Chapter 3

Debits and Credits

As you learned in the last chapter, accountants use the accounting equation to analyze a firm's transactions and determine the effects of those transactions on the firm's assets, liabilities, and owner's equity. You also saw how a firm's financial position is reported on the balance sheet and how the results of the firm's operations for a time period are reported on the income statement.

In Chapter 1, we described accounting as the "language of business." Like any other language, accounting has rules and conventions for common usage. In this chapter you will learn the rules used to record changes caused by business transactions. Such records form an essential part of all accounting systems.

The accounting cycle is a series of steps performed during each accounting period to analyze, record, classify, and summarize data for a business and produce needed financial information. In Chapter 2, you learned how to analyze the effects of business transactions. In this chapter you will learn to *record* this information for future use. You will learn to prepare a record of business transactions, to classify financial data, and to summarize the information in the form of financial statements. These written records enable an individual to trace the details of the transaction long after it has happened.

New Terms

- Account balance (page 55)
- Accounts (page 47)
- Audit trail (page 49)
- Chronological order (page 47)
- Classification (page 47)
- Compound entry (page 62)
- Credit (page 46)
- Debit (page 46)
- Double-entry system (page 47)
- Drawing account (page 61)
- General journal (page 48)
- Journal (page 47)
- Journalizing (page 48)
- Ledger (page 54)
- Normal balance (page 56)
- Posting (page 54)
- T account (page 54)

Objectives

1. Define debit and credit.
2. Describe the relationship between debits and credits, and the accounting equation.
3. Record transactions in the general journal.
4. Post transactions from the general journal to T accounts.
5. Record transactions affecting owner's equity in the general journal.
6. Prepare journal entries.

THE RULES OF DEBIT AND CREDIT

OBJECTIVE 1

Debit = left side; Credit = right side.

Debit: *An entry on the left side of an account.*

Credit: *An entry on the right side of an account.*

Define debit and credit.

Debit is defined as "a record of indebtedness." It is related to the word *debtor*—a person who owes a debt. A ***credit*** is "something entrusted to another." It is related to the word *creditor*—a person to whom a debt is owed. The two words are opposites: one is used to record increases and the other to record decreases in amounts owed to and/or by an organization. The use of debit and credit to describe changes that occur in accounting records is a language convention. Accountants use the words *debit* and *credit* to describe actions taken in the accounting records.

WHY DO THE TERMS DEBIT AND CREDIT SOMETIMES CAUSE DIFFICULTY?

www.quickmba.com/accounting/fin/trial-balance/

An accounting glossary, which includes definitions of credit, debit, and trial balance.

The words *debit* and *credit* are not used exclusively by accountants. English-speaking people use these terms in common, everyday language. If I say that something is "to your credit," what do I mean? Most of us will understand that I mean you have accomplished something worthwhile or honourable. In common usage, a credit is desirable or good. We assume, then, that a debit must be undesirable or bad. Assigning these "values" to these two terms is what often causes students problems. In accounting, debit and credit are not assumed to be good or bad; they are simply actions performed in the accounting records. Think of them as "decreases and increases," not "bad and good."

DESCRIBE THE RELATIONSHIP BETWEEN DEBITS AND CREDITS AND THE ACCOUNTING EQUATION

OBJECTIVE 2

www.quickmba.com/accounting/fin/double-entry/

An explanation of the double-entry system.

Describe the relationship between debits and credits, and the accounting equation.

As you remember from Chapters 1 and 2, the accounting equation can be stated as: Assets = Liabilities + Owner's Equity.

Like all equations, the accounting equation must balance. The left side must equal the right side: Left = Right.

In accounting terms, the debits and credits must balance. The debits must equal the credits: Debits = Credits.

The key to remembering the rules for using debits and credits lies in the accounting equation and the need to remain in balance:

Assets = Liabilities + Owner's Equity
Left = Right
Debits = Credits

Assets are on the left side of the accounting equation; increases to assets will be recorded on the left and called debits. Liabilities and owner's equity are on the right side of the accounting equation; increases to liabilities and owner's equity will be recorded on the right and called credits. Since debits and credits are opposites, decreases to assets (on the left side of the accounting equation) will be made on the right and called credits. Decreases to liabilities and owner's equity (on the right side of the accounting equation) will be made on the left and called debits.

Double-entry system: *An accounting system that involves recording the effects of each transaction as debits and credits.*

The analysis of each transaction produces at least two effects. The effect of an entry on the debit, or left side of one account is balanced by the effect of an entry on the credit, or right side of another account. For this reason, the modern system of accounting is usually called the ***double-entry system***. This system involves recording both effects of every transaction to present a complete picture. The balancing relationship also explains why both sides of the equations shown in Chapter 1 are always equal.

