chapter

2

Analyzing Transactions

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OPENING COMMENTS

Chapter 2 is the *most* important chapter in the text. It introduces students to the rules of debit and credit, chart of accounts, two-column journals, four-column ledgers, T accounts, and the trial balance. Quite frankly, if students fail to grasp the concepts in this chapter, the first seeds of destruction will be sown for those students who will ultimately withdraw from or fail the course.

Emphasize that Chapter 2 builds the foundation for all that will be learned about accounting principles. Unlike many other college courses, it is impossible to understand Chapter 3 and beyond if the principles of Chapter 2 are not mastered. You need to dispel the false belief that “maybe I’ll get the next chapter—even though I’m totally lost now.”

Also encourage your students to seek help immediately if they begin to struggle with course content. Make them aware of the resources available at your institution: tutorial services, peer assistance, your office hours, use of CengageNOW, and support services, etc. Too frequently, students wait until after they have failed their first examination to seek help. For those who heed them, these simple suggestions will help students avoid failure.

Reinforce the fact that accounting is best learned by doing. Students must work the exercises to grasp the concepts introduced in this chapter.

The chapter ends with an explanation and demonstration of analyzing financial statements using horizontal analysis. Interpretation explains possible relationships among the changes revealed in the analysis.

After studying the chapter, your students should be able to:

1. Describe the characteristics of an account and a chart of accounts.
2. Describe and illustrate journalizing transactions using the double-entry accounting system.
3. Describe and illustrate the journalizing and posting of transactions to accounts.
4. Prepare an unadjusted trial balance and explain how it can be used to discover errors.
5. Describe and illustrate the use of horizontal analysis in evaluating a company’s performance and financial condition.

KEY TERMS

account

account receivable

assets

balance of the account

chart of accounts

correcting journal entry

common stock

credit

debit

dividends

double-entry accounting system

expenses

horizontal analysis

journal

journal entry

journalizing

ledger

liabilities

normal balance of an account

posting

retained earnings

revenues

rules of debit and credit

slide

stockholders’ equity

T account

transposition

trial balance

unadjusted trial balance

unearned revenue

STUDENT FAQS

* Why does Cash have a debit balance instead of a credit? My bank tells me they are crediting my account when I put money in. This question has to be answered several times until the student realizes that to the bank it is a liability, and they are telling the student what they are doing to their books.
* Why is the abbreviation for a debit “Dr” when there is no “r” in the spelling?
* Why can’t the normal balances of all the accounts be opposite what they are?
* Who dreamed this accounting system up?
* Who uses these statements, and what do they do with the information?
* What is the difference between journalizing and posting?
* What is the difference between an expense and a liability?
* Aren’t assets and revenue the same? If a business works for someone and gets paid, aren’t Cash and Revenue exactly the same thing?
* Aren’t expenses and liabilities the same? If a business gets a utility bill and hasn’t paid it yet, aren’t Utility Expense and Utility Payable exactly the same account?
* Why do they call it a credit card? Who is crediting what?
* “I work in a bank and we use debits and credits, but you have them all reversed in the book. The bank where I work does everything exactly the opposite.”
* Why can’t we just record the transactions directly into the ledger?
* Why are the ledger accounts in a specific order? Why aren’t they listed in alphabetical order?
* Why aren’t increases (+) always a debit and decreases (–) always a credit? Wouldn’t that make more sense?
* Why can’t you wait until the end of the month to compute the balance of each account in the ledger? Isn’t it a lot of work to re-compute a new balance after each posting?
* In business, we say that we need to raise capital to start a business, so why aren’t cash and capital the same thing?
* How do I know whether to use wages expense or wages payable?
* Do small businesses really need to do all this work to keep track of their income? Can’t they just add and subtract from their bank account?

OBJECTIVE 1

Describe the characteristics of an account and a chart of accounts.

