Chapter 2: Analyzing Transactions into Debit and Credit Parts: Chapter Overview

Learning Objectives

After studying Chapter 2, in addition to defining key terms, you will be able to:

LO1 Show the relationship between the accounting equation and a T account.

LO2 Identify the debit and credit side, the increase and decrease side, and the balance side of various accounts.

LO3 Restate and apply the two rules that are associated with the increase side of an account.

LO4 Restate and apply the four questions necessary to analyze transactions for starting a business into debit and credit parts.

LO5 Analyze transactions for operating a business into debit and credit parts.

Analyzing Transactions into Debit and Credit Parts:

Accounting in the Real World: Great Clips

When you need a new hair style or a new hair color, you may think of Great Clips. But, does Great Clips come to mind when you think of NASCAR racing? You might be surprised to learn that Great Clips is one of the longest-running sponsors of the NASCAR Nationwide Series. Great Clips is a franchising operation. It was started near the University of Minnesota in 1982, by Ray Barton. Mr. Barton felt that the haircutting industry was changing and would soon be led by national franchise brands. With that in mind, Mr. Barton set out to grow the business. Currently, Great Clips is the largest no-appointment hair salon brand in North America, with over 2,700 salons. The Great Clips website states that its “hair salons are conveniently located in high-visibility strip malls and offer quality haircuts and perms for men, women, and children at competitive prices.”

What does all of this have to do with NASCAR? Great Clips is a primary sponsor of NASCAR and has its own car in the Nationwide Series. The Great Clips car won its first victory in 2003. As a service business similar to Delgado Web Services, each Great Clips salon keeps track of its own revenues and expenses. It must establish a list of accounts for recording its daily business transactions.

Critical Thinking

1. If you owned a Great Clips franchise, why might you support Great Clips' sponsorship of NASCAR racing?

2.What asset and liability accounts might a Great Clips salon use to record its transactions? List at least two transactions that a Great Clips salon might record.

Analyzing Transactions into Debit and Credit Parts:

Key Terms

- T account
- debit
- credit
- normal balance
- chart of accounts
- accounts payable
- accounts receivable

Lesson 2-1: Using T Accounts

- LO1 Show the relationship between the accounting equation and a T account.
- LO2 Identify the debit and credit side, the increase and decrease side, and the balance side of various accounts.
- LO3 Restate and apply the two rules that are associated with the increase side of an account.

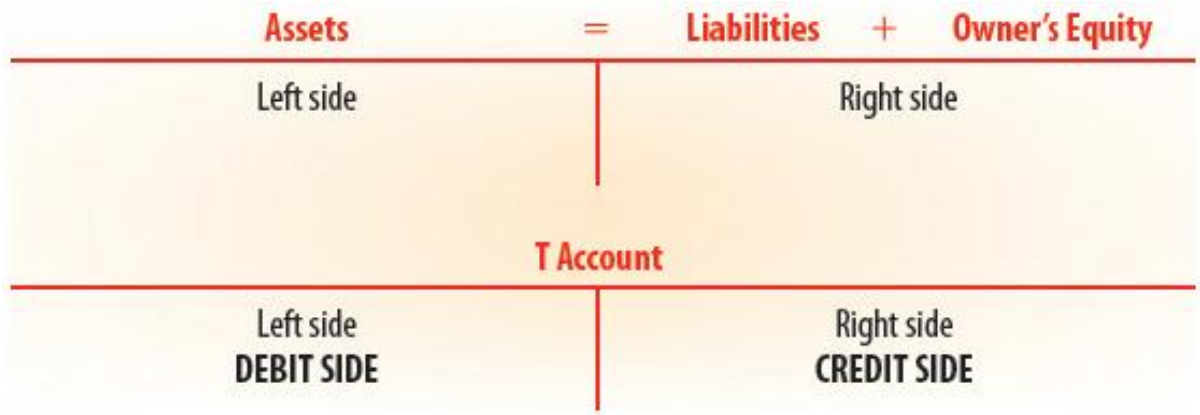
Analyzing the Accounting Equation LO1

In Chapter 1, the effects of transactions were recorded in an accounting equation. This procedure is not practical in an actual accounting system. Because of the number of accounts used by most businesses, recording transactions in the accounting equation would be cumbersome. Therefore, a separate record is commonly used for each account. The accounting equation can be represented as a T, as shown below.

Assets	=	Liabilities + Owner's Equity
Left side		Right side

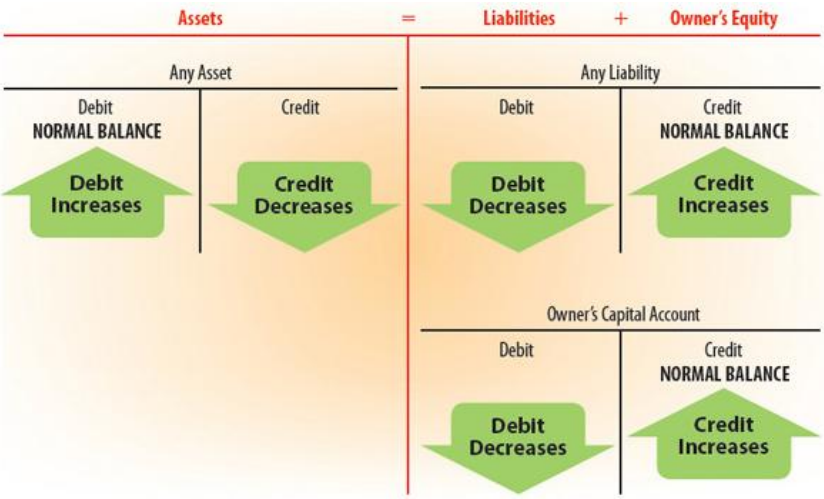
The values of all things owned (assets) are on the left side of the accounting equation. The

values of all equities or claims against the assets (liabilities and owner's equity) are on the right side of the accounting equation. The total of amounts on the left side of the accounting equation must always equal the total of amounts on the right side. Therefore, the total of all assets on the left side of the accounting equation must always equal the total of all liabilities and owner's equity on the right side.



A record summarizing all the information affecting a single item in the accounting equation is known as an account. Transactions change the balances of accounts in the accounting equation. Accounting transactions must be analyzed to determine how account balances are changed. An accounting device used to analyze transactions is called a T account .

There are special names for amounts recorded on the left and right sides of an account. An amount recorded on the left side of an account is called a debit . An amount recorded on the right side of an account is called a credit . The words debit and credit come from the Latin and Italian words debere and credere. Common abbreviations are dr. for debit and cr. for credit. It is important to understand that in an accounting system, the words debit and credit do not have the same meaning as in everyday life. In an accounting system, the terms mean only the left side or right side of an account. Debit means an amount recorded on the left side of an account. Credit means an amount recorded on the right side of an account.



Increases, Decreases, and Balances in Accounts LO3

The sides of a T account are used to show increases and decreases in account

balances. The increase side of each kind of account can be associated with the accounting equation using two rules:

1. Assets are on the left side of the accounting equation. Therefore, assets increase on the left, or debit, side of the account.
2. Liabilities and the owner's capital account are on the right side of the accounting equation. Therefore, liabilities and the owner's capital account increase on the right, or credit, side of the account.

The side of the account that is increased is called the normal balance of the account. Assets have normal debit balances because they increase on the debit side. Liabilities and the owner's capital account have normal credit balances because they increase on the credit side.

Accounts decrease on the side opposite their increase side. Therefore, assets decrease on the right, or credit, side of the account. Liabilities and the owner's capital account decrease on the left, or debit, side of the account.

End of Lesson Review

- LO1 Show the relationship between the accounting equation and a T account.
- LO2 Identify the debit and credit side, the increase and decrease side, and the balance side of various accounts.
- LO3 Restate and apply the two rules that are associated with the increase side of an account.

Terms Review

- T account
- debit
- credit
- normal balance

Audit Your Understanding

1.Draw the accounting equation on a T account.

2.What are the two accounting rules that explain increases of account balances?

Work Together 2-1

Determining the increase and decrease and the normal balance sides for accounts

Write the answers to the following problems in the Working Papers. Your instructor will guide

you through the following examples.

Cash

Accounts Receivable—Sullivan Company

Supplies

Prepaid Insurance

Accounts Payable—Sawyer Supplies

Accounts Payable—Oceanside Supplies

Parker Vogel, Capital

For each account, complete the following:

1. Prepare a T account.
2. Label the debit and credit side.
3. Draw an up arrow (↑) on the increase side.
4. Draw a down arrow (↓) on the decrease side.
5. Label the normal balance side.

