A. Accounts

LO1 – Describe asset, liability, and equity accounts, identifying the effect of debits and credits on each.

Previous chapter reviewed the analysis of financial transactions and the resulting impact on the accounting equation. We now expand that discussion by introducing the way transaction is recorded in an *account*. An **account** accumulates detailed information regarding the increases and decreases in a specific asset, liability, or shareholders' equity item. Accounts are maintained in a **general ledger**. We now review and expand our understanding of asset, liability, and shareholders' equity accounts.

A.1 Asset Accounts

Recall that assets are resources that have future economic benefits for the business. The primary purpose of assets is that they be used in day-to-day operating activities in order to generate revenue either directly or indirectly. A separate account is established for each asset. Examples of asset accounts are reviewed below.

- Cash has future purchasing power. Coins, currency, cheques, and bank account balances are examples of cash.

- Accounts receivable occur when products or services are sold on account (or "on credit"). When a sale occurs on account or on credit, the customer has not paid cash but promises to pay in the future.

- **Notes receivable** are formal promises to pay accounts receivable on a specific future date along with a predetermined amount of interest.

- **Unused supplies** are things like paper, staples, and other business stock to be used in the future. If the supplies are used before the end of the accounting period or immaterial in amounts, they are considered an expense of the period rather than an asset.

- **Merchandize inventory** are items to be sold in the future.

- *Prepaid insurance* represents an amount paid in advance for insurance. The prepaid insurance will be used in the future.

- *Prepaid rent* represents an amount paid in advance for rent. The prepaid rent will be used in the future.

- **Buildings** indirectly help a business generate revenue over future accounting periods since they provide space for day-to-day operating activities.

- **Land** cost must be in a separate account from any building that might be on the land. Land usually has an indefinite useful life.

A.2 Liability Accounts

As explained in previous chapter, a liability is an obligation settled in time through the transfer of economic benefits like cash. One purpose of liabilities is to finance the purchase of assets like land, buildings, and equipment. Liabilities are also used to finance day-to-day operating activities. Examples of liability accounts are reviewed below.

- Accounts payable are debts owed to suppliers for goods purchased or services received as a result of day-to-day operating activities. An example of a service received on credit might be a plumber billing the business for a repair.

- **Wages payable** are wages owed to employees for work performed but not paid at the statement of financial position date.

- **Bank loans** are debts owed to a bank or other financial institution.

- **Unearned revenues** are payments received in advance of the product or service being provided. If a customer pays $1,000 for an automobile repair to be done in the next accounting period, this is recorded as a liability.

A.3 Shareholders' Equity Accounts

Previous chapter explained that shareholders' equity represents the net assets owned by the owners of a corporation. There are five different types of shareholders' equity accounts: share capital, retained earnings, dividends, revenues, and expenses. Share capital represents the investments made by owners into the business and causes shareholders' equity to increase. Retained earnings is the sum of all net incomes earned over the life of the corporation to date, less any dividends distributed to shareholders over the same time period. Therefore, the Retained Earnings account includes revenues, which cause shareholders' equity to increase, along with expenses and dividends, which cause shareholders' equity to decrease. Figure 2-1 summarizes shareholders' equity accounts.