SYNOPSIS

In the previous chapter, transactions were recorded using the accounting equation format. Exhibit 1 presents a summary of the transactions we analyzed in the previous chapter for NetSolutions. This chapter demonstrates how to record transactions using accounts. Accounts make it easy to track increases and decreases in a company’s assets, liabilities, stockholders’ equity, revenues, expenses, and dividends. For example, NetSolutions will need 12 accounts, one for each of the financial statement items shown in Exhibit 1. Basically, accounts have two sides, a left side and a right side. Because the letter “T” has a left side and a right side, the term “T account” is often used to refer to accounts. Debits are recorded on the left side of the T, and credits are recorded on the right side of the T. The balance of the account is the amount of the difference between the debits and the credits that have been entered into an account. All the accounts used in a business are grouped together in a ledger. A list of the accounts maintained in the ledger is known as a chart of accounts. Exhibit 2 presents the chart of accounts for NetSolutions. Assets are the resources owned by a business. Liabilities are the rights of creditors that represent debts of the business. Stockholders’ equity represents the rights of owners to the assets of the business. For a corporation, stockholders’ equity in the business is composed of common stock and retained earnings. The dividends account represents distributions of earnings to stockholders. Revenues are increases in assets and stockholders’ equity as a result of selling services or products to customers. Expenses are assets used up or services consumed in the process of generating revenues. Each account in the chart of accounts is assigned an account number. These accounts are used to record the business’s transactions.

***Key Terms and Definitions***

* **Account** - An accounting form that is used to record the increases and decreases in each financial statement item.
* **Assets** -The resources owned by a business.
* **Balance of the Account** -The amount of the difference between the debits and the credits that have been entered into an account.
* **Chart of Accounts** -A list of the accounts in the ledger.
* **Common Stock** - The stock outstanding when a corporation has issued only one class of stock.
* **Credit** - Amount entered on the right side of an account.
* **Debit** - Amount entered on the left side of an account.
* **Dividends** - Distribution of a corporation’s earnings to stockholders.
* **Expenses** - Assets used up or services consumed in the process of generating revenues.
* **Ledger** - A group of accounts for a business.
* **Liabilities** - The rights of creditors that represent debts of the business.
* **Retained Earnings** - Net income retained in a corporation.
* **Revenues** -Increases in assets and stockholders’ equity as a result of selling services or products to customers.
* **Stockholders’ Equity** - The owners’ equity in a corporation.
* **T account** -The simplest form of an account.

***Relevant Example Exercises and Exhibits***

* Exhibit 1 – NetSolutions’ November Transaction
* Exhibit 2 – Chart of Accounts for NetSolutions

SUGGESTED APPROACH

Remind students that accounts are used to record business transactions. An account is simply a record of all the increases and decreases in a financial statement item (such as cash, supplies, and accounts payable). A group of accounts is called a ledger.

Point out that only a very small enterprise with very few transactions (such as a lawn-mowing service run by students) could use the accounting system illustrated in Chapter 1. For most businesses, this system would be inefficient. For example, in the prior chapter, all business transactions affecting stockholders’ equity were recorded as stockholders’ equity. In Chapter 2, these different types of transactions will be separated and recorded in the common stock, retained earnings, dividends, revenue, and expense accounts. Issuance of common stock and revenue accounts increase stockholders’ equity; dividends and expense accounts reduce stockholders’ equity. This separation will make it easier to prepare financial statements. Transparency Master (TM) 2-1 can be used to highlight this change.

T accounts are introduced as a convenient way to track increases and decreases in accounts. You may want to stress that T accounts are a representation of the general ledger, which is the official place to record and track account balances.

GROUP LEARNING ACTIVITY—Chart of Accounts

Objective 1 also introduces a chart of accounts and a flexible system of numbering accounts. Under the text’s indexing system, accounts are assigned a two-digit number. The first digit indicates the account’s classification (1 = assets, 2 = liabilities, 3 = stockholders’ equity, 4 = revenue, and 5 = expenses). Stress that all enterprises will have the same categories of accounts; however, the account titles used and the number of accounts will vary. You can emphasize this variety by asking students to bring in charts of accounts from businesses where they or a relative work.