<u>On Your Own 2-1</u>

Determining the increase and decrease and the normal balance sides for accounts

Write the answers to the following problems in the Working Papers. Work this problem independently.

Cash

Accounts Receivable—White Company

Accounts Receivable—Jagerstrom Inc.

Supplies

Prepaid Insurance

Accounts Payable—West End Hardware

Shelley Feinstein, Capital

For each account, complete the following:

1. Prepare a T account.
2. Label the debit and credit side.

3. Draw an up arrow (↑) on the increase side.
4. Draw a down arrow (↓) on the decrease side.
5. Label the normal balance side.

Ethics in Action: Ethics versus Morality

Ethics and morality—these words are often used to refer to an individual's ability to “do what is right.” These synonymous English words were derived from different languages. “Ethics” is derived from Greek, and “morality” is derived from Latin. Over time, our society has given a slightly different meaning to each word.

Over 100 years ago, C. C. Everett wrote, “Ethics is the science of morality.” Morality is the standard of conduct that is acceptable in a society. Ethics is an organized method that relies on our morality to make moral decisions. Science students learn the scientific method—a model that guides how a proper experiment should be conducted. In the same manner, many ethical models have been proposed to guide individuals in applying their morality to business decisions.

The following ethical model will be used in this textbook:

1. Recognize you are facing an ethical dilemma.
2. Identify the action taken or the proposed action.
3. Analyze the action.

a. Is the action illegal?

b. Does the action violate company or professional standards?

c. Who is affected, and how, by the action?

4. Determine if the action is ethical.

Instructions

Prepare a short report that contrasts the ethical model with the scientific method. How are the models similar? How are they different?

Think Like an Accountant: Planning for College and Beyond

John Melby wants to be sure that he has enough money to send his newborn son to college.

His college of choice is estimated to cost $100,000 for a four-year education, including tuition, books, room, and board. John wants to know whether a $5,000 annual contribution to a college fund will grow to $100,000 when his son enters college at the age of 18. The money would be invested in an account that is not subject to income taxes as long as the money will be used to pay educational expenses.

Open the Spreadsheet TLA_CH02

Answer the Following Questions about the College Fund Investment:

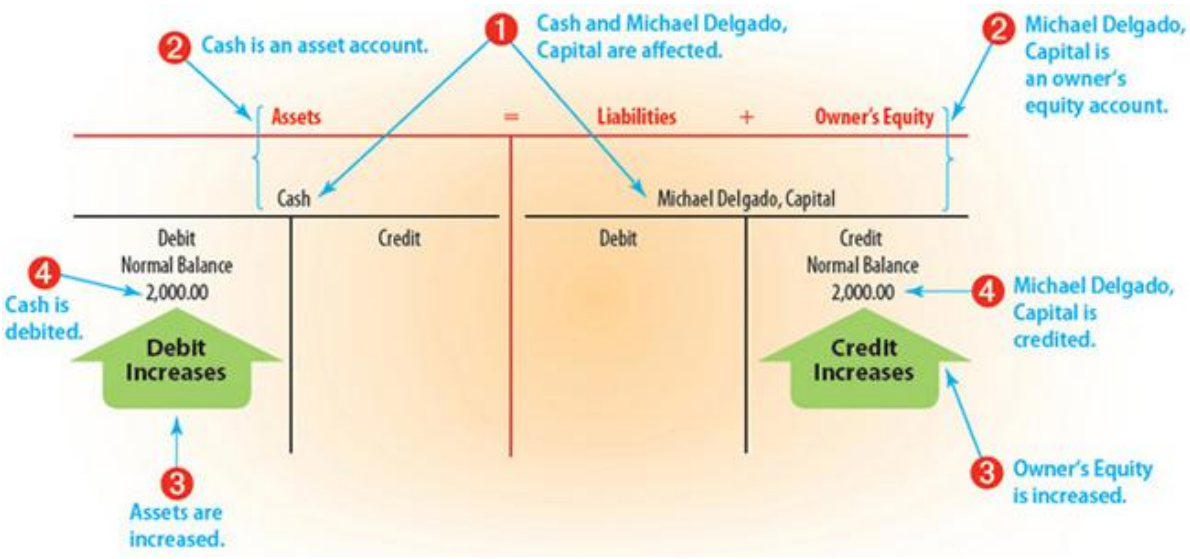
1. If John can earn a 6% annual return on the fund's investments, will he reach his $100,000 goal?
1. What amount would he need to contribute each year to reach his goal?
2. What annual contribution would be required if his son elects to enroll in a major that requires five years of coursework?
3. Planning for his son's college makes John realize that he needs to begin planning for his retirement. John is currently 25 years old and wants to have $1,000,000 in his retirement fund when he reaches age 65.
4. Answer the Following Questions about John's Retirement Fund Investment:
    a. If John can earn a 6% annual return on the fund's investments, how much will he have to contribute each year to reach his goal?
    b. What if John waits until his son begins college to start investing in his retirement fund (age 43)? How much would John have to contribute each year to reach his goal?

Chapter 2: Analyzing Transactions into Debit and Credit Parts:
Lesson 2-2: Analyzing How Transactions Affect Accounts

Lesson 2-2: Analyzing How Transactions Affect Accounts

- LO4 Restate and apply the four questions necessary to analyze transactions for starting a business into debit and credit parts.

Received Cash from Owner as an Investment LO4



January 2. Received cash from owner as an investment, $2,000.00.

The effect of this transaction is shown in the illustration. Before a transaction is recorded in the records of a business, the information is analyzed to determine which accounts are changed and how. Each transaction changes the balances of at least two accounts. A list of accounts used by a business is called a chart of accounts . The chart of accounts for Delgado Web Services is on page 3.

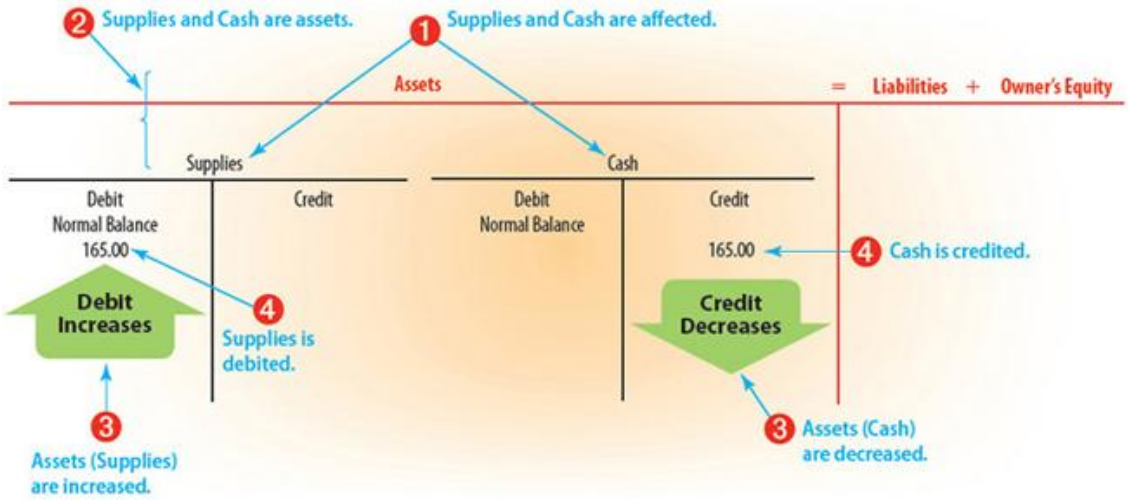
When accounts are analyzed, debits must equal credits for each transaction. In addition, after a transaction is recorded, total debits must equal total credits.

The same four questions are used every time a transaction is analyzed into its debit and credit parts.

Questions for Analyzing a Transaction into Its Debit and Credit Parts

1. 1 Which accounts are affected? Cash and Michael Delgado, Capital.
2. 2 How is each account classified? Cash is an asset account. Michael Delgado, Capital is an owner's equity account.
3. 3 How is each classification changed? Assets increase. Owner's equity increases.
4. 4 How is each amount entered in the accounts? Assets increase on the debit side. Therefore, debit the asset account, Cash. Owner's equity accounts increase on the credit side. Therefore, credit the owner's equity account, Michael Delgado, Capital.

Paid Cash for Supplies



January 2. Paid cash for supplies, $165.00.

The effect of this transaction on the accounting equation is shown in the illustration. In this transaction, two asset accounts are changed. One asset, cash, has been exchanged for another asset, supplies. The asset account, Cash, decreases by $165.00, the amount of cash paid out. This decrease is on the left side of the accounting equation. The asset account, Supplies, increases by $165.00, the amount of supplies bought. This increase is also on the left side of the accounting equation.

