained Earnings, Ending	$8,500

The statement of retained earnings has been prepared. The income summary account balance of $13,500 and the (contra equity) dividends account balance of $5,000 can be closed out to the retained earnings account, as follows:

Income summary	$13,500	
Retained earnings		$13,500

Retained earnings	$5,000	
Dividends		$5,000

The following actions have been taken, since preparing the trial balance:

1. The income statement has been prepared.
2. The revenue account balances have been closed out to the income summary account.
3. The expense account balances have been closed out to the income summary account.
4. Having summarized income, the income summary account has been closed out to the retained earnings account.

5. The dividends account balance has been closed out to the retained earnings account.

At this time, having closed out all temporary and nominal accounts, a post-closing trial balance can be prepared. Those accounts with zero balance (e.g., accounts receivable and accounts payable) are not presented. The post-closing trial balance, with all balance sheet or real account balances, is presented, as is the balance sheet, below:

Soltis Corporation
Post-Closing Trial Balance
For the Month Ended December 31, 2013

	Debit	Credit
Cash	$3,500	
Supplies	$20,000	
Property, plant & equipment	$35,000	
Common stock		$50,000
Retained earnings		$8,500
Totals	$58,500	$58,500

Soltis Corporation
Balance Sheet
December 31, 2013
Assets

Cash	$3,500
Supplies	$20,000
Property, plant & equipment	$35,000
Total assets	$58,500

Liabilities and Owners' Equity

Common stock	$50,000
Retained earnings	$8,500
Total equities	$58,500

Additional Transactions and Analysis

Transactions can be purely cash-based (or cash basis), purely accrual-based (or accrual basis), or a combination of cash and accrual based. Quite a few examples of a variety of transactions are provided below, where they are presented in general journal entry form and without any dollar amounts or measures or descriptions. You should use this as a self-test to identify any weaknesses. Focus on understanding the debits and credits and the mechanics of these transactions and the accounts involved. Most find the purely cash-based or cash basis transactions easier and the purely or combined accrual-based or basis transactions more difficult.

Examples of Transactions – Cash Receipts (Cash Basis)
Examples of transactions involving <u>only</u> <u>cash</u> <u>receipts</u> include (a) issuing common stock for cash, (b) providing services for cash, (c) receiving cash on an **<u>account receivable</u>** for services already provided on account, and (d) receiving cash, in advance, for services to be provided. All include a debit to cash and are summarized, below:

(a) Issuing common stock for cash:

Cash	$XXX	
Common stock		$XXX

(b) Providing services for cash:

Cash	$XXX	
Revenues		$XXX

(c) Receiving cash on an **<u>account receivable</u>** for services already provided on account:

Cash	$XXX	
Accounts receivable		$XXX

(d) Receiving cash, in advance, for services to be provided:

Cash	$XXX	
Unearned revenues		$XXX

Examples of Transactions – Cash Disbursements (Cash Basis)
Examples of transactions involving only cash disbursements include (e) purchasing and paying for equipment with cash, (f) paying rent expense with cash, (g) paying salaries expense with cash, (h) paying utilities expense with cash, (i) paying an **account payable** to a supplier for a credit purchase with cash, (j) paying of a cash dividend with cash, (k) prepaying a six month insurance policy with cash, and (l) purchasing and paying for supplies inventory with cash. All include a credit to cash and are summarized, below:

(e) Purchasing and paying for equipment with cash:

Equipment	$XXX	
Cash		$XXX

(f) Paying rent expense with cash:

Rent expense	$XXX	
Cash		$XXX

(g) Paying salaries expense with cash:

Salaries expense	$XXX	
Cash		$XXX

(h) Paying utilities expense with cash

Utilities expense	$XXX	
Cash		$XXX

(i) Paying an **account payable** to a supplier for a credit purchase with cash

Accounts payable	$XXX	
Cash		$XXX

(j) Paying of a cash dividend with cash

Dividend	$XXX	
Cash		$XXX

(k) Prepaying a six month insurance policy with cash:

Prepaid insurance	$XXX	
Cash		$XXX

(l) Purchasing and paying for supplies inventory with cash:

Supplies	$XXX	
Cash		$XXX

Examples of Transactions – Non-Cash Revenues (Accrual Basis)
Examples of transactions requiring the recording of revenue, but that do not involve any cash receipts include (m) providing consulting services on account and (n) providing rental equipment on account. Both include a credit to a revenue account and a debit to an account receivable or accrual account, as follows:

(m) Providing consulting services on account:

Account receivable	$XXX	
Consulting revenue		$XXX

(n) Providing rental equipment on account:

Rent receivable	$XXX	
Rent revenue		$XXX

Examples of Transactions – Non-Cash Expenses (Accrual Basis)
Examples of transactions requiring the recording of expense, but that do not involve any cash disbursements include (o) purchasing equipment on account and (p) purchasing supplies inventory on account. Both include a debit to an asset account and a credit to an account payable or accrual account, as follows:

(o) Purchasing equipment on account:

Equipment	$XXX	
Account payable		$XXX

(p) Purchasing supplies inventory on account:

Supplies inventory	$XXX	
Account payable		$XXX

Appendix A

Debt Ratio

Risk assessment is an important process associated with the development and presentation of accounting and financial information. Recall that all assets are financed with either liabilities or equity:

Assets = Liabilities + Equity

A firm using a high degree, percentage or relative amount of debt to finance assets is said to be using a high degree or level of *financial leverage*. Higher financial leverage is associated with higher risk, since liabilities tend to involve regular payments interest or both interest and principal. Equity financing does not involve the payment of interest. Therefore, there is some level of risk that a firm might not be able to make these payments of interest or both interest and principal. One measure of the level of debt or risk associated with a firm's "capital structure" is the debt ratio, as follows:

Debt Ratio = Total Liabilities ÷ Total Assets

For example, assume a firm has $100 in total assets, $40 in total liabilities, and $60 in total equity. The debt ratio is 40 percent, as follows:

40% = $40 ÷ $100