

CHAPTER 2

The Recording Process

LECTURE OUTLINE

1. The Account

- 1.1. An account is an individual accounting record of increases and decreases in a specific asset, liability, or owner's equity item.
- 1.2. An account consists of three parts:
- The title of the account,
 - A left or debit side,
 - A right or credit side.

TEACHING TIP

Use **ILLUSTRATION 2.1** to explain the concept of an account. 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: name, debit side and credit side.

1.3 Debits and Credits

- 1.3.1 The term **debit** signifies left and the term **credit** signifies right. Entering an amount on the left side of an account is called debiting the account and entering an amount on the right side of an account is called crediting the account.
- 1.3.2 The system of using debits and credits is based on the basic accounting equation; whereby, $\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$.
- 1.3.3 Since assets are on the left side of the accounting equation, the normal balance of an asset is on the left or debit side of the account. Assets are increased by debits and decreased by credits.
- 1.3.4 Since liabilities and owner's equity are on the right side of the accounting equation, the normal balance of a liability or equity account is on the right or credit side of the account. Liabilities and owner's equity are increased by credits and decreased by debits.
- 1.3.5 Owner's investments are credited to the owner's capital account because it

increases owner's equity. Owner's withdrawals are debited since they decrease owner's equity.

- 1.3.6. Revenues are recorded as credits since revenues increase owner's equity. Expenses are recorded as debits since expenses decrease owner's equity.

TEACHING TIP

ILLUSTRATION 2.12 – Summary of Debit and Credit Effects, can be used to 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. The asset side increases with a debit and therefore has a normal debit balance. The liabilities and equity side increases with a credit and therefore has a normal credit balance. Think of the difference between the asset side and the liabilities/equity side as looking in a mirror i.e., things are always reversed in a mirror. This also provides a good opportunity to expand on and explain that owner's equity is made up of owner's capital, owner's draw, revenues and expenses.

1.4 Double-Entry Accounting

- 1.4.1. As was explained in Chapter 1, each transaction must affect two or more accounts to keep the accounting equation in balance. This is known as the double-entry accounting system.
- 1.4.2. For each transaction, debits must equal credits.
- 1.4.3. Since every transaction must be recorded with equal debits and credits, the total debits will equal the total credits and therefore the accounting equation stays in balance.

2. Analyzing and Recording Transactions

2.1 The Accounting Cycle and Steps in the Recording Process

- 2.1.1. The accounting cycle is a series of steps followed in preparing financial statements.
- 2.1.2. The procedures used in analyzing and recording transactions are the first three steps and are known as the recording process.
- 2.1.3. The basic steps in the recording process are:
 - Analyze each transaction in terms of its effect on the accounts.
 - Enter the transaction information in a journal (book of original entry).
 - Transfer the journal information to the appropriate accounts in the ledger (book of accounts).

TEACHING TIP

ILLUSTRATION 2.13 can be used to explain that the steps in the recording process are the first three steps in the accounting cycle. Emphasize that the remaining steps in the accounting cycle will be taught later in Chapter 2, in Chapter 3 and Chapter 4.

2.2 The Journal

- 2.2.1. Transactions are first recorded in chronological (date) order in a journal.
- 2.2.2. Entering transaction data in the general journal is called journalizing.
- 2.2.3. The general journal:
 - Discloses in one place the complete effect of a transaction.
 - Provides a chronological record of transactions.
 - Helps to prevent or locate errors because the debit and credit amounts for each entry can be easily compared.
 - Provides an explanation of the transaction and, where applicable, identifies the source document.
- 2.2.4. Separate journal entries are made for each transaction and include the following:
 - The date of the transaction including the year, month and day.
 - The accounts and the amounts that are to be debited and credited. Record debit accounts on the first line and at the left margin of the column headed Account Titles and Explanation. Credit accounts are recorded on the next line and are indented from the left margin to distinguish them from the debit accounts.
 - The amounts for the debits are recorded in the Debit (left) column and the amounts for the credits are recorded in the Credit (right) column.
 - A brief explanation of the transaction is given on the line below the credit account title.
 - Leave one blank space between each entry for ease of reading.
 - The Ref (Reference) column is left blank until the entry is posted to the ledger at which time the account number will be placed in the Ref column.

TEACHING TIP

Illustration 2.16 provides an example of recording two transactions in the General Journal. It would be useful to compare the journal entries in this example with the tabular summary learned in Chapter 1. Emphasize to the students that what was learned in Chapter 1 is a simplistic way of recording transactions. It is useful to think of whether accounts have increased or decreased and translate that into whether the accounts need to be debited or credited. Explain to the students that it is acceptable to determine the account (s) that needs to be credited first and to record the

credit account first. However, they should leave enough space to add the accounts to be debited. It may be useful to take students through the “BEFORE YOU GO ON...**DO IT**” section on page 68 in order to demonstrate this process.

- 2.2.5. A simple journal entry involves only two accounts (one debit and one credit) whereas a compound journal entry involves three or more accounts (for example: two debits and one credit).