The two changes are both on the left side of the accounting equation. When changes are made on only one side of the accounting equation, the equation must still be in balance. Therefore, if one account is increased, another account on the same side of the equation must be decreased.

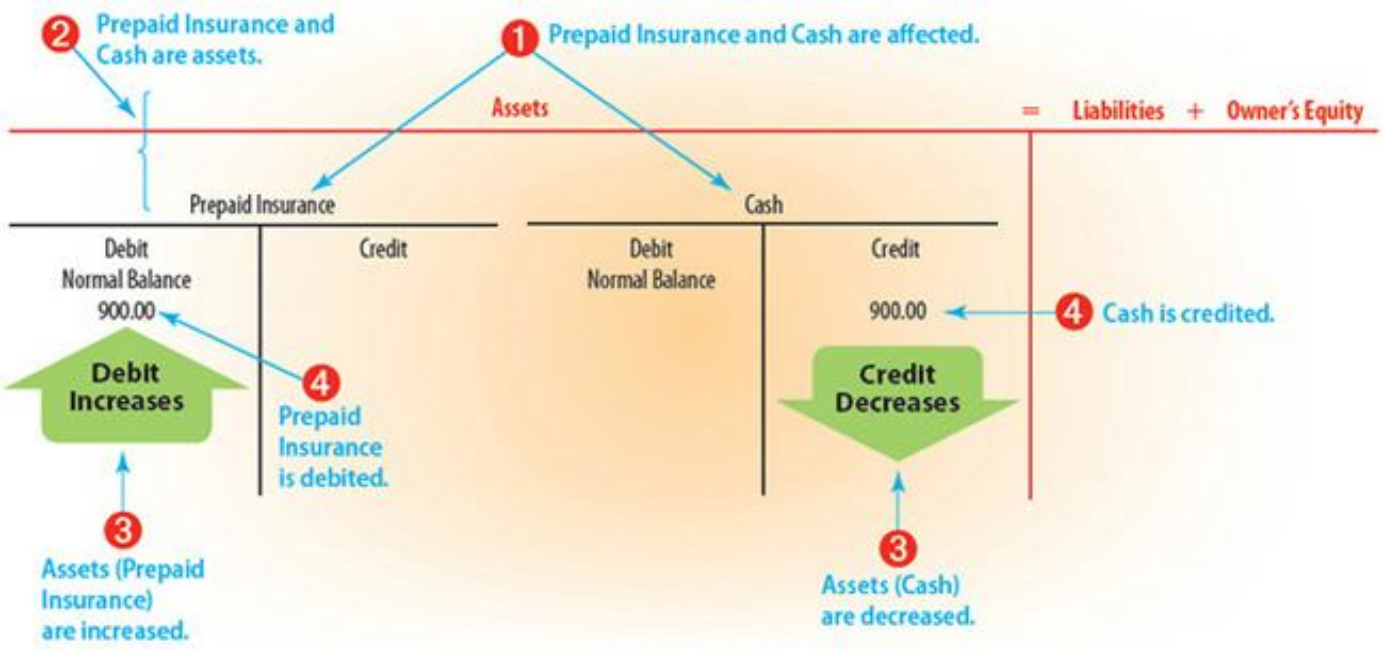
Transactions must always be carefully analyzed. A transaction may affect accounts from both sides of the accounting equation. Or, a transaction may affect accounts that are on the same side of the accounting equation, as is true in this example. A common error is to assume that every transaction must affect accounts on both sides of the accounting equation.

Do not attach any meaning to debit/credit other than left side/right side. Don't think of them as “good” or “bad.” Debit simply means left and credit simply means right.

Questions for Analyzing a Transaction into Its Debit and Credit Parts

1. Which accounts are affected?Supplies and Cash
2. How is each account classified?Supplies is an asset account. Cash is an asset account.
3. How is each classification changed?One asset (Supplies) increases and another asset (Cash) decreases.
4. How is each amount entered in the accounts?Assets increase on the debit side. Therefore, debit the asset account, Supplies. Assets decrease on the credit side. Therefore, credit the asset account, Cash.

Paid Cash for Insurance



January 3. Paid cash for insurance, $900.00.

Paying cash for insurance is very similar to paying cash for supplies. One asset is increased and one asset is decreased.

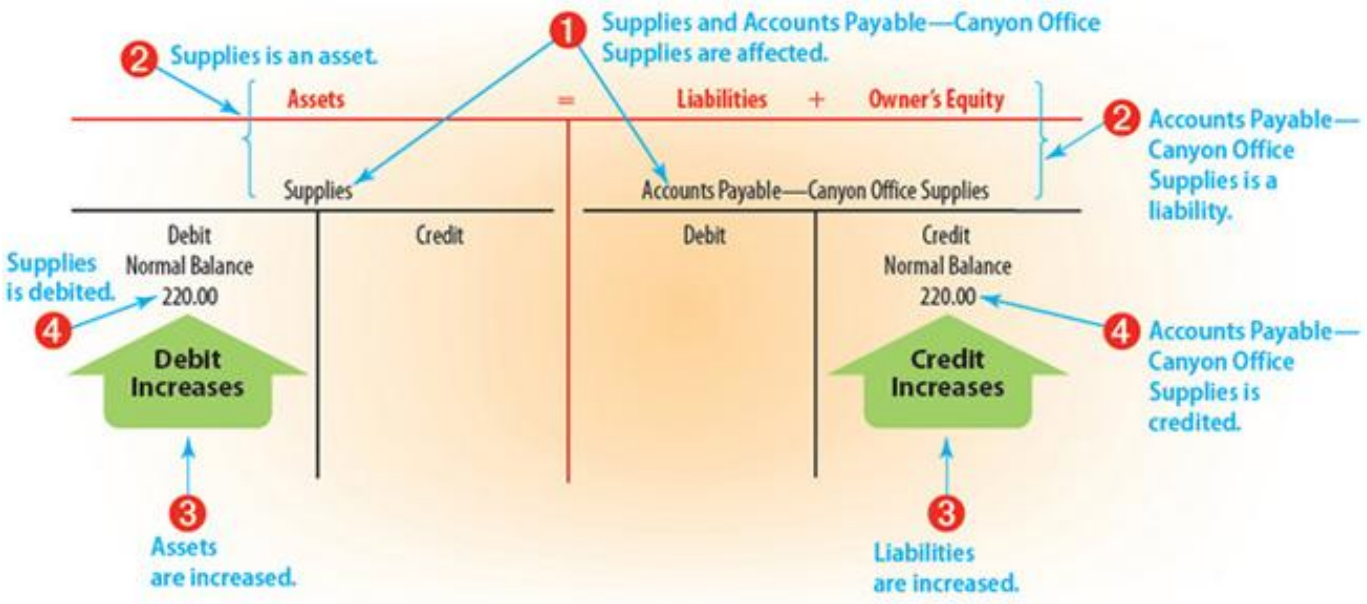
The effect of this transaction on the accounting equation is shown in the illustration. In this transaction, two assets are changed. One asset, cash, has been exchanged for another

asset, prepaid insurance. The asset account, Cash, decreases by $900.00, the amount of cash paid out. This decrease is on the left side of the accounting equation. The asset account, Prepaid Insurance, increases by $900.00, the amount of insurance bought. This increase is also on the left side of the accounting equation.

Questions for Analyzing a Transaction into Its Debit and Credit Parts

1. Which accounts are affected?Prepaid Insurance and Cash
2. How is each account classified?Prepaid Insurance is an asset account. Cash is an asset account.
3. How is each classification changed?One asset (Prepaid Insurance) increases and another asset (Cash) decreases.
4. How is each amount entered in the accounts?Assets increase on the debit side. Therefore, debit the asset account, Prepaid Insurance. Assets decrease on the credit side. Therefore, credit the asset account, Cash.

Bought Supplies on Account



January 5. Bought supplies on account from Canyon Office Supplies, $220.00.