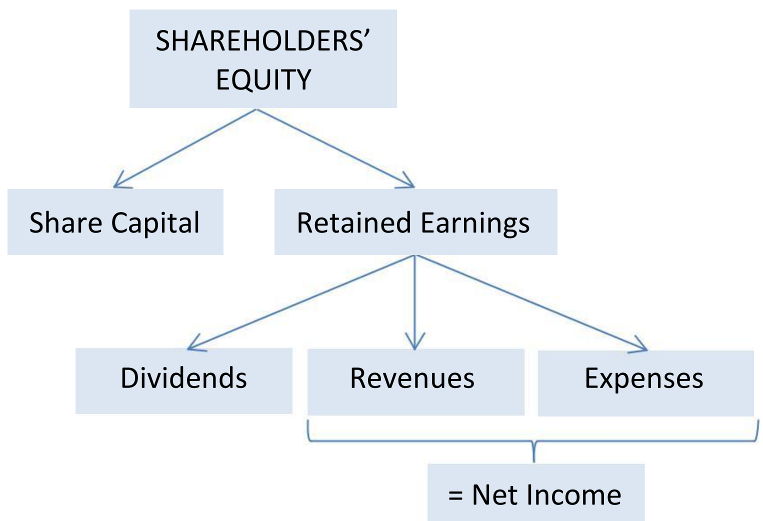

Figure 2-1 Composition of Shareholders' Equity

A.4 T-accounts

A simplified account, called a **T-account**, is often used as a learning tool to show increases and decreases in an account. It is called a T-account because it resembles the letter *T*. As shown in the T-account below, the left side records **debit** entries and the right side records **credit** entries.

Account Name	
Debit (always on left)	Credit (always on right)

The *type* of account determines whether an increase or a decrease in a particular transaction is represented by a debit or credit. For financial transactions that affect *assets*, *dividend*s, and *expenses,* increases are recorded by debits and decreases by credits. This guideline is shown in the following T-account.

Assets, Dividends, Expenses	
Debits are always increases ↑	Credits are always decreases ↓

For financial transactions that affect *liabilities, share capital,* and *revenues*, increases are recorded by credits and decreases by debits, as follows:

Liabilities, Revenues, Share Capital	
Debits are always decreases ↓	Credits are always increases ↑

	Assets	=	Liabilities	+	S/H Equity
Increases are recorded as:	Debits		Credits		Credits*
Decreases are recorded as:	Credits		Debits		Debits**

* Revenue and share capital transactions cause shareholders' equity to increase, so they are recorded as credits.

**Expense and dividend transactions cause shareholders' equity to decrease, so they are recorded as debits.

The following summary shows how debits and credits are used to record increases and decreases in various types of accounts.

ASSETS DIVIDENDS EXPENSES	LIABILITIES SHARE CAPITAL
Increases are DEBITED	Increases are CREDITED
Decreases are CREDITED	Decreases are DEBITED

This summary will be used in a later section to illustrate the recording of debits and credits regarding the transactions of Big Dog Carworks Corp. introduced in previous chapter.

The **account balance** is determined by adding and subtracting the increases and decreases in an account as shown below:

Cash

Debit	*Credit*
10,000	4,000
3,000	2,000
400	2,400
Balance 5,000	

Accounts Payable

Debit	*Credit*
700	5,000
Balance	4,300

The $5,000 debit balance in the Cash account was calculated by adding all the debits and subtracting the credits (10,000 + 3,000 + 400 – 4,000 – 2,000 – 2,400). The $5,000 is recorded on the debit side of the T-account because the debits are greater than the credits. In Accounts Payable, the balance is a $4,300 credit calculated by subtracting the debits from the credits (5,000 – 700).

Notice that Cash shows a debit balance while Accounts Payable shows a credit balance. The Cash account is an asset so its *normal balance* is a debit. A **normal balance** is the side on which increases occur. Accounts Payable is a liability and because liabilities increase with credits, the normal balance in Accounts Payable is a credit as shown in the T-account above.

A.5 Chart of Accounts

A business will create a list of accounts called a **chart of accounts** where each account is assigned both a name and a number. A common practice is to have the accounts arranged in a manner that is compatible with the order of their use in financial statements. For instance, Asset accounts may begin with the digit '1', liability accounts with the digit '2', and shareholders' equity accounts (excluding revenues and expenses) with the digit '3'. Each business will have a unique chart of accounts that corresponds to its specific needs. Assume Big Dog Carworks Corp. uses the following numbering system for its accounts:

100-199	Asset accounts
200-299	Liability accounts
300-399	Share capital, retained earnings, and dividend accounts
400-499	Revenue accounts
600-699	Expense accounts

B. The Trial Balance

LO2 – Prepare a trial balance, explain its use, and prepare financial statements from it.