SELF-REVIEW

1. On which side of asset, liability, and owner's equity accounts are increases recorded?
2. On which side of asset, liability, and owner's equity accounts are decreases recorded?

ANSWERS TO SELF-REVIEW

1. Increases in asset, liability, and owner's equity accounts are recorded on the same side on which the account appears in the fundamental accounting equation. Increases in asset accounts are recorded on the left side; increases in liability and owner's equity accounts are recorded on the right side.
2. Decreases in asset accounts are recorded on the right side; decreases in liability and owner's equity accounts are recorded on the left side.

ACCOUNTS FOR ASSETS, LIABILITIES, AND OWNER'S EQUITY

Accounts: *Written records of a business's assets, liabilities, and owner's equity.*

Classification: *A means of identifying each account as an asset, liability, or owner's equity account.*

The accounting equation is a tool for analyzing the effects of business transactions. It would be awkward, though, to record every transaction in the equation format if a business had many transactions. Instead, separate written records called ***accounts*** are kept for the business's assets, liabilities, and owner's equity. Accounts are kept so that financial information can be analyzed, recorded, classified, summarized, and reported. Accounts are identified by their account ***classification***; that is, as asset accounts (the property a business owns), liability accounts (the debts of the business), or owner's equity accounts (the owner's financial interest in the business). The title of each account describes the type of property, the debt, or the financial interest.

JOURNALS

Analyzing transactions is the first step in the accounting cycle.

Journal: *The record of original entry.*

Chronological order: *Organized on a day-to-day basis.*

Business transactions are recorded in a financial record called a ***journal***, which is a diary of business activities that lists events involving financial affairs—transactions—as they occur. The transactions are entered in ***chronological order***—the order in which they happen day by day.

Since the journal is the first accounting record where transactions are entered, it is sometimes referred to as a *record of original entry*. A number of different types of journals are used in business. The one that will be examined in this chapter is the general journal. As we discuss more complex accounting systems and records in later chapters, you will become familiar with other kinds of journals.

THE GENERAL JOURNAL

OBJECTIVE 3 **Record transactions in the general journal.**

General journal: *A permanent, classified record of all accounts used in a firm's operation; a record of final entry.*

Journalizing: *Recording transactions in a journal.*

As its name implies, the ***general journal*** can be used to record all types of business transactions. The process of recording transactions in the general journal is referred to as ***journalizing***. To illustrate how transactions are entered in this journal, let's start with the first transaction of Arrow Employment Services.

When the owner, John Arrow, invested $40,000 on November 6 to start the firm, the transaction was analyzed and the following effects were identified.

RECORDING A CASH INVESTMENT

www.vienna.cc/networld/free_report_setup_bookkeeping_system.htm

Details the importance of and how to set up and maintain a simple bookkeeping system.

Asset accounts record the items of value owned by a business. The location of items in the fundamental accounting equation determines how amounts are recorded in the general journal. The cash investment of $40,000 is entered in the left, or Debit, column of the journal because assets always appear on the left side of the accounting equation. Owner's equity accounts show the financial interest of the owner of the business. The account called John Arrow, Capital, is used to record John Arrow's $40,000 investment. Because owner's equity always appears on the right side of the accounting equation, Viriginia Richey, the office manager, entered the opening balance of $40,000 in the right-hand column of the journal.

a. Arrow Employment Services received $40,000 of property in the form of cash.
b. John Arrow had a $40,000 financial investment in the business.

Using this analysis as a guide, Richey knew that the accounting transaction should be entered as shown in Figure 3-1.

FIGURE 3-1
General Journal Entry

Record the year first, then the month and day.

Record the increase (debit) to cash first.

Indent about half an inch and record the increase (credit) to John Arrow, Capital.

GENERAL JOURNAL PAGE 1

	DATE		DESCRIPTION	POST. REF.	DEBIT	CREDIT
1	20X5					
2	Nov.	6	Cash		40 0 0 0 00	
3			John Arrow, Capital			40 0 0 0 00
4			Beginning investment			
5						
6						

Write a description of the transaction.

Notice that each page in the general journal is given a number and that the year is recorded at the top of the Date column. The month and day are also written in the Date column on the first line of the first entry. After the first entry, the year and month are recorded only when a new page is begun or when either the year or the month changes. However, the day of each transaction is written in the Date column on the first line of each entry.

The account to be debited is always recorded first in the Description column. The account title is written close to the left margin, and the debit amount is then entered on the same line in the Debit column.

The account to be credited is always recorded on the line beneath the debit. The account title is indented about half an inch from the left margin. Next, the credit amount is entered on the same line in the Credit column.