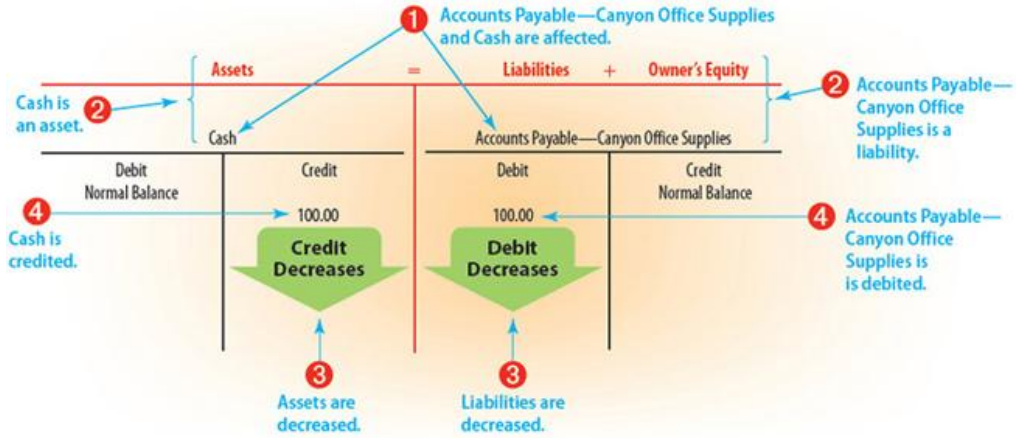
The effect of this transaction on the accounting equation is shown in the illustration. In this

transaction, one asset and one liability are changed. The asset account, Supplies, increases by $220.00, the amount of supplies bought. This increase is on the left side of the accounting equation. Amounts to be paid in the future for goods or services already acquired are called accounts payable . Canyon Office Supplies will have a claim against some of Delgado Web Services' assets until Delgado Web Services pays for the supplies bought. Therefore, Accounts Payable—Canyon Office Supplies is a liability account. The liability account, Accounts Payable—Canyon Office Supplies, increases by $220.00, the amount owed for the supplies. This increase is on the right side of the accounting equation.

Questions for Analyzing a Transaction into Its Debit and Credit Parts

1. Which accounts are affected?Supplies and Accounts Payable—Canyon Office Supplies
2. How is each account classified?Supplies is an asset account. Accounts Payable—Canyon Office Supplies is a liability account.
3. How is each classification changed?Assets increase. Liabilities increase.
4. How is each amount entered in the accounts?Assets increase on the debit side. Therefore, debit the asset account, Supplies. Liabilities increase on the credit side. Therefore, credit the liability, Accounts Payable—Canyon Office Supplies.

Paid Cash on Account



January 9. Paid cash on account to Canyon Office Supplies, $100.00.

The effect of this transaction on the accounting equation is shown in the illustration. In this transaction, one asset and one liability are changed. The asset account, Cash, is decreased

by $100.00, the amount of cash paid out. This decrease is on the left side of the accounting equation. After this payment, Delgado Web Services owes less money to Canyon Office Supplies. Therefore, the liability account, Accounts Payable—Canyon Office Supplies, is decreased by $100.00, the amount paid on account. This decrease is on the right side of the accounting equation.

Questions for Analyzing a Transaction into Its Debit and Credit Parts

1. Which accounts are affected?Accounts Payable—Canyon Office Supplies and Cash
2. How is each account classified?Accounts Payable—Canyon Office Supplies is a liability account. Cash is an asset account.
3. How is each classification changed?Liabilities decrease. Assets decrease.
4. How is each amount entered in the accounts?Liabilities decrease on the debit side. Therefore, debit the liability account, Accounts Payable—Canyon Office Supplies. Assets decrease on the credit side. Therefore, credit the asset account, Cash.

When you decrease an account balance, record the decrease on the side opposite the normal balance side of the account. The side opposite the normal balance side can be on the left or the right, depending on the type of account.

End of Lesson Review

- LO4 Restate and apply the four questions necessary to analyze transactions for starting a business into debit and credit parts.

Terms Review

- chart of accounts
- accounts payable

Audit Your Understanding

1.State the four questions used to analyze a transaction.

2.What two accounts are affected when a business buys supplies on account?

Work Together 2-2

Analyzing transactions into debit and credit parts

T accounts are given in the Working Papers. Your instructor will guide you through the

following examples. Jensen Cleaning Service uses the following accounts. Some of the accounts will be explained in Lesson 2-3.

Cash	John Jensen, Capital
Accts. Rec.—Johannes Erickson	John Jensen, Drawing
Supplies	Sales
Prepaid Insurance	Rent Expense
Accts. Pay.—Supply Depot	Utilities Expense

Transactions:

Mar. 1. Received cash from owner as an investment, $4,000.00.

3. Paid cash for supplies, $95.00.

4. Bought supplies on account from Supply Depot, $120.00.

6. Paid cash for insurance, $250.00.

9. Paid cash on account to Supply Depot, $80.00.

3. Prepare two T accounts for each transaction. On each T account, write the account title of one of the accounts affected by the transaction.
4. Write the debit or credit amount in each T account to show the transaction's effect.

<u>On Your Own 2-2</u>

Analyzing transactions into debit and credit parts

T accounts are given in the Working Papers. Work this problem independently. Plumbing Solutions uses the following accounts. Some of the accounts will be explained in Lesson 2-3.

Cash	Brian Helfrey, Capital
Accts. Rec.—Theo Moses	Brian Helfrey, Drawing
Supplies	Sales
Prepaid Insurance	Advertising Expense
Accts. Pay.—Plumbing World	Rent Expense

Transactions:

June 2. Received cash from owner as an investment, $3,500.00.

4. Paid cash for insurance, $105.00.

5. Paid cash for supplies, $60.00.

8. Bought supplies on account from Plumbing World, $800.00.
9. Paid cash on account to Plumbing World, $500.00.

1. Prepare two T accounts for each transaction. On each T account, write the account title of one of the accounts affected by the transaction.
2. Write the debit or credit amount in each T account to show the transaction's effect.

Chapter 2: Analyzing Transactions into Debit and Credit Parts: Global Awareness: The Global Business Day

Global Awareness: The Global Business Day

When doing business internationally, time zone differences and cultural factors affect the business day. For example, in Spain, the normal business day is from 9 A.M. to 8 P.M. But many businesses traditionally close from 2 P.M. to 5 P.M. for a long lunch or siesta. In 2006, the Spanish government implemented new working hours for all government employees. Only one hour is allowed for lunch, and workers go home at 6 P.M. These new hours better align the Spanish business day with the rest of Central Europe.

Critical Thinking

If your company has offices around the world, what methods could you use to facilitate working together on a team project?

Chapter 2: Analyzing Transactions into Debit and Credit Parts: Why Accounting?: Record High Box Office Receipts + Accounting = Net Loss?

Why Accounting?:

Record High Box Office Receipts + Accounting = Net Loss?

When you hear that a movie has broken all records for box office receipts, do you automatically assume that everyone connected with the movie received a share of the profits? That may not be the case. The answer depends on how those profits are calculated.

It is well known that some movies that have broken records for box office receipts have never

shown a profit. How could this happen? For any company, revenues minus expenses equal net income. How those revenues and expenses are calculated has a dramatic effect on the calculation of net income.

There are three controversial costs involved in the making of a movie. (1) The cost of producing the movie. (2) The cost of distributing the movie. (3) The cost of advertising. Each of these costs includes the concept of overhead. Overhead costs are the costs of running the business. Overhead may include the cost of the administrative offices, electricity, heat, and payroll. Calculating the overhead costs of a movie usually involves estimating what percentage of the total cost should be applied to the specific movie. The higher the overhead estimate, the lower the net profit.

Actors are more often refusing to accept a percentage of net profits as part of their compensation. Instead, they negotiate for a flat fee in place of a percentage of net profits.

The next time you watch a movie, read through the credits at the end of the movie. In the listing of the crew, you will see the names of the accountants or controller for the movie. Then ask yourself if you think the movie will ever report a net profit.

Critical Thinking

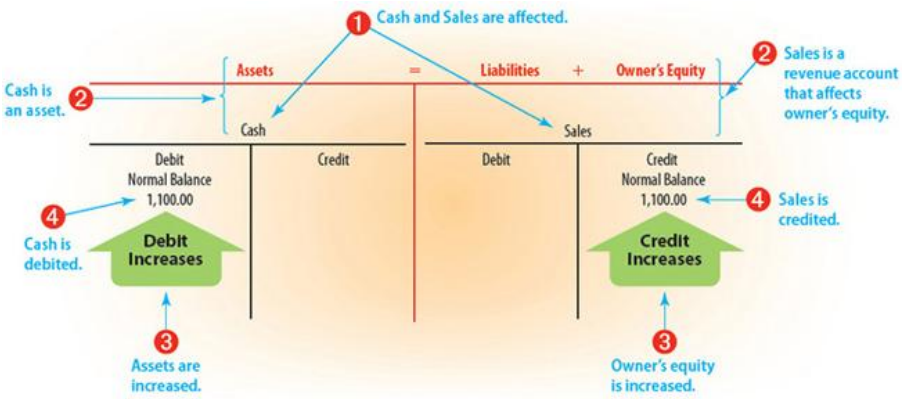
1. List three costs that would be included in the cost of advertising.
2. Use the Internet to search for the accountants for a recent movie. List the title of the movie and the name(s) of the accountants/controller.