TM 2-2 presents information related to the business transactions of Larry Sharp, M.D. Divide students into small groups and ask them to use the information to develop a chart of accounts for Dr. Sharp. Also ask them to assign a number to each account.

This activity will test whether your students can identify the accounts needed to record Dr. Sharp’s typical business transactions and apply the concept of a flexible numbering system. The group activity may be assigned before discussing the information related to charts of accounts presented in the text. This will force students to recall some information from their reading assignment and reinforce your expectation that all reading assignments are to be completed prior to classroom discussion.

TM 2-3 presents a suggested chart of accounts that you may want to share with the class after they have completed their group work. Remind them that the chart of accounts is different for every company, reflecting each company’s typical business transactions.

You will notice that the suggested solution in TM 2-3 does not include insurance expense or depreciation expense accounts. These accounts, although necessary for preparing adjusting entries, have been omitted since that step in the accounting cycle will not be introduced until Chapter 3.

The first account form introduced in Chapter 2 is the T account. Draw a T account on the board, and remind students that the left side will be called the debit or Dr. side and the right side will be called the credit or Cr. side. Each T account has a name as well as a normal balance side.

To demonstrate how a T account works, you may want to use the Cash account and record the increases and decreases to the account from one of the problems worked in Chapter 1 (1-3A, for example). Show how the balance is recorded and compare it to the balance reached in the Chapter 1 problem.

INTERNET ACTIVITY—Chart of Accounts

There are organizations that post recommended charts of accounts on the Internet, so your students can see some real-world examples. A standard chart of accounts is provided by Small Business Notes. The Web address is:

http://www.smallbusinessnotes.com/operating/finmgmt/financialstmts/cofa.html

You might also want to encourage your students to search for other suggested charts of accounts.

OBJECTIVE 2

Describe and illustrate journalizing transactions using the double-entry accounting system.

SYNOPSIS

Businesses use the double-entry accounting system for recording transactions, based on recording increases and decreases in accounts so that debits equal credits. In this system, the rules of debit and credit specify how to record increases and decreases in the accounts. The normal balance of an account can be either a debit or a credit depending on whether increases in the account are recorded as debits or credits. For asset and expense accounts, a debit increases the account, and a credit decreases the account. For liability, stockholders’ equity, and revenue accounts, a debit decreases the account, and a credit increases the account. The word *debit* can be abbreviated as Dr., and *credit* can be abbreviated as Cr. Exhibit 3 summarizes the debit/credit rules and indicates the normal balance in each type of account. Using the rules of debit and credit, transactions are entered in a journal chronologically as they occur; this is the initial record in which the effects of a transaction are recorded. The process of entering a transaction is called journaling. Each such record is known as a journal entry. Exhibit 4 summarizes terminology that is often used to describe common transactions along with the specific accounts that would be debited and credited. The transaction is recorded using the following steps: the date of the transaction is recorded in the date column, the title of the account to be debited is entered first in the description column, and the amount to be debited is entered in the debit column. The title of the account to be credited is listed under the account debited and indented and the amount to be credited is entered in the credit column. A brief description may be entered at this time in the description column below the account credited. The Post. Ref. column is not used until the entry in transferred to the ledger.

***Key Terms and Definitions***

* **Double-Entry Accounting System** - A system of accounting for recording transactions, based on recording increases and decreases in accounts so that debits equal credits.
* **Journal** - The initial record in which the effects of a transaction are recorded.
* **Journal Entry** - The form of recording a transaction in a journal.
* **Journalizing** - The process of recording a transaction in the journal.
* **Normal Balance of an Account** - The normal balance of an account can be either a debit or a credit depending on whether increases in the account are recorded as debits or credits.
* **Rules of Debit and Credit** - In the double-entry accounting system, specific rules for recording debits and credits based on the type of account.

