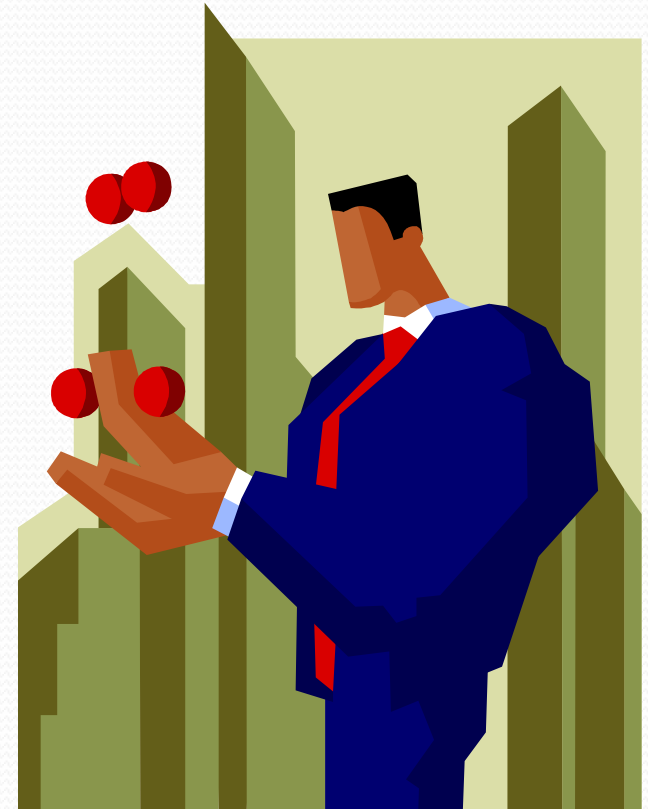


Chapter

3

THE ACCOUNTING CYCLE: Capturing Economic Events

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The Role of Accounting Records

Establishes accountability for assets and transactions.

Keeps track of routine business activities.

Obtains detailed information about a particular transaction.

Evaluates efficiency and performance within company.

Maintains evidence of company's business activities.

The Ledger



Accounts are individual records showing **increases** and **decreases**.

The entire group of accounts is kept together in an accounting record called a **ledger**.

The Use of Accounts

Increases are recorded on one side of the T-account, and **decreases** are recorded on the other side.

Title of Account	
Left or Debit Side	Right or Credit Side



**Let's see how
debits and credits
are recorded in the
Cash account for
JJ's Lawn Care
Service.**

Debit and Credit Entries

Cash

Receipts
are on
the debit
side.

5/1	8,000	5/2	2,500
5/25	75	5/8	2,000
5/29	750	5/28	150
		5/31	50

Payments
are on the
credit
side.

5/31 4,125
Bal.

The balance is the difference between the debit and credit entries in the account.

Debit and Credit Rules

Debits and credits affect accounts as follows:

$$A = L + OE$$

ASSETS

Debit
for
Increase

Credit
for
Decrease

LIABILITIES

Debit
for
Decrease

Credit
for
Increase

EQUITIES

Debit
for
Decrease

Credit
for
Increase

Double Entry Accounting — The Equality of Debits and Credits

$$\underbrace{A}_{\text{Debit balances}} = \underbrace{L + OE}_{\text{Credit balances}}$$

In the double-entry accounting system, every transaction is recorded by equal dollar amounts of debits and credits.



**Let's record
selected
transactions for
JJ's Lawn Care
Service in the
accounts.**

① May 1: Jill Jones and her family invested \$8,000 in JJ's Lawn Care Service and received 800 shares of stock.

Will Cash increase or decrease?

Will Capital Stock increase or decrease?

① May 1: Jill Jones and her family invested \$8,000 in JJ's Lawn Care Service and received 800 shares of stock.

Cash increases
\$8,000 with a debit.

Capital Stock
increases \$8,000
with a credit.

