

# CHAPTER 2

## Recording Business Transactions

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### Chapter Overview

Chapter 2 introduces the account, the journal. Asset, liability, and owner's equity accounts are briefly described. Owner's equity accounts; capital, withdrawals, revenues and expenses are then discussed in greater detail. The concept that accounting involves a "double-entry system" is explained. Every transaction will affect at least two accounts. The text uses a T-account to record transactions. The T-account has a left and a right side. Every transaction will result in amounts being entered on the left and right side of the accounts, the total of which will be equal after each transaction is recorded. The term "debit" is used to describe entries on the left side and the term "credit" is used to describe entries on the right side of the account. For every debit, there is an equal amount of credit entered in the accounts. The accounting equation can be viewed as one large T-account with assets on the left and liabilities and owner's equity accounts on the right. The rules for "debits" and "credits" are explained for asset, liability or owner's equity accounts.

The journal is introduced and the four-step process of recording transactions (journalizing) is illustrated. The posting process is explained briefly. A series of entries are analyzed, journalized, and posted to T-accounts in the ledger. The trial balance is defined and prepared. The reason for preparing the trial balance is explained, and some accounting errors revealed by a trial balance are described. A mid-chapter summary problem reviews how to journalize, post, and prepare a trial balance.

Details of journals, ledgers, and the posting process are presented, including an illustration of a 3-column account with a running balance. A chart of accounts is illustrated, and the normal balances of accounts are explained. Appendix D, at the end of the textbook, illustrates typical charts of accounts for different types of businesses. The rules of debit and credit are expanded to include specific types of owner's equity accounts.

**DECISION GUIDELINES** are presented that assist the student in analyzing and recording transactions.

The chapter concludes with a summary problem that reviews opening accounts, journalizing, posting, preparing a trial balance, and computing net income or net loss.

Students should be directed to [www.myaccountinglab.com](http://www.myaccountinglab.com). The **Student CD-ROM** includes a number of tutorials (Accounting Cycle Tutorials) covering various topics in Chapter 2; 1. Balance Sheet Accounts and Transactions, 2. Income Statement Accounts and Transactions, and 3. The Journal and the Ledger. Also included are Excel templates for Exercise 2-5 and 2-10.

### Learning Objectives

*After studying Chapter 2, your students should be able to:*

1. Define and use key accounting terms
2. Apply the rules of debit and credit
3. Analyze and record transactions in the journal
4. Post from the journal to the ledger
5. Prepare and use a trial balance
6. Set up a chart of accounts for a business

### **Suggested Priority of Chapter Topics**

#### *Must Cover*

- Terminology and description of the accounts
- Double-entry accounting
- Transaction analysis
- The T-account
- The debit credit rules
- The recording transactions in the journal
- Posting from the journal to the ledger accounts
- Details of ledgers and journals
- The trial balance
- Correcting errors trial balance errors

#### *Recommended*

- Chart of accounts
- Normal balance of an account
- Expanding the rules of debit and credit to include withdrawals, revenue and expense accounts

## Chapter Outline

### *Objective 1: Define and use key accounting terms*

- A. **Account** — a basic component of an accounting system. The account shows all the increases and decreases in a particular asset, liability, or owner's equity during a period. Accounts are grouped based on the accounting equation,  $A = L + O/E$ .
- B. **Ledger** — a group of accounts. All the accounts of a business grouped together form a book called the ledger. Exhibit 2-1 shows how accounts are grouped in the ledger.
- C. **Assets** — economic resources that will benefit the business in the future. Cash, accounts and notes receivable, prepaid expenses, land, building, furniture, and equipment are examples of assets.
- D. **Liabilities** — debts or other obligations of the business that must be satisfied in the future. Examples of liabilities are accounts and notes payable, and other accrued liabilities such as taxes payable, salary payable, and interest payable. **Accrued liabilities** are expenses that have not been paid.
- E. **Owner's Equity** — in a proprietorship, the owner's claims to the assets owned by the business. Capital, withdrawals, revenues, and expenses are owner's equity accounts.
1. **Capital** — the owner's claim to the business. The owner's investments and net income increase capital and therefore increase owner's equity.
  2. **Withdrawals** — the owner's withdrawals of cash or other assets from the business for personal use. Withdrawals decrease owner's equity.
  3. **Revenues** — increases in owner's equity from performing services or selling products. Service revenue, interest revenue, and rent revenue are examples.
  4. **Expenses** — costs incurred in operating a business. Expenses decrease owner's equity. A business may have many different expenses, including salary, rent, interest, repairs, and so on.