***Relevant Example Exercises and Exhibits***

* Example Exercise 2-1 – Rules of Debit and Credit and Normal Balances
* Example Exercise 2-2 – Journal Entry for Asset Purchase
* Exhibit 3 – Rules of Debit and Credit, Normal Balances of Accounts
* Exhibit 4 – Transaction Terminology and Related Journal Entry Accounts

SUGGESTED APPROACH

Learning the rules of debit and credit is one of the first major hurdles for students in accounting principles. Remind students that debit and credit simply represent the left and right sides of an account. The trick is remembering which accounts are increased with debits and which are increased with credits.

LECTURE AID—Rules of Debit and Credit

Three approaches to explain the rules of debit and credit follow. You may want to present all methods to your class and encourage each student to use the approach that he or she understands best.

“Mirror Image” Approach: One way to explain the rules of debit and credit is to draw the following equation on the board.

Assets = Liabilities + Stockholders’ Equity

+ – – + – +

Point out that the rules for increasing and decreasing liabilities and stockholders’ equity accounts are the mirror image of the rules for assets. Therefore, if students can remember the rules for assets, they can deduce the rules for the remaining accounts. This method requires that the student understand that the negative effect of the dividends and expense accounts on stockholders’ equity requires the opposite treatment of the rules of debit and credit for these types of accounts. Exhibit 3 from the text is excellent to help explain this concept.

Although this is the most simplistic approach, some students become very confused by the treatment of the dividends and expense accounts. Increases to these accounts are debits, since they reduce stockholders’ equity. However, some students want to record expenses and dividends as credits because the schematic has a + sign on the credit side of stockholders’ equity accounts.

“After Eating Dinner” Approach: The rules of debit and credit can also be explained with the following saying: “After eating dinner, let’s relax and snooze.”

Here’s how it works.

After Eating Dinner, Let’s Relax and Snooze

Accounts increased Accounts increased

with a debit: with a credit:

Assets Liabilities

Expenses Revenues

Dividends Stockholders’ Equity

“ALSIE” Approach: The rules of debit and credit can also be explained using the acronym “ALSIE.”

List the types of classifications of accounts:

A = Assets

L = Liabilities

S = Stockholders’ Equity

I = Income (Revenue)

E = Expense

Arrange the letters to read “ALSIE.” Then list normal balances by the side of each.

|  |  |  |
| --- | --- | --- |
| A | = | Dr. |
| L | = | Cr. |
| S | = | Cr. |
| I | = | Cr. |
| E | = | Dr. |

Note that ALSIE begins and ends with normal Dr. balance accounts, while the three middle classifications are normal Cr. balance accounts. The dividends account is not included in this explanation, so the student must memorize the proper treatment of this account.

No matter which approach the student uses to learn the rules, you will need to reinforce the categories and the proper treatment of increases and decreases over and over. Start by emphasizing that half of the accounts are increased with debits (assets, dividends, and expenses) and half are increased with credits (liabilities, stockholders’ equity, and revenue). It is also important to discuss the meaning of normal balance. Normal balance is the side of the account in which increases are recorded. At this point in the learning process, the student can assume that typically only assets and liabilities will have both debit and credit entries. Dividends and expense accounts will typically have only debit entries, and stockholders’ equity and revenue accounts will have only credit entries. This generalization will hold true until Chapter 4. By that time, the student should be comfortable with the debit and credit rules.

GROUP LEARNING ACTIVITY—Rules of Debit and Credit

After explaining the rules of debit and credit, it is important to reinforce those concepts with an example.

Remind students that business transactions are initially recorded in a record called a journal. After each entry is journalized, it is posted to the proper account in the ledger. In this group exercise, students will post entries into T accounts.

