



This is “How Does an Organization Accumulate and Organize the Information Necessary to Create Financial Statements?”, chapter 4 from the book [Business Accounting \(index.html\)](#) (v. 2.0).

This book is licensed under a [Creative Commons by-nc-sa 3.0](http://creativecommons.org/licenses/by-nc-sa/3.0/) license. See the license for more details, but that basically means you can share this book as long as you credit the author (but see below), don't make money from it, and do make it available to everyone else under the same terms.

This content was accessible as of December 29, 2012, and it was downloaded then by [Andy Schmitz](#) (<http://lardbucket.org>) in an effort to preserve the availability of this book.

Normally, the author and publisher would be credited here. However, the publisher has asked for the customary Creative Commons attribution to the original publisher, authors, title, and book URI to be removed. Additionally, per the publisher's request, their name has been removed in some passages. More information is available on this project's [attribution page](http://2012books.lardbucket.org/attribution.html?utm_source=header).

For more information on the source of this book, or why it is available for free, please see [the project's home page](#) (<http://2012books.lardbucket.org/>). You can browse or download additional books there.

Chapter 4

How Does an Organization Accumulate and Organize the Information Necessary to Create Financial Statements?

Video Clip

[\(click to see video\)](#)

In this video, Professor Joe Hoyle introduces the essential points covered in [Chapter 4 "How Does an Organization Accumulate and Organize the Information Necessary to Create Financial Statements?"](#).

4.1 The Essential Role of Transaction Analysis

LEARNING OBJECTIVES

At the end of this section, students should be able to meet the following objectives:

1. Define “transaction” and provide several common examples.
2. Define “transaction analysis” and explain its importance to the accounting process.
3. Identify the account changes created by the purchase of inventory, the payment of a salary, and the borrowing of money.
4. Understand that corporate accounting systems can be programmed to record expenses such as salary automatically as they accrue.

The Nature of a Transaction

Question: Information provided by a set of financial statements is essential to any individual analyzing a business or other organization. The availability of a fair representation of a company’s financial position, operations, and cash flows is invaluable for a wide array of decision makers. However, the sheer volume of data that a business such as General Mills, McDonald’s, or PepsiCo must gather in order to prepare these statements has to be astronomical. Even a small enterprise—a local convenience store, for example—generates a significant quantity of information virtually every day. How does an accountant begin the process of accumulating all the necessary data so that financial statements can be produced and distributed to decision makers?

*Answer: The accounting process starts by analyzing the effect of **transactions**¹—any event that has an immediate financial impact on a company. Large organizations participate in literally millions of transactions each year. The resulting information must be gathered, sorted, classified, and turned into a set of financial statements that cover a mere four or five pages. Over the decades, accountants have had to become very efficient to fulfill this seemingly impossible assignment. Despite the volume of transactions, the goal remains the same: to prepare financial statements that are presented fairly because they contain no material misstatements according to U.S. GAAP or IFRS.*

1. Events that have a financial impact on an organization; information on the resulting changes must be gathered, sorted, classified, and turned into financial statements by means of an accounting system.

For example, all the occurrences listed in [Figure 4.1 "Transactions Frequently Encountered by a Business"](#) are typical transactions that any business might encounter. Each causes some measurable effect on the company's assets, liabilities, revenues, expenses, gains, losses, capital stock, or dividends paid. The accounting process begins with an analysis of each transaction to determine the specific financial changes that took place. Was revenue earned? Did a liability increase? Has an asset been acquired? What changed as a result of this event?

Figure 4.1 Transactions Frequently Encountered by a Business

- 1—Buy inventory on credit for \$2,000
- 2—Pay regular salary of \$300 to an employee for work done during the past week; no amount had previously been recorded
- 3—Borrow \$9,000 in cash from bank by signing a loan agreement
- 4—Make a sale of the inventory bought in (1) to a customer for \$5,000 on credit
- 5—Pay \$700 for insurance coverage for the past few months; this amount has previously been recognized in the company's accounting system as it was incurred
- 6—Buy a new automobile for the company for a price of \$40,000 by paying \$10,000 in cash and signing a note for the remainder
- 7—Issue ownership shares to a new stockholder for cash of \$19,000
- 8—Collect cash from customer on earlier sale in (4)
- 9—Pay cash for the inventory acquired in (1)
- 10—Pay \$4,000 to rent a building for the next four months

In any language, successful communication is only possible if the information to be conveyed is properly understood. Likewise, in accounting, transactions must be analyzed so that their impact is understood. A vast majority of transactions are relatively straightforward so that, with experience, the accountant can ascertain the financial impact almost automatically. Within this process, each individual asset, liability, revenue, expense, and the like is referred to as an account. For example, rent expense and salary expense are both expense accounts. The monetary amount attributed to an account is known as an account balance.

For transactions with greater complexity, the necessary analysis becomes more challenging. However, the importance of this initial step in the production of financial statements cannot be overstressed. The well-known computer aphorism captures the essence quite succinctly: "garbage in, garbage out." There is little hope that financial statements can be fairly presented unless the entering information is based on an appropriate identification of the changes in account balances created by each transaction.

TEST YOURSELF

Question:

Each of the following events took place this week in connection with the operations of the Hammond Corporation. Which does not qualify as a transaction?

- a. An employee is hired who will be paid \$1,000 per month.
- b. Inventory is bought on account for \$2,000 with payment to be made next month.
- c. An owner invests \$3,000 cash in the business to receive capital stock.
- d. A truck is bought for \$39,000 by signing a note payable.

Answer:

The correct answer is choice a: An employee is hired who will be paid \$1,000 per month.

Explanation:

A transaction is any event that has a financial impact on an organization. The purchase of inventory increases that asset and the company liabilities. The investment increases the company's cash. The acquisition of the truck raises the assets as well as the note payable. However, hiring an employee is not, by itself, a transaction because there is no financial impact at that time. There will be an impact only after the person has done work and earned a salary.

Analyzing the Impact of a Transaction

Question: Transaction 1—A company buys inventory on credit for \$2,000. How does transaction analysis work here? What accounts are affected by the purchase of merchandise?

Answer: Inventory, which is an asset, increases by \$2,000 because of the purchase. The organization has more inventory than it did previously. Because no money was paid for these goods when bought, a liability for the same amount has been created.

The term **accounts payable**² is often used in financial accounting to represent debts resulting from the acquisition of inventory and supplies.

Transaction 1: Inventory Purchased on Credit

Inventory (asset) increases by \$2,000

Accounts Payable (liability) increases by \$2,000

Note that the accounting equation described in the previous chapter remains in balance here. Assets have gone up by \$2,000 while the liability side of the equation has also increased by the same amount to reflect the source of this increase.

TEST YOURSELF

Question:

A company incurred a transaction where its assets as well as its liabilities increased. Which of the following transactions does not result in this impact?

- a. Money is borrowed from a bank.
- b. A sale is made to a customer for cash.
- c. Supplies are bought and will be paid for next week.
- d. A truck is bought by signing a note payable.

Answer:

The correct answer is choice b: A sale is made to a customer for cash.

Explanation:

In all four of these cases, assets increase. Cash goes up in the first two, while supplies and a truck increase assets in the last two, respectively. The company owes the bank in A and the supplier in C. In D, the company has a liability to the party that provided the money for the truck. In B, there is no debt or other obligation to any party.

2. Short-term liabilities to pay for goods and services that have been acquired on credit.

The Financial Impact of Paying an Employee

Question: Transaction 2—A company pays a salary of \$300 to one of its employees for work performed during the past week. No amount had previously been recorded by the accounting system for this amount. What accounts are affected by payment of a salary?

Answer: Cash (an asset) is decreased here by \$300. Whenever cash is involved in a transaction, identifying that change is a good place to start the analysis. Increases and decreases in cash are often obvious.

The cash balance declined because salary was paid to an employee. Assets were reduced as a result of the payment. That is a cost to the company. Recognizing an expense as a result is appropriate rather than an asset because the employee's work reflects a past benefit. The person's effort has already been carried out, generating revenues for the company in the previous week rather than in the future. Thus, a salary expense of \$300 is reported.

Transaction 2: Salary Paid to Employee

Salary Expense (expense) increases by \$300

Cash (asset) decreased by \$300

The continued equilibrium of the accounting equation does exist here although it is less apparent. Assets are decreased. At the same time, an expense is recognized. This expense reduces reported net income. On the statement of retained earnings, current net income becomes a component of retained earnings. The reduction in income serves to decrease retained earnings. An expense ultimately reduces reported retained earnings. Because both assets and retained earnings go down by the same amount as a result of this transaction, the accounting equation continues to balance.

Recording Accrued Expenses

Question: In Transaction 2, the company paid a salary of \$300 that it owed to a worker. Why does a payment to an employee not always reduce a salary payable balance?

Answer: Costs such as salary, rent, or interest increase gradually over time and are often referred to as **accrued expenses** because the term “accrue” means “to grow.” How should the very slow growth of an expense be recognized? An accounting system can be mechanically structured to record such costs in either of two ways. On the financial statements, reported results are the same but the steps in the process differ.

- Some companies simply ignore accrued expenses until paid. At that time, the expense is recognized and cash is reduced. No liability is entered into the accounting system or removed. Because the information provided specifies that nothing has been recorded to date, this approach was apparently used here. When financial statements are produced, any amount that is still owed must be recognized for a fair presentation.
- Other companies choose to program their computer systems so that both the expense and the related liability are recognized automatically as the amount grows. For salary, as an example, this increase could literally be recorded each day or week based on the amount earned by employees. At the time payment is finally conveyed, the expense has already been recorded. Thus, the liability is removed because that debt is being settled. Later, in Transaction 5, this second possible approach to recording accrued expenses is illustrated.

A company can recognize an accrued expense (such as a salary) as it is incurred or wait until payment is made. This decision depends on the preference of company officials. The end result (an expense is reported and cash decreased) is the same, but the recording procedures differ. As mentioned, if no entry has been made prior to the production of financial statements (the first alternative), both the expense and the payable have to be recognized at that time so that all balances are properly included for reporting purposes.

TEST YOURSELF

Question:

The Abraham Company rents a building for \$4,000 per month with payment being made on the tenth day following that month. The accounting system is organized so that the expense and liability are recorded throughout the month. In that way, the accounting records are kept up to date. However, when the appropriate payment was made for November on December 10 of the current year, the accountant increased the rent expense and decreased cash. Which of the following statements is true in connection with this recording?

- a. Reported expenses are understated by \$4,000.
- b. Net income is understated by \$4,000.
- c. Liabilities are understated by \$4,000.
- d. All account balances are stated properly.

Answer:

The correct answer is choice b: Net income is understated by \$4,000.

Explanation:

Because the expense and the liability have already been recorded as incurred in November, the accountant should have decreased the liability rather than increased the expense when payment was made. The liability balance was not properly reduced; it is overstated. The expense was erroneously increased, so it is overstated. Simply stated, the expense was recorded twice and is overstated by \$4,000. That causes reported net income to be understated by that amount.