A brief explanation follows the credit part of the entry. This explanation begins on the line following the credit. Explanations should be complete but concise.

Audit trail: *A chain of references that makes it possible to trace information through the accounting system.*

Whenever possible, the explanation for a journal entry should include a description of the source of the information contained in the entry. For example, if a cheque is written to make a payment, the explanation in the journal entry for that transaction should include the cheque number. Similarly, if goods are purchased on credit, the explanation in the journal entry should show the number of the supplier's invoice (bill). These source document numbers are part of an ***audit trail***—a chain of references that makes it possible to trace information about transactions through the accounting system. The audit trail helps locate errors in the system. It also helps to prevent fraud because it provides a means of checking the data in a firm's financial records against the original data that appear on the source documents.

Usually a blank line is left between general journal entries. This blank line separates the transactions and makes them easier to identify and read. Some accountants prefer to use this blank line to number each general journal entry for identification purposes.

RECORDING PREPAID RENT

When Arrow Employment Services rented its facilities, the lease specified that eight months' rent must be paid in advance. Arrow issued a cheque for $20,000 to make the necessary payment. As a result, the firm obtained the right to occupy the facilities for an eight-month period. This right is accounted for as property—an asset. Thus the transaction is analyzed as follows.

c. The firm required an asset, totalling $20,000 in the form of prepaid rent.
d. The firm paid $20,000 in cash.

To record the prepaid rent, an asset called prepaid rent is increased; the $20,000 is entered in the left (debit) column of the journal. Since the cash payment reduced the firm's cash balance, the $20,000 is recorded on the right (credit) to decrease Cash.

Explanations should be complete, including document numbers where appropriate to establish an audit trial.

GENERAL JOURNAL PAGE 1

	DATE		DESCRIPTION	POST. REF.	DEBIT	CREDIT
7	Nov.	7	Prepaid Rent		20 000 00	
8			Cash			20 000 00
9			Paid rent in advance for			
10			an eight-month period			
11			(Dec. 20X5 through			
12			July 20X6), Cheque 1001			
13						

Notice the use of the cheque number in the explanation for the journal entry. This number will form part of the audit trail for the transaction.

When Arrow Employment Services purchased equipment on November 9 for cash (Cheque 1002), the office manager made the following analysis and then recorded the journal entry that follows.

e. The firm purchased new assets in the form of equipment at a cost of $10,000.
f. The firm paid $10,000 in cash.

To record the purchase of equipment, a new asset, Equipment, was increased by $10,000 by an entry on the left (debit) side of the journal. The payment of $10,000 in cash is entered on the right (credit) side of the journal because decreases in assets are recorded on the right.

GENERAL JOURNAL PAGE 1

	DATE		DESCRIPTION	POST. REF.	DEBIT	CREDIT
14	Nov.	9	Equipment		10 000 00	
15			Cash			10 000 00
16			Purchased equipment,			
17			Cheque 1002			
18						

RECORDING A CREDIT PURCHASE OF EQUIPMENT

Liabilities are amounts owed by a business to its creditors. Like owner's equity, liabilities always appear on the right side of the accounting equation. Thus the increases to liabilities are recorded in the right column of the journal.

On November 10 the business purchased a copy machine, a fax machine, calculators, and other necessary equipment for $5,000 on credit from Organ, Inc., Invoice 2788, payable in 60 days. The transaction was analyzed and the journal entry was recorded as shown below.

g. The business purchased new assets (Equipment) at a cost of $5,000.
h. The business owed $5,000 as an Account Payable to Organ, Inc.

The $5,000 increase in equipment is entered in the left column.

Remember!
Liabilities are increased on the right (credit) and decreased on the left (debit).

The amount owed to Organ, Inc. is recorded as a liability, accounts payable. The $5,000 is entered on the right (credit) column to increase accounts payable because liabilities appear on the right side of the accounting equation.

GENERAL JOURNAL PAGE 1

	DATE		DESCRIPTION	POST. REF.	DEBIT	CREDIT
19	Nov.	10	Equipment		5 0 0 0 00	
20			Accounts Payable			5 0 0 0 00
21			Purchased equipment			
22			on credit from Organ, Inc.,			
23			Invoice 2788, payable in			
24			60 days			
25						

Notice how the audit trail is created for this transaction by listing the supplier's invoice number in the explanation for the journal entry.

On November 28, when the firm purchased supplies for $1,000 in cash (Cheque 1003), the transaction was analyzed and the journal entry was prepared as shown below.

i. The business purchased new assets (supplies) at a cost of $1,000.
j. The business paid $1,000 in cash.

To record this purchase of supplies, an asset, $1,000, was entered on the left, or increase side. The payment of $1,000 in cash is entered on the right (Credit) column of the journal because decreases in assets are recorded on the right.