Chapter 2: Analyzing Transactions into Debit and Credit Parts: Lesson 2-3: Analyzing How Transactions Affect Owner's Equity Accounts

Lesson 2-3: Analyzing How Transactions Affect Owner's Equity Accounts

- LO5 Analyze transactions for operating a business into debit and credit parts.

Received Cash from Sales LO5



January 10. Received cash from sales, $1,100.00.

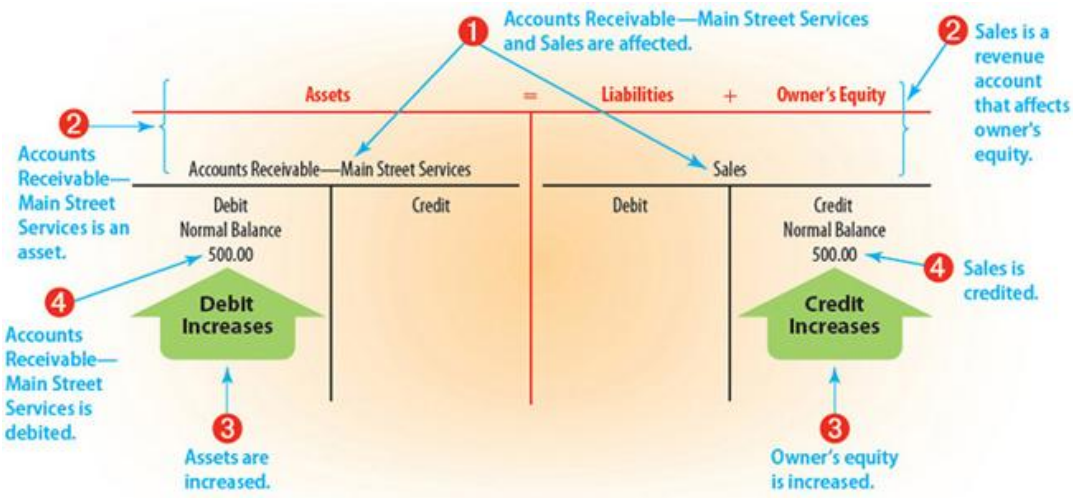
Revenue increases owner's equity. The increases from revenue could be recorded directly in the owner's capital account. However, to avoid a capital account with a large number of entries and to summarize revenue information separately from the other records, Delgado Web Services uses a separate revenue account titled Sales.

The owner's capital account has a normal credit balance. Therefore, increases in the owner's capital account are shown as credits. Because revenue increases owner's equity, increases in revenue are also recorded as credits. Therefore, a revenue account has a normal credit balance.

Questions for Analyzing a Transaction into Its Debit and Credit Parts

1. Which accounts are affected?Cash and Sales
2. How is each account classified?Cash is an asset account. Sales is a revenue account that affects owner's equity.
3. How is each classification changed?Assets increase. Owner's equity increases.
4. How is each amount entered in the accounts?Assets increase on the debit side. Therefore, debit the asset account, Cash. Owner's equity accounts increase on the credit side. Revenue increases owner's equity. Therefore, credit the revenue account, Sales.

Sold Services on Account



January 12. Sold services on account to Main Street Services, $500.00.

The analysis for selling services on account is similar to that for selling services for cash. The only difference is that cash is not received at the time of the transaction. Therefore, the Cash account is not affected by the transaction. Amounts to be received in the future due to the sale of goods or services are called accounts receivable . This transaction increases an accounts receivable account. The same four questions are used to analyze this transaction into its debit and credit parts.

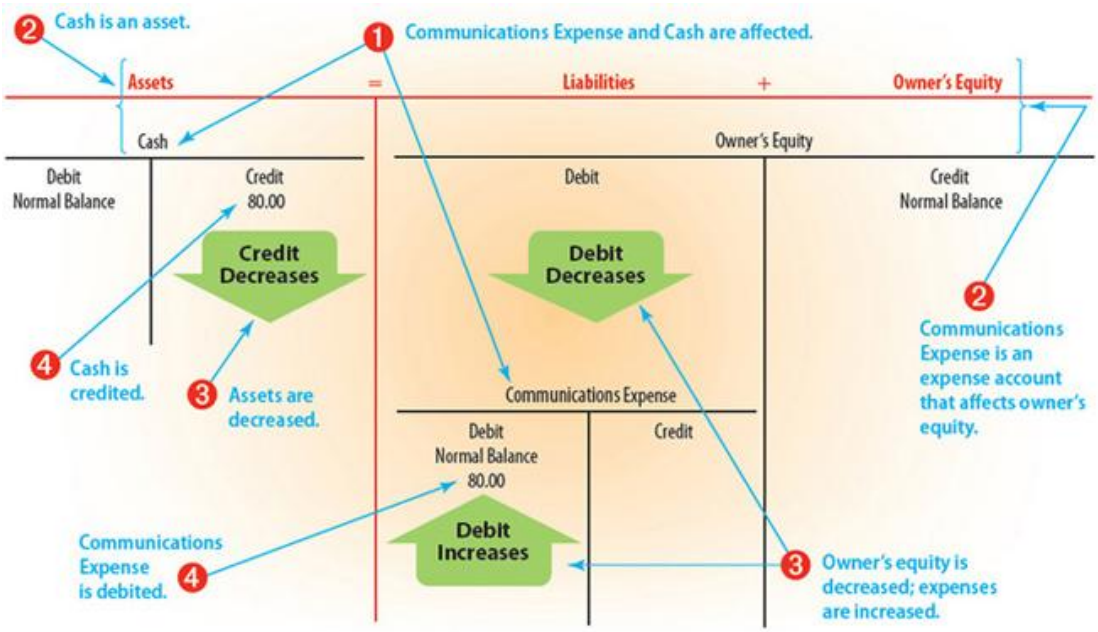
Questions for Analyzing a Transaction into Its Debit and Credit Parts

1. Which accounts are affected?Accounts Receivable—Main Street Services and Sales
2. How is each account classified? Accounts Receivable—Main Street Services is an asset account. Sales is a revenue account that affects owner's equity.
3. How is each classification changed? Assets increase. Owner's equity increases.
4. How is each amount entered in the accounts? Assets increase on the debit side. Therefore, debit the asset account, Accounts Receivable—Main Street Services. Owner's equity accounts increase on the credit side. Revenue increases owner's equity. Therefore, credit the revenue account, Sales.

Owner's equity is recorded on the right side of the accounting equation. The right side of a T

account is the credit side. Therefore, owner's equity has a normal credit balance.

Paid Cash for an Expense



<u>January 12. Paid cash for communications bill for cell phone and Internet service, $80.00.</u>

Expenses decrease owner's equity. The decreases from expenses could be recorded directly in the owner's capital account. However, to avoid a capital account with a large number of entries and to summarize expense information separately from the other records, Delgado Web Services uses separate expense accounts.

The titles of Delgado Web Services' expense accounts are shown on its chart of accounts. The expense account, Communications Expense, is used for all payments for cell phone charges.

The owner's capital account has a normal credit balance. Decreases in the owner's capital account are shown as debits. Therefore, an expense account has a normal debit balance. Because expenses decrease owner's equity, increases in expenses are recorded as debits. All expense transactions are recorded in a similar manner.