Borrowing Money from the Bank

Question: Transaction 3—A company borrows \$9,000 from a bank on a long-term note. What is the financial impact of signing a loan agreement with a bank or other lending institution?

Answer: In this transaction, cash is increased by the amount of money received from the lender. The company is obligated to repay this balance and, thus, has incurred a new liability. As with many common transactions, the financial impact is reasonably easy to ascertain.

Transaction 3: Money Borrowed on Loan

Cash (asset) increases by \$9,000

Note Payable (liability) increases by \$9,000

KEY TAKEAWAY

Most organizations must gather an enormous quantity of information as a prerequisite for the periodic preparation of financial statements. This process begins with an analysis of the impact of each transaction (financial event). After the effect on all account balances is ascertained, the recording of a transaction is relatively straightforward. The changes caused by most transactions—the purchase of inventory or the signing of a note, for example—can often be determined quickly. For accrued expenses, such as salary or rent that grow over time, the accounting system can record the amounts gradually as incurred or only at the point of payment. However, the figures to be reported on the financial statements are not impacted by the specific mechanical steps that are taken.

4.2 Understanding the Effects Caused by Common Transactions

LEARNING OBJECTIVES

At the end of this section, students should be able to meet the following objectives:

1. Explain the reason that a minimum of two accounts are impacted by every transaction.
2. Identify the individual account changes that are created by the payment of insurance and rent, the sale of merchandise, the acquisition of a long-lived asset, a capital contribution, the collection of a receivable, and the payment of a liability.
3. Separate the two events that occur when inventory is sold and determine the financial effect of each.

Recording the Sale of Inventory

Question: Transaction 4—Assume that the inventory items bought in Transaction 1 for \$2,000 are now sold to a customer for \$5,000 on credit. What account balances are impacted by the sale of merchandise in this manner?

Answer: Two connected events actually take place in the sale of inventory. First, revenue of \$5,000 is generated by the sale. This account is frequently labeled as “Sales” or “Sales revenue.”

In this example, because the money will not be collected until a later date, accounts receivable (an asset) is initially increased. The reporting of a receivable balance indicates that this amount of money is due from a customer and should be collected at some subsequent point in time.

Transaction 4, Part 1: Sale Occurs on Credit

Accounts Receivable (asset) increases by \$5,000

Sales (revenue) increases by \$5,000

Second, the inventory is removed. Companies have an option in the method by which inventory balances are monitored. Here, a **perpetual inventory system**³ is utilized. That approach is extremely common due to the prevalence of computer systems in the business world. It maintains an ongoing record of the inventory held and the amount that has been sold to date. All changes in inventory are recorded immediately. However, in a later chapter, an alternative approach—still used by some smaller businesses—known as a **periodic inventory system**⁴ will also be demonstrated.

Because a perpetual system is used here, the reduction in inventory is recorded simultaneously with the sale. Inventory costing \$2,000 is taken away by the customer. The company's net assets are reduced by this amount. Therefore, a \$2,000 expense is recognized. That inventory no longer provides a future benefit for the company but rather is a past benefit. Cost of goods sold is reported to reflect this decrease in the amount of merchandise on hand.

Transaction 4, Part 2: Inventory Acquired by Customer

Cost of Goods Sold (expense) increases by \$2,000

Inventory (asset) decreases by \$2,000

As discussed in the previous chapter, the \$3,000 difference between the sales revenue of \$5,000 and the related cost of goods sold of \$2,000 is known as the gross profit (or gross margin or mark up) on the sale.

3. Accounting system that maintains an ongoing record of all inventory items both in total and individually; records increases and decreases in inventory accounts as they occur as well as the cost of goods sold to date.

4. Accounting system that does not maintain an ongoing record of all inventory items; instead, ending inventory is determined by a physical count so that a formula (beginning inventory plus purchases less ending inventory) can be used to calculate cost of goods sold.

TEST YOURSELF

Question:

The Hashan Company buys inventory for \$7,000 that it eventually sells to a customer for \$8,000 in cash. The company's accountant increases cash by \$8,000, reduces inventory by \$7,000, and records a "gain on sale of inventory" for \$1,000. Which of the following statements is true?

- a. The company's reported net income is stated properly.
- b. The company's reported revenues are too high.
- c. The company's reported expenses are too high.
- d. All reported figures are properly stated.

Answer:

The correct answer is choice a: The company's reported net income is stated properly.

Explanation:

The company should have recognized revenues of \$8,000 and a cost of goods sold of \$7,000 so that a gross profit of \$1,000 would be reported on the company's income statement. Both the revenue and the expense were omitted and are too low. Instead, a gain of \$1,000 was recorded. That gain has the same impact as the \$1,000 gross profit, so net income was not affected by the mistake.

The Dual Effect of Transactions

Question: In each of the events studied so far, two accounts have been affected. Are two accounts impacted by every possible transaction?

Answer: In every transaction, a cause-and-effect relationship is always present. For example, the accounts receivable balance increases because of a sale. Cash decreases as a result of paying salary expense. Cost of goods sold increases because inventory is removed. No account balance can possibly change without some identifiable cause. Thus, every transaction must touch a minimum of two accounts.

Many transactions actually affect more than two accounts but at least two are impacted by each of these financial events.

Paying a Previously Recorded Expense

Question: Transaction 5—In this transaction, the reporting company pays \$700 for insurance coverage relating to the past few months. The information provided indicates that the cost was previously recorded in the company's accounting system as incurred. Apparently, the computers were programmed to accrue this expense periodically. What is the financial impact of paying an expense if the balance has already been recognized over time as the liability grew larger?

Answer: Several pieces of information should be noted in analyzing this example.

- Cash declined by \$700 as a result of the payment.
- This cost relates to a past benefit. Thus, an expense must be recorded. No future economic benefit is created by the insurance payment. Cash was paid for coverage over the previous months.
- The company's accounting system has already recorded this amount. Thus, \$700 in insurance expense and the related liability were recognized as incurred. This is clearly a different mechanical procedure than that demonstrated in Transaction 2 for the salary payment.

The expense cannot be recorded again or it will be double counted. Instead, cash is reduced along with the liability that was established through the accrual process. The expense was recorded already so no additional change in that balance is needed. Instead, the liability is removed and cash decreased.

Transaction 5: Payment of Amount Owed for Insurance

Insurance Payable (liability) decreases by \$700

Cash (asset) decreases by \$700

Note that accounting recognition is dependent on the recording that has already taken place. The final results to be reported should be the same (here an expense is recognized and cash decreased), but the steps in the process can vary.

TEST YOURSELF

Question:

Sara Frances is the accountant for National Lumber Company of Cleveland. She receives an invoice for three months' rent for one of the warehouses that the company uses. This bill is for \$3,000 per month, or \$9,000 in total. The check is written, and Ms. Frances is getting ready to record the payment but is not sure whether the expense has been previously accrued. Which one of the following statements is not true?

- a. If the expense has been accrued, a rent payable balance of \$9,000 should be present in the accounting records.
- b. If the expense has not been accrued, no rent payable balance should currently be present in the accounting records.
- c. If the expense has been accrued, the net income figure should already be properly stated before the payment is recorded.
- d. If the expense has not been accrued, a liability will need to be established when the payment is recorded.

Answer:

The correct answer is choice d: If the expense has not been accrued, a liability will need to be established when the payment is recorded.

Explanation:

If the accounting system recognized the rent as it accrued, the expense balance and the related liability have already been recorded. The expense recognition means that net income can be determined appropriately based on the reported balances. If no accrual has been recorded to date, there is neither an expense nor a liability. At the time of payment, cash is decreased and the expense is recorded. Because the liability was never entered into the records, no change is made in that balance.

Acquisition of an Asset

Question: Transaction 6—According to the original information, a truck is acquired for \$40,000, but only \$10,000 in cash is paid by the company. The other \$30,000 is covered by signing a note payable. This transaction seems a bit more complicated because more than

two accounts are involved. What is the financial impact of buying an asset when only a portion of the cost is paid on that date?

Answer: In this transaction, for the first time, three accounts are impacted. A truck is bought for \$40,000 so the balance recorded for this asset is increased by that cost. Cash decreases \$10,000 while the notes payable balance rises by \$30,000. These events each happened. To achieve a fair presentation, the accounting process seeks to reflect the actual occurrences that took place. As long as the analysis is performed properly, recording a transaction is no more complicated when more than two accounts are affected.

Transaction 6: Acquisition of Truck for Cash and a Note

Truck (asset) increases by \$40,000

Cash (asset) decreases by \$10,000

Notes Payable (liability) increases by \$30,000

Recording a Capital Contribution by an Owner

Question: Transaction 7—Assume that several individuals approach the company and offer to contribute \$19,000 in cash to the business in exchange for capital stock so that they can join the ownership. The offer is accepted. What accounts are impacted by the issuance of capital stock to the owners of a business?

Answer: When cash is contributed to a company for a portion of the ownership, cash obviously goes up by the amount received. This money was not generated by revenues or by liabilities but rather represents assets given freely so that new ownership shares could be obtained. This inflow is reflected in financial accounting as increases in both the cash and capital stock accounts. Outside decision makers can see that this amount of the company's net assets came from investments made by owners.

Transaction 7: Cash Contributed in Exchange for Capital Stock

Cash (asset) increases by \$19,000

Capital Stock (stockholders' equity) increases by \$19,000

TEST YOURSELF

Question:

The Hamilton Company issues capital stock to new owners in exchange for a cash contribution of \$34,000. The company's accountant thought the money came from a sale and recorded an increase in cash and an increase in revenue. Which of the following statements is not true as a result of this recording?

- a. The company's assets are overstated on the balance sheet.
- b. The company's net income is overstated on the income statement.
- c. The company's capital stock account is understated on the balance sheet.
- d. The company's expenses are correctly stated on the income statement.

Answer:

The correct answer is choice a: The company's assets are overstated on the balance sheet.

Explanation:

The company should have increased cash, and it did, so that balance (as well as the other assets) is properly stated. The revenue balance was overstated, so that reported net income is also overstated. The capital stock account should have been increased but was not, so it is understated. Expenses were not affected by either the transaction or the recording, so that total is correct.

The Collection of an Account Receivable

Question: Transaction 8—A sale of merchandise was made previously in Transaction 4 for \$5,000. No cash was received at that time, but the entire amount is collected now. What accounts are affected by the receipt of money from an earlier sale?

Answer: The revenue from this transaction was properly recorded in Transaction 4 when the sale originally took place and the account receivable balance was established. Revenue should not be recorded again or it will be double counted, causing reported net income to be overstated. In simple terms, revenue is recorded when earned, and that has already taken place. Instead, for recording purposes, the accountant indicates that this increase in cash is caused by the decrease in the accounts receivable balance established in Transaction 4.