GENERAL JOURNAL PAGE 1

	DATE		DESCRIPTION	POST. REF.	DEBIT	CREDIT
26	Nov.	28	Supplies		1 0 0 0 00	
27			Cash			1 0 0 0 00
28			Purchased supplies,			
29			Cheque 1003			
30						

A final transaction, the payment of Invoice 2788 for $1,000 by Cheque 1004 to Organ, Inc. on November 30, was analyzed as shown and the journal entry that follows was made.

k. The firm paid $1,000 in cash.
l. Organ's claim against the firm was reduced by $1,000.

The decrease in cash (k) is entered on the right (credit). The decrease in the liability (l) is entered on the left (debit).

GENERAL JOURNAL PAGE 1

	DATE		DESCRIPTION	POST. REF.	DEBIT	CREDIT
31	Nov.	30	Accounts Payable		1 0 0 0 00	
32			Cash			1 0 0 0 00
33			Paid Organ, Inc., on			
34			account for Invoice 2788,			
35			Cheque 1004			

SELF-REVIEW

1. In which column of the journal are increases to assets, liabilities, and owner's equity recorded?

2. In which column of the journal are decreases to assets, liabilities, and owner's equity recorded?

3. Why is the journal referred to as the "record of original entry"?

4. Transactions are entered in the general journal in chronological order. What does this mean?

5. Why are cheque and invoice numbers included in the journal entry explanation?

6. Analyze the following transactions and record the general journal entries that would be made for Rapid Delivery Service.

TRANSACTIONS

Jan. 1 The owner, Ronald Thomas, invested $10,000 in cash.

Jan. 5 Issued a cheque for $1,700 for two months' rent.

Jan. 6 Purchased supplies for $300 on credit.

Jan. 7 Purchased office furniture for $5,000.

GENERAL JOURNAL

PAGE_____

	DATE		DESCRIPTION	POST. REF.	DEBIT	CREDIT
1						
2						
3						
4						
5						
6						
7						
8						
9						
10						
11						
12						
13						
14						
15						
16						
17						
18						
19						
20						

ANSWERS TO SELF-REVIEW

1. Increases in asset, liability, and owner's equity accounts are recorded on the same side on which the account appears in the fundamental accounting equation. Increases to assets are recorded on the left; increases to liability and owner's equity accounts are recorded on the right.

2. Decreases to asset accounts are recorded on the right; decreases to liability and owner's equity accounts are recorded on the left.

3. The journal is referred to as the "record of original entry" because it is the first accounting record in which transactions are entered.

4. Entering transactions in chronological order means they are entered in the order in which they occur day by day.

5. Cheque and invoice numbers are included in the explanation in the journal entry to provide an audit trail that makes it possible to trace information about transactions through the accounting system.

6.

GENERAL JOURNAL PAGE 1

	DATE		DESCRIPTION	POST. REF.	DEBIT	CREDIT
1	Jan.	1	Cash		10 000 00	
2			Ronald Thomas, Capital			10 000 00
3			Beginning investment of			
4			owner			
5						
6		5	Prepaid Rent		1 700 00	
7			Cash			1 700 00
8			Paid for two months' rent			
9			in advance			
10						
11		6	Supplies		300 00	
12			Accounts Payable			300 00
13			Purchased supplies, on			
14			account			
15						
16		7	Office Furniture		5 000 00	
17			Cash			5 000 00
18			Purchased furniture for			
19			cash			
20						

LEDGERS

Posting to ledger accounts is the third step in the accounting cycle.

Ledger: *The record of final entry.*

Posting: *Transferring data from a journal to a ledger.*

T account: *A type of account, resembling a T, used to analyze the effects of a business transaction.*

As you have seen, a journal contains a chronological (day-by-day) record of a firm's transactions. Each entry provides a written analysis of a transaction, showing what accounts should be debited and credited and the amounts involved. With the journal as a guide, data about transactions can be entered in the accounts that are affected.

All the accounts together are referred to as a ***ledger***. The process of transferring data from a journal to a ledger is known as ***posting***. Because posting takes place after the transactions are journalized and the ledger is the last accounting record where a transaction is recorded, a ledger is sometimes called a *record of final entry*.

One type of account that accountants use to classify financial information is a ***T account***. This account consists of two lines, one vertical and one horizontal, that resemble the letter T. The title of the account is written on the horizontal (top) line. Increases and decreases in the account are entered on different sides of the vertical line.

T accounts for assets, liabilities, and owner's equity follow.

