CHAPTER 2

THE RECORDING PROCESS

LEARNING OBJECTIVES

1. EXPLAIN WHAT AN ACCOUNT IS AND HOW IT HELPS IN THE RECORDING PROCESS.

2. DEFINE DEBITS AND CREDITS AND EXPLAIN THEIR USE IN RECORDING BUSINESS TRANSACTIONS.

3. IDENTIFY THE BASIC STEPS IN THE RECORDING PROCESS.

4. EXPLAIN WHAT A JOURNAL IS AND HOW IT HELPS IN THE RECORDING PROCESS.

5. EXPLAIN WHAT A LEDGER IS AND HOW IT HELPS IN THE RECORDING PROCESS.

6. EXPLAIN WHAT POSTING IS AND HOW IT HELPS IN THE RECORDING PROCESS.

7. PREPARE A TRIAL BALANCE AND EXPLAIN ITS PURPOSES.
CHAPTER REVIEW

The Account

1. (L.O. 1) An account is an individual accounting record of increases and decreases in a specific asset, liability, or owner's equity item.

2. In its simplest form, an account consists of (a) the title of the account, (b) a left or debit side, and (c) a right or credit side. The alignment of these parts resembles the letter T, and therefore the account form is called a T-account.

Debits and Credits

3. (L.O. 2) The terms debit and credit mean left and right, respectively.
   a. The act of entering an amount on the left side of an account is called debiting the account and making an entry on the right side is crediting the account.
   b. When the debit amounts exceed the credits, an account has a debit balance; when the reverse is true, the account has a credit balance.

4. In a double-entry system, equal debits and credits are made in the accounts for each transaction. Thus, the total debits will always equal the total credits.

5. The effects of debits and credits on assets and liabilities and the normal balances are:

<table>
<thead>
<tr>
<th>Accounts</th>
<th>Debits</th>
<th>Credits</th>
<th>Normal Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>Increase</td>
<td>Decrease</td>
<td>Debit</td>
</tr>
<tr>
<td>Liabilities</td>
<td>Decrease</td>
<td>Increase</td>
<td>Credit</td>
</tr>
</tbody>
</table>

6. Accounts are kept for each of the four subdivisions of owner's equity: capital, drawings, revenues, and expenses.

7. The effects of debits and credits on the owner's equity accounts and the normal balances are:

<table>
<thead>
<tr>
<th>Accounts</th>
<th>Debits</th>
<th>Credits</th>
<th>Normal Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Owner's Capital</td>
<td>Decrease</td>
<td>Increase</td>
<td>Credit</td>
</tr>
<tr>
<td>Owner's Drawings</td>
<td>Increase</td>
<td>Decrease</td>
<td>Debit</td>
</tr>
<tr>
<td>Revenues</td>
<td>Decrease</td>
<td>Increase</td>
<td>Credit</td>
</tr>
<tr>
<td>Expenses</td>
<td>Increase</td>
<td>Decrease</td>
<td>Debit</td>
</tr>
</tbody>
</table>

8. The expanded accounting equation is:

   Assets = Liabilities + Owner's Capital – Owner's Drawings + Revenues – Expenses

The Recording Process

9. (L.O. 3) The basic steps in the recording process are:
   a. Analyze each transaction for its effect on the accounts.
   b. Enter the transaction information in a journal.
   c. Transfer the journal information to the appropriate accounts in the ledger.
The Journal

10. (L.O. 4) Transactions are initially recorded in a journal.
    a. A journal is referred to as a book of original entry.
    b. A general journal is the most basic form of journal.

11. The journal makes several significant contributions to the recording process:
    a. It discloses in one place the complete effect of a transaction.
    b. It provides a chronological record of transactions.
    c. It helps to prevent or locate errors because the debit and credit amounts for each entry can be easily compared.

12. Entering transaction data in the journal is known as journalizing. When three or more accounts are required in one journal entry, the entry is known as a compound entry.

The Ledger

13. (L.O. 5) The ledger is the entire group of accounts maintained by a company. It keeps in one place all the information about changes in account balances and it is a source of useful data for management.

14. The standard form of a ledger account has three columns and the balance in the account is determined after each transaction.

15. (L.O. 6) Posting is the procedure of transferring journal entries to the ledger accounts. The following steps are used in posting:
    a. In the ledger, enter in the appropriate columns of the account(s) debited the date, journal page, and debit amount.
    b. In the reference column of the journal, write the account number to which the debit amount was posted.
    c. Perform the same steps in a. and b. for the credit amount.