Ask your students to draw the following T accounts on a sheet of paper:

Cash Retained Earnings

Accounts Receivable Dividends

Supplies Fees Earned

Stereo Equipment Wages Expense

Accounts Payable Advertising Expense

Common Stock

TM 2-4 lists several business transactions. Illustrate the process by recording the first two or three transactions in a journal format and by posting them to the appropriate T account. As you work these examples, emphasize that there is a three-step process in analyzing each entry: (1) determine which accounts are affected, (2) decide whether each account should be increased or decreased, and (3) translate the increase or decrease into a debit or a credit.

Students may find it helpful when initially analyzing transactions to first see if the transaction involves cash. Most transactions in this stage of learning involve cash. If cash is being received, the debit portion of the transaction is cash. If cash is being given, the credit portion of the transaction is cash. This will provide students with half the transaction entry and allow them to focus on determining the other account to complete the journal entry.

After completing your examples, ask students to work in small groups to complete the transactions. TM 2-5 presents the solution to this exercise.

LECTURE AID—Double-Entry Accounting

To help the student understand the effect of double-entry accounting, it can be helpful to illustrate examples of some of the more common transactions, such as the ones below, as you lecture.

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| TRANSACTION |  | AFFECTED ACCOUNTS | | | | |
|  |  |  |  |  |  |  |
|  |  | Cash | |  | Common Stock | |
|  |  | Dr. | Cr. |  | Dr. | Cr. |
|  |  |  |  |  |  |  |
|  |  | Increase |  |  |  | Increase |
| Issued stock for cash |  |  |  |  |  |  |
|  |  |  |  |  |  |  |

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  | Cash | |  | Fees Earned | |
|  |  | Dr. | Cr. |  | Dr. | Cr. |
|  |  |  |  |  |  |  |
| Received cash for services rendered |  | Increase |  |  |  | Increase |
|  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |
|  |  | Accounts Receivable | |  | Fees Earned | |
|  |  | Dr. | Cr. |  | Dr. | Cr. |
|  |  |  |  |  |  |  |
| Billed customers on account |  | Increase |  |  |  | Increase |
|  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |
|  |  | Cash | |  | Expense Account | |
|  |  | Dr. | Cr. |  | Dr. | Cr. |
|  |  |  |  |  |  |  |
| Paid for expenses |  |  | Decrease |  | Increase |  |
|  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |
|  |  | Cash | |  | Accounts Receivable | |
|  |  | Dr. | Cr. |  | Dr. | Cr. |
|  |  |  |  |  |  |  |
| Received cash on account |  | Increase |  |  |  | Decrease |
|  |  |  |  |  |  |  |
|  |  |  |  |  |  | |
|  |  | Cash | |  | Accounts Payable | |
|  |  | Dr. | Cr. |  | Dr. | Cr. |
|  |  |  |  |  |  |  |
| Paid on account |  |  | Decrease |  | Decrease |  |
|  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |
|  |  | Supplies | |  | Accounts Payable | |
|  |  | Dr. | Cr. |  | Dr. | Cr. |
|  |  |  |  |  |  |  |
| Purchased on account |  | Increase |  |  |  | Increase |
|  |  |  |  |  |  |  |
|  |  |  |  |  |  | |
|  |  | Cash | |  | Dividends | |
|  |  | Dr. | Cr. |  | Dr. | Cr. |
|  |  |  |  |  |  |  |
| Paid cash dividends |  |  | Decrease |  | Increase |  |
|  |  |  |  |  |  |  |

LECTURE AID—Journalizing

At this point, it is time to introduce your students to the standard journal format. It is interesting to point out that while T accounts are not actually used to record business transactions, accountants frequently use them to analyze complex transactions. In the same way, students will find the T account a useful tool throughout this and future accounting courses.

You may wish to point out the useful table that summarizes common transaction terminology in Exhibit 4 of the text.