To help prove that the accounting equation is in balance, a trial balance is normally prepared instead of the T-account listing shown in the previous section. A **trial balance** is an internal document that lists all the account balances at a point in time. The total debits must equal total credits on the trial balance. The form and content of a trial balance is illustrated below, using the account numbers, account names, and account balances of Big Dog Carworks Corp. at January 31, 2017. Assume that the account numbers are those assigned by the business.

Big Dog Carworks Corp.
Trial Balance

Acct. No.	*Account*	*Account balances* Debit	Credit
101	Cash	$6,200	
110	Accounts receivable	2,500	
161	Prepaid insurance	2,400	
183	Equipment	3,000	
184	Truck	8,000	
201	Bank loan		$9,000
210	Accounts payable		700
247	Unearned repair revenue		400
320	Share capital		10,000
350	Dividends	200	
450	Repair revenue		10,000
654	Rent expense	1,600	
656	Salaries expense	4,000	
668	Supplies expense	1,500	
670	Truck operating expense	700	
		$30,100	$30,100

Double-entry accounting requires that debits equal credits. The trial balance establishes that this equality exists for Big Dog but it does not ensure that each item has been recorded in the proper account. Neither does the trial balance ensure that all items that should have been entered have been entered. In addition, a transaction may be recorded twice. Any or all of these errors could occur and the trial balance would still balance. Nevertheless, a trial balance provides a useful mathematical check before preparing financial statements.

Preparation of Financial Statements

Financial statements for the one -month period ended January 31, 2017 can now be prepared from the trial balance figures.

Big Dog Carworks Corp.
Trial Balance
At January 31, 2017

Acct. No.		*Account Balances* *Debit*	*Credit*
101	Cash	$ 6,200	
110	Accounts receivable	2,500	
161	Prepaid insurance	2,400	
183	Equipment	3,000	
184	Truck	8,000	
201	Bank loan		$ 9,000
210	Accounts payable		700
247	Unearned repair revenue		400
320	Share capital		10,000
350	Dividends	200	
450	Repair revenue		10,000
654	Rent expense	1,600	
656	Salaries expense	4,000	
668	Supplies expense	1,500	
670	Truck operating expense	700	
		$30,100	$30,100

Big Dog Carworks Corp.
Income Statement
For the Month Ended Jan. 31, 2017

Revenue		
Repairs		$10,000
Expenses		
Rent	1,600	
Salaries	4,000	
Supplies	1,500	
Truck operating	700	
Total expenses		7,800
Net income		$2,200

First, an income statement is prepared for January. Expenses are deducted from revenue to measure the amount of net income for January.

Second, net income is transferred to the statement of changes in equity as part of retained earnings.

Third, share capital and dividend amounts are transferred to the statement of changes in equity. Dividends reduce retained earnings. They are distributions of net income to owners.

Big Dog Carworks Corp.
Statement Of Changes In Equity
For the Month Ended January 31, 2017

	Share capital	*Retained earnings*	*Total equity*
Balance, January 1, 2017	$ -0-	$ -0-	$ -0-
Shares issued	10,000		10,000
Net income		2,200	2,200
Dividends		(200)	(200)
Balance, January 31, 2017	$10,000	$ 2,000	$12,000

Fourth, the columns are totaled and carried forward to the applicable section of the statement of financial position (see next page).

The asset and liability accounts from the trial balance and the ending balances for share capital and retained earnings on the statement of changes in equity are used to prepare the statement of financial position.

These accounts are used to prepare the statement of financial position.

The share capital and retained earnings balances are transferred to the statement of financial position from the statement of changes in equity.