Transaction 8: Collection of Account Receivable

Cash (asset) increases by \$5,000

Accounts Receivable (asset) decreases by \$5,000

Payment Made on an Earlier Purchase

Question: Transaction 9—Inventory was bought in Transaction 1 for \$2,000 and later sold in Transaction 4. Now, however, the company is ready to make payment of the amount owed for this merchandise. When cash is delivered to settle a previous purchase of inventory, what is the financial effect of the transaction?

Answer: As a result of the payment, cash is decreased by \$2,000. The inventory was recorded previously when acquired. Therefore, this subsequent transaction does not replicate that effect. Instead, the liability established in number 1 is now removed from the books. The company is not buying the inventory again but simply paying off the debt established for these goods when they were purchased.

Transaction 9: Payment of a Liability for a Purchase

Accounts Payable (liability) decreases by \$2,000

Cash (asset) decreases by \$2,000

TEST YOURSELF

Question:

A company buys inventory for \$10 on Monday on account. The company sells the inventory for credit on Tuesday for \$12. The company pays for the inventory on Wednesday. The company collects the money from the sale on Thursday. On which day or days does this company increase its net assets (assets minus liabilities)?

- a. All four days
- b. Tuesday only
- c. Tuesday and Wednesday
- d. Wednesday and Thursday

Answer:

The correct answer is choice b: Tuesday only.

Explanation:

No change in net assets occurs on Monday, Wednesday, or Thursday. Buying inventory (Monday) increases inventory but also accounts payable, so the net asset total is unchanged. Paying for inventory (Wednesday) decreases cash but also accounts payable. Collecting for the sale (Thursday) increases cash but also decreases accounts receivable. No change in net assets takes place except for the sale on Tuesday. The sale causes an increase in net assets that is the equivalent of the gross profit.

Payment of Rent in Advance

Question: Transaction 10—The company wants to rent a building to use for the next four months and pays the property's owner \$4,000 to cover this cost. When payment is made for rent (or a similar cost) with a future economic benefit, what recording is appropriate in financial accounting?

Answer: In acquiring the use of this property, the company's cash decreases by \$4,000. The money was paid to utilize the building for four months in the future.

The anticipated economic benefit is an asset, and that information should be reported to decision makers by establishing a prepaid rent balance. Money has been paid to use the property at a designated time in the future to help generate revenues.

Transaction 10: Payment of Rent in Advance

Prepaid Rent (asset) increases \$4,000

Cash (asset) decreases by \$4,000

KEY TAKEAWAY

Accountants cannot record transactions without understanding the financial impact that has occurred. Whether inventory is sold, an account receivable is collected, or some other event takes place, at least two accounts are always affected because all such events have both a cause and an effect. Individual account balances rise or fall depending on the nature of each transaction. The payment of insurance, the collection of a receivable, an owner's contribution, and the like all cause very specific changes in account balances. One of the most common is the sale of inventory where both an increase in revenue and the removal of the merchandise takes place. Increases and decreases in inventory are often monitored by a perpetual system that reflects all such changes immediately. In a perpetual system, cost of goods sold—the expense that measures the cost of inventory acquired by a company's customers—is recorded at the time of sale.

4.3 Double-Entry Bookkeeping

LEARNING OBJECTIVES

At the end of this section, students should be able to meet the following objectives:

1. Explain the history of double-entry bookkeeping.
2. List the four steps followed in the accounting process.
3. Indicate the purpose of a T-account.
4. List the basic rules for making use of debits and credits.
5. Describe the reason that debits and credits are always equal for every transaction.

Double-Entry Bookkeeping

Question: Transaction analysis determines the changes that occur in accounts whenever various events take place. Financial statements eventually provide a formal structure to communicate the resulting balances to an array of interested parties.

- Revenues, expenses, gains, and losses are presented on an income statement where they are combined to arrive at reported net income for the period.
- Total income earned and dividends distributed by the company over its entire life are netted to compute the retained earnings balance to be reported.
- Assets, liabilities, capital stock, and retained earnings are all displayed on a balance sheet.
- Changes in cash are separated into operating activities, investing activities, and financing activities and disclosed on a statement of cash flows.
- Notes offer pages of additional explanatory information.

The amount of financial data that is readily available to any decision maker is impressive.

Accountants for a business of any significant size face a daunting challenge in creating financial statements. They must gather, measure, and report the impact of the many varied events that occur virtually every day. As an example, for 2010, Xerox Corporation disclosed revenues of over \$21.6 billion and operating expenses and other costs of \$20.8 billion. At the end of 2010, the Kellogg Company reported holding \$1.1 billion in inventory—which is a lot of cereal—and indicated that its operating activities that year generated a net cash inflow of approximately \$1 billion. How can any organization possibly amass and maintain such an

enormous volume of data so that financial statements can be produced with no material misstatements?

Answer: Over five hundred years ago, Venetian merchants in Italy developed a system that continues to serve in the twenty-first century as the basis for accumulating financial data throughout much of the world. Today, when every aspect of modern society seems to be in a constant state of flux, a process that has remained in use for over five centuries is almost impossible to comprehend. However, the **double-entry bookkeeping**⁵ procedures that were first documented in 1494 by Fra Luca Bartolomeo de Pacioli (a friend of Leonardo da Vinci) remain virtually unchanged by time. Organizations, both small and large, use the fundamentals of double-entry bookkeeping to gather the monetary information needed to produce financial statements that are fairly presented according to the rules of U.S. GAAP or IFRS.

Analyze, Record, Adjust, and Report

Question: This assertion sounds like science fiction. It hardly seems believable that Xerox keeps up with over \$21.6 billion in revenue (approximately \$59 million per day) using the same methods that Venetian merchants applied to their transactions during the Renaissance. How can a five-hundred-year-old bookkeeping system possibly be usable in today's modern world?

Answer: State-of-the-art computers and other electronic devices are designed to refine and accelerate the financial accounting process, but the same basic organizing procedures have been utilized now for hundreds of years. In simplest terms, accounting systems are all created to follow four sequential steps:

- Analyze
- Record
- Adjust
- Report

5. A mechanical process created over five hundred years ago and documented by Fra Luca Bartolomeo de Pacioli that facilitates the gathering and reporting of financial information.

The first two of these steps are studied in this chapter. As explained previously, financial accounting starts by analyzing each transaction—every event that has a monetary impact on the organization—to ascertain the changes created in accounts such as rent expense, cash, inventory, and dividends paid. Fortunately, a vast

majority of any company's transactions are repetitive so that many of the effects can be easily anticipated. A sale on credit always increases both accounts receivable and revenue. Regardless of the time or place, a cash purchase of a piece of equipment increases the balance reported for equipment while decreasing cash. Computer systems can be programmed to record the impact of these events automatically allowing the accountant to focus on analyzing more complex transactions.

Debits, Credits, and T-Accounts

Question: The second step in the financial accounting process is "record." At the beginning of this chapter, a number of transactions were presented and their impact on individual accounts determined. Following this analysis, some method must be devised to capture the information in an orderly fashion. Officials could just list the effect of each transaction on a sheet of paper:

"Increase inventory \$2,000 and increase accounts payable \$2,000."

"Increase salary expense \$300 and decrease cash \$300."

"Increase cash \$9,000 and increase note payable \$9,000."

However, this process is slow and poorly organized. A more efficient process is required for companies like Xerox and Kellogg. After all monetary changes are identified, how are these effects accumulated?

*Answer: An essential step in understanding double-entry bookkeeping is to realize that financial information is accumulated by **accounts**⁶. As mentioned previously, every balance to be reported in a set of financial statements is maintained in a separate account. Thus, for assets, an individual account is established to monitor cash, accounts receivable, inventory, and so on. To keep track of expenses, a number of additional accounts are needed, such as cost of goods sold, rent expense, salary expense, and repair expense. The same is true for revenues, liabilities, and other categories. A small organization might utilize only a few dozen accounts in its entire record-keeping system. A large business probably has thousands.*

*Based on the original Venetian model, the balance for each account is monitored in a form known as a **T-account**⁷ as displayed in [Figure 4.2 "Examples of Common T-](#)*

6. Detailed records of the transactions and current balances of individual assets, liabilities, stockholders' equity, revenues and expenses.

7. Maintains the monetary balance for each of the accounts reported by an organization with a left (debit) side and a right (credit) side used to show increases and decreases.

Accounts". This structure provides room for recording on both the left side (known as the **debit**⁸ side) and the right side (the **credit**⁹ side).

Figure 4.2 Examples of Common T-Accounts

Cash		Salary Payable		Revenue		Rent Expense	
Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit

One side of every T-account records increases; the other side records decreases. For over five hundred years, the following rules have applied.

In some accounts, debits indicate an increase and credits indicate a decrease. They are grouped together because they all refer to costs.

Increase Shown with a Debit:

- Expenses and losses
 - Assets
 - Dividends paid
- One method to keep track of these accounts initially is to remember them as the “DEAD” accounts: **d**ebits increase, **e**xpenses and losses, **a**ssets, and **d**ividends paid. Quickly, though, through practice, such mnemonic devices will not be needed.

In other accounts, credits indicate an increase and debits indicate a decrease. They are grouped together because they all reflect sources of funding.

Increase Shown with a Credit:

- Liabilities
 - Capital stock
 - Revenues and gains
 - Retained earnings
- Changes in the balance reported for retained earnings normally do not come as a direct result of a transaction. As discussed previously, this account reflects all the net income earned to date reduced by all dividend payments. Income is made up of revenues, expenses, gains, and losses. Accounting recognition of revenues and

8. Left side of a T-account; it indicates increases in assets, expenses, and dividends paid as well as decreases in liabilities, capital stock, and revenue and gains.

9. Right side of a T-account; it indicates increases in liabilities, capital stock, retained earnings, and revenue and gains as well as decreases in assets, expenses, and dividends paid.

gains (which increase with credits) lead to a larger retained earnings balance. Expenses, losses, and dividends paid (which all increase with debits) reduce retained earnings. Consequently, credits cause an increase in retained earnings whereas debits produce a decrease.

The debit and credit rules for these seven general types of accounts provide a shorthand method for recording the financial impact that a transaction has on any account. They were constructed in this manner so that the following would be true:

Basic Rule for Double-Entry Bookkeeping

Debits must always equal credits for every transaction.

At first view, the debit and credit rules might seem completely arbitrary. However, they are structured to mirror the cause-and-effect relationship found in every transaction. This is the basis of what the Venetian merchants came to understand so long ago: every effect must have a cause.

