CHAPTER 2
ANALYZING AND RECORDING TRANSACTIONS

Chapter Outline

Notes

I. Analyzing and Recording Process—steps include:

A. Analyzing each transaction and event from *source documents*. *Source documents* are *business papers* that identify and describe economic events and transactions. Examples: sales tickets, checks, purchase orders, bills, and bank statements. Source documents provide objective and reliable evidence about transactions and events.

B. Record relevant transactions and events in a *journal*.

C. Post journal information to ledger *accounts*.

D. Prepare and analyze the *trial balance*.

II. The Account and its Analysis

A. An *account* is a record of increases and decreases in a specific asset, liability, equity, revenue, or expense item.

B. Accounts are arranged into three basic categories based on the accounting equation. Categories are:

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, Office Supplies, Store Supplies, Equipment, Buildings, and Land.
2. Liabilities—claims (by creditors) against assets, which means they are obligations to transfer assets or provide products or services to other entities. Examples include Accounts Payable, Note Payable, Unearned Revenues, and Accrued Liabilities.
   a. Unearned revenue—revenue collected before it is earned; before services or goods are provided.
   b. Accrued liabilities—amounts owed that are not yet paid.
3. *Equity*—owner's claim on company's assets is called *equity* or *owner's equity*. Examples include Owner's Capital, Owner's Withdrawals (decreases in equity), and different kinds of revenue (increases in equity) and expense (decreases in equity) accounts reflecting their own important activities.

III. Analyzing and Processing Transactions

A. The *general ledger* or *ledger* (referred to as the *books*) is a record containing all the accounts a company uses.

B. The *chart of accounts* is a list of all the accounts in the ledger with their identification numbers.

C. A *Taccount* represents a ledger account and is a tool used to understand the effects of one or more transactions. Has shape like the letter T with account title on top.

IV. Debits and Credits

A. The *left* side of an account is called the *debit* side. A debit is an entry on the left side of an account.

B. The *right* side of an account is called the *credit* side. A credit is an entry on the right side of an account.

C. Accounts are *assigned balance sides* based on their classification or type.

D. 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*.

E. 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 two sides are equal the account has a zero balance.

V. Double-Entry Accounting—requires that each transaction affect, and be recorded in, at least two accounts. The total debits must equal total credits for each transaction.

A. The assignment of balance sides (debit or credit) follows the accounting equation.

1. *Assets* are on the *left side* of the equation; therefore, the left, or *debit,* side is the normal balance for assets.
2. *Liabilities and equities* are on the *right side;* therefore, the right, or credit, side is the normal balance for liabilities and equity.
3. *Withdrawals, 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.

B. Three important rules for recording transactions in a double-entry accounting system are:

1. Increases to assets are debits to the asset accounts. Decreases to assets are credits to the asset accounts.
2. Increases to liabilities are credits to the liability accounts. Decreases to liabilities are debits to the liability accounts.
3. Increases to equity are credits to the equity accounts. Decreases to equity are debits to the equity accounts.

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VI. Journalizing and Posting Transactions

A. Four steps in processing transactions are as follows:

Journalizing--The process of recording each transaction in a journal.

1. Analyze transaction and source documents.
2. Apply double-entry accounting. (Determine account to be debited and credited.)
3. Journalize—record each transaction in a journal. (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. Posting—transfer (or *post*) each entry from journal to 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 Taccounts 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.

VII. Trial Balance

A. A *trial balance* is a list of accounts and their balances at a point in time.

B. The purpose of the trial balance is to summarize the ledger accounts to simplify the task of preparing the financial statements. It also tests for the equality of the debit and credit account balances as required by double-entry accounting.

C. Three steps to prepare a trial balance are as follows:

1. List each account and its amount (from the ledger).
2. Compute the total debit balances and the total credit balances.
3. Verify (prove) total debit balances equal total credit balances.

D. When a trial balance does not balance (the columns are not equal), an error has occurred in one of the following steps:

1. Preparing the journal entries.
2. Posting the journal entries to the ledger.
3. Calculating account balances.
4. Copying account balances to the trial balance.
5. Totaling the trial balance columns.

(***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)

VIII. 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 (non-owners), or liability financing. The higher this ratio, the more risk a company faces, because liabilities must be repaid and often require regular interest payments.