TM 2-6 shows a series of transactions recorded in a two-column journal. Use this exhibit to review the two-column journal format with your students. You may want to stress the following format issues:

1. *Dates:* The year is entered only at the top of the date column. The month is entered on the first line of the date column on each page; it is also entered for the first transaction whenever changing to a new month. The date is entered for each transaction.
2. The description column is where account names are entered. Debited accounts should be on top, and credited accounts should be on the bottom and indented to the right (credits are always on the right).
3. Proper journalizing always has at least one debit and one credit, and total debits must always equal total credits. Proper journalizing will keep the accounting equation in balance.
4. *Explanations:* A brief description of the transaction should be written below the debit and credit account titles. This description may be omitted if the transaction is a normal business occurrence and its nature is obvious from the entry. When calculations are required, they should be noted here.
5. *Blank Lines:* A blank line should separate all transactions in a manual journal to make them easier to read. Computerized systems are normally designed to separate journal entries without special input.

It is also helpful to emphasize the importance of using the correct journal entry format of left justifying debits and indenting credits by writing the following entry on the board and asking students to identify what is wrong:

Supplies 500

Cash 500

Since the credit in the entry is not indented, it is difficult to identify the debit and the credit. Were supplies purchased using cash, or were they sold for cash?

In most computerized systems, the indention of the names of accounts credited is not necessary because debits and credits are recorded in separate columns.

OBJECTIVE 3

Describe and illustrate the journalizing and posting of transactions to accounts.

SYNOPSIS

This objective continues with journalizing and also demonstrates how to post the journal entries to the ledger. Posting is the process of transferring the debits and credits from the journal entries to the accounts in the ledger. Exhibit 5 illustrates this process. Using the company NetSolutions, the chapter shows the journalizing of a transaction in a standard account form and then demonstrates how to record each entry in the ledger. The debits and credits from each entry are transferred to the ledger in the order in which they occurred. The ledger account is located for the first line of the entry, the date is transferred first, then the amount of the debit is entered in the debit column, the journal page is entered in the Post Reference (Post. Ref.) column of the ledger, and the account number is entered in the Post. Ref. column in the journal. The ledger account is located for the second line of the entry, the date is transferred first, then the amount of the credit is entered in the credit column, the journal page is entered in the Post. Ref. column of the ledger, and the account number is entered in the Post. Ref. column in the journal. Thus, the Post. Ref. notations serve to link the journal and ledger and provide an easy way to trace transactions from the journal to the ledger or vice versa.

Several transactions are analyzed with the text showing both the journal entry and its posting to the ledger. The transaction in which NetSolutions rents land to another entity for three months introduces the concept of unearned revenue. This transaction creates a liability by receiving revenue in advance. As the three months passes, the liability will decrease and become revenue. The transaction in which NetSolutions agrees that a customer may receive services and pay at a later date creates an account receivable. This is a claim against the customer created by selling merchandise or services on credit. This account is an asset, and the revenue is earned even though no cash is yet received. Exhibit 6 presents the general ledger for NetSolutions after all of the transactions have been posted. Notice the use of the four-column account format which facilitates the determination of account balances.

***Key Terms and Definitions***

* **Account Receivable** - A claim against the customer created by selling merchandise or services on credit.
* **Posting** - The process of transferring the debits and credits from the journal entries to the accounts in the ledger.
* **Unearned Revenue** - The liability created by receiving revenue in advance.

***Relevant Example Exercises and Exhibits***

* Example Exercise 2-3 – Journal Entry for Fees Earned
* Example Exercise 2-4 – Journal Entry for Dividends
* Example Exercise 2-5 – Missing Amount from an Account
* Exhibit 5 – Diagram of the Recording and Posting of a Debit and a Credit
* Exhibit 6 – Cash Receipts Journal for a Merchandising Business

SUGGESTED APPROACH

Remind students that journalizing transactions is a sequential record of business dealings and posting is the updating of individual account balances. Getting the journal entry correct is the bigger challenge; the posting is a merely a process of transferring the information from the journal to the proper ledger accounts. Although posting can be a tedious process, it is critical that the student follow the process and not resort to shortcuts; otherwise, information may be omitted, resulting in incorrect account balances.