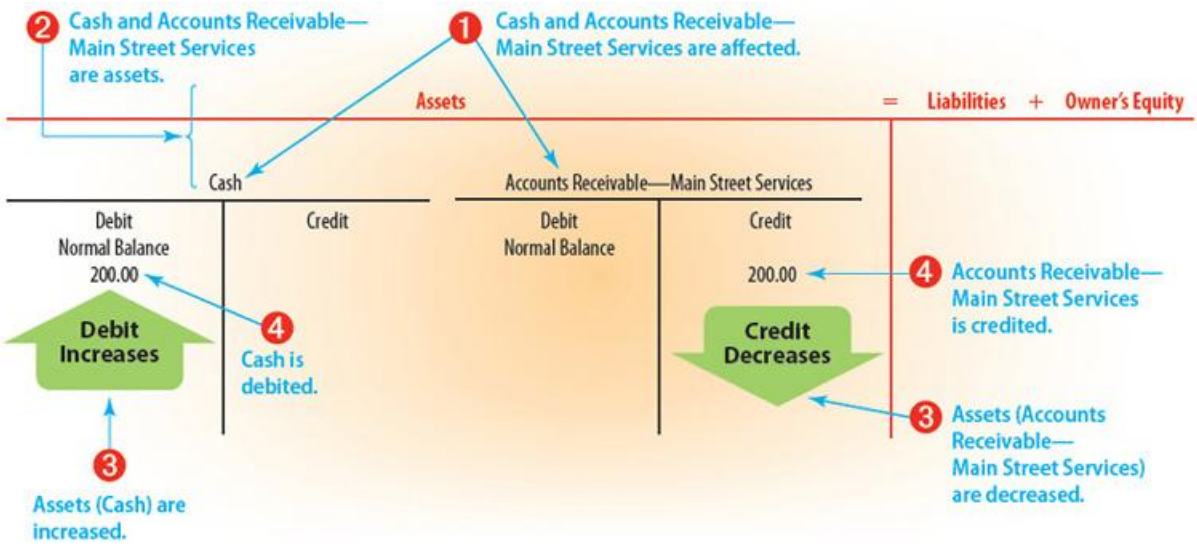
Questions for Analyzing a Transaction into Its Debit and Credit Parts

1. Which accounts are affected?Communications Expense and Cash
2. How is each account classified? Communications Expense is an expense account that

affects owner's equity. Cash is an asset account.

3. How is each classification changed? Owner's equity decreases from an increase in expenses. Assets decrease.
4. How is each amount entered in the accounts? Owner's equity accounts decrease on the debit side. An increase in expenses decreases owner's equity. Expense accounts have normal debit balances. Therefore, debit the expense account, Communications Expense. Assets decrease on the credit side. Therefore, credit the asset account, Cash.

Received Cash on Account



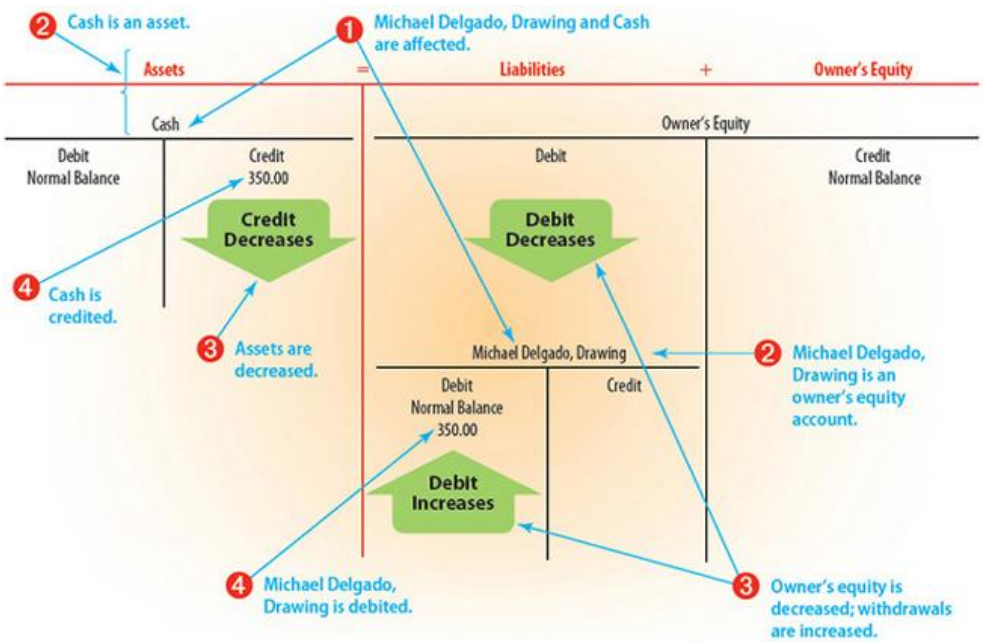
January 16. Received cash on account from Main Street Services, $200.00.

The effect of this transaction on the accounting equation is shown in the illustration. In this transaction, two asset accounts are changed. One asset, cash, has been exchanged for another asset, accounts receivable. The asset account, Cash, increases by $200.00, the amount of cash received. This increase is on the left side of the accounting equation. After this receipt of cash, Main Street Services owes less money to Delgado Web Services. The asset account, Accounts Receivable—Main Street Services decreases by $200.00, the amount of cash received on account. This decrease is also on the left side of the accounting equation.

Questions for Analyzing a Transaction into Its Debit and Credit Parts

1. Which accounts are affected?Cash and Accounts Receivable—Main Street Services
2. How is each account classified? Cash is an asset account. Accounts Receivable—Main Street Services is an asset account.
3. How is each classification changed? One asset (Cash) increases and another asset (Accounts Receivable—Main Street Services) decreases.
4. How is each amount entered in the accounts? Assets increase on the debit side. Therefore, debit the asset account, Cash. Assets decrease on the credit side. Therefore, credit the asset account, Accounts Receivable—Main Street Services.

Paid Cash to Owner for Personal Use



<u>January 16. Michael Delgado withdrew equity in the form of cash, $350.00.</u>

Withdrawals decrease owner's equity. Withdrawals could be recorded directly in the owner's capital account. However, to avoid a capital account with a large number of entries and to summarize withdrawal information separately from the other records, Delgado Web Services uses a separate withdrawing account titled Michael Delgado, Drawing.

When drawing T accounts to analyze transactions, stack the accounts instead of writing them horizontally. Stacking the accounts will make it easier to recognize debits and credits.

Questions for Analyzing a Transaction into Its Debit and Credit Parts

1. Which accounts are affected?Michael Delgado, Drawing and Cash
2. How is each account classified?Michael Delgado, Drawing is an owner's equity account. Cash is an asset account.
3. How is each classification changed?Owner's equity decreases from an increase in withdrawals. Assets decrease.
4. How is each amount entered in the accounts?Owner's equity accounts decrease on the debit side. An increase in withdrawals decreases owner's equity. Withdrawal accounts have normal debit balances. Therefore, debit the owner's equity account, Michael Delgado, Drawing. Assets decrease on the credit side. Therefore, credit the asset account, Cash.

End of Lesson Review

- LO5 Analyze transactions for operating a business into debit and credit parts.

Term Review

- accounts receivable

Audit Your Understanding

1. What two accounts are affected when a business pays cash for a cell phone bill?
2. What two accounts are affected when a business sells services on account?
3. What two accounts are affected when a business receives cash on account?
4. Is the drawing account increased on the debit side or credit side?
5. Are revenue accounts increased on the debit side or credit side?

Work Together 2-3

Analyzing revenue, expense, and withdrawal transactions into debit and credit parts

T accounts are given in the Working Papers. Your instructor will guide you through the following examples. Use the chart of accounts for Jensen Cleaning Service in Work Together 2-2.

Transactions:

Mar. 11. Sold services on account to Johannes Erickson, $125.00.

13. Received cash from sales, $260.00.

14. Paid cash for telephone bill, $54.00.

16. Received cash on account from Johannes Erickson, $125.00.

19. Paid cash to owner for a withdrawal of equity, $200.00.

1. Prepare two T accounts for each transaction. On each T account, write the account title of one of the accounts affected by the transaction.
2. Write the debit or credit amount in each T account to show the transaction's effect.

On Your Own 2-3

Analyzing revenue, expense, and withdrawal transactions into debit and credit parts

T accounts are given in the Working Papers. Work this problem independently. Use the chart of accounts for Plumbing Solutions in On Your Own 2-2.

Transactions:

June 12. Paid cash for rent, $800.00.

14. Received cash from sales, $68.00.

15. Sold services on account to Theo Moses, $130.00.

18. Paid cash to owner for a withdrawal of equity, $280.00.

19. Received cash on account from Theo Moses, $130.00.

1. Prepare two T accounts for each transaction. On each T account, write the account title of one of the accounts affected by the transaction.
2. Write the debit or credit amount in each T account to show the transaction's effect.

Chapter 2: Analyzing Transactions into Debit and Credit Parts: Forensic Accounting: Pyramid Schemes

Forensic Accounting: Pyramid Schemes

In 1912, Ivar Kreuger began his quest to take control of the European match market. He borrowed money and sold stock in the company to buy out his competitors. After World War I, he loaned money to war-torn countries that dropped trade restrictions that had prevented his company from entering their markets. He also bribed government officials to become the sole provider of matches in that country.

The stock of the company was widely owned and provided investors with a high return on their investments. Everyone wanted to own a piece of his company. Kreuger's fame and fortune landed him on the cover of Time magazine. He was welcome at the White House and enjoyed a lavish lifestyle including a Park Avenue penthouse in New York City furnished with

paintings by Rembrandt.