#### **Teaching Tip**

Accounting is based on these six types of accounts; Assets, Liabilities, Capital, Withdrawals, Revenues and Expenses. Students should have a good understanding of each before continuing.

- F. **Double-entry accounting** — records the dual effects of a business transaction. The dual effects of a transaction can also be described as having a "receiving side" and a "giving side" Each transaction affects at least two accounts. One account "receives" while the other "gives" Consider the purchase of a Building for Cash. A Building was "received" and Cash was "given."
- G. The **T-account** is an abbreviated form of a ledger account used to help illustrate the effect of transactions.

Account Name	
<b>Debit</b> entries (left side)	<b>Credit</b> entries (right side)

**Objective 2: Apply the rules of debit and credit**

A. The type of account determines the side on which increases and decreases are recorded; the **rules of debit and credit** keep the accounting equation in balance.

1. **Increases in assets** are recorded on the **left (debit)** side of the account. **Decreases in assets** are recorded on the **right (credit)** side.

Asset	
<b>Debit</b> entries (left side) Increases	<b>Credit</b> entries (right side) Decreases

2. Rules for liabilities and owner's equity accounts are the opposite of the rules for assets. **Increases in liabilities** and **owner's equity** accounts are recorded on the **right (credit)** side of an account, and **decreases** are recorded on the **left (debit)** side.

Liability and Owner's Equity	
<b>Debit</b> entries (left side) Decreases	<b>Credit</b> entries (right side) Increases

- B. Summaries of the **rules of debit and credit** are found in Exhibits 2-3 and 2-8. Assets, liabilities, and owner's equity are listed first in Exhibit 2-3, and then revenues, and expenses, and withdrawals are added in Exhibit 2-8.
- C. Double-entry accounting and the rules of debit and credit are based on the **accounting equation**,  $A = L + O/E$ . After each transaction is recorded, the equation must remain in balance, as illustrated in Exhibit 2-4.
- D. After increases and decreases in an account are recorded, the amount remaining in the account is its **balance**. Account balances are computed by adding the beginning balance and the increases, and subtracting the decreases. (The balance equals the difference between total debit entries and total credit entries.)
- E. Create or **open** new accounts as needed when recording transactions.

**Objective 3: Analyze and record transactions in the journal**

- A. Transactions are **recorded first in the journal**, a chronological listing of all the entity's business transactions. (Refer to Exhibit 2-5 for an illustration of the journal.)
- B. **Analysis of each transaction** involves these steps:
1. **Identify the transaction** from the source document, such as a sales invoice or cheque stub.
  2. **Identify the types of accounts** affected by the transaction, such as asset or expense.
  3. **Determine which accounts increase and which decrease.** (Some transactions may require *only* increases or *only* decreases.) **Apply the rules of debit and credit.**
  4. **Write the transaction in the journal**, listing first the debit and then the credit. Include a brief explanation. Verify that total debits equal total credits.
- C. The journal shows the **complete effect of each transaction**, not just one part of it. The journal provides more information than the ledger.
- D. Personal transactions of the owner and transactions of other businesses are not included on the financial statements of a business.