Cash

5/1	8,000	

Capital Stock

	5/1	8,000

② May 2: JJ's purchased a riding lawn mower for \$2,500 cash.

Will Cash increase or decrease?

Will Tools & Equipment increase or decrease?

② May 2: JJ's purchased a riding lawn mower for \$2,500 cash.

Cash decreases \$2,500 with a credit.

Tools & Equipment increases \$2,500 with a debit.

Cash

5/1	8,000	5/2	2,500
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Tools & Equipment

5/2	2,500		
-----	-------	--	--

⑧ May 8: JJ's purchased a \$15,000 truck. JJ's paid \$2,000 down in cash and issued a note payable for the remaining \$13,000.

**Will Truck increase
or decrease?**

**Will Cash and
Notes Payable
increase or
decrease?**

③ May 8: JJ's purchased a \$15,000 truck. JJ's paid \$2,000 down in cash and issued a note payable for the remaining \$13,000.

Truck increases \$15,000 with a debit.

Cash decreases \$2,000 with a credit.
Notes Payable increases \$13,000 with a credit.

Truck	
5/8	15,000

Cash			
5/1	8,000	5/2	2,500
		5/8	2,000

Notes Payable	
	5/8 13,000

④ May 11: JJ's purchased some repair parts for \$300 on account.

Will Tools & Equipment increase or decrease?

Will Accounts Payable increase or decrease?

④ May 11: JJ's purchased some repair parts for \$300 on account.

Tools & Equipment
increases \$300 with
a debit.

Accounts Payable
increases \$300 with
a credit.

Tools & Equipment

5/2	2,500
5/11	300

Accounts Payable

5/11	300
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⑤ May 18: JJ's sold half of the repair parts to ABC Lawns for \$150, a price equal to JJ's cost. ABC Lawns agrees to pay JJ's within 30 days.

Will Tools & Equipment increase or decrease?

Will Accounts Receivable increase or decrease?

⑤ May 18: JJ's sold half of the repair parts to ABC Lawns for \$150, a price equal to JJ's cost. ABC Lawns agrees to pay JJ's within 30 days.

**Tools & Equipment
decreases \$150 with
a credit.**

**Accounts Receivable
increases \$150 with
a debit.**

Tools & Equipment

5/2	2,500	5/18	150
5/11	300		

Accounts Receivable

5/18	150	

The Journal

In an actual accounting system, transactions are initially recorded in the **journal**.

GENERAL JOURNAL

Date		Account Titles and Explanation	Debit	Credit
2003				
May	1	Cash	8,000	
		Capital Stock		8,000
		Owners invest cash in the business.		

Posting Journal Entries to the Ledger Accounts

Posting involves copying information from the journal to the ledger accounts.