ASSETS	
+	–
Record increases	Record decreases
Debits	Credits

LIABILITIES	
–	+
Record decreases	Record increases
Debits	Credits

OWNER'S EQUITY	
–	+
Record decreases	Record increases
Debits	Credits

POSTING TO THE LEDGER

OBJECTIVE 4

About Accounting: Refinement of the realignment
How can my company be run better? Sometimes it takes an accounting consultant to determine how a company can become more competitive.

Account balance:
The difference between the amounts recorded on the two sides of an account.

Post transactions from the general journal to T accounts.

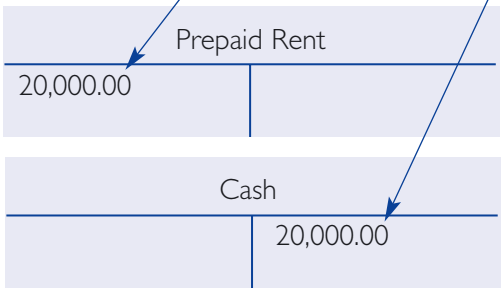
To understand the posting process, examine Figure 3-2. On November 7, 20X5, the office manager for Arrow Employment Services made an entry in the general journal to record the payment of rent in advance for an eight-month period. Next, the data from the journal were posted to the proper account in the ledger. The debit amount in the journal was transferred to the Debit column in the Prepaid Rent account and the credit amount in the journal was transferred to the Credit column in the Cash account.

An ***account balance*** is the difference between the amounts recorded on the two sides of an account. It is computed by first adding the figures on each side of the account. When the column is added, the total is entered in small pencil figures called a footing. The smaller total is subtracted from the larger one, and the result is the account balance. If the total of the figures on the right side is greater than the total on the left side, the balance is recorded on the right side. If the total of the figures on the left side is greater, the balance is recorded on the left side. If an account contains only one amount, that figure is the balance. If an account contains entries on only one side, the total of those entries is the account balance.

FIGURE 3-2
Posting to the General Ledger

GENERAL JOURNAL PAGE 1

	DATE		DESCRIPTION	POST. REF.	DEBIT	CREDIT
1	20X5					
2	Nov.	7	Prepaid Rent		20 000 00	
3			Cash			20 000 00
4			Paid rent in advance for			
5			an eight-month period			
6			(Dec. 20X5 through			
7			July 20X6), Cheque 1001			



For example, the total of the figures on the left side of Arrow Employment Service's Cash account on November 30, 20X5, is $40,000. The total of the figures on the right side is $32,000. By subtracting the footing of $32,000 from $40,000, we obtain the account balance of $8,000. The account balance is recorded on the increase (left) side of the account. The account balance for Cash is shown below.

Cash	
+	–
(a) 40,000	(d) 20,000
	(f) 10,000
	(j) 1,000
	(k) 1,000
Bal. 8,000	32,000 ← Footing

Normal balance: *The increase side of an account.*

The balance of an account is normally recorded on the increase side of the account. The increase side of the account is the ***normal balance*** of the account. The increase side of an account depends on whether the account is classified as an asset, liability, or owner's equity account. A summary of the procedures to increase or decrease accounts and the normal balance of accounts in the basic accounting equation follows.

ASSETS		=	LIABILITIES		+	OWNER'S EQUITY	
+	–		–	+		–	+
Increase (Normal Bal.)	Decrease		Decrease	Increase (Normal Bal.)		Decrease	Increase (Normal Bal.)
Debits	Credits		Debits	Credits		Debits	Credits

A summary of the account balances for Arrow Employment Services is shown in Figure 3-3. The firm's position after these transactions can be given in equation form.

Assets					**= Liabilities**	**+**	**Owner's Equity**
Cash	+ Supplies	+ Prepaid Rent	+ Equipment	=	Accounts Payable	+	John Arrow, Capital
$8,000	+ $1,000	+ $20,000	+ $15,000	=	$4,000	+	$40,000

A formal balance sheet prepared for November 30, 20X5, is shown in Figure 3-4.

ACCOUNTS FOR REVENUE AND EXPENSES

OBJECTIVE 5 **Record transactions affecting owner's equity in the general journal.**

Some owner's equity accounts can be further classified as revenue or expense accounts. Many business transactions involve revenue and expenses. Separate accounts are used to record these amounts. Let's examine the revenue and expense transactions of Arrow Employment Services for December to see how they are recorded.