- Assume an asset (such as cash) increases. As shown here, that change is recorded on the debit side of the T-account for that asset. What could cause an asset to become larger? A reason must exist. A liability—possibly a bank loan—could have been incurred (recorded as a credit); capital stock could have been issued to an owner (a credit); revenue could have been earned from a sale (a credit). The list of possible reasons is relatively short. In each case, the debit (increase) to the asset is caused by an equal and offsetting credit.
- Assume an asset (such as cash) decreases. This change is recorded on the credit side of the asset's T-account. What might cause this reduction? An expense could have been paid (recorded as a debit); a dividend could have been distributed to shareholders (a debit); a liability could have been extinguished (a debit); another asset could have been acquired (a debit). Once again, the cause-and-effect relationship is reflected; the debits equal the credits. Each effect is set equal and opposite to its cause.

There are only seven types of accounts. Therefore, a mastery of debit and credit rules can be achieved with a moderate amount of practice. Because of the fundamental role that debits and credits play within every accounting system, this knowledge is well worth the effort required to obtain it.

TEST YOURSELF

Question:

A company incurs a transaction that is reflected in its accounting system through a debit to salary expense and a credit to salary payable for salary for one month. Which one of the following is the best description of the transaction that took place?

- a. Employee salaries for the past month were paid.
- b. Employee salaries for the upcoming month were paid.
- c. Employee salaries for the past month are recognized but not paid.
- d. Employee salaries for the past month have been accrued and are now paid.

Answer:

The correct answer is choice c: Employee salaries for the past month are recognized but not paid.

Explanation:

A debit to an expense is an increase, while a credit to a liability is also an increase. The expense increased, indicating that salary for the past month has been incurred. The payable also increased, which means that the amount owed to the employees has risen. Recognition is made here that an expense has been incurred but not yet paid.

KEY TAKEAWAY

Most companies participate in numerous transactions each day that must be examined and organized so that financial statements can eventually be prepared. This process requires four steps: analyze, record, adjust, and report. Over five hundred years ago, double-entry bookkeeping was created as a mechanical process to facilitate this gathering and reporting of financial information. A T-account is maintained for each account (such as cash, accounts payable, and rent expense) to be reported by a company. The left side of the T-account is the debit side, and the right side is the credit. Expenses and losses, assets, and dividends paid increase with debits. Liabilities, revenues and gains, capital stock, and retained earnings increase with credits. Debits always equal credits because every transaction must have both an effect and a cause for that effect.

4.4 Recording Transactions Using Journal Entries

LEARNING OBJECTIVES

At the end of this section, students should be able to meet the following objectives:

1. Describe the purpose and structure of a journal entry.
2. Identify the purpose of a journal.
3. Define trial balance and indicate the source of its monetary balances.
4. Prepare journal entries to record the effect of acquiring inventory, paying salary, borrowing money, and selling merchandise.
5. Define accrual accounting and list its two components.
6. Explain the purpose of the revenue realization principle.
7. Explain the purpose of the matching principle.

The Purpose of a Journal Entry

Question: In an accounting system, the impact of each transaction is analyzed and must then be recorded. Debits and credits are used for this purpose. How does the actual recording of a transaction take place?

10. The physical form used in double-entry bookkeeping to record the financial changes caused by a transaction; each must have at least one debit and one credit and the total debit(s) must always equal the total credit(s).
11. The physical location of all journal entries; it is the financial diary of an organization capturing the impact of transactions as they took place; it is also referred to as the general journal.
12. The physical location of all journal entries; it is the financial diary of an organization capturing the impact of transactions as they took place; it is also referred to as the journal.

Answer: The effects produced on various accounts by a transaction should be entered into an accounting system as quickly as possible so that information is not lost and mistakes have less time to occur. After each event is analyzed, the financial changes caused by a transaction are initially recorded as a **journal entry**¹⁰. In larger organizations, similar transactions are often grouped, summed, and recorded together for efficiency. For example, all cash sales at one store might be totaled automatically and recorded at one time at the end of each day. To help focus on the mechanics of the accounting process, the journal entries in this textbook will be prepared for transactions individually. A list of a company's journal entries is maintained in a **journal**¹¹ (also referred to as a **general journal**¹²), which is one of the most important components within any accounting system. The journal is a financial diary for a company. It provides a history of the impact of all financial events, recorded as they took place.

A journal entry is no more than an indication of the accounts and balances that were changed by a single transaction.

Practicing with Debits and Credits

Question: Debit and credit rules are best learned through practice. In order to master the use of debits and credits for recording purposes, where should the needed work begin?

Answer: When faced with debits and credits, everyone has to practice at first. That is normal and to be expected. These rules can be learned quickly but only by investing a bit of effort. Earlier in this chapter, a number of common transactions were presented ([Figure 4.1 "Transactions Frequently Encountered by a Business"](#)) and then analyzed to demonstrate their impact on account balances. Assume now that these same transactions are to be recorded as journal entries.

To provide more information for this illustration, the reporting company will be a small farm supply store known as the Lawndale Company that is located in a rural area. For convenience, assume that the business incurs each of these transactions during the final two days of Year Four, just prior to preparing financial statements.

Assume further that this company already has the various T-account balances as of December 29, Year Four, presented in [Figure 4.3 "Balances From T-accounts in Ledger"](#) before recording the impact of this last group of transactions. A company keeps its T-accounts together in a ledger (or general ledger). This listing of the account balances found in the ledger is known as a **trial balance**¹³. Note that the total of all the debit and credit balances do agree (\$360,700) and that every account shows a positive balance. In other words, the current figure being reported is either a debit or credit based on what reflects an increase in that particular type of account. Few T-accounts contain negative balances.

13. List of account balances at a specific point in time for each of the T-accounts maintained in a company's ledger; eventually, financial statements are created using these balances.

Figure 4.3 Balances From T-accounts in Ledger

Lawndale Company Trial Balance (prior to recording new transactions) December 29, Year Four		
Account	Debit	Credit
Cash	\$20,000	
Accounts Receivable	50,000	
Inventory	65,000	
Accounts Payable		\$18,000
Insurance Payable		700
Notes Payable (long-term)		40,000
Capital Stock		30,000
Retained Earnings (beginning of year)		32,000
Sales of Merchandise		250,000
Cost of Goods Sold	150,000	
Rent Expense	12,000	
Salary Expense	60,000	
Utilities Expense	10,000	
Insurance Expense	3,700	
Totals	<u>\$370,700</u>	<u>\$370,700</u>

Journal Entry for Acquisition of Inventory on Credit

Question: After the balances in Figure 4.3 "Balances From T-accounts in Ledger" were determined, several additional transactions took place during the last two days of Year Four. The first transaction analyzed at the start of this chapter (Figure 4.1 "Transactions Frequently Encountered by a Business") was the purchase of inventory on credit for \$2,000. This acquisition increases the recorded amount of inventory while also raising one of the company's liabilities (accounts payable). How is the acquisition of inventory on credit recorded in the form of a journal entry?

Answer: Following the transactional analysis, a journal entry is prepared to record the impact that the event has on the Lawndale Company. Inventory is an asset. An asset always uses a debit to note an increase. Accounts payable is a liability so that a credit indicates that an increase has occurred. Thus, the journal entry shown in Figure 4.4 "Journal Entry 1: Inventory Acquired on Credit" is appropriate. The parenthetical information is included here only for clarification purposes and does not appear in a true journal entry.

Figure 4.4 Journal Entry 1: Inventory Acquired on Credit

Inventory	2,000		(increase an asset—debit)
Accounts Payable		2,000	(increase a liability—credit)

Notice that the word “inventory” is physically on the left of the journal entry and the words “accounts payable” are indented to the right. This positioning clearly shows which account is debited and which is credited. In the same way, the \$2,000 numerical amount added to the inventory total appears on the left (debit) side whereas the \$2,000 change in accounts payable is clearly on the right (credit) side.

Preparing journal entries is a mechanical process but one that is fundamental to the gathering of information for financial reporting purposes. Any person familiar with accounting could easily “read” the previous entry: Based on the debit and credit, both inventory and accounts payable have gone up so a purchase of merchandise for \$2,000 on credit is indicated. Interestingly, with translation of the words, a Venetian merchant from the later part of the fifteenth century would be capable of understanding the information captured by this journal entry even if prepared by a modern company as large as **Xerox** or **Kellogg**.

Recording Payment of an Expense

Question: In Transaction 2, the Lawndale Company pays its employees salary of \$300 for work performed during the past week. If no entry has been recorded previously for this amount, what journal entry is appropriate when a salary payment is made?

Answer: Because the information provided indicates that no entry has yet been made, neither the \$300 salary expense nor the related salary payable already exists in the accounting records. Apparently, the \$60,000 salary expense appearing in the trial balance reflects earlier payments made during the period to company employees.

Payment is made here for past work so this cost represents an expense rather than an asset. Thus, the balance recorded as salary expense goes up while cash decreases. As shown in **Figure 4.5 "Journal Entry 2: Salary Paid to Employees"**, increasing an expense is always shown by means of a debit. Decreasing an asset is reflected through a credit.

Figure 4.5 *Journal Entry 2: Salary Paid to Employees*

Salary Expense	300		(increase an expense—debit)
Cash		300	(decrease an asset—credit)

In practice, the date of each transaction could also be included here. For illustration purposes, this extra information is not necessary.

Journal Entry When Money Is Borrowed

Question: According to Transaction 3, \$9,000 is borrowed from a bank when officials sign a note payable that will have to be repaid in several years. What journal entry is prepared by a company to reflect the inflow of cash received from a loan?

Answer: As always, recording begins with an analysis of the transaction. Cash—an asset—increases \$9,000, which is shown as a debit. The notes payable balance also goes up by the same amount. As a liability, this increase is recorded through a credit. By using debits and credits in this way, a record of the financial effects of this transaction are entered into the accounting records.

Figure 4.6 *Journal Entry 3: Money Borrowed from Bank*

Cash	9,000		(increase an asset—debit)
Notes Payable		9,000	(increase a liability—credit)

TEST YOURSELF

Question:

An accountant looks at a journal entry found in a company's journal that shows a debit to notes payable and a credit to cash. Which of the following events is being recorded?

- a. Money has been borrowed from a bank.
- b. Money has been contributed by an owner.
- c. Money has been received from a sale.
- d. Money has been paid on a liability.

Answer:

The correct answer is choice d: Money has been paid on a liability.

Explanation:

Cash is an asset that decreases by means of a credit. Notes payable is a liability that decreases with a debit. Both cash and notes payable decreased, indicating that a payment was made.

Recording Sale of Inventory on Credit

Question: In Transaction 1, inventory was bought for \$2,000. That journal entry is recorded earlier. Now, in Transaction 4, these goods are sold for \$5,000 to a customer with payment to be made at a later date. How is the sale of merchandise on credit recorded in journal entry form?

Answer: As discussed previously, two events happen when inventory is sold. First, the sale is made and, second, the customer takes possession of the merchandise from the company. Assuming again that a perpetual inventory system is in use, both the sale and the related expense are recorded immediately.