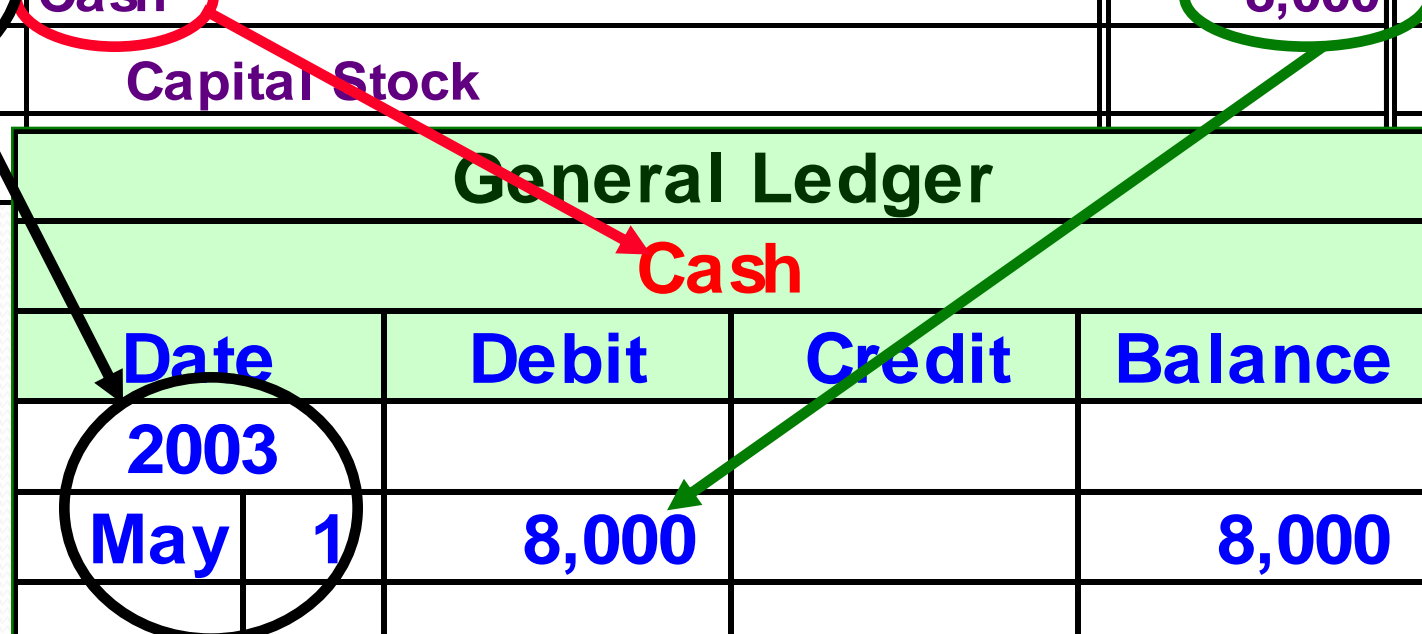
Posting Journal Entries to the Ledger

Accounts

GENERAL JOURNAL

Date	Account Titles and Explanation	Debit	Credit
2003			
May 1	Cash	8,000	
	Capital Stock		8,000

General Ledger			
Cash			
Date	Debit	Credit	Balance
2003			
May 1	8,000		8,000



Posting Journal Entries to the Ledger

Accounts

GENERAL JOURNAL

Date	Account Titles and Explanation	Debit	Credit
2003			
May 1	Cash	8,000	
	Capital Stock		8,000

General Ledger

Capital Stock

Date	Debit	Credit	Balance
2003			
May 1		8,000	8,000

Posting Journal Entries to the Ledger

Accounts

GENERAL JOURNAL

Date	Account Titles and Explanation	Debit	Credit
2003			
May 2	Tools & Equipment	2,500	
	Cash		2,500
	Purchased lawn mower.		

Let's see what the cash account looks like after posting the cash portion of this transaction for JJ's Lawn Care Service.

Ledger Accounts After Posting

General Ledger				
Cash				
Date		Debit	Credit	Balance
2003				
May	1	8,000		8,000
	2		2,500	5,500

This ledger format is referred to as a **running balance** (as opposed to simple T accounts).

What is Net Income?

Net income is not an asset — it's an increase in owners' equity from profits of the business.

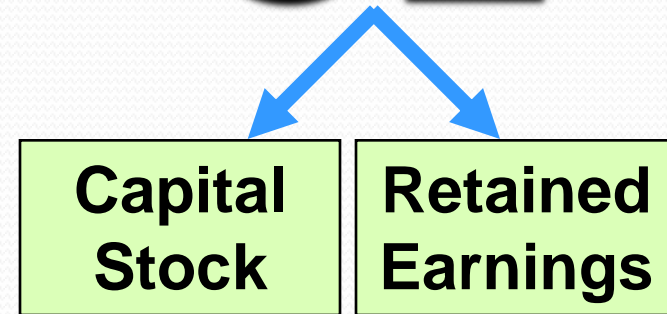
$$\begin{array}{ccccccc} \mathbf{A} & = & \mathbf{L} & + & \mathbf{OE} \\ \text{Increase} & & \text{Decrease} & & \text{Increase} \end{array}$$

Either (or both) of these effects occur as net income is earned . . .

