

Chapter 3 Recording Business Transactions

Topics:

- Double entry system
- Journal entries
- Ledger Accounts
- Trial Balance

Double Entry System of Accounting:

The double entry system of accounting is a system in which two-fold aspect of each and every mercantile transaction in money or money's worth is recorded. This system recognizes the fundamental fact that a transaction is a double-sided affair. In fact, every debit must have its corresponding credit under double entry system.

Rules for determining Debit and Credit:

Assets:	Increase...Debit Decrease.....Credit.
Expenses:	Increase...Debit Decrease.....Credit
Liabilities:	Decrease ...Debit IncreaseCredit
Capital:	Decrease ...Debit IncreaseCredit
Revenues:	Decrease ...Debit IncreaseCredit

Debit: Left-hand side of an account.

Credit: Right-hand side of an account.

Debit balance: The balance of an account in which the total amount of debits exceeds the total amount of credits.

Credit balance: The balance of an account in which the total amount of credits exceeds the total amount of debits.

Journal: A journal is a chronological record of the entity's transactions. The very first process of accounting is to record the business transactions chronologically (according to date), by analyzing debit and credit, with interpretation as soon as they take place in the books of original entry.

Recording process: The recording process follows five steps, which are:

1. Identify the transaction from source documents, such as bank deposit slips, sales receipts, and check stubs.
2. Specify each account affected by the transaction and classify it by type (assets, liability, or owner's equity).
3. Determine whether each account is increased or decreased by the transaction.
4. Using the rules of debit and credit, determine whether to debit or credit the account.
5. Enter the transaction in the journal, including a brief explanation for the journal entry.

Ledger: The entire group of accounts maintained by a company, including all the asset, liability and owner's equity accounts is referred to collectively as the ledger. The ledger keeps in one place all the information about changes in specific account balances.

After recording transactions in journal these are transferred to a principal book, which is called ledger. Companies may use various kinds of ledgers, but every company has a general ledger. A **general ledger** contains all the assets, liabilities, and owner's equity accounts.

Trial Balance: A trial balance is a list of accounts and their balances at a given time. It is prepared at the end of the accounting period to prove that the debits equal the credits after posting.

A Trial Balance is not a conclusive proof of accuracy.—Do you agree? Why?

Or, Limitations of Trial Balance.

A Trial Balance is not a conclusive proof of the arithmetical accuracy of the postings. Because, the trial may agree in both side and yet there may be some errors in the books remaining undisclosed. The errors may be:

a) **Clerical errors:**

- 1) **Errors of omission:** A transaction is not journalized, or journalized but not posted in ledger.
- 2) **Errors of commission:** A wrong entry in the original book entered Tk.500 instead of Tk.5000.
- 3) **Errors of posting:** If a transaction has been transferred to Rahman's A/C instead of Rahim's A/C.
- 4) **Compensating error:** Some errors arise from the over-debits or under-debits of account being neutralized by the over-credits or under-credits to the same extent of some other account.

b) **Errors of Principle:** Journalizing revenue expenses/income as capital expenses/ income or vice-versa.

Example:

- 1) Livon invested \$50,000 cash and \$30000 furniture in the business.
- 2) Paid \$40,000 cash for Land.
- 3) Purchased \$500 of Office Supplies on account.
- 4) Received \$5,500 cash from clients for accounting service revenue earned.
- 5) Performed accounting service for a client on account, \$3,000.

Livon's Journal Entries

Date	Particulars	Ref.	Debit	Credit
1	Cash account Furniture account Livon's Capital account (investment of cash and furniture)		50000 30000	80000
2	Land account Cash account (paid for land)		40000	40000
3	Office supplies account Account payable account (purchased office supplies on account)		500	500
4	Cash account Service revenue account (received cash revenue)		5500	5500
5	Account receivable account Service revenue account		3000	3000

Livon's Ledger Accounts

Cash account

Date	Accounts	Ref.	Debit	Credit	Balance	
					Debit	Credit
	Beginning balance				-	
1	Capital account		50000		50000	
2	Land account			40000	10000	
4	Service revenue account		5500		15500	

Furniture account

Date	Accounts	Ref.	Debit	Credit	Balance	
					Debit	Credit
1	Capital account		30000		30000	

Capital account

Date	Accounts	Ref.	Debit	Credit	Balance	
					Debit	Credit
1	Cash account Furniture account			50000 30000		80000

Land account

Date	Accounts	Ref.	Debit	Credit	Balance	
					Debit	Credit
2	Cash account		40000		40000	

Office supplies account

Date	Accounts	Ref.	Debit	Credit	Balance	
					Debit	Credit
3	Account payable account		500		500	

Account payable account

Date	Accounts	Ref.	Debit	Credit	Balance	
					Debit	Credit
3	Office supplies account			500		500

Service revenue account

Date	Accounts	Ref.	Debit	Credit	Balance	
					Debit	Credit
4	Cash account			5500		5500
5	Account receivable acc.			3000		8500

Account receivable account

Date	Accounts	Ref.	Debit	Credit	Balance	
					Debit	Credit
5	Service revenue account		3000		3000	

Livon's Trial Balance

Date.....

SL	Accounts	Ref.	Debit	Credit
1	Cash account		15500	
2	Furniture account		30000	
3	Capital account			80000
4	Land account		40000	
5	Office supplies account		500	
6	Account payable account			500
7	Service revenue account			8500
8	Account receivable account		3000	
	Total		89000	89000

Problem 1: Try yourself

Ahmed Hisham started a cable television service organization in 2018. During the first week of operations completed the following selected transactions:

- Jan. 1 Investment of \$30,000 cash and a building valued at \$70,000.
 „ 2 Borrowed \$85,000 from the bank signing a note payable.
 „ 3 Paid \$50,000 for office furniture.
 „ 5 Purchased office supplies on account, \$1200.
 „ 7 Received \$5,000 for cable TV service performed for customers.
 “ 8 Paid on account \$700

Required:

- Journalize the above transactions.
- Post the Journal entries to the ledger.
- Prepare a Trial Balance.

SL	Accounts	Ref.	Debit	Credit
1	Cash account		69300	
2	Building account		70000	
3	Capital account			100000
4	Note payable account			85000
5	Office furniture account		50000	
6	Office supplies acc.		1200	
7	Account payable account			500
8	Service revenue account			5000
	Total		<u>190500</u>	<u>190500</u>

Problem 2: Try yourself

Shanta Reed owns and operates an interior design studio called “Shanta Interiors”. The following amounts summarize the financial position of her business on March 31, 2007:

<u>Assets</u>				<u>= Liabilities + Owner's Equity</u>	
Cash + A / R + Supplies + Land				=	A / P + Shanta's Capital
Bal.	1,250	1,500	12,000	8,000	6,750

During April 2007, the following transactions occurred:

- Shanta invested \$ 15,000 in the business.
- Performed services for a client and received cash of \$800.
- Paid off the beginning balance of Accounts Payable.
- Purchased supplies on account, \$500.
- Collected cash from a client on account, \$1,000.
- Consulted on the interior design of a major office building and billed the client for the service rendered, \$2,500.
- Recorded the following business expenses for the month:
 - Paid office rent ----\$400.
 - Paid advertising --- \$300.
 - Paid utilities ----- \$300.
- Sold supplies to another business for \$ 150 cash, which was the cost of the supplies.
- Purchased a Land for \$8,000; cash paid \$3,000 and the balance will be paid in the next month.
- Withdraw cash of \$1,500 for personal use.

Required:

- Journalize the above transactions.
- Post the Journal entries to the ledger.
- Prepare a Trial Balance.