#### Teaching Tip

Refer students to the Student CD-ROM to work through the Accounting Cycle Tutorials for The Journal and The Ledger

#### **Objective 4: Post from the journal to the ledger**

- A. **Posting** — the process of transferring data from the journal to the accounts in the ledger.
1. Debits in the journal are posted as debits to the appropriate accounts; credits in the journal are posted as credits to the appropriate accounts.
  2. All transactions must be keyed by date or number to link information. (Exhibits 2-5 and 2-6 illustrate the flow of accounting information, from journalizing the original entry to posting it to the accounts in the ledger.)
- B. Posting may be performed manually, or a computerized accounting program may be used to perform the task quickly and error-free.

#### Teaching Tip

Walk through the journalizing and posting process with students from the first step of identifying source documents to recording the account numbers in the journal after amounts have been posted to the ledger.

- C. An expanded accounting equation, in Exhibit 2-8, illustrates how beginning capital, withdrawals, revenues, and expenses are all part of owner's equity.

1. An expense is recorded with a debit to a specific expense account.
  2. A revenue is recorded with a credit to a specific revenue account.
  3. Withdrawals are recorded with a debit to the Withdrawals account.
- D. The **normal balance** of an account is the side used to record increases; Exhibit 2-9 lists the normal balances for all types of accounts.
- E. An account that has a **negative balance** (the opposite of its normal balance) may indicate that an error has been made.

### Teaching Tip

Students should become thoroughly familiar with the rules of debits and credits and the normal balances of accounts.

#### **Objective 5: Prepare and use a trial balance**

- A. The **trial balance** is a listing, in general ledger order, of the debit or credit balance in each account. (Refer to Exhibit 2-12.) The trial balance is *not* one of the four financial statements, but merely a **tool** for the accountant.
- B. The trial balance proves whether debit balances in the accounts equal credit balances.
- C. Unequal column totals indicate at least one error. Some **common errors** are:
1. Posting incorrectly.
  2. Mathematical errors.
    - a. **Transposition** means digits are written in the wrong order. (For example, instead of \$567, the number is written as \$657.) A transposition error is always evenly divisible by 9 ( $\$657 - \$567 = \$90$ , which is divisible by 9).
    - b. A **slide** means that one or more zeroes are added to, or left off, a number (\$1,000 is written as \$100). A slide is always evenly divisible by 9.
  3. Omitting or entering account balances in the wrong column of the trial balance.
- D. Equal trial balance totals prove only that **debits posted to accounts equal credits posted to accounts**. Errors in transactions that have equal debits and credits will not be revealed by unequal trial balance totals.
- E. Posting provides a **cross-reference** between the journal and the ledger.
1. Exhibit 2-13 illustrates a journal and ledger, including several transactions, showing in full the details of the posting process, references, and account numbers. The three-column format of ledger with a running balance is most often used in practice and is shown in Exhibit 2-13.
  2. **“Journal reference”** tells which journal and page number the entry comes *from*.
  3. **“Posting reference”** tells which account number the entry is posted *to*.

4. The reference columns indicate which transactions or parts of transactions have been posted.

**Teaching Tip**

Emphasize the trial balance as a “tool” used to ensure that the dollar amount of debits equal credits. Students often confuse the trial balance with the balance sheet. Point out the differences between them and emphasize their role in the accounting reporting process.

**Objective 6: Set up a chart of accounts for a business**

- A. The **chart of accounts** lists all the accounts by account number. (Two examples are given in Exhibit 2-14 and 2-15.)
- B. Accounts are **numbered** beginning with assets, then liabilities, owner’s equity, revenues, and finally expenses; accounts in the ledger are always in this same order.