In the initial part of the transaction, the accounts receivable balance goes up \$5,000 because the money from the customer will not be collected until a future point in time. The increase in this asset is shown by means of a debit. The new receivable

resulted from a sale. Thus, revenue is also recorded (through a credit) to indicate the cause of that effect.

Figure 4.7 Journal Entry 4A: Sale of Inventory Made on Account

Accounts Receivable	5,000		(increase an asset—debit)
Sales of Merchandise		5,000	(increase revenue—credit)

At the same time, inventory costing \$2,000 is surrendered by the company. The reduction of any asset is recorded by means of a credit. The expense account that represents the outflow of inventory has been identified previously as “cost of goods sold.” Like any expense, it is entered into the accounting system through a debit.

Figure 4.8 Journal Entry 4B: Merchandise Acquired by Customers

Cost of Goods Sold	2,000		(increase an expense—debit)
Inventory		2,000	(decrease an asset—credit)

The Role of Accrual Accounting

Question: In the previous transaction, the Lawndale Company made a sale but no cash was to be collected until some later date. Why is revenue reported at the time of sale rather than when cash is eventually collected? Accounting is conservative. Delaying recognition of sales revenue (and the resulting increase in net income) until the \$5,000 is physically received seems logical. Why is the revenue recognized here before the cash is collected?

Answer: This question reflects a common misconception about the information conveyed through financial statements. As shown in Journal Entry 4A, the reporting of revenue is not tied directly to the receipt of cash. One of the most important components of U.S. GAAP is **accrual accounting**¹⁴. It serves as the basis for timing the recognition of revenues and expenses. Because of the direct impact on net income, such issues are among the most complicated and controversial in accounting. The accountant must constantly monitor events as they occur to determine the appropriate point in time for reporting each revenue and expense. Accrual accounting provides standard guidance for that process.

14. A method of accounting used by U.S. GAAP to standardize the timing of the recognition of revenues and expenses; it is made up of the revenue realization principle and the matching principle.

Accrual accounting is really made up of two distinct elements. The **revenue realization principle**¹⁵ provides authoritative direction as to the proper timing for the recognition of revenue. The **matching principle**¹⁶ establishes similar guidelines for expenses. These two principles have been utilized for decades in the application of U.S. GAAP. Their importance within financial accounting can hardly be overstated.

Revenue realization principle. Revenue is properly recognized at the point that (1) the earning process needed to generate the revenue is substantially complete and (2) the amount eventually to be received can be reasonably estimated. As the study of financial accounting progresses into more complex situations, both of these criteria will require careful analysis and understanding.

Matching principle. Expenses are recognized in the same time period as the revenue they help to create. Thus, if specific revenue is to be recognized in the year 2019, all associated costs should be reported as expenses in that same year. Expenses are matched with revenues. However, when a cost cannot be tied directly to identifiable revenue, matching is not possible. In those cases, the expense is recognized in the most logical time period, in some systematic fashion, or as incurred—depending on the situation.

Revenue is reported in Journal Entry 4A. Assuming that the Lawndale Company has substantially completed the work required of this sale and \$5,000 is a reasonable estimate of the amount that will be collected, recognition at the time of sale is appropriate. Because the revenue is reported at that moment, the related expense (cost of goods sold) should also be recorded as can be seen in Journal Entry 4B.

15. The component of accrual accounting that guides the timing of revenue recognition; it states that revenue is properly recognized when the earning process needed to generate the revenue is substantially complete and the amount to be received can be reasonably estimated.

16. The component of accrual accounting that guides the timing of expense recognition; it states that expense is properly recognized in the same time period as the revenue that it helped generate.

Accrual accounting provides an excellent example of how U.S. GAAP guides the reporting process in order to produce fairly presented financial statements that can be understood by all possible decision makers.

TEST YOURSELF

Question:

Which of the following statements is not true?

- a. Accrual accounting is a component of U.S. GAAP.
- b. According to the matching principle, revenues should be recognized in the same period as the expenses that help to generate those revenues.
- c. The revenue realization principle and the matching principle are components of accrual accounting.
- d. Revenues should not be recognized until the amount to be realized can be reasonably estimated.

Answer:

The correct answer is choice b: According to the matching principle, revenues should be recognized in the same period as the expenses that help to generate those revenues.

Explanation:

Accrual accounting is the U.S. GAAP that structures timing for reporting revenues and expenses. It is made up of the revenue realization principle and the matching principle. Revenues are reported when the earning process is substantially complete and the amount to be received can be reasonably estimated. Expenses are recognized in the same period as revenues they help generate. The answer is b; it is stated backward. Expenses are matched with revenues; revenues are not matched with expenses.

KEY TAKEAWAY

After the financial effects of a transaction are analyzed, the impact is recorded within a company's accounting system through a journal entry. The purchase of inventory, payment of a salary, and borrowing of money are all typical transactions that are recorded in this manner by means of debits and credits. All journal entries are maintained within a journal. The timing of recognition is especially important in connection with revenues and expenses. Accrual accounting provides formal guidance within U.S. GAAP. Revenues are recognized when the earning process is substantially complete and the amount to be collected can be reasonably estimated. Expenses are recognized based on the matching principle. It holds that expenses should be reported in the same period as the revenue they help generate.

4.5 Connecting the Journal to the Ledger

LEARNING OBJECTIVES

At the end of this section, students should be able to meet the following objectives:

1. Prepare journal entries for basic transactions such as the payment of insurance, the acquisition of a long-lived asset, the contribution of capital by owners, the distribution of a dividend, and the like.
2. Explain the recording of a gain or loss.
3. Describe the recording of an unearned revenue.
4. Understand the purpose within an accounting system of both the journal and the ledger.
5. Discuss the posting of journal entries to T-accounts in the ledger and describe the purpose of that process.

Payment of a Previously Recognized Expense

Question: In Transaction 5, the Lawndale Company pays \$700 for insurance coverage received over the past few months. Here, though, the amount has already been recognized. Both the insurance expense and an insurance payable were recorded as incurred. That information was provided in [Figure 4.1 "Transactions Frequently Encountered by a Business"](#), and both amounts can be seen on the trial balance in [Figure 4.3 "Balances From T-accounts in Ledger"](#). Apparently, Lawndale's accounting system was programmed to recognize this particular expense as it grew over time. When an expense has already been recorded, what journal entry is appropriate at the time payment is made?

Answer: Because of the previous recognition, the expense should not now be recorded a second time. Instead, this payment eliminates the liability that was established by the accounting system. Cash—an asset—is decreased, which is shown in accounting by means of a credit. At the same time, the previously recorded payable is removed. Any reduction of a liability is communicated by a debit. To reiterate, no expense is included in this entry because that amount has already been recognized as incurred.

Figure 4.9 Journal Entry 5: Payment of Liability for Insurance Coverage

Insurance Payable	700		(decrease a liability—debit)
Cash		700	(decrease an asset—credit)

Note that Journal Entries 2 and 5 differ although the events are similar. As discussed previously, specific recording techniques are influenced by the manner in which the accounting system has handled earlier events. In Journal Entry 2, neither the expense nor the payable had yet been recorded. Thus, the expense was recognized at the time of payment. Conversely, in Journal Entry 5, both the expense and payable had already been entered into the records as the amount gradually grew over time. Hence, when paid, the liability is settled, but no further expense is recognized. The proper amount is already present in the insurance expense T-account.

Acquisition of an Asset

Question: In Transaction 6, a new truck is acquired by the Lawndale Company for \$40,000. Cash of \$10,000 is paid at the time of purchase but a note payable—due in several years—is signed for the remaining \$30,000. This transaction impacts three accounts rather than just two. How is a journal entry constructed when more than two accounts are affected?

Answer: As has been discussed, every transaction changes at least two accounts because of the cause-and-effect relationship underlying all financial events. However, beyond that limit, any number of accounts can be impacted. Complex transactions often touch numerous balances. Here, the truck account (an asset) is increased and must be debited. Part of the acquisition was funded by paying cash (an asset) with that decrease recorded as a credit. The remainder of the cost was covered by signing a note payable (a liability). Any increase in a liability is recorded by means of a credit. Note that the debits do equal the credits even when more than two accounts are affected by a transaction.

Figure 4.10 Journal Entry 6: Truck Acquired for Cash and by Signing a Note

Truck	40,000		(increase an asset—debit)
Cash		10,000	(decrease an asset—credit)
Notes Payable		30,000	(increase a liability—credit)

Issuance of Capital Stock

Question: In Transaction 7, the Lawndale Company needs additional financing so officials go to current or potential shareholders and convince them to contribute cash of \$19,000 in exchange for new shares of the company's capital stock. These individuals invest their money in order to join the ownership or increase the number of shares they already hold. What journal entry does a business record when capital stock is issued?

Answer: The asset cash is increased in this transaction, a change that is always shown as a debit. Capital stock also goes up because new shares are issued to company owners. As indicated in the debit and credit rules, the capital stock account increases by means of a credit.

Figure 4.11 *Journal Entry 7: Capital Stock Issued for Cash*

Cash	19,000		(increase an asset—debit)
Capital Stock		19,000	(increase a capital stock—credit)

TEST YOURSELF

Question:

A corporation issues a balance sheet on December 31, Year Ten. Within stockholders' equity, a balance of \$89,000 is reported in the capital stock account. What does this figure represent?

- a. The current market value of the company's own stock.
- b. The current market value of stocks the company holds in other companies.
- c. The amount of assets contributed to the business by its owners since the company was created.
- d. The amount of assets contributed to the business by its owners in the current year.

Answer:

The correct answer is choice c: The amount of assets contributed to the business by its owners since the company was created.

Explanation:

The stockholders' equity balances indicate the source of the company's net assets (the amount by which assets exceed liabilities). Normally, the net assets come either from the owners or from the operations of the business (total net income minus all dividends). The capital stock account (sometimes shown as contributed capital) is the amount of net assets put into the company by the owners since the company was started.

Collection Made on Account Receivable

Question: In Journal Entry 4A, a sale was made on credit. An account receivable was established at that time for \$5,000. Assume that the customer now pays this amount to the Lawndale Company. How does the collection of an amount from an earlier sales transaction affect the account balances?

Answer: When a customer makes payment on a previous sale, the cash balance increases while accounts receivable decrease. Both are assets; one balance goes up (by a debit) while the other is reduced (by a credit).

Figure 4.12 Journal Entry 8: Money Collected on Account

Cash	5,000		(increase an asset—debit)
Accounts Receivable		5,000	(decrease an asset—credit)

Note that cash is collected here, but no additional revenue is recorded. Based on the requirements of accrual accounting, revenue of \$5,000 was recognized previously in Journal Entry 4A. Apparently, the revenue realization principle was met at that time, the earning process was substantially complete, and a reasonable estimation could be made of the amount to be received. Recognizing the revenue again at the current date would incorrectly inflate reported net income. Instead, the previously created receivable balance is removed.