The Chart of Accounts

16. A chart of accounts is a listing of the accounts and the account numbers which identify their location in the ledger. The numbering system usually starts with the balance sheet accounts and follows with the income statement accounts.
The Basic Steps

17. The basic steps in the recording process are illustrated as follows:

Transaction  
On September 4, Fesmire Inc. pays $3,000 cash to a creditor in full payment of the balance due.

Basic analysis  
The liability Accounts Payable is decreased $3,000, and the asset Cash is decreased $3,000.

Debit-credit analysis  
Debits decrease liabilities: debit Accounts Payable $3,000. Credits decrease assets: credit Cash $3,000.

<table>
<thead>
<tr>
<th>Journal entry</th>
<th>Accounts Payable</th>
<th>201</th>
<th>3,000</th>
<th>3,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sept. 4</td>
<td>Cash</td>
<td>101</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(Paid creditor in full)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Posting</th>
<th>Cash 101</th>
<th>Accounts Payable 201</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Sept. 4 3,000</td>
<td>Sept. 4 3,000</td>
</tr>
</tbody>
</table>

The Trial Balance

18. (L.O. 7) A trial balance is a list of accounts and their balances at a given time. The trial balance proves the mathematical equality of debits and credits after posting.

19. A trial balance does not prove that the company has recorded all transactions or that the ledger is correct because the trial balance may balance even when
   a. a transaction is not journalized.
   b. a correct journal entry is not posted.
   c. a journal entry is posted twice.
   d. incorrect accounts are used in journalizing or posting.
   e. offsetting errors are made in recording the amount of a transaction.
A. The Account.

An account is an individual accounting record of increases and decreases in a specific asset, liability, or owner’s equity item.

An account consists of three parts:

1. A title.
2. A left or debit side.
3. A right or credit side.

TEACHING TIP

Emphasize that a T-account is used frequently in the classroom because it can be constructed quickly and it contains the three major parts of an account.

B. Debits and Credits.

The terms debit and credit are directional signals: Debit indicates left, and credit indicates right.

TEACHING TIP

Explain the debit and credit rules for increasing and decreasing accounts. Emphasize that the normal balance of an account is the same as the increase side.

1. Assets, drawings, and expenses are increased by debits and decreased by credits.
2. Liabilities, owner’s capital, and revenues are increased by credits and decreased by debits.

C. **Steps in the Recording Process.**

There are three basic steps in the recording process:

1. Analyze each transaction for its effects on the accounts.
2. Enter the transaction information in a journal.
3. Transfer the journal information to the appropriate accounts in the ledger.

D. **The General Journal/Journalizing.**

Entering transaction data in the general journal is called journalizing.

The general journal:

1. Discloses in one place the complete effects of a transaction.
2. Provides a chronological record of transactions.
3. Helps to prevent or locate errors because the debit and credit amounts for each entry can be easily compared.
4. A simple journal entry involves only two accounts (one debit and one credit) whereas a compound journal entry involves three or more accounts.

E. **The Ledger.**

The ledger is the entire group of accounts maintained by a company. A general ledger contains all the assets, liabilities, and owner’s equity accounts.
1. The ledger provides the balance in each of the accounts as well as keeps track of changes in these balances.

2. Companies arrange the ledger in the sequence in which they present the accounts in the financial statements, beginning with the balance sheet accounts.

**F. Posting/Chart of Accounts.**

1. Posting is transferring journal entries to the ledger accounts.

2. Posting involves the following steps:
   a. In the ledger, in the appropriate columns of the account(s) debited, enter the date, journal page, and debit amount shown in the journal.
   b. In the reference column of the journal, write the account number to which the debit amount was posted.
   c. In the ledger, in the appropriate columns of the account(s) credited, enter the date, journal page, and credit amount shown in the journal.
   d. In the reference column of the journal, write the account number to which the credit amount was posted.

3. A chart of accounts lists the accounts and the account numbers that identify their location in the ledger. Accounts are usually numbered starting with the balance sheet accounts followed by income statement accounts.

**G. Trial Balance.**

A trial balance is a list of accounts and their balances at a given time.

1. It proves the mathematical equity of debits and credits after posting.

2. It may also uncover errors in journalizing and posting.

3. It is useful the preparation of financial statements.
INVESTOR INSIGHT

Bank regulators fined Bank One Corporation (Now Chase) $1.8 million because they felt the reliability of the bank’s accounting system caused it to violate regulatory requirements. The financial records of Waste Management Inc. were in such disarray that 10,000 employees were receiving pay slips that were in error.