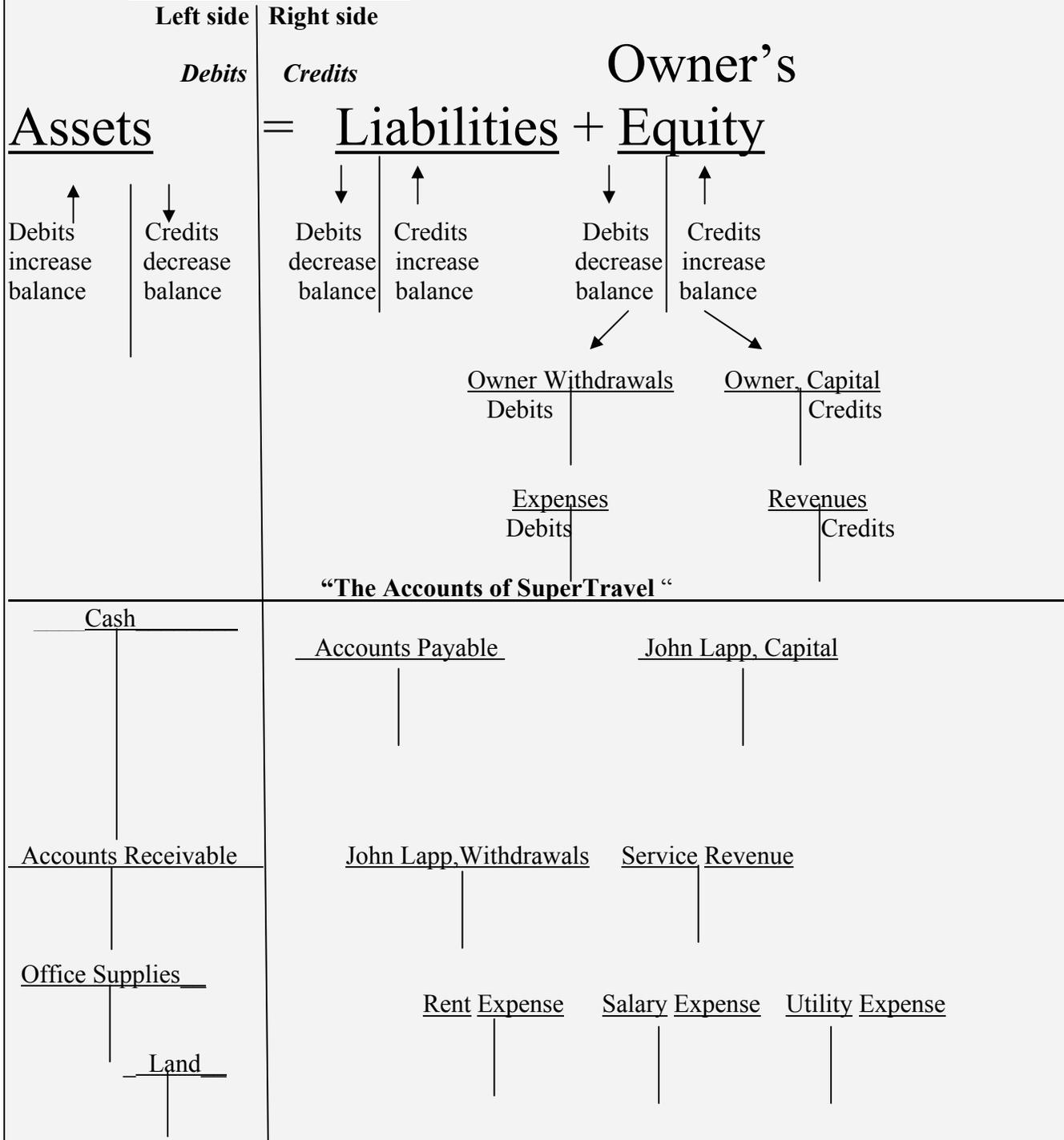
**Teaching Tip**

Assets are normally numbered in the 100’s or 1000’s, Liabilities 200 or 2000’s, Owner’s Equity 300 or 3000’s, Revenues 400 or 4000’s, and Expenses 500 or 5000’s

**DECISION GUIDELINES** for analyzing and recording transactions are presented.

**Teaching Tip**

**Apply the Rules of Debit and Credit to  
The Accounting Equation**



Have students use the above T-accounts to post the transactions shown in Exhibit 1-9 from Chapter 1. Point out that both the owner’s Capital and Revenue accounts increase with credits, while Withdrawals and Expenses increase with debits.