The Pyramid Collapses

Unknown to the public and undetected by accountants, Kreuger was running a fraud known as a pyramid scheme. Investors being paid a return on their investment from the earnings of the business are, in fact, being paid with money contributed by new investors. The scheme is destined to collapse when the new investors are no longer willing to invest.

The stock market crash of 1929 and the Great Depression left few banks and individuals with any money to invest in Kreuger's company. As rumors of his financial troubles grew, the value of the company's stock tumbled. Unable to continue the pyramid scheme, Kreuger committed suicide in 1932.

In response to public outcry, Congress passed the Securities Act of 1933 that established the Securities and Exchange Commission and increased the amount and quality of information companies must provide to investors.

History Repeats Itself

Public outcry over the financial disasters of the early twenty-first century—Enron and WorldCom in particular—led Congress to pass the Sarbanes-Oxley Act in the hope that these disasters would never be repeated.

These Forensic Accounting features highlight famous frauds and how Congress and the accounting profession have reacted by reforming laws governing financial reporting information. You will also learn about typical occupational frauds involving employees stealing from their employers. An accountant who combines accounting and investigating skills to uncover fraudulent business activity, or to prevent such activity, is called a forensic accountant.

Activity

Peter Webb began his pool maintenance business in May. He visits each of his clients once a month for a three-hour cleaning procedure. Wanting to expand his business, he has provided a potential investor with financial information indicating that he is earning revenue of nearly $6,000 per month.

Instructions

Open the spreadsheet FA_CH02 and complete the steps on the Instructions tab.

Source: Called to Account, Paul M Clikeman, Routledge (New York), 2009.

Chapter 2: Analyzing Transactions into Debit and Credit Parts: End of Chapter Review

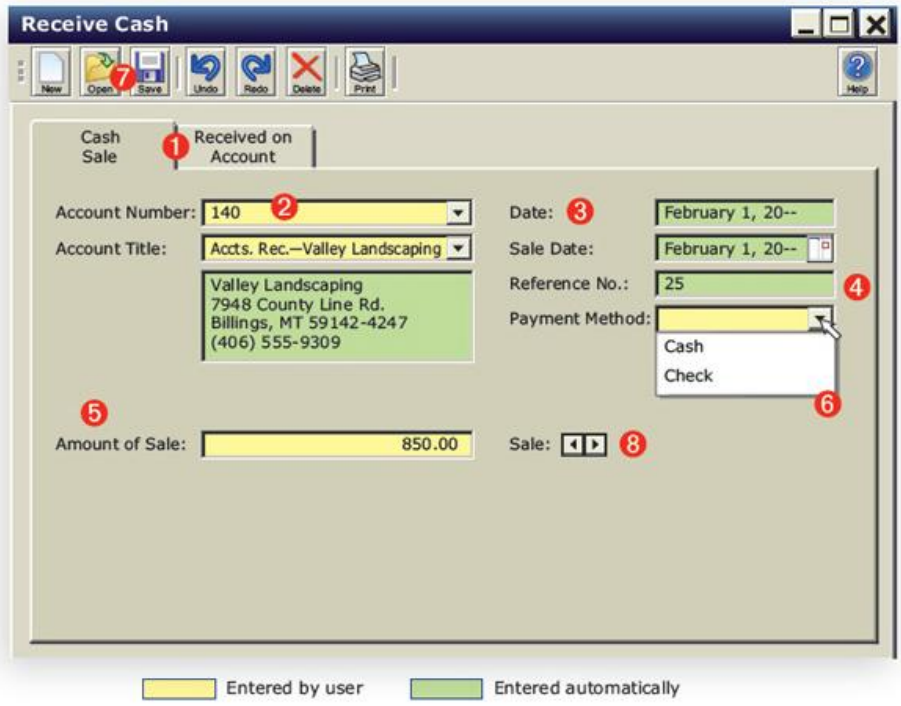
End of Chapter Review

Analyzing Transactions into Debit and Credit Parts: A Look at Accounting Software

Analyzing Transactions with Accounting Software Systems

You learned in this chapter that accountants use T accounts to analyze transactions. After doing accounting for a period of time, these analyses are done mentally without the help of T accounts. Occasionally, however, even experienced accountants will encounter complicated transactions and use T accounts to help them sort things out.

In a computerized system, with routine transactions, the system knows how to “analyze” the transaction. For example, when cash is received, the accountant tells the system where the money is coming from. The system knows how to correctly apply both debits and credits to the proper accounts. But even with computerized accounting systems, accountants still use T accounts to analyze more complicated transactions.



1. In a manual system, the accountant analyzes each transaction and decides which account to debit and which account to credit. In a computerized system, when cash is received, the user tells the system whether it is for a cash sale or for a payment on account. For the cash sale above, the system knows to debit Cash and credit Sales.
2. The user can select the customer from drop menus either by account number or title. The system automatically displays the customer address and contact information. If this were cash received on account, the system would then know to debit Cash and to credit Accts. Rec.—Valley Landscaping.
3. The system automatically displays the current date. The first field is the system date. That is the date the transaction is entered. It cannot be changed. However, if the sale date was earlier (for example, over a weekend), Sale Date can be changed.
4. The system automatically assigns the next sequential number to the sale.
5. The user enters the sale amount.
6. A drop menu lets the user choose how the cash was received.
7. The user clicks on Save to store the transaction.
8. Navigation buttons allow the user to move forward or backward to review sales that have been entered.

Analyzing Transactions into Debit and Credit Parts: Chapter Summary

This chapter introduced the concept of debits and credits. It is important to remember that sometimes a debit increases an account balance and sometimes a debit decreases an account balance. The rules for debits and credits can be tied to the accounting equation. Assets are on the left side of the accounting equation; therefore, assets increase on the left, or debit side, of the account. Liabilities and the owner's capital account are on the right side of the accounting equation; therefore, liabilities and the owner's capital account increase on the right, or credit, side of the account. T accounts can be used to help determine which accounts are debited and credited for each transaction. Four questions are used to analyze transactions into their debit and credit parts: (1) Which accounts are affected? (2) How is each account classified? (3) How is each classification changed? (4) How is each amount entered in the accounts?

Analyzing Transactions into Debit and Credit Parts: Explore Accounting

Owner Withdrawals vs. Salary Expense

When the owner of a business withdraws cash for personal use, that withdrawal decreases owner's equity. However, it is not considered an expense of the business. On the other hand, when wages or salaries are paid to employees, those wages or salaries are considered an expense of the business. These are called Wages Expense or Salary Expense.

The income of a business is calculated by subtracting total expenses from total revenue. Since employee wages and salaries are an expense of the business, they reduce the net income of the company. Since owner withdrawals are not considered an expense of the business, they do not reduce the net income of the company.

A business owned by one person is called a proprietorship. The Internal Revenue Service does not require the proprietorship, itself, to pay taxes. However, the owner of the proprietorship must include the net income of the proprietorship in his or her own taxable income.

The income of a proprietorship is affected by employee wages and salaries. Therefore, the income tax paid by the owner is affected by the amount of wages or salaries expense. The more wages or salaries expense the company has, the lower the net income will be. The lower the net income of a business, the lower the amount of income tax that will be paid on the net income. Because the income of a proprietorship is not affected by owner withdrawals,

the income tax paid by the owner is not affected by how much cash the owner withdraws from the business.

If Bergum Consulting Company has revenues of $35,000.00 and expenses of $17,000.00, its income is $18,000.00 ($35,000.00 – $17,000.00). Bergum Consulting Company will have income of $18,000.00 whether the owner withdraws $300.00 or $3,000.00 from the business during that period.

Instructions

1. A mar Gupta owns St. Croix Photography. He is considering withdrawing $4,000.00 from St. Croix Photography for his personal use. What effect would this withdrawal have on the income tax Mr. Gupta must pay this year?
2. M r. Gupta is also considering giving his employees a raise that would increase total salaries by $35,000.00 per year. What effect would this raise have on Mr. Gupta's income tax?

Analyzing Transactions into Debit and Credit Parts: Apply Your Understanding: Application Problem

2-1 Application Problem: Determining the Increase, Decrease, and Normal Balance Side for Accounts LO2, 3

Write the answers for the following problem in the Working Papers.