DEMONSTRATION PROBLEM—The Ledger

TM 2-7 is a series of four-column ledger accounts. Use these blank accounts to demonstrate posting of the first three transactions from TM 2-6. As you post the transactions, remind students that a posting reference must be entered in the appropriate columns of both the journal and the ledger. Also emphasize that transactions should be posted carefully to avoid errors. Careless posting may result in a lot of time being wasted trying to find errors. Emphasize that with a software package, posting will usually be done automatically, so there is less chance of making mistakes in posting.

WRITING EXERCISE—The Journal and the Ledger

It is important for students to understand the reason that business transactions are recorded in a journal as the book of original entry and later posted to a ledger. To check their understanding of these concepts, ask them to write a response to the following questions. These questions are also found on TM 2-8.

1. Why are business transactions initially recorded in a journal?

2. Why are business transactions posted from the journal to a ledger?

**Question 1 possible response:** The journal is used to record transactions in the order in which they occur. The journal shows the entire effect of the transaction and how the transaction impacts the accounting equation. Without the journal, the general ledger accounts would not reflect the entire history of the transaction.

**Question 2 possible response:** The ledger tracks the balance of the individual accounts. Without posting transaction to the ledger, the accountant would have to go back and track every individual transaction to find those that impact the account in question and track the increases and decreases over the accounting period to determine the balance in the account.

GROUP LEARNING ACTIVITY—The Journal and the Ledger

This activity presents another method to emphasize the purpose of the journal and the ledger in the accounting process. TM 2-9 lists questions a business owner might ask that can be answered by examining the company’s accounting records. Your students’ task is to determine which accounting record holds the answer: the journal or the ledger. Answers to this activity are provided on TM 2-10.

OBJECTIVE 4

Prepare an unadjusted trial balance and explain how it can be used to discover errors.

SYNOPSIS

This objective explains the purpose and the steps in the preparation of the trial balance. The trial balance is a summary listing of the titles and balances of accounts in the ledger, and it verifies the equality of the debits and the credits which double-entry accounting requires. The first step in preparing a trial balance is to create the heading. This includes the company name, the title of the document, and the date it is prepared. Next, list all the accounts from the ledger, in order, and enter their debit or credit balances. Total the debit and credit columns and verify the totals match. The trial balance shown in Exhibit 7 is an unadjusted trial balance, which distinguishes it from other trial balances that will be introduced later. An unadjusted trial balance is a summary listing of the titles and balances of accounts in the ledger *prior* to the posting of adjusting entries.

If the trial balance does not show equality, an error occurred. Several errors are common and easy to find. If the difference between the columns is 10, 100, or 1,000, an addition error may exist. Recalculate the totals. If the same error exists, recalculate the account balances. If the difference between the totals is divisible by 2, a debit may have been entered as a credit or vice versa. A transposition error may have occurred if the difference is divisible by 9. This is an error in which the order of the digits is changed, such as writing $542 as $452 or $524. A similar error is called a slide. In a slide, the entire number is moved one or more spaces to the right or the left, such as writing $542.00 as $54.20 or $5,420.00. If the difference is not divisible by 2 or 9, review the ledger to see if accounts have been omitted. If no accounts have been omitted from the ledger, review the journal to see if the postings are complete.

Some errors do not cause the trial balance to be unequal. These may be discovered at any time. An entry that is prepared when an error has already been journalized and posted is called a correcting journal entry. An entry of this type is illustrated in Example Exercise 2-7.

***Key Terms and Definitions***

* **Correcting Journal Entry** - An entry that is prepared when an error has already been journalized and posted.
* **Slide** - An error in which the entire number is moved one or more spaces to the right or the left, such as writing $542.00 as $54.20 or $5,420.00.
* **Transposition** - An error in which the order of the digits is changed, such as writing $542 as $452 or $524.
* **Trial Balance** - A summary listing of the titles and balances of accounts in the ledger.
* **Unadjusted Trial Balance** - A summary listing of the titles and balances of accounts in the ledger prior to the posting of adjusting entries.