. . . but this is what “net income” really means.

Retained Earnings

$$A = L + OE$$



The balance in the **Retained Earnings** account represents the total net income of the corporation over the entire lifetime of the business, less all amounts which have been distributed to the stockholders as dividends.

Revenue and Expenses

Revenue

The price for goods sold and services rendered during a given accounting period.

Increases owner's equity.

Expenses

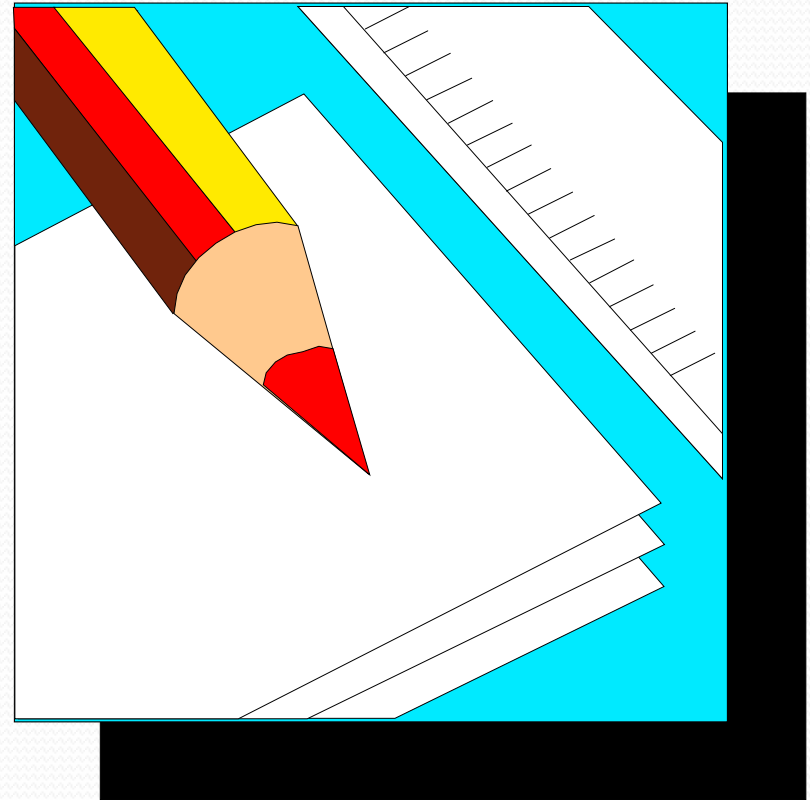
The costs of goods and services used up in the process of earning revenue.

Decreases owner's equity.

The Realization Principle: When To Record Revenue

Realization Principle

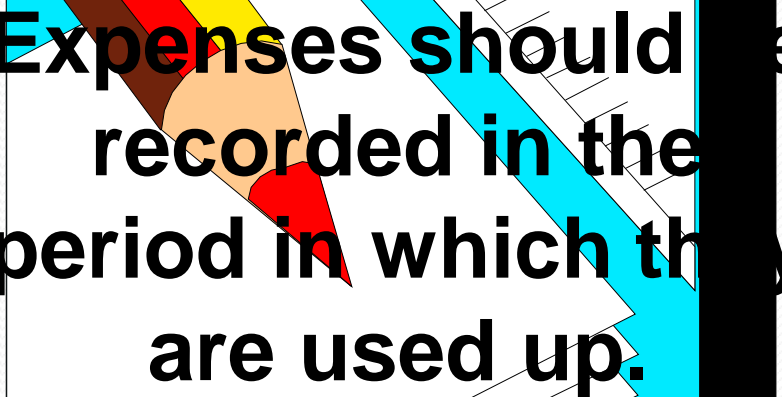
Revenue should be recognized at the time goods are sold and services are rendered.