Big Dog Carworks Corp.
Trial Balance
At January 31, 2017

Acct. No.		Account Balances Debit	Credit
101	Cash	$ 6,200	
110	Accounts receivable	2,500	
161	Prepaid insurance	2,400	
183	Equipment	3,000	
184	Truck	8,000	
201	Bank loan		$ 9,000
210	Accounts payable		700
247	Unearned repair revenue		400
320	Share capital		10,000
350	Dividends	200	
450	Repair revenue		10,000
654	Rent expense	1,600	
656	Salaries expense	4,000	
668	Supplies expense	1,500	
670	Truck operating expense	700	
		$30,100	$30,100

Big Dog Carworks Corp.
Statement of Financial Position
At January 31, 2017

Assets		
Cash	$ 6,200	
Accounts receivable	2,500	
Prepaid insurance	2,400	
Equipment	3,000	
Truck	8,000	
Total assets		$22,100
Liabilities		
Bank loan	$ 9,000	
Accounts payable	700	
Unearned repair rev.	400	$10,100
Shareholders' Equity		
Share capital	$10,000	
Retained earnings	2,000	12,000
Total liabilities and shareholders' equity		$22,100

Note the links between financial statements:

The income statement is linked to the statement of changes in equity. Revenues and expenses are reported on the income statement to show the details of net income. Because net income causes shareholders' equity to change, it is then reported on the statement of changes in equity.

The statement of changes in equity is linked to the statement of financial position. The statement of changes in equity shows the details of how shareholders' equity changed during the accounting period. The balances for share capital and retained earnings that appear on the statement of changes in equity are transferred to the shareholders' equity section of the statement of financial position.

The statement of financial position summarizes shareholders' equity. It shows only account balances for share capital and retained earnings. To obtain the details regarding these shareholders' equity accounts, we must look at the income statement and the statement of changes in equity.

C. Using Formal Accounting Records

LO3 – Record transactions in a general journal and post them to a general ledger.

The preceding analysis of financial transactions used T-accounts to record debits and credits. T-accounts will continue to be used for illustrative purposes throughout this book. In actual practice, financial transactions are recorded in a **general journal**.

A general journal is a document that is used to chronologically record a business's debit and credit transactions (see Figure 2-2). It is often referred to as the *book of original entry*. **Journalizing** is the process of recording a financial transaction in the journal. The resulting debit and credit entry recorded in the journal is called a **journal entry**.

A **general ledger** is a record that contains all of a business's accounts. **Posting** is the process of transferring amounts from the journal to the matching ledger accounts. Because amounts recorded in the journal eventually end up in a ledger account, the ledger is sometimes referred to as a *book of final entry*.

C.1 Recording Transactions in the General Journal

Each transaction is first recorded in the journal. The January transactions of Big Dog Carworks Corp. are recorded in its journal as shown in Figure 2-2. The journalizing procedure follows these steps (refer to Figure 2-2 for corresponding numbers):

1. The year is recorded at the top and the month is entered on the first line of page 1. This information is repeated only on each new journal page used to record transactions.
2. The date of the first transaction is entered in the second column, on the first line. The day of each transaction is always recorded in this second column.
3. The name of the account to be debited is entered in the description column on the first line. By convention, accounts to be debited are usually recorded before accounts to be credited. The column titled Folio indicates the number given to the account in

the General Ledger. For example, the account number for Cash is 101. The amount of the debit is recorded in the debit column.

4. The name of the account to be credited is on the second line of the description column and is indented about one centimeter into the column. Accounts to be credited are always indented in this way in the journal. The amount of the credit is recorded in the credit column.

5. An explanation of the transaction is entered in the description column on the next line. It is not indented.

6. A line is usually skipped after each journal entry to separate individual journal entries and the date of the next entry recorded. It is unnecessary to repeat the month if it is unchanged from that recorded at the top of the page.