Cash

Accounts Receivable—Tyler Choi

Accounts Receivable—Nolan Esby

Supplies

Prepaid Insurance

Accounts Payable—Green Solutions

Georganne Hayner, Capital

1	2	3	4	5	6	7	8
Account	Account Classification	Increase Side		Decrease Side		Account's Normal Balance	
		Debit	Credit	Debit	Credit	Debit	Credit
Cash	Asset	↑			↓	✔	

Instructions:

Do the following for each account. The Cash account is given as an example.

1. Write the account title in Column 1.
2. Write the account classification in Column 2.
3. Place an up arrow (↑) in either Column 3 or 4 to indicate the increase side of the account.
4. Place a down arrow (↓) in either Column 5 or 6 to indicate the decrease side of the account.
5. Place a check mark in either Column 7 or 8 to indicate the normal balance of the account.

2-2 Application Problem: Analyzing Transactions into Debit and Credit Parts LO4

Helfrey Marketing Services uses the following accounts.

Cash
Supplies
Prepaid Insurance
Accounts Receivable—Neco Valenza
Accounts Payable—All Star Company
Sawyer Helfrey, Capital
Sawyer Helfrey, Drawing
Sales
Advertising Expense
Rent Expense

Transactions:

June 1. Received cash from owner as an investment, $10,000.00.

2. Paid cash for insurance, $4,000.00.

4. Bought supplies on account from All Star Company, $6,000.00.

5. Paid cash for supplies, $1,000.00.

8. Paid cash on account to All Star Company, $4,000.00.

Instructions:

1. Prepare two T accounts for each transaction. On each T account, write the account title of one of the accounts affected by the transaction. Use the forms in your Working

Papers.

2. Write the debit or credit amount in each T account to show how the transaction affected that account. T accounts for the first transaction are given as an example.

June 1.

Cash	
10,000.00	

Sawyer Helfrey, Capital	
	10,000.00

2-3 Application Problem: Analyzing Revenue, Expense, and Withdrawal Transactions into Debit and Credit Parts LO5

Use the chart of accounts for Helfrey Marketing Services given in Problem 2-2.

Transactions:

June 11. Received cash from sales, $22,000.00.

12. Paid cash for advertising, $1,500.00.

14. Sold services on account to Neco Valenza, $17,000.00.

18. Paid cash to owner for personal use, $5,000.00.

19. Received cash on account from Neco Valenza, $10,000.00.

Instructions:

1. Prepare two T accounts for each transaction. On each T account, write the account title of one of the accounts affected by the transaction. Use the forms in your Working Papers.
2. Write the debit or credit amount in each T account to show how the transaction affected that account.

Analyzing Transactions into Debit and Credit Parts: Apply Your Understanding: Mastery Problem

2-M Mastery Problem: Analyzing Transactions into Debit and Credit Parts LO 4, 5

Gardens Plus uses the following accounts.

Cash
Accounts Receivable—Lee Chen
Accounts Receivable—Ginger McCure
Supplies
Prepaid Insurance
Accounts Payable—West End Supplies
Accounts Payable—Bellville Supplies
Simon Dirks, Capital
Simon Dirks, Drawing
Sales
Advertising Expense
Miscellaneous Expense
Rent Expense
Repair Expense
Utilities Expense

Instructions:

1. Prepare a T account for each account. Use the forms in your Working Papers.
2. Analyze each transaction into its debit and credit parts. Write the debit and credit amounts in the proper T accounts to show how each transaction changes account balances. Write the date of the transactions before each amount.

May 1. Received cash from owner as an investment, $3,700.00.

2. Paid cash for rent, $600.00.

4. Paid cash for supplies, $400.00.

4. Received cash from sales, $950.00.

5. Paid cash for insurance, $375.00.

8. Sold services on account to Lee Chen, $800.00.

9. Bought supplies on account from Bellville Supplies, $300.00.

10. Paid cash for repairs, $85.00.

11. Received cash from owner as an investment, $2,900.00.

May 11. Received cash from sales, $1,000.00.

12. Bought supplies on account from West End Supplies, $230.00.

13. Received cash on account from Lee Chen, $650.00.

15. Paid cash for miscellaneous expense, $35.00.

16. Paid cash on account to Bellville Supplies, $60.00.

22. Paid cash for electric bill (utilities expense), $65.00.

23. Paid cash for advertising, $105.00.

25. Sold services on account to Ginger McCure, $550.00.

26. Paid cash to owner for personal use, $500.00.

30. Received cash on account from Ginger McCure, $300.00.

Analyzing Transactions into Debit and Credit Parts: Apply Your Understanding: Challenge Problem

2-C Challenge Problem: Analyzing Transactions Recorded in T Accounts LO 4, 5

The following T accounts show the current financial situation for Sunshine Cleaners. Write the answers for the following problem in the Working Papers.

Cash

(1)	3,000.00	(2)	50.00
(5)	350.00	(3)	35.00
(8)	200.00	(6)	40.00
(9)	450.00	(7)	450.00
		(10)	300.00
		(11)	275.00
		(12)	250.00

Accounts Receivable—Ellie Morgan

(13)	115.00		

Supplies

(4)	550.00		
(10)	300.00		

Accounts Payable—Tri State Supplies

(11)	275.00	(4)	550.00

Kelsey Guerrero, Capital

		(1)	3,000.00

Kelsey Guerrero, Drawing

(12)	250.00		

Sales

		(5)	350.00
		(8)	200.00
		(9)	450.00
		(13)	115.00

Advertising Expense

(6)	40.00		

Miscellaneous Expense

(3)	35.00		

Rent Expense

(7)	450.00		

Utilities Expense

(2)	50.00		

1	2	3	4	5	6
Trans. No.	Accounts Affected	Account Classification	Entered in Account as a		Description of Transaction
			Debit	Credit	
1	Cash Kelsey Guerrero, Capital	Asset Owner's Equity	✔	 ✔	Received cash from owner as an investment

Instructions:

1. Analyze each numbered transaction in the T accounts. Write the titles of accounts affected in Column 2. For each account, write the classification of the account in Column 3.
2. For each account, place a check mark in either Column 4 or 5 to indicate if the account is affected by a debit or a credit.
3. For each transaction, write a brief statement in column 6 describing the transaction. Information for Transaction 1 is given as an example.

Analyzing Transactions into Debit and Credit Parts: 21st Century Skills

Franchise—The Startup Alternative

Theme: Financial, Economic, Business, and Entrepreneurial Literacy

Skills: ICT Literacy, Critical Thinking and Problem Solving, Information Literacy

Entrepreneurs may wish to explore an alternative to starting a business from scratch. Franchising is a popular alternative. A franchise is a right granted to an individual or business to sell the products or services of another, larger business within a defined geographical area. Franchises reduce some risk and often provide training for the franchisor. While others have already paved the way, there is no guarantee of success with a franchise. In addition, since rules are set by the franchisor, many entrepreneurs feel stifled in their ability to be creative. Before considering the purchase of a franchise, the requirements of each company should be researched. Each company sets its own conditions for ownership of a franchise. An example of a condition is the franchise fee. This is the amount of money initially paid to use the franchise name. Another example is the yearly fee for the use of the name, called a royalty fee.

Application

1. Use the Internet to investigate five companies currently offering franchises and obtain their franchise and royalty fees. Search individual company websites or sites like www.entrepreneur.com/franzone to obtain the information. Organize your information in a spreadsheet.

2. Imagine that you have the funds to start a new business. Explain whether you would prefer to start a new business from scratch or purchase a franchise. Include the reasons for your preference.

Analyzing Transactions into Debit and Credit Parts: Auditing for Errors

The bookkeeper for The Wellness Center used T accounts to analyze three transactions as follows:

Transaction 1:

Abu Owusu, Drawing	
450.00	

Cash	
	450.00

Transaction 2:

Accounts Receivable—Maria Chu	
450.00	

Sales	
	450.00

Transaction 3:

Supplies	
	150.00

Accounts Payable—Northstar Supplies	
	150.00

Review the three sets of T accounts and answer the following questions.

1. Which T account analysis is incorrect? How did you determine it was incorrect?
2. What information would you need to determine the correct T account analysis for this transaction?

Analyzing Transactions into Debit and Credit Parts: Analyzing Nike's Financial Statements

The Consolidated Balance Sheets in Appendix B on page B-6 list the assets, liabilities, and shareholders' equity for Nike for 2010 and 2011. Shareholders' equity for a corporation is similar to the capital for a proprietorship because it shows the value of the company to the owners.

Instructions

Find the total assets, total liabilities, and total equity for Nike for 2011 and 2010. Put your answer in the form of an accounting equation. You will have to add the total current liabilities, long-term debt, deferred income taxes and other liabilities, commitments and contingencies, and redeemable preferred stock to find the total liabilities.