

EFFECTS OF TRANSACTIONS ON THE BALANCE SHEET

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The Double-Entry System

- **Transaction:**
 - Any event that affects the entity's financial position and requires recording
- Every accounting transaction affects at least two items
- The basic equation is preserved

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An Example Entity

- MicroFlex, microcomputer retailing company with three investors
- Transaction 1:
 - Owners invest \$400,000 in the company

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Initial Paid-in Capital

- Owners deposit cash into the entity
- Cash increases
 -
- Paid-in capital increases
 -
- Dual-aspect concept: $A=L+E$
 -

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Transaction 2

- Company borrows \$100,000 from a local bank

What accounts are affected?

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Borrowing Money

- Signing a promissory note to get a loan
- Cash
 -
- Note payable
 -
 -

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Balance Sheet Transactions

Transaction 3

- Clone computers bought from supplier for \$150,000 cash

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Cash Purchase of Inventory

- No credit involved
- Inventory
 -
- Cash
 -
- Effect on
 - Total Assets?
 - Total Liabilities?

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Transaction 4

- Additional computer parts bought on open account from wholesaler for \$10,000

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Credit Purchase of Inventory

- Inventory
- Accounts payable (liability)
-

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Transaction 5

- Purchase of \$15,000 store equipment for \$4,000 cash and \$11,000 on credit

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Purchase Long-Term Asset

- Long-term asset
- Cash
- Payable liability
-

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Balance Sheet Transactions

Transaction 6

- Some store equipment sold to business neighbor for \$1000 cost, on 30-day credit
- Sale of Long-Term Asset
 - Decrease
 - Increase

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Transaction 7

- Microflex returns \$800 in defective computer parts to wholesaler for credit
- Return of Inventory
 - Decrease
 - Decrease

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Transaction 8

- Company pays \$4,000 to store equipment manufacturer
- Repayment of Loan
 - Decrease
 - Decrease

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Transaction 9

- Microflex collects \$700 of \$1000 owed by business neighbor
- Payment on account
 - Increase
 - Decrease

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INCOME STATEMENT

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Income

- **An increase in equity (retained earnings)**
 - due to operations
 - over some period of time
- Comes from transactions involving:
 - Revenue
 - Expense

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Balance Sheet Transactions

Revenue

- **The increase in Retained Earnings**
 - from one transaction
 - that involves operations
- Revenue results when a sale is made
 - Even if cash was not received at that time

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Expense

- **The decrease in R/E**
 - from one transaction
 - that involves operations
- Expense is the cost of a sale
 -
 -
 -

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Earnings/Income/Profit

- Difference between revenues and expenses for an accounting period
- **Loss: negative profit, when expenses > revenues**
- What is the difference between revenue and income?

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Retained Earnings

- **Income retained in the entity**
- Varies over time

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The Income Statement Reports:

- Amount and sources of income
- For a given period of time
 -
- Amount of

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Transaction 10

- Sale of computers, on credit, \$160,000
- Cost of inventory sold is \$100,000

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Balance Sheet Transactions

Sale of Goods on Credit

- Inventory
- Accounts Receivable
 - Legal claim on customer
- Earnings on transaction:
 - \$160,000 - 100,000 = 60,000
 - in Retained Earnings

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Transaction 11

- Paid \$6,000 cash for three months of rent, in advance

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Purchase of Prepaid Rent

- Cash
- Prepaid Rent, asset,
-

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Transaction 12

- Recognize expiration of rental services, \$2,000
- Prepaid Rent,
- Rent Expense

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Transaction 13

- Recognize depreciation of \$100 on store equipment

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THE RECORDING PROCESS

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Double-Entry Bookkeeping

Accounts

- Accumulate the effects of transactions on the individual items to be reported in financial statements
- Used instead of direct changes to balance sheets
- A transaction affects at least two accounts

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Double-Entry Bookkeeping

T-Account

- An account, depicted by a large “T”
- Account name appears over the T
- Amounts are added to the left & right sides of the T:

Account Name	
100	50

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Increasing Accounts

Increases in ... are recorded on...

- | | |
|----------------------|---|
| • Asset | • |
| • Liability & equity | • |
| • Revenue | • |
| • Expense | |

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Debits and Credits

- **Debit:**
an entry on the left side of any account

- The account is “debited”
- “To debit” means
–
- Abbreviated “Dr.”

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Debits and Credits

- **Credit:**
an entry on the right side of any account

- The account is “credited”
- “To credit” means
–
- Abbreviated “Cr.”
- Debits and credits should not be viewed as favorable or unfavorable

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Debits and Credits

Increases in this account... Are recorded on:

- | | |
|----------------------|---|
| • Asset | • |
| • Liability & Equity | • |
| • Revenue | • |
| • Expense | • |

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An Account's Balance

- **Difference between the totals of the two sides**
- An account has either
- The total of all accounts' debits = total of all accounts' credits

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Income Statement Accounts

- Revenues:
–
 - Expenses:
–
- Increases in... are...*
Revenues
Expenses

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THE ACCOUNTING CYCLE

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The Accounting Cycle

1. Beginning balance sheet & account balances
2. Journalize transactions
3. Post journal entries to ledger accounts
4. Closing process
5. Financial statements



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Journal

- **The initial record of all transactions**
- A series of journal entries
- Journal entry:
–
–
–
–
- Recorded in chronological order

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The Ledger

- **Ledger: a group of related accounts**
 - Often appear as bound record books, looseleaf pages, diskettes, CD-ROMs
- **General ledger**
 - Accounts supporting the main financial statements

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Balance Sheet Transactions

Posting

- **Transferring debits and credits from the journal to the ledger accounts**
- **Trial balance**
 - A list of all ledger accounts, each with its debit or credit balance

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The Closing Process

- **Closing the books for a period, to create final financial statements**
- Uses a temporary account
 - To compute the change in retained earnings
 - The *Income Summary account*

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Income Summary Account

- Revenue and Expense accounts are balanced and totals transferred to the this account
 - Dr.
 - Cr.
- Income Summary balance is transferred to Retained Earnings

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Final Financial Statements

- The last step in the Closing Process
- Balance sheet is created from
 - balances in asset, liability, and equity accounts
- Income statement is prepared from
 - information in the Income Summary account

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