FIGURE 3-3
T-Account Balances for Arrow Employment Services

ASSETS Cash		=	LIABILITIES Accounts Payable		+	OWNER'S EQUITY John Arrow, Capital	
+	–		–	+		–	+
(a) 40,000	(d) 20,000		(l) 1,000	(h) 5,000			(b) 40,000
	(f) 10,000			Bal. 4,000			
	(j) 1,000						
	(k) 1,000						
Bal. 8,000	32,000						

Supplies	
+	–
(i) 1,000	

Prepaid Rent	
+	–
(c) 20,000	

Equipment	
+	–
(e) 10,000	
(g) 5,000	
Bal. 15,000	

FIGURE 3-4
Balance Sheet for Arrow Employment Services

ARROW EMPLOYMENT SERVICES
Balance Sheet
November 30, 20X5

Assets		Liabilities	
Cash	$ 8 0 0 0 00	Accounts Payable	$ 4 0 0 0 00
Supplies	1 0 0 0 00		
Prepaid Rent	20 0 0 0 00	Owner's Equity	
Equipment	15 0 0 0 00	John Arrow, Capital	40 0 0 0 00
Total Assets	$44 0 0 0 00	Total Liabilities and Owner's Equity	$44 0 0 0 00

RECORDING REVENUE FROM SERVICES SOLD FOR CASH

During December the business earned a total of $10,500 in revenue from clients who paid cash for services. The office manager made the following analysis.

m. The firm received $10,500 in cash.
n. The owner's equity increased by $10,500 because of this inflow of assets from revenue.

GENERAL JOURNAL ENTRIES FOR DECEMBER

About Accounting: The Story of Your Life?
The general journal is similar to a personal diary. You write all types of business transactions in it. The general journal details, in chronological order, the economic events of the business.

How is the increase in owner's equity recorded? One way would be to record the $10,500 in the John Arrow, Capital account. However, the preferred way is to keep the revenue figures separate from the owner's investment until the end of the month or until financial reports are prepared. Therefore, Viriginia Richey opens a new account called Fees Income (a revenue account). Remember that revenue is a subdivision of owner's equity. At this point in its operations, Arrow Employment Services needs just one revenue account, which is called Fees Income. The title of this account describes the specific type of revenue recorded in it. The revenue subdivision is used to classify and summarize various kinds of revenue of a business.

The $10,500 of revenue is entered in the right column of the journal because revenue increases owner's equity and an owner's equity account is increased on the right side.

Since the right side of the revenue account is used to record increases, the left side is used to record decreases. Decreases in a revenue account may be required by corrections, by transfers to other accounts, or by refunds. However, such entries are not required often.

Different accounts are used for different types of revenue. For instance, in a business where goods are sold, an accountant would set up a revenue account called Sales. When more than one revenue account is used, the accounts are classified under the heading *Revenue* on the income statement, and the total of their balances would be the total operating revenue of the business for the accounting period.

GENERAL JOURNAL PAGE 2

	DATE		DESCRIPTION	POST. REF.	DEBIT	CREDIT
1	20X5					
2	Dec.	31	Cash		10 500 00	
3			Fees Income			10 500 00
4			Performed services for			
5			cash			

RECORDING REVENUE FROM SERVICES SOLD ON CREDIT

During December Arrow Employment Services also earned revenue of $3,500 from charge account clients. The office manager's analysis showed the following effects.

o. The firm obtained a new asset—accounts receivable of $3,500.
p. The owner's equity was increased by $3,500 of revenue.

To record this transaction, Richey first opened a new asset account called Accounts Receivable and entered the $3,500 in the left (increase) column of the journal. Richey entered the $3,500 increase in owner's equity on the right (increase).

GENERAL JOURNAL PAGE 2

	DATE		DESCRIPTION	POST. REF.	DEBIT	CREDIT
6						
7	Dec.	31	Accounts Receivable		3 5 0 0 00	
8			Fees Income			3 5 0 0 00
9			Performed services on			
10			credit			

RECORDING COLLECTIONS FROM ACCOUNTS RECEIVABLE

When charge account clients paid a total of $1,500 to apply to their accounts, Richey made the following analysis.

q. The firm received $1,500 in cash.
r. Accounts receivable decreased by $1,500.

Recording this information involved the use of two asset accounts. Richey entered the $1,500 increase in Cash in the left column of the journal and the $1,500 decrease in Accounts Receivable on the right. Notice that there is no revenue from this transaction. The revenue was entered when the sales on credit were recorded (p).

GENERAL JOURNAL PAGE 2

	DATE		DESCRIPTION	POST. REF.	DEBIT	CREDIT
11						
12	Dec.	31	Cash		1 5 0 0 00	
13			Accounts Receivable			1 5 0 0 00
14			Received cash from credit			
15			clients on account			

RECORDING AN EXPENSE FOR SALARIES

Like other firms, Arrow Employment Services had expenses in running its business. The first expense was for employees' salaries of $2,500. The office manager determined that this expense had the following effects.

s. The payment of $2,500 for salaries reduced the asset Cash.
t. Expenses increased by $2,500, specifically the Salaries Expense account.

The decrease in Cash is recorded in the right column of the journal.