In order for these companies to prepare and issue financial statements, their accounting equations must have been in balance at year-end. How could these errors or misstatements have occurred?

Answer: A company’s accounting equation (its books) can be in balance yet its financial statements have errors or misstatements because of the following: entire transactions were not recorded, transactions were recorded at wrong amounts; transactions were recorded in the wrong accounts; transactions were recorded in the wrong accounting period. Audits of financial statements uncover some, but not all, errors or misstatements.
IFRS

A Look At IFRS

International companies use the same set of procedures and records to keep track of transaction data. Thus, the material in Chapter 2 dealing with the account, general rules of debit and credit, and steps in the recording process—the journal, ledger, and chart of accounts—is the same under both GAAP and IFRS.

KEY POINTS

- Transaction analysis is the same under IFRS and GAAP but, as you will see in later chapters, different standards sometimes impact how transactions are recorded.
- Rules for accounting for specific events sometimes differ across countries. For example, European companies rely less on historical cost and more on fair value than U.S. companies. Despite the differences, the double-entry accounting system is the basis of accounting systems worldwide.
- Both the IASB and FASB go beyond the basic definitions provided in this textbook for the key elements of financial statements, that is, assets, liabilities, equity, revenues, and expenses. The more substantive definitions, using the IASB definitional structure, are provided in the Chapter 1 A Look at IFRS discussion.
- A trial balance under IFRS follows the same format as shown in the textbook.
- As shown in the textbook, dollar signs are typically used only in the trial balance and the financial statements. The same practice is followed under IFRS, using the currency of the country that the reporting company is headquartered.
- In February 2010, the SEC expressed a desire to continue working toward a single set of high-quality standards. In deciding whether the United States should adopt IFRS, some of the issues the SEC said should be considered are:
  - Whether IFRS is sufficiently developed and consistent in application.
  - Whether the IASB is sufficiently independent.
  - Whether IFRS is established for the benefit of investors.
  - The issues involved in educating investors about IFRS.
  - The impact of a switch to IFRS on U.S. laws and regulations.
  - The impact on companies including changes to their accounting systems, contractual arrangements, corporate governance, and litigation.
  - The issues involved in educating accountants, so they can prepare financial statements under IFRS.
LOOKING TO THE FUTURE

The basic recording process shown in this textbook is followed by companies across the globe. It is unlikely to change in the future. The definitional structure of assets, liabilities, equity, revenues, and expenses may change over time as the IASB and FASB evaluate their overall conceptual framework for establishing accounting standards.
20 MINUTE QUIZ

Circle the correct answer.

True/False

1. Assets are increased by debits and liabilities are decreased by credits.
   True  False

2. The owner’s capital account is increased by credits.
   True  False

3. An account will have a credit balance if the total debit amounts exceed the total credit amounts.
   True  False

4. The ledger is the entire group of accounts maintained by a company.
   True  False

5. The basic steps in the recording process are (1) to analyze each transaction, (2) to enter the transaction in a journal, and (3) to transfer the journal entry to the appropriate ledger accounts.
   True  False

6. Transferring journal entries to the ledger accounts is called posting and should be performed in chronological order.
   True  False

7. Assets = liabilities + owner’s capital – drawings + revenues – expenses is a correct form of the expanded basic accounting equation.
   True  False

8. In posting, one should enter “J2” in the Post. Ref. Column on page two of the journal.
   True  False

9. When the columns of the trial balance equal each other, it proves no errors occurred in recording and posting.
   True  False

10. The double-entry system helps ensure the accuracy of the recorded amounts and helps to detect errors.
   True  False
Multiple Choice

1. Transactions are initially recorded in the
   a. general ledger.
   b. general journal.
   c. trial balance.
   d. balance sheet.

2. The right side of an account is referred to as the
   a. footing.
   b. chart side.
   c. debit side.
   d. credit side.

3. A purchase of equipment for cash requires a credit to
   a. Equipment.
   b. Cash.
   c. Accounts Payable.
   d. Owner’s Capital.

4. The equality of the accounting equation can be proven by preparing a
   a. trial balance.
   b. journal.
   c. general ledger.
   d. T-account.

5. Which of the following accounts would be increased with a debit?
   a. Rent Payable
   b. Owner’s Capital
   c. Service Revenue
   d. Owner’s Drawings
ANSWERS TO QUIZ

True/False

1. False 6. True
2. True 7. True
3. False 8. False
5. True 10. True

Multiple Choice

1. b.
2. d.
3. b.
4. a.
5. d.