GENERAL JOURNAL — Page 1

	Date 2017		Description	Folio	Debit	Credit
1	Jan.	1	Cash	101	10,000	
2			Share Capital	320		10000
			To record share capital issued.			
3		2	Cash	101	4,000	
4			Bank Loan	201		4,000
5			To record receipt of bank loan.			
6						
		2	Equipment	183	3,000	
			Cash	101		3,000
			To record purchase of equipment for cash.			
		3	Truck	184	8,000	
			Bank Loan	201		7,000
			Cash	101		1,000
			To record purchase of a tow truck; paid cash and incurred additional bank loan.			
		5	Prepaid Insurance	161	2,400	
			Cash	101		2,400
			To record payment for one-year			

		insurance policy.			
	10	Bank Loan	201	2,000	
		Cash	101		2,000
		To record payment on bank loan.			
	15	Cash	101	400	
		Unearned Repair Revenue	247		400
		To record receipt of cash for services that will not be performed in January.			
	31	Cash	101	7,500	
		Accounts Receivable	110	2,500	
		Repair Revenue	450		10,000
		To record repair revenue earned in January.			
	31	Rent Expense	654	1,600	
		Salaries Expense	656	4,000	
		Supplies Expense	668	1,500	
		Truck Operating Expense	670	700	
		Cash	101		7,100
		Accounts Payable	210		700
		To record payment of expenses for January.			
	31	Dividends	350	200	
		Cash	101		200
		To record payment of dividends.			

Figure 2–2 January General Journal Transactions for BDCC

Most of Big Dog's entries have one debit and credit. An entry can also have more than one debit or credit, in which case it is referred to as a **compound entry**. The entry dated January 3 is an example of a compound entry.

C.2 Posting Transactions to the General Ledger

The **ledger account** is a formal variation of the T- account. The ledger accounts shown in Figure 2-3 are similar to what is used in electronic/digital accounting programs. Ledger accounts are kept in the general ledger. Debits and credits recorded in the journal are transferred or “posted” to appropriate ledger accounts so that the details and balance for each account can be found easily. Figure 2-3 uses the first transaction of Big Dog Carworks Corp. to illustrate how to post amounts and record other information. The posting procedure follows these steps (refer to Figure 2-3 for corresponding numbers):

1. The date is recorded in the appropriate general ledger account.
2. The general journal page number is recorded in the Folio column of each ledger account as a cross reference. In this case, the posting has been made from general journal page 1 so the reference is recorded as “GJ1”.
3. The debit and credit amounts from the general journal are posted to the debit or credit columns in the appropriate general ledger account. Here the entry debiting Cash is posted to the Cash ledger account. The entry crediting share capital is then posted to the Share Capital general ledger account.
4. After posting the entry, a balance is calculated in the Balance column of each general ledger account. A notation is recorded in the column to the left of the Balance column indicating whether the balance is a debit (DR) or credit (CR). A brief description can be entered in the Description column of the account but this is usually not necessary since the journal includes a detailed description for each journal entry.

GENERAL JOURNAL Page 1

Date 2017		Description	Folio	Debit	Credit
Jan.	1	Cash	101	10,000	
		Share Capital	320		10000
		To record share capital issued.			

The general journal records each financial transaction in double-entry form. Each side of the entry is posted to a separate ledger account.

2

1

GENERAL LEDGER 3

Cash Acct. No. 101

Date 2017		Description	Folio	Debit	Credit		Balance
Jan.	1		GJ1	10,000		DR	10,000

4

The general ledger stores transactions according to account and keeps a running total of each account balance.

GENERAL LEDGER

Share Capital Acct. No. 320

Date 2017		Description	Folio	Debit	Credit		Balance
Jan.	1		GJ1		10,000	CR	10,000

4

Figure 2–3 Illustration of a Transaction Posted to Two Accounts in the General Ledger

This manual process of recording, posting, summarizing, and preparing financial statements is cumbersome and time-consuming. In virtually all businesses, the use of accounting software automates much of the process. In this and subsequent chapters, either the T-account or the general ledger account format will be used to explain and illustrate concepts.