3. The Ledger

- 3.1 The general ledger is the entire group of accounts maintained by a company, including all assets, liabilities, equity, revenues and expenses.
- 3.2. The general ledger provides information about changes in specific account balances for a company.
- 3.3. The general ledger should be arranged in this order: assets, liabilities, owner's capital, owner's drawings, revenues, and expenses.

3.4 Posting

- 3.4.1. Posting is the procedure of transferring journal entries to the ledger accounts. Posting accumulates the effects of journalized transactions in the individual accounts.
- 3.4.2. Posting involves the following steps:
In the ledger enter the date, journal page number, and debit or credit amount shown in the journal in the correct columns of each affected account.
In the reference column of the journal, write the account number to which the debit or credit amount was posted.

TEACHING TIP

ILLUSTRATION 2.20 demonstrates the posting process of a general journal entry to the appropriate general ledger accounts. By posting from the general journal to the general ledger we are able to see at a glance individual account balances. We can determine what our Cash account balance is; if our Account Receivables account balance seems unusually high or our Accounts Payable account balance is high. While both the journal and the ledger have similarities, the main difference is that the general ledger focuses on the account whereas the general journal focuses on the transaction.

- 3.4.3. A chart of accounts is a listing of the account names and account numbers, which identify their location in the ledger. Accounts are usually numbered starting with the balance sheet accounts followed by income statement accounts.

TEACHING TIP

ILLUSTRATION 2.21 illustrates a typical chart of accounts for a service company. You may wish to inform students that a sample chart of accounts is available on the student resource website. This chart is also helpful for students who don't know what name to give to accounts in journal entries.

3.5 The Recording Process Illustrated

- 3.5.1 The purpose of transaction analysis is first to identify if the transaction should be recorded or not. The first step in transaction analysis is to decide whether a transaction has occurred to determine if a transaction should be recorded. If it should be recorded then determine how to record it, i.e., the type of account involved; second whether it is increased or decreased; and third, whether it needs to be debited or credited.
- 3.5.2 Every journal entry affects one or more of the following items: assets, liabilities, owner's equity, revenues, expenses, or drawings.

TEACHING TIP

Refer the students to the 13 transactions presented in the chapter showing the basic steps in the recording process for common business transactions. Refer to **ILLUSTRATION 2.20** and have the students get into the habit of using the three steps to recording each transaction. Point out to students that not all events require recording. If a transaction has occurred and needs to be recorded, then the student should think about the accounts that have been affected and whether the accounts have gone up or have gone down. Then with this information the student should determine whether the accounts need to be debited or credited. Once this has been determined, the journal entry will be prepared in proper journal entry format. Emphasize to the students that what was learned in Chapter 1 is useful when following the debit and credit rules learned in Chapter 2.

Also, refer the students to the **Summary Illustration of Journalizing and Posting** presented in the chapter.

4. The Trial Balance

- 4.1. A trial balance is a list of accounts in the ledger and their balances at a specific time. Its primary purpose is to prove (check) that the debits equal the credits after posting. It uncovers some errors in journalizing and posting. It is useful in the preparation of financial statements.
- 4.2. The procedure for preparing a trial balance is as follows:
List account titles and balances in same order as the chart of accounts.

Total the debit and credit columns.
Ensure the totals of both columns are equal.

TEACHING TIP

ILLUSTRATION 2.38 can be used to demonstrate what a trial balance looks like.

4.3 Limitations of a Trial Balance

- 4.3.1. A trial balance has limitations and there still may be errors even if the debit and credit columns balance. Some reasons the trial balance may balance, but include errors, are:
- a transaction is not journalized
 - a correct journal entry is not posted
 - a journal entry is posted twice
 - incorrect accounts are used in journalizing or posting, or
 - errors that hide each other (off-setting errors) are made in recording the amount of the transaction.

4.4 Locating Errors

- 4.4.1. If there is a difference between the two columns, use the following steps to help find the error:
- If the difference is in the amount of \$1, \$100 or \$1,000, recalculate the account balances and re-add the trial balance.
 - If the difference can be divided by two, a balance equal to half the error could have been entered in the wrong column.
 - If the difference is divisible by nine, an amount on the trial balance could have been copied incorrectly from the ledger. That is, there could have been a transposition error.
 - If the error cannot be evenly divided by two or nine, an account balance in the amount or the error could have been omitted or a posting in the amount of the error could have been omitted.

4.5 Some Process Explanations

- 4.5.1. Cents are always used when recording a transaction in a journal and posting to the ledger. However, when preparing financial statements, account balances are rounded to nearest dollar for small companies.
- 4.5.2. Dollars signs are not used in journals or ledgers. Dollar signs are only used in the trial balance and financial statements.
- 4.5.3. In practice, companies use account names and account numbers.

TEACHING TIPS

Explain to the students that cents are not recorded in the textbook but in a company all transactions are recorded and rounded to the nearest cent.

In the textbook, sales taxes are ignored to simplify the recording process but in a company sales taxes would be accounted for.

Explain to the students when and how items need to be underlined or double underlined in the Financial Statements. This can be difficult for the students to fully grasp.

HIGHLIGHTS OF IFRS CHANGES

The recording process is the same under International Financial Reporting Standards (IFRS) and Accounting Standards for Private Enterprises (ASPE).