Paying for a Previous Purchase

Question: In Journal Entry 1, inventory was purchased on credit for \$2,000. Assume, now, in Transaction 9, that Lawndale makes payment of the entire amount that is due. How is a cash outflow to pay for inventory previously acquired shown in a company's journal?

Answer: Inventory was bought at an earlier time, and payment is now being made. The inventory was properly recorded when acquired and should not be entered again. The merchandise was only obtained that one time. Here, cash is reduced (a credit). The liability set up in Journal Entry 1 (accounts payable) is removed by means of a debit.

Figure 4.13 Journal Entry 9: Money Paid for Previous Purchase

Accounts Payable	2,000		(decrease a liability—debit)
Cash		2,000	(decrease an asset—credit)

Prepayment of an Expense

Question: Company officials like the building that is being used for operations and decide to rent it for four additional months at a rate of \$1,000 per month. An immediate payment of \$4,000 is made. This cost provides a future economic benefit rather than a past value. Recognition of an expense is not yet appropriate. What recording is appropriate when rent or other costs such as insurance or advertising are paid in advance?

Answer: Cash is decreased by the payment made here to rent this building. As an asset, a reduction in cash is reported by means of a credit. However, this rent provides a future value for Lawndale Company. The cost is not for past usage of the building but rather for the upcoming months. Therefore, the amount paid creates an asset. The probable economic benefit is the ability to make use of this facility over the next four months to generate new revenue. When the \$4,000 is paid, an asset—normally called prepaid rent—is recorded through a debit.

Figure 4.14 Journal Entry 10: Money Paid for Future Rent

Prepaid Rent	4,000		(increase an asset—debit)
Cash		4,000	(decrease an asset—credit)

Note that Lawndale does not record the building itself because the company does not gain ownership or control (beyond these four months). The payment only provides the right to make use of the building for the specified period in the future so that a prepaid rent balance is appropriate.

Acquisition of Land

Question: Before this illustration of typical journal entries is completed, four additional transactions will be examined. In total, these fourteen provide an excellent cross-section of basic events encountered by most businesses and the journal entries created to capture that information. An understanding of the recording of these transactions is of paramount importance in mastering the mechanical rules for debits and credits.

Officials of the Lawndale Company decide to purchase a small tract of land by paying \$8,000 in cash. Perhaps they think the space might be used sometime in the future as a parking lot. What recording is made to reflect the cash purchase of a plot of land?

Answer: The transaction here is straightforward. As an asset, land increases with a debit. The company's cash balance goes down because of the acquisition. That drop is recorded using a credit. As stated earlier in this section, Venetian merchants would probably have made the same recording five hundred years ago (although not in U.S. dollars).

Figure 4.15 Journal Entry 11: Land Acquired for Cash

Land	8,000		(increase an asset—debit)
Cash		8,000	(decrease an asset—credit)

Sale of an Asset Other Than Inventory

Question: Now, assume that—for demonstration purposes—this same piece of land is sold almost immediately to an outside party for cash of \$11,000. A sale occurs but the land is not inventory. It was not bought specifically to be resold within the normal course of business. As a farm supply store, selling land is not the primary operation of the Lawndale Company. Should revenue be recorded along with cost of goods sold when land rather than inventory is sold? These two accounts are used in journalizing the sale of inventory. Does the same reporting apply to the sale of other assets such as land or equipment?

Answer: Because the sale of land is not viewed as a central portion of this company's operations, neither revenue nor cost of goods sold is reported as in the sale of inventory. An \$11,000 increase in cash is recorded along with the removal of the \$8,000 cost of the land that was conveyed to the new owner. However, to alert decision makers that a tangential or incidental event has taken place, a gain (if the sales price is more than the cost of the land) or a loss (if sales price is less than cost) is recognized for the difference. The effect on net income is the same (a net increase of \$3,000), but the method of reporting has changed.

The resulting gain or loss is then separated from revenues and expenses on the income statement to more clearly communicate information as to the nature of the transaction. The decision maker can see the operating income earned by the reporting company from the normal sale of goods and services distinct from any other gains and losses. For example, if an investor or creditor is looking at the

financial statements produced by an Italian restaurant, the amount of income from selling pizzas, spaghetti, and the like is important information apart from any gains and losses that were not part of typical operations. Consequently, neither revenue nor cost of goods sold is found in the following entry as was demonstrated in Journal Entries 4A and 4B.

Figure 4.16 *Journal Entry 12: Land Sold for Cash in Excess of Cost*

Cash	11,000		(increase an asset—debit)
Land		8,000	(decrease an asset—credit)
Gain on Sale of Land		3,000	(increase revenue/gain—credit)

TEST YOURSELF

Question:

A company buys and sells pots and pans for the kitchen. This same company bought land for a possible warehouse for \$43,000. Several years later, the land was sold for \$54,000 cash when the decision was made not to construct the new warehouse. In its accounting system, the company increased revenues by \$54,000 (along with cash). Cost of goods sold was also recorded as \$43,000 (along with a decrease in the land account). Which of the following statements is true?

- a. Net income is correctly reported.
- b. Gross profit is correctly reported.
- c. The reported total for assets is overstated.
- d. The journal entry was properly made.

Answer:

The correct answer is choice a: Net income is correctly reported.

Explanation:

The company's entry increased revenues and the cost of goods sold so that the gross profit was raised by \$11,000 (\$54,000 minus \$43,000). However, a gain of \$11,000 should have been reported instead. Thus, the components of net income are wrong, but the total impact of \$11,000 is properly shown. The balance sheet accounts (cash and land) were recorded in an appropriate fashion.

Receiving Cash before the Earning Process Is Complete

Question: Accrual accounting, as specified in the revenue realization principle, mandates that revenues should not be recognized until the earning process is substantially complete. Assume a customer gives the Lawndale Company \$3,000 in cash for some type of service to be performed at a future date. The work has not yet begun. Thus, Lawndale cannot report revenue of \$3,000. How is a cash inflow recorded if received for work before the earning process is substantially complete?

Answer: Although cash is received, accrual accounting dictates that revenue cannot be recognized until the earning process is substantially complete. Here, the earning process will not take place for some time in the future. As an asset, the cash account is increased (debit) but no revenue can yet be recorded. Instead, an unearned revenue account is established for the \$3,000 credit. This balance is reported by the Lawndale Company as a liability. Because the money has been accepted, the company is obliged to provide the service or return the \$3,000 to the customer. Recording this liability mirrors that responsibility.

Figure 4.17 Journal Entry 13: Money Received for Work to Be Done Later

Cash	3,000		(increase an asset—debit)
Unearned Revenue		3,000	(increase a liability—credit)

Distribution of a Dividend

Question: Here is one final transaction to provide a full range of basic examples at this preliminary stage of coverage. Many additional transactions and their journal entries will be introduced throughout this textbook, but these fourteen form a strong core of the typical events encountered by most businesses.

Assume that the Lawndale Company has been profitable. As a result, at the end of the year, the board of directors votes to distribute a cash dividend to all owners, a reward that totals \$600. Payment is made immediately. What recording is appropriate when a dividend is distributed to the owners of a corporation?

Answer: Cash is reduced by this payment to the company’s owners. As an asset, a credit is appropriate. The cause of the decrease in cash was a dividend. Hence, a “dividends paid” account is established to measure this particular outflow of net assets. According to the debit and credit rules, an increase in this account is shown through a debit. Thus, the recording of this last illustration is as follows.

Figure 4.18 Journal Entry 14: Dividend Distributed to Owners

Dividends Paid	600		(increase dividends paid—debit)
Cash		600	(decrease an asset—credit)

Chapter 4 How Does an Organization Accumulate and Organize the Information Necessary to Create Financial Statements?

To help visualize the components of an accounting system, all of the journal entries presented here have been gathered into an actual journal in [Figure 4.19 "Lawndale Company Journal—Final Days of Year Four"](#) as the accountant for the Lawndale Company might have kept. Normally, a date for each entry is included for reference purposes, but that has been omitted here.

Figure 4.19 Lawndale Company Journal—Final Days of Year Four

Lawndale Company Journal—Final Days of Year Four			
Journal Entry	Accounts	Debit	Credit
1	Inventory Accounts Payable	\$2,000	\$2,000
2	Salary Expense Cash	300	300
3	Cash Notes Payable	9,000	9,000
4A	Accounts Receivable Sales of Merchandise	5,000	5,000
4B	Cost of Goods Sold Inventory	2,000	2,000
5	Insurance Payable Cash	700	700
6	Truck Cash Notes Payable	40,000	10,000 30,000
7	Cash Capital Stock	19,000	19,000
8	Cash Accounts Receivable	5,000	5,000
9	Accounts Payable Cash	2,000	2,000
10	Prepaid Rent Cash	4,000	4,000
11	Land Cash	8,000	8,000
12	Cash Land Gain on Sale of Land	11,000	8,000 3,000
13	Cash Unearned Revenue	3,000	3,000
14	Dividends Paid Cash	600	600

Current T-Account Balances

Question: With adequate practice, obtaining an understanding of the rules for debits and credits is a reasonable goal. However, these journal entries do not provide the current balance of any account. They record the effect of each transaction but not the updated account totals, figures that could change many times every day. How does an accountant keep track of the current balance of cash, inventory, rent expense, or the myriad other accounts that appear on a set of financial statements?

Answer: In an accounting system, the recording process is composed of two distinct steps.

1. After analyzing the financial impact of a transaction, a journal entry is created to reflect the monetary impact on relevant accounts.
2. Then, each individual debit and credit is added to the specific T-account being altered, a process known as “posting.” A debit to cash in a journal entry is listed as a debit in the cash T-account. A credit made to notes payable is recorded as a credit within the corresponding T-account. After all entries are posted, the current balance for any account can be determined by adding the debit and the credit sides of the T-account and netting the two.

Historically, posting the individual changes shown in each journal entry to the specific T-accounts was a tedious and slow process performed manually. Today, automated systems are designed so that the impact of each entry is simultaneously recorded in the proper T-accounts found in the ledger.

For illustration purposes, all of the journal entries recorded earlier have been posted into the ledger T-accounts shown in [Figure 4.19 "Lawndale Company Journal—Final Days of Year Four"](#). Each account includes the previous balance (PB) found in the trial balance in [Figure 4.3 "Balances From T-accounts in Ledger"](#). The new debits and credits are then posted for each of the fourteen sample transactions. For cross-referencing purposes, the number of the corresponding journal entry is included. The debit and credit sides of each account are summed and netted to determine the current balance (CB). For example, the cash T-account has \$67,000 as the total of all debits and \$25,600 for all credits, which net to a current balance of \$41,400.

After all of the additional journal entries have been posted into the ledger, an updated trial balance can be drawn from the individual T-account balances. No change is created by this process, but, as can be seen in [Figure 4.21 "Lawndale Company Trial Balance \(after all journal entries have been posted\)—December 31, Year Four"](#), the accounts and their current balances are much easier to see. Simply the clarity of the information can help accountants spot accounts that may contain errors because of unusual or unexpected totals.