**Answer key to Chapter 2 Quiz**

1. B   2. A   3. C   4. D   5. A   6. A   7. B   8. C   9. B   10. D

**Assignment Grid**

<b>Assignment</b>	<b>Topic(s)</b>	<b>Learning Objective(s)</b>	<b>Estimated Time in Minutes</b>	<b>Level of Difficulty</b>
Starter 2-1	Use accounting terms	1	5-10	Easy
Starter 2-2	Use accounting terms	1	5-10	Easy
Starter 2-3	Use accounting terms	1	5-10	Easy
Starter 2-4	Explaining the rules of debit and credit	2	5-10	Easy
Starter 2-5	Normal account balances	2	5-10	Easy
Starter 2-6	Recording transactions	3	10-15	Medium
Starter 2-7	Recording transactions	3	10-15	Medium
Starter 2-8	Journalizing transactions, posting	3,4	10-15	Medium
Starter 2-9	Journalizing transactions, posting	3,4	15-20	Medium
Starter 2-10	Posting, preparing a trial balance	4,5	20-30	Medium
Starter 2-11	Preparing a trial balance	5	20-30	Medium
Starter 2-12	Correcting a trial balance	5	20-30	Difficult
Starter 2-13	Correcting a trial balance	5	20-30	Difficult
E2-1	Using accounting vocabulary	1	10-15	Easy
E2-2	Using debits and credits with the accounting equation	1,2	10-15	Easy
E2-3	Analyzing and journalizing transactions	2,3	10-20	Easy
E2-4	Applying the rules of debit and credit	2	10-20	Medium
E2-5	Journalizing transactions	3	10-25	Easy
E2-6	Posting to the ledger and preparing a trial balance	4,5	20-30	Medium
E2-7	Describing transactions and posting	3,4	20-30	Difficult
E2-8	Journalizing transactions	3	10-20	Medium
E2-9	Preparing a trial balance	5	10-20	Medium
E2-10	Preparing a trial balance	5	10-20	Medium
E2-11	Journalizing and posting	3,4	15-25	Medium
E2-12	Preparing a trial balance	5	5-15	Easy
E2-13	Correcting errors in a trial balance	5	20-30	Medium
E2-14	Recording transactions and preparing a trial balance	2,3,4,5	20-30	Medium
E2-15	Computing financial statement amounts	2,5	30-50	Difficult
E2-16	Analyzing accounting errors	2,3,5	20-30	Difficult
BN2-1	Identifying the accounts of a new business	6	15-20	Difficult
Ethical Issue				
P2-1A	Analyzing a trial balance	1	15-30	Easy
P2-2A	Analyzing and journalizing transactions	2,3	20-30	Medium
P2-3A	Journalizing transactions, posting to T-accounts, and preparing a trial balance	2,3,4,5	40-50	Medium
P2-4A	Journalizing transactions, posting to ledger accounts, and preparing a trial balance	2,3,4,5	45-60	Medium
P2-5A	Recording transactions; using three-column ledger accounts; preparing a trial balance	2,5	15-20	Difficult
P2-6A	Preparing the financial statements	5	40-50	Medium
P2-7A	Correcting errors in a trial balance	2,5	20-30	Difficult
P2-8A	Applying the rules of debit and credit,			