The decrease in owner's equity that results from the expense could be debited to John Arrow, Capital. However, the preferred method is to keep expenses separate from the owner's equity account until the end of the month, or until financial reports are prepared. Like revenue, expenses are a subdivision of owner's equity. This subdivision is used to classify and summarize the various costs of operating the business.

A new account called Salaries Expense is opened for Arrow Employment Services. The account title describes the specific type of expense recorded in the account.

The $2,500 for salaries is entered in the left column of the journal because expenses decrease owner's equity and an owner's equity account is decreased on the left side. Remember that an increase in an expense brings about a decrease in owner's equity.

GENERAL JOURNAL PAGE 2

	DATE		DESCRIPTION	POST. REF.	DEBIT	CREDIT
16						
17	Dec.	31	Salaries Expense		2 500 00	
18			Cash			2 500 00
19			Paid monthly salaries			
20			to employees,			
21			Cheques 1005–1006			

Other kinds of expenses will be recorded in separate accounts, each with its own descriptive title. For example, the payment of monthly utility bills will be recorded in an account called Utilities Expense. Salaries Expense and Utilities Expense are classified under the heading *Expenses* on the income statement. The total of all such account balances is the total operating expenses of the business for the accounting period.

RECORDING AN EXPENSE FOR UTILITIES

During December Arrow Employment Services also had an expense of $300 for utilities, which it paid by issuing a cheque. Richey made the following analysis of this transaction.

u. The payment of $300 for utilities reduced the asset Cash.
v. The account Utilities Expense was increased by $300.

The reduction in Cash (u) was recorded by an entry in the right (credit) column in the journal.

Increases in expenses are recorded on the left because expenses reduce owner's equity. Decreases in expenses are recorded on the right. Decreases in expenses may result from corrections, transfers to other expense accounts, or refunds. However, such entries are not required often.

GENERAL JOURNAL PAGE 2

	DATE		DESCRIPTION	POST. REF.	DEBIT	CREDIT
22						
23	Dec.	31	Utilities Expense		300 00	
24			Cash			300 00
25			Paid monthly bill for			
26			utilities, Cheque 1007			

THE DRAWING ACCOUNT

Drawing account: *A special type of owner's equity account set up to record the owner's withdrawal of cash from the business.*

In sole proprietorships and partnerships, the owners do not pay themselves salaries. To obtain funds for personal living expenses, owners make withdrawals of cash against previously earned profits that have become part of their capital or against profits that are expected in the future. A special type of owner's equity account called a ***drawing account*** is set up to record these withdrawals. Since withdrawals of assets decrease owner's equity, withdrawals can be debited to the Capital account. However, the preferred method is to separate withdrawals from the owner's equity account until the end of the accounting period. On December 30, 20X5, John Arrow withdrew $1,000 in cash from the business to pay for personal expenses. The effect of the withdrawal is shown below.

w. Cash was reduced by the $1,000 withdrawal.
x. The amount of cash the owner withdrew from the business increased by $1,000.

The decrease in cash is recorded with an entry in the right (credit) column of the journal. To record the increase in withdrawals, the $1,000 is entered in the left (debit) column of the journal. The balance of the Drawing account decreases the Capital account and is reported on the statement of owner's equity as withdrawals for the period.

GENERAL JOURNAL PAGE 2

	DATE		DESCRIPTION	POST. REF.	DEBIT	CREDIT
27						
28	Dec.	31	John Arrow, Drawing		1 000 00	
29			Cash			1 000 00
30			Owner withdrew cash for			
31			personal expenses,			
32			Cheque 1008			
33						

COMPOUND ENTRIES

OBJECTIVE 6

Compound entry: *A journal entry that contains more than one debit or credit.*

Remember! *No matter how many accounts are involved, the total debits must equal the total credits in each entry.*

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This article, written for business owners, details the importance of financial records. Advice and tips on using computerized accounting software and converting to a computerized system are offered.

Prepare journal entries.

Each of the journal entries shown so far consists of a single debit and a single credit. However, some transactions require a ***compound entry***—a journal entry that contains several debits or several credits. In a compound entry all debits are recorded first followed by the recording of the credits.

Suppose that when Arrow Employment Services purchased the equipment on November 9 for $10,000, John Arrow provided $5,000 in cash (Cheque 1002) and agreed to pay the balance in 30 days. This transaction would be analyzed as follows.

1. An asset, Equipment, is increased by $10,000.
2. An asset, Cash, is decreased by $5,000.
3. A liability, Accounts Payable, is increased by $5,000.

The compound entry shown below would be entered in the general journal.