Chapter 4 How Does an Organization Accumulate and Organize the Information Necessary to Create Financial Statements?

Figure 4.20 *Lawndale Company Ledger—December 31, Year Four*

CASH		ACCOUNTS RECEIVABLE		INVENTORY	
PB 20,000		PB 50,000		PB 65,000	
(3) 9,000	(2) 300	(4A) 5,000	(8) 5,000	(1) 2,000	(4B) 2,000
(7) 19,000	(5) 700	14,000	5,000	10,000	2,000
(8) 5,000	(6) 10,000	CB 50,000		CB 65,000	
(12) 11,000	(9) 2,000				
(13) 3,000	(10) 4,000				
	(11) 8,000				
	(14) 600				
67,000	25,600				
CB 41,400					

PREPAID RENT		TRUCK		LAND	
(10) 4,000		(5) 40,000		(11) 8,000	(12) 8,000
CB 4,000		CB 40,000		8,000	8,000
				CB 0	

INSURANCE PAYABLE		ACCOUNTS PAYABLE		NOTES PAYABLE	
(5) 700	PB 700	(9) 2,000	PB 18,000		PB 40,000
700	700	2,000	(1) 2,000		(3) 9,000
CB 0			4,600		(6) 30,000
			CB 18,000		CB 79,000

UNEARNED REVENUE	
(13) 3,000	
CB 3,000	

CAPITAL STOCK		RETAINED EARNINGS		DIVIDENDS PAID	
PB 30,000		PB 32,000		14,600	
(7) 19,000		CB 32,000		CB 600	
CB 49,000					

SALES OF MERCHANDISE		COST OF GOODS SOLD		RENT EXPENSE	
PB 250,000		PB 150,000		PB 12,000	
(4A) 5,000		(4B) 2,000		CB 12,000	
CB 255,000		CB 152,000			

SALARY EXPENSE		INSURANCE EXPENSE		GAIN ON SALE OF LAND	
PB 60,000		PB 3,700		(12) 3,000	
(2) 300		CB 3,700		CB 3,000	
CB 60,300					

UTILITIES EXPENSE	
PB 10,000	

Figure 4.21 *Lawndale Company Trial Balance (after all journal entries have been posted)—December 31, Year Four*

Lawndale Company Updated Trial Balance December 31, Year Four		
<u>Account</u>	<u>Debit</u>	<u>Credit</u>
Cash	\$41,400	
Accounts Receivable	50,000	
Inventory	65,000	
Prepaid Rent	4,000	
Truck	40,000	
Accounts Payable		\$18,000
Unearned Revenue		3,000
Notes Payable (long-term)		79,000
Capital Stock		49,000
Retained Earnings (beginning of year)		32,000
Dividends Paid	600	
Sales of Merchandise		255,000
Cost of Goods Sold	152,000	
Rent Expense	12,000	
Salary Expense	60,300	
Utilities Expense	10,000	
Insurance Expense	3,700	
Gain on Sale of Land		3,000
Totals	\$439,000	\$439,000

KEY TAKEAWAY

Initial coverage of the recording of basic transactions is concluded here through analysis of the payment of insurance, the contribution of capital, the purchase and sale of land, the receipt of cash prior to work being performed, the payment of dividends to owners, and the like. After the impact of each event is ascertained, debits and credits are used to record these changes within the journal. These journal entries are then posted to the appropriate T-accounts to monitor the ever-changing account balances. All T-accounts are physically located in a ledger, which is also known as a general ledger. Journal entries document the effect of transactions. T-accounts maintain the current balance of every account.

Talking with a Real Investing Pro (Continued)

Following is a continuation of our interview with Kevin G. Burns.

Question: When you were a college student majoring in accounting, you learned all the debit and credit rules as well as about the role of journal entries and the general ledger. In your years as an investment advisor, has this knowledge ever proven to be helpful to you and your career?

Kevin Burns: Although I never planned to be an accountant when I was in college, I found the internal logic of the debit and credit rules quite fascinating. Thinking through transactions and figuring out the proper recording process was a great introduction to business operations. In all honesty, as an investment advisor, I pay more attention to asset values and other balance sheet information than the accounting process that is used to gather this information. However, I also happen to own a restaurant and I always find it interesting when I dig through the specific expense accounts looking for ways to be more efficient.

For instance, recently when I saw that we had spent a lot of money last year on building maintenance, I could not imagine how that was possible. I dug through the T-account myself and found a recording error that needed to be fixed that changed our net income. My background allowed me to understand the entire process. Frequently, as I study the various debits within our expenses, I am able to spot areas where the restaurant can save money. I am always amazed that some business owners seem almost scared to look into their own financial information. I think they are afraid of feeling stupid. But, the more information you have, the more likely it is that you will make money.

Video Clip

[\(click to see video\)](#)

Professor Joe Hoyle talks about the five most important points in [Chapter 4 "How Does an Organization Accumulate and Organize the Information Necessary to Create Financial Statements?"](#).

4.6 End-of-Chapter Exercises

QUESTIONS

1. What is a transaction?
2. When and where was the basic accounting system developed that is still used by organizations today?
3. What is meant by the term “double-entry bookkeeping”?
4. What are the four basic steps followed in an accounting system?
5. How is information about the impact of a transaction initially captured in an accounting system?
6. How is information about specific account balances accumulated?
7. Which accounts are increased with a debit?
8. Which accounts are increased with a credit?
9. Susan Osgood works as an accountant and maintains the journal for the Nelson Corporation. What is the purpose of a journal?
10. In a journal entry, why do the debit figures always agree with the credit figures?
11. What is a trial balance?
12. What function does accrual accounting serve?
13. Accrual accounting is composed of which two principles? Define each.
14. An accountant indicates that a certain expense was recognized in the current year because of the matching principle. What does that mean?
15. The Abraham Company receives \$27,000 to do a job. However, the work is not yet completed. How is the receipt of this money recognized for financial reporting purposes?

TRUE OR FALSE

1. ____ Debits and credits must equal for every transaction.
2. ____ A list of all recorded journal entries is recorded in the ledger, which is maintained by a company.
3. ____ Revenue may not be recorded until cash is collected.
4. ____ A transaction is any event that has a financial impact on a company.
5. ____ The balance of an expense account is increased with a credit.
6. ____ Examples of accrued expenses include salary, rent, and interest.
7. ____ The term “revenue” and the term “gain” are interchangeable.
8. ____ Posting refers to the process of analyzing transactions and producing journal entries.
9. ____ A company must recognize each accrued expense as it is incurred.
10. ____ The matching principle states that expenses should be recognized in the same period as the revenue they help generate.
11. ____ Unearned revenue is reported on the balance sheet as a liability account.
12. ____ The Hampstone Company buys 20,000 pieces of inventory (all identical) for \$70,000. The company sells 8,000 units of this inventory for \$5 each in cash. The company should debit cash for \$40,000, credit inventory for \$28,000, and credit gain for \$12,000.
13. ____ Assume a company buys inventory for \$8,000 for cash. It then spends \$700 in cash on advertising in order to sell 60 percent of the inventory for \$11,000. Of that amount, it collects \$5,000 immediately and will collect the remaining \$6,000 next year. The company pays a cash dividend of \$1,000. The amount of net income to be recognized this year will be \$5,500.
14. ____ A company buys inventory for \$6,000 on credit on December 31, Year One. By accident, the journal entry is made backward (debits are shown as credits and credits are shown as debits). The company reports working capital of \$140,000. The correct amount of working capital is \$134,000.
15. ____ A matching principle is the portion of U.S. GAAP that sets the rule for the timing of recognition of revenues.
16. ____ Assume a company buys inventory for \$3,000 on credit. It then spends \$400 on advertising in order to sell 30 percent of the inventory for \$9,000. Of that amount, it collects \$5,000 immediately and will collect the remaining \$4,000 next year. The amount of gross profit to be recognized this year will be \$7,700.

MULTIPLE CHOICE

1. Which of the following is **not** true about double-entry bookkeeping?
 - a. It originated in Italy.
 - b. Debits and credits must equal.
 - c. It is still used today by most businesses.
 - d. Each entry can have only one credit and one debit.
2. Which of the following entries could Yeats Company not make when they perform a service for a client?

a. *Figure 4.22*

Accounts Receivable	XXX	
Revenue		XXX

b. *Figure 4.23*

Cash	XXX	
Revenue		XXX

c. *Figure 4.24*

Accounts Payable	XXX	
Revenue		XXX

d. *Figure 4.25*

Cash	XXX	
Accounts Receivable	XXX	
Revenue		XXX

3. Which of the following is a transaction for Tyler Corporation?
 - a. Tyler pays its employees \$400 for work done.
 - b. Tyler considers renting office space that will cost \$1,500 per month.

- c. Tyler agrees to perform services for a client, which will cost \$7,000.
 - d. Tyler places an order for supplies that will be delivered in two weeks. The supplies cost \$200.
4. Elenor Company sells 400 units of inventory for \$40 each. The inventory originally cost Elenor \$26 each. What is Elenor's gross profit on this transaction?
- a. \$ 5,600
 - b. \$ 9,600
 - c. \$10,400
 - d. \$16,000
5. Which of the following increases with a debit?
- a. Retained earnings
 - b. Sales revenue
 - c. Inventory
 - d. Note payable
6. In January, Rollins Company is paid \$500 by a client for work that Rollins will not begin until February. Which of the following is the correct journal entry for Rollins to make when the \$500 is received?

a. *Figure 4.26*

Cash	500	
Accounts Receivable		500

b. *Figure 4.27*

Cash	500	
Unearned Revenue		500

c. *Figure 4.28*

Cash	500	500
Revenue		

d. *Figure 4.29*

Accounts Receivable	500	500
Revenue		

7. The accountant for the Babson Corporation determines that the current Cash balance held by the company is \$32,564. Which of the following could not have been the source of that information?
 - a. Trial balance
 - b. Journal
 - c. T-account
 - d. Ledger

8. In the accounting system for the Caldwell Company, which of the following comes first?
 - a. Journal
 - b. Financial statements
 - c. T-account
 - d. Ledger

9. Which of the following T-accounts is least likely to have a credit balance?
 - a. Revenue
 - b. Equipment
 - c. Accounts payable
 - d. Capital stock

10. The Brooklyn Corporation rents a building for \$100 per day. The company's accounting system accrues this expense each day.

After twelve days, payment is made. What account is debited when that payment is made?

- a. Rent expense
- b. Rent payable
- c. Cash
- d. Cannot be determined based on the information provided

11. The Bronx Corporation rents a building for \$100 per day. The company's accounting system makes no recognition of this expense as it accrues. After twelve days, payment is made. What account is debited when that payment is made?