The Matching Principle: When To Record Expenses

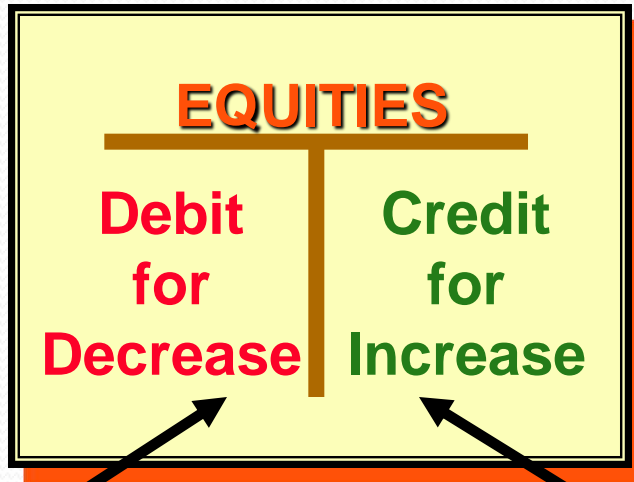
Matching Principle

Expenses should be recorded in the period in which they are used up.

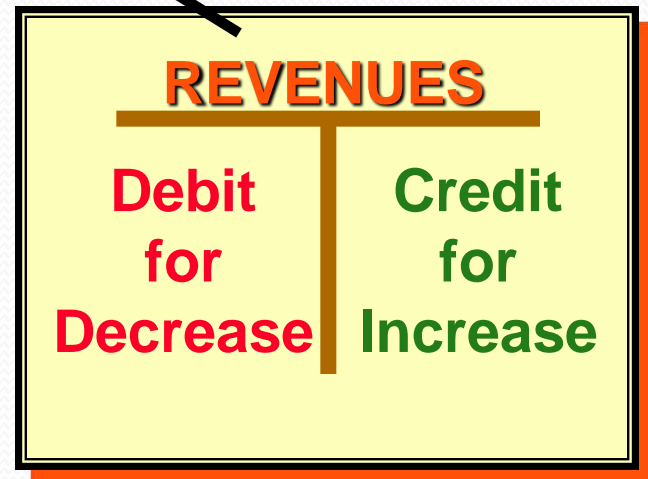
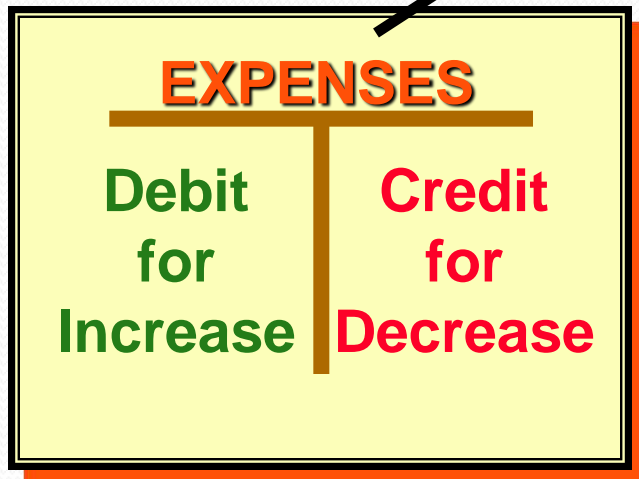


Debits and Credits for Revenue and Expense

Expenses decrease owner's equity.



Revenues increase owner's equity.



Investments by and Payments to Owners

Payments to owners decrease owners' equity.

EQUITIES	
Debit for Decrease	Credit for Increase

Owners' investments increase owners' equity.

DIVIDENDS	
Debit for Increase	Credit for Decrease

CAPITAL STOCK	
Debit for Decrease	Credit for Increase



**Let's analyze the
revenue, and
expense
transactions for
JJ's Lawn Care
Service for the
month of May.**

**We will also
analyze a dividend
transaction.**

⑧ May 29: JJ's provided lawn care services for a client and received \$750 in cash.

