

Topic 2: Transaction Analysis

What is Transaction Analysis?

Transaction analysis is the process of identifying the economic impact of business events and determining how they affect the accounting equation. Each transaction must be carefully examined to determine which accounts are affected, whether they increase or decrease, and by what amount. This systematic approach ensures accurate financial record-keeping and proper preparation of financial statements.

Steps in Transaction Analysis

Step 1: Identify the transaction - Determine what economic event has occurred. Not all events are transactions; only those that can be measured in monetary terms and affect the financial position of the business qualify as accounting transactions.

Step 2: Identify affected accounts - Determine which specific accounts are impacted by the transaction. Every transaction affects at least two accounts (double-entry system).

Step 3: Classify accounts - Determine whether each affected account is an asset, liability, or equity account. This classification guides the recording process.

Step 4: Determine the direction of change - Decide whether each affected account increases or decreases as a result of the transaction.

Step 5: Record the amounts - Quantify the dollar amount of the increase or decrease for each affected account.

Step 6: Verify the balance - Ensure that the accounting equation remains in balance after recording the transaction.

Types of Transactions

1. Asset Exchange Transactions

These transactions involve exchanging one asset for another, leaving total assets unchanged. Example: Purchasing equipment for cash exchanges the asset "Cash" for the asset "Equipment." The total value of assets remains the same, but the composition changes.

2. Asset Source Transactions

These transactions increase both assets and either liabilities or equity. Example: Stockholders investing cash increases the asset "Cash" and increases equity through "Common Stock." Similarly, borrowing money increases "Cash" (asset) and "Notes Payable" (liability).

3. Asset Use Transactions

These transactions decrease both assets and either liabilities or equity. Example: Paying dividends decreases "Cash" (asset) and decreases "Retained Earnings" (equity). Paying off a loan decreases "Cash" (asset) and decreases "Notes Payable" (liability).

4. Revenue Transactions

Revenue transactions increase assets and increase equity (through retained earnings). Example: Providing services for cash increases "Cash" and increases "Service Revenue," which ultimately increases retained earnings. Providing services on account increases "Accounts Receivable" and increases "Service Revenue."

5. Expense Transactions

Expense transactions decrease assets and decrease equity (through retained earnings). Example: Paying salaries decreases "Cash" and increases "Salary Expense," which ultimately decreases retained earnings. Paying rent decreases "Cash" and increases "Rent Expense."

Special Considerations

Prepaid Expenses

When paying for expenses in advance (like rent), the initial transaction is an asset exchange: Cash decreases and Prepaid Rent (asset) increases. As time passes, the prepaid amount is expensed: Prepaid Rent decreases and Rent Expense increases. This demonstrates the matching principle.

Accounts Receivable and Revenue Recognition

Under accrual accounting, revenue is recognized when earned, not when cash is received. Providing services on account creates Accounts Receivable (asset increase) and Service Revenue (equity increase). Later collection of cash is merely an asset exchange: Cash increases and Accounts Receivable decreases.

Depreciation

Long-lived assets like equipment are expensed over their useful lives through depreciation. This is an expense transaction that decreases the asset (through Accumulated Depreciation) and decreases equity (through Depreciation Expense).

Common Errors in Transaction Analysis

Failing to identify all affected accounts, incorrectly classifying accounts, confusing cash flows with revenue/expense recognition, forgetting that dividends are not expenses (they reduce retained earnings directly), and failing to verify that the equation balances after recording. Careful, systematic analysis prevents

these errors.