***Relevant Example Exercises and Exhibits***

* Example Exercise 2-6 – Trial Balance Errors
* Example Exercise 2-7 – Correcting Entries
* Exhibit 7 – Trial Balance

SUGGESTED APPROACH

Remind students that a trial balance is simply a listing of accounts and their balances. It is used to check the accuracy of posting by testing to see that total debits equal total credits. At this point, students have learned two controls over recording entries in a double-entry accounting system: (1) Debits = Credits and (2) Assets = Liabilities + Stockholders’ Equity.

You may point out at this time that this is the first of three times in the accounting cycle that the trial balance will be completed.

DEMONSTRATION PROBLEM—Preparing a Trial Balance

To demonstrate how to prepare a trial balance, show TM 2-5 (the T accounts from the group learning activity under Objective 2). Ask your students to work in small groups to complete a trial balance using these account balances. TM 2-11 shows the completed trial balance.

GROUP LEARNING ACTIVITY—Errors in a Trial Balance

The goal of this activity is to demonstrate the use of a trial balance in detecting errors made while recording journal entries, posting, and computing account balances. TM 2-12 presents journal entries, T accounts, and a trial balance. Several errors have been made in posting the journal entries, and as a result, the trial balance does not balance. Ask your students to work in small groups to uncover the errors and correct the trial balance. TM 2-13 shows the corrected trial balance.

You may want to give your students the following hints to help them detect the errors:

1. Re-add the columns of the trial balance to check for math errors. This usually is not a problem with a computerized program.
2. Look for accounts with abnormal balances on the trial balance. This usually points to an error.
3. Compare account balances on the trial balance with those in the ledger. Watch for omitted accounts, slide errors, or transposition errors.
4. Re-compute the balance of each account to check for math errors. Again, this usually doesn’t happen with a computerized program.
5. Trace each posting back to the journal entry to make sure the proper amount was posted. Watch for slide or transposition errors.

You will also want to point out that the trial balance does not catch every possible accounting error. The following errors will not be discovered simply by preparing a trial balance:

1. Failing to record a transaction or to post a transaction.
2. Recording the same erroneous amount for both the debit and the credit parts of a transaction.
3. Recording the same transaction more than once.
4. Posting part of a transaction correctly as a debit or credit but to the wrong account.

As an example, ask your class the following question: Would recording an $800 sale on account as a debit to Cash and a credit to Fees Earned cause the columns of a trial balance to be unequal? Answer: No.

OBJECTIVE 5 

Describe and illustrate the use of horizontal analysis in evaluating a company’s performance and financial condition.

SYNOPSIS

It is useful in business to compare a company’s performance with its past performance. Financial analysis that compares an item in a current statement with the same item in prior statements is called horizontal analysis. The financial statements being compared are arranged next to each other to facilitate the comparison. Two additional columns are presented to the right. The first column shows the numerical difference between the amounts, and the second displays the percentage difference as an increase or a decrease. The significance of these changes should be investigated to determine if operations can be improved. The example in the chapter shows a comparison of income statements; however, this analysis can be used on any financial statement.

***Key Terms and Definitions***

* **Horizontal Analysis** - Financial analysis that compares an item in a current statement with the same item in prior statements.

***Relevant Example Exercises and Exhibits***

* Example Exercise 2-8 – Horizontal Analysis

SUGGESTED APPROACH

This objective introduces the value of horizontal analysis as a tool to indicate trends in a company’s performance. Remind students that financial statements are a “snapshot” in time without any means of comparison to other time periods. The horizontal analysis indicates changes (increase or decrease) in both amounts and percentages.

TM 2-14 shows an example of what a horizontal analysis of income statements for Music Express using figures from TM 2-11 might look like. Note that while the June expenditures were greater than those in May so, too, were the fees earned—enough to show increases in the amount and percentage of net income for Music Express.