**Will Cash increase
or decrease?**

**Will Sales Revenue
increase or
decrease?**

⑧ May 29: JJ's provided lawn care services for a client and received \$750 in cash.

Cash increases
\$750 with a debit.

Sales Revenue
increases \$750 with
a credit.

Cash

5/1	8,000	5/2	2,500
5/29	750	5/8	2,000

Sales Revenue

	5/29	750
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⑨ May 31: JJ's purchased gasoline for the lawn mower and the truck for \$50 cash.

Will Cash increase or decrease?

Will Gasoline Expense increase or decrease?

⑨ May 31: JJ's purchased gasoline for the lawn mower and the truck for \$50 cash.

Cash decreases \$50
with a credit.

Gasoline Expense
increases \$50 with a
debit.

Cash

5/1	8,000	5/2	2,500
5/29	750	5/8	2,000
		5/31	50

Gasoline Expense

5/31	50	
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⑩ May 31: JJ's Lawn Care paid Jill Jones and her family a \$200 dividend.

Will Cash increase or decrease?

Will Dividends increase or decrease?

⑩ May 31: JJ's Lawn Care paid Jill Jones and her family a \$200 dividend.

Cash decreases
\$200 with a credit.

Dividends increase
\$200 with a debit.

Cash

5/1	8,000	5/2	2,500
5/29	750	5/8	2,000
		5/31	50
		5/31	200

Dividends

5/31	200	
------	-----	--



**Now, let's look at
the Trial Balance
for JJ's Lawn Care
Service for the
month of May.**

**JJ's Lawn Care Service
Unadjusted Trial Balance
May 31, 2003**

Cash	\$ 3,925	
Accounts receivable	75	
Tools & equipment	2,650	
Truck	15,000	
Notes payable		\$ 13,000
Accounts payable		150
Capital stock		8,000
Dividends	200	
Sales revenue		750
Gasoline expense	50	
Total	\$ 21,900	\$ 21,900

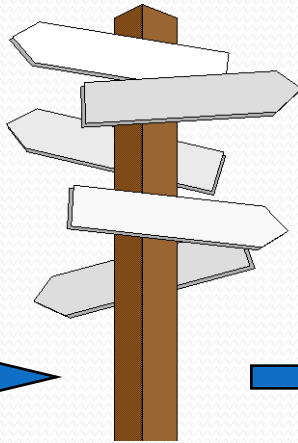
All balances are taken from the ledger accounts on May 31 after considering all of JJ's transactions for the month.

Proves equality of debits and credits.

The Accounting Cycle



Journalize transactions.



Post entries to the ledger accounts.



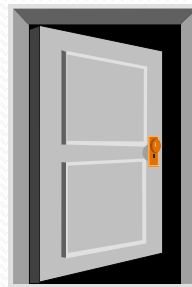
Prepare trial balance.



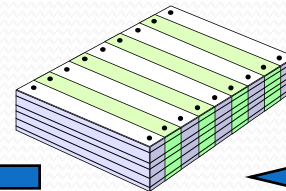
Make end-of-year adjustments.



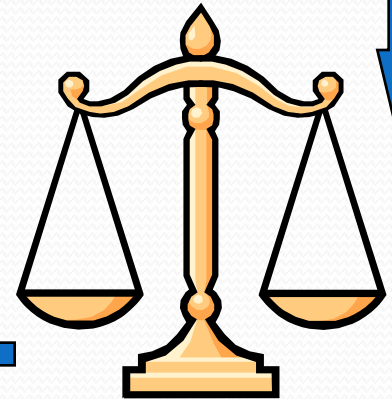
Prepare after closing trial balance.



Journalize and post closing entries.



Prepare financial statements.



Prepare adjusted trial balance.



Reference

Williams et al. 2011. *Financial and Managerial Accounting: The Basis for Business Decision 16 ed.* New York: McGraw-Hill.