- a. Rent expense
- b. Rent payable
- c. Cash
- d. Cannot be determined based on the information provided

VIDEO PROBLEMS

Professor Joe Hoyle discusses the answers to these two problems at the links that are indicated. After formulating your answers, watch each video to see how Professor Hoyle answers these questions.

1. Your roommate is an English major. One of the roommate's parents works as an accountant for the family's business, a corporation that owns a number of ice cream stores in Florida. The parent is constantly talking about working with debits and credits, which seems like some foreign language to your roommate. One day, on the way to the fitness center, your roommate blurts out this question: "What in the world are debits and credits? How can they possibly be so important?" How would you respond?

[\(click to see video\)](#)

2. Your uncle and two friends started a small office supply store at the beginning of the current year. Almost immediately, it becomes obvious to them that they need some system for keeping their financial records. They will eventually have to report their income taxes, and they may well need monetary information for a bank loan. Your uncle knows that you are taking a financial accounting course in college. He sends you an e-mail and asks if you can provide some suggestions on getting started with this record-keeping process. He realizes that you have just started your course, but he hopes that you can give him some basic ideas on how to gather the needed information. How would you respond?

[\(click to see video\)](#)

PROBLEMS

1. For each of the following transactions of the Hamner Corporation, indicate what accounts are affected and whether they increase or decrease.
 - a. Owners put \$30,000 in cash into the business.
 - b. The company borrows \$15,000 in cash from the bank on a note payable.
 - c. The company buys equipment for \$19,000 using cash.
 - d. The company buys machinery at a cost of \$11,000 that will be paid within thirty days.
 - e. The company sells services for \$14,000. It collects \$2,000 immediately (when the work is done) with the rest due at the end of the month.
 - f. The company pays \$5,000 in rent on a building that was used during the past month. The expense has not been accrued over that time.
 - g. The company pays a \$3,000 dividend to its owners.
 - h. The company buys inventory for \$10,000 on credit.
 - i. The company sells the above inventory for \$18,000. It collects \$7,000 immediately with the rest to be received within the next few weeks.
 - j. The company pays for inventory bought in transaction h.
 - k. The company collects money due from the sale in transaction i.

2. For each of the following is a debit or credit needed to reflect the impact?
 - a. Equipment increases
 - b. Salary payable increases
 - c. Cash decreases
 - d. Rent expense increases
 - e. Sales revenue increases
 - f. Accounts receivable decreases
 - g. Capital stock increases
 - h. Inventory decreases
 - i. Accounts payable decreases
 - j. Salary expense decreases

3. Record the following journal entries for Taylor Company for the month of March:
 - a. Borrowed \$4,500 from Local Bank and Trust
 - b. Investors contributed \$10,000 in cash for shares of the company's stock.
 - c. Bought inventory costing \$2,000 on credit
 - d. Sold inventory that originally cost \$400 for \$600 on credit
 - e. Purchased a new piece of equipment for \$500 cash
 - f. Collected \$600 in cash from sale of inventory in (d)
 - g. Paid for inventory purchased in (c)
 - h. Paid \$1,200 in cash for an insurance policy that covers the next year
 - i. Employees earned \$3,000 during the month but have not yet been paid; this amount has been recorded by the company as it was earned.
 - j. Paid employees \$2,900 of the wages earned and recorded during February
4. For each of the following transactions, determine if Raymond Corporation has earned revenue during the month of May and, if so, how much has been earned.
 - a. Customer A paid Raymond \$1,500 for work Raymond will perform in June.
 - b. Customer B purchased \$6,000 in inventory with the total payment expected to be received in four weeks. Those items had cost Raymond \$3,600 in February.
 - c. Raymond performed a service for Customer C and was paid \$3,400 in cash.
 - d. Customer D paid Raymond \$2,300 for inventory that was purchased previously in April.
5. Record the journal entries for the transactions in number 4 above.
6. The following are the account balances for the Ester Company for December 31, Year Four, and the year that ended. All accounts have normal debit or credit balances. For some reason, company accountants do not know the amount of sales revenue earned this year. What is the balance of that account?

Figure 4.30
Trial Balance—Ester Company

Ester Company T-Account Balances December 31, Year Four	
Account	Balance
Cash	\$22,000
Accounts Receivable	85,000
Inventory	113,000
Land	175,000
Accounts Payable	14,000
Salary Payable	7,000
Notes Payable	125,000
Capital Stock	90,000
Retained Earnings, 1/1/04	114,000
Sales Revenue	not given
Cost of Goods Sold	185,000
Salary Expense	89,000
Utilities Expense	15,000
Dividends Paid	6,000

7. State whether a debit or credit balance is normal for each of the following T-accounts:
- Cash
 - Dividends paid
 - Notes payable
 - Unearned revenue
 - Cost of goods sold
 - Prepaid rent
 - Accounts receivable
 - Capital stock
8. Near the end of her freshman year at college, Heather Miller is faced with the decision of whether to get a summer job, go to summer school, or start a summer dress-making business. Heather has some experience designing and sewing and believes that third option might be the most lucrative of her summer alternatives. Consequently, she starts “Sew Cool.”

During June, the first month of business, the following occur:

- Heather deposits \$1,000 of her own money into Sew Cool’s checking account.
- Sew Cool purchases equipment for \$1,000. The company signs a note payable for this purchase.

- c. Sew Cool purchases \$1,000 in sewing supplies and material paying cash.
- d. Sew Cool gives Heather's parents a check for \$80 for rent (\$70) and utilities (\$10) for the past four weeks.
- e. Heather sews and sells twenty dresses during the month. Each dress has a price of \$60. Cash is received for twelve of the dresses, with customers owing for the remaining eight.
- f. The dresses sold cost \$35 each to make.
- g. Sew Cool purchases advertising for \$50 cash.
- h. Sew Cool pays Heather a cash dividend of \$10 cash.

- i. Sew Cool's taxes, paid in cash, amount to \$87.

Required:

- a. Prepare journal entries for the previous transactions.
 - b. Prepare t-accounts for each account used.
 - c. Prepare a trial balance for June.
9. Bowling Corporation had the following transactions occur during January:
- a. Bowling purchased \$450,000 in inventory on credit.
 - b. Bowling received \$13,000 in cash from customers for subscriptions that will not begin until the following month.
 - c. Bowling signed a note from Midwest Bank for \$67,000.
 - d. Bowling sold all the inventory purchased in (a) for \$700,000 on account.
 - e. Bowling paid employees \$120,000 for services performed (and recorded) during the previous year.
 - f. Bowling purchased land for \$56,000 in cash.
 - g. Bowling received \$650,000 in cash from customers paying off previous accounts receivable.
 - h. Bowling paid dividends to stockholders in the amount of \$4,000.
 - i. Bowling owes its employees \$123,000 for work performed during the current month but not yet paid.
 - j. Bowling paid \$300,000 on its accounts payable.

 - k. Bowling paid taxes in cash of \$45,000.

Required:

- a. Prepare journal entries for the previous transactions.
- b. Complete the following T-accounts. Numbers already under the accounts represent the prior balance in that account.

Figure 4.31
Opening T-Account Balances

<u>Cash</u> 500,000	<u>Accounts Receivable</u> 650,000	<u>Inventory</u> 0	<u>Land</u> 22,000	<u>Accounts Payable</u> 100,000
<u>Unearned Revenue</u> 0	<u>Salary Payable</u> 120,000	<u>Notes Payable</u> 430,000	<u>Capital Stock</u> 302,000	
<u>Retained Earnings</u> 220,000	<u>Sales Revenue</u> 0	<u>Cost of Goods Sold</u> 0	<u>Salary Expense</u> 0	
<u>Tax Expense</u> 0	<u>Dividends</u> 0			

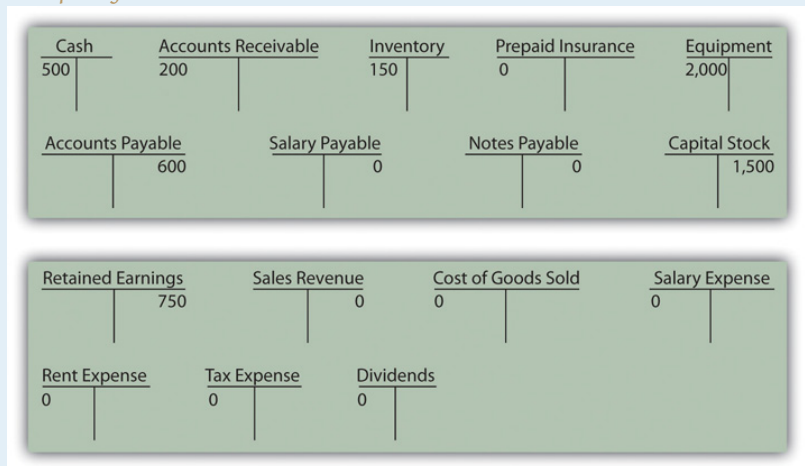
- c. Prepare a trial balance for the end of January.
10. The following events occurred during the month of January for McLain Company.
- a. McLain purchases inventory costing \$1,800 on account.
 - b. McLain sells 240 units for \$20 each. McLain collects cash for 200 of these units. These specific units cost McLain \$8 each to purchase.
 - c. McLain collects \$500 in cash on its accounts receivable.
 - d. McLain takes out a loan for \$400.
 - e. McLain pays out \$350 cash in dividends.
 - f. McLain receives a contribution of \$600 in cash from its owners in exchange for capital stock shares.
 - g. McLain purchased a new piece of equipment. The new equipment cost \$1,000 and was paid for in cash.

- h. McLain pays \$500 of its accounts payable.
- i. McLain incurs \$500 in salaries expense, but will not pay workers until next month.
- j. McLain incurs \$300 in rent expense and pays it in cash.
- k. McLain prepays \$200 in cash for insurance.
- l. Taxes, paid in cash, are \$110.

Required:

1. Prepare journal entries for the earlier transactions.
2. Complete the following T-accounts. Numbers already under the accounts represent the prior balance in that account.

Figure 4.32
Opening T-Account Balances



3. Prepare a trial balance for January.

RESEARCH ASSIGNMENT

A newspaper company collects money for subscriptions before its newspapers are physically delivered. How large is that liability, and when does it become revenue?

Go to <http://www.nytimes.com/>. At **The New York Times** Web site, scroll to the bottom of the screen and click on “The New York Times Company.” Click on “Investors” at the top of the next screen. Click on “Financials” on the left side of the next screen. In the center of the next page, click on “2010 Annual Report & Form 10-K” to download.

After the document has downloaded, scroll to page 63 to look at the company’s balance sheet. Does **The New York Times Company** report any unearned revenue within its liabilities?

Next, scroll to page 72. Within the notes to financial statements, a description is provided of the revenue recognition procedures used by **The New York Times Company**. What information is presented to decision makers by the last sentence in the fourth bullet point?