GENERAL JOURNAL PAGE 1

	DATE		DESCRIPTION	POST. REF.	DEBIT	CREDIT
1	20X5					
2	Nov.	9	Equipment		10 000 00	
3			Cash			5 000 00
4			Accounts Payable			5 000 00
5			Purchased equipment on			
6			credit from Organ, Inc.,			
7			Invoice 2787, issued			
8			Cheque 1002 for a $5,000			
9			down payment; bal. due			
10			30 days			
11						

Notice that this compound entry contains equal debits and credits, just as any journal entry should ($10,000 = $5,000 + $5,000).

CHAPTER 3

Review and Applications

CHAPTER SUMMARY

Objective 1: Define debit and credit. A debit is an entry on the left side of an account; a credit is an entry on the right side of an account.

Objective 2: Describe the relationship between debits and credits, and the accounting equation.

Assets = Liabilities + Owner's Equity
Left = Right
Debits = Credits

Assets are on the left side of the accounting equation; therefore, increases to assets are made on the left side of asset accounts and are called debits. Decreases to assets are made on the right side of asset accounts and are called credits. Liabilities and owner's equity are on the right side of the accounting equation; therefore, increases to liabilities and owner's equity are made on the right side of liabilities and owner's equity accounts and are called credits. Decreases to liabilities and owner's equity are made on the left side of liabilities and owner's equity accounts and are called debits.

Objective 3: Record transactions in the general journal.

- Record the year and month at the top of the Date column.
- Write the day in the Date column on the first line of each entry.
- Record the account to be debited in the Description column close to the left margin, then enter the debit amount on the same line in the Debit column.
- Record the account to be credited on the line beneath the debit, indented about half an inch from the left margin, then enter the credit amount on the same line in the Credit column.
- Enter a complete, but concise explanation on the line following the credit.
- Leave a blank line between journal entries.

Objective 4: Post transactions from the general journal to T accounts.

- Copy the debit amount in the journal to the Debit column in the ledger account specified in the Description column.
- Copy the credit amount in the journal to the Credit column in the ledger account specified in the Description column.

Objective 5: Record transactions affecting owner's equity in the general journal. Owner's equity accounts are divided into revenue, expense, and drawing accounts. Revenue accounts increase owner's equity; therefore, increases are recorded on the credit side of revenue accounts. Expenses are recorded on the debit side of the separate expense accounts because expenses decrease owner's equity. The Drawing account is used to record the withdrawal of cash or other assets from the business by the owner. Like expenses, the Drawing account decreases owner's equity.

Objective 6: Prepare journal entries. A compound journal entry contains several debits or several credits. In a compound entry all debits are recorded first, followed by the credits. Just as any journal entry must, a compound entry contains equal debits and credits.

REVIEW QUESTIONS

1. What are accounts?
2. Why is prepaid rent considered an asset account?
3. Why is the modern system of accounting usually called the double-entry system?
4. The terms *debit* and *credit* are often used in describing the effects of transactions on different accounts. What do these terms mean?
5. Decide whether each of the following types of accounts would normally have a debit balance or a credit balance.
   a. An asset account
   b. A liability account
   c. The owner's capital account
   d. A revenue account
   e. An expense account
6. How is the balance of an account determined?

EXERCISES

EXERCISE 3-1
(Obj. 1, 2, 3)

Analyzing transactions. Kathy Nelson decided to start her dental practice. The first five transactions for the business are listed below. For each transaction, (1) determine which two accounts are affected, and (2) prepare journal entries without explanations and dates to record the transactions.

1. Kathy invested $20,000 cash in the business.
2. Paid $5,000 in cash for equipment.
3. Performed services for cash amounting to $2,000.
4. Paid $700 in cash for one month's rent expense.
5. Paid $500 in cash for supplies.

EXERCISE 3-2
(Obj. 2)

Identifying debits and credits. Determine whether the word *debit* or *credit* is correct for each space in the sentences below.

1. Asset accounts normally have ___?____ balances. These accounts increase on the ___?____ side and decrease on the ___?____ side.
2. Liability accounts normally have ___?____ balances. These accounts increase on the ___?____ side and decrease on the ___?____ side.
3. The owner's capital account normally has a ___?____ balance. This account increases on the ___?____ side and decreases on the ___?____ side.

4. Revenue accounts normally have ___?____ balances. These accounts increase on the ___?____ side and decrease on the ___?____ side.
5. Expense accounts normally have ___?____ balances. These accounts increase on the ___?____ side and decrease on the ___?____ side.

EXERCISE 3-3
(Obj. 2)

Determining debit and credit balances. Indicate whether each of the following accounts would normally have a debit balance or a credit balance.

1. Accounts Payable
2. Fees Income
3. Cash
4. Arthur Roberts, Capital
5. Equipment
6. Accounts Receivable
7. Salaries