P2-9A	and recording transactions in the journal Applying the rules of debit and credit, recording transactions	2,3	30-40	Medium
P2-1B	Analyzing a trial balance	1	15-30	Difficult Easy
P2-2B	Analyzing and journalizing transactions	2,3	20-30	Medium
P2-3B	Journalizing transactions, posting to T-accounts, and preparing a trial balance	2,3,4,5	40-50	Medium
P2-4B	Journalizing transactions, posting to three-column ledger accounts, and preparing a trial balance	2,3,4,5	45-60	Medium
P2-5B	Recording transactions, using three-column ledger accounts, preparing a trial balance	2,3,5	15-20	Difficult
P2-6B	Preparing the financial statements	5	40-50	Medium
P2-7B	Correcting errors in a trial balance	2,5	20-30	Medium
P2-8B	Applying the rules of debit and credit, and recording transactions in the journal	2,3	30-40	Medium
P2-9B	Applying the rules of debit and credit, and recording transactions	2,3	20-30	Medium
P2-1C	Understanding the rules of debit and credit	2	15-20	Medium
P2-2C	Using a formal accounting system	3,4	15-20	Medium
P2-3C	Understanding the rules of debit and credit; preparing a trial balance	2,5	20-30	Difficult
Decision Problem-1	Recording transactions directly in the ledger, preparing a trial balance, and measuring net income or loss	2,3,4,5,	40-50	Difficult
Decision Problem-2	Using the accounting equation	2	15-30	Medium
Financial Statement Cases-1	Journalizing transactions	2,3	20-30	Medium
Financial Statement Cases-2	Journalizing transactions; posting to t-accounts	2,3,4	30-40	Medium

Name \_\_\_\_\_ Date \_\_\_\_\_ Section \_\_\_\_\_

**CHAPTER 2  
TEN-MINUTE QUIZ****Circle the letter of the best response.**

1. Which of these is (are) an example of a liability account?
  - A. Withdrawals
  - B. Salary Payable
  - C. Rent Expense
  - D. All of the above are liabilities
  
2. Swanson Company agreed to sell to Fowler Company \$500 of office supplies for \$500 cash—the cost of these supplies. The effect of this transaction on the accounting equation is to:
  - A. Have no effect on total assets.
  - B. Increase assets and decrease owner's equity.
  - C. Increase assets and increase liabilities.
  - D. Decrease assets and decrease owner's equity.
  
3. Which of these statements is true?
  - A. Decreases in assets and increases in liabilities are recorded with a debit.
  - B. Increases in assets and increases in owner's equity are recorded with a credit.
  - C. Increases in both assets and expenses are recorded with a debit.
  - D. Decreases in liabilities and increases in revenues are recorded with a credit.
  
4. Accounts Payable has a normal beginning balance of \$18,500. During the period, purchases on account total \$45,600 and payments on account total \$50,500. Determine the correct ending balance in Accounts Payable.
  - A. \$23,400, credit
  - B. \$13,600, debit
  - C. \$23,400, debit
  - D. \$13,600, credit
  
5. Which of these statements is correct?
  - A. The journal is the first place accounting transactions are written.
  - B. A business transaction is recorded first in the ledger and then posted to the journal.
  - C. The ledger is a chronological listing of all transactions.
  - D. Either the debit or the credit entry may be recorded first in a journal entry.
  
6. Which of these accounts has a normal credit balance?
  - A. Capital
  - B. Withdrawals
  - C. Cash
  - D. Salary Expense
  
7. A list of all accounts with their balances is the:
  - A. Chart of accounts
  - B. Trial balance
  - C. Ledger
  - D. Journal

8. The beginning Cash account balance is \$44,200. During the period, cash receipts are \$98,100. If ending Cash is \$32,800, then cash payments must have been:

- A. \$21,100
- B. \$86,700
- C. \$109,500
- D. \$175,100

9. Use the following selected information for Martinez Company to calculate the correct debit column total for a trial balance:

Accounts receivable	\$ 3,600
Accounts payable	3,450
Building	89,800
Cash	7,800
Capital	32,000
Insurance expense	3,300
Salary expense	28,000
Salary payable	1,800
Service revenue	95,250

- A. \$101,200
- B. \$132,500
- C. \$227,750
- D. \$164,500

10. The journal entry to record the payment of \$750 to a vendor on account is:

- A. Accounts Receivable           750  
    Cash                                       750
- B. Cash                               750  
    Accounts Payable                       750
- C. Cash                               750  
    Accounts Receivable                   750
- D. Accounts Payable               750  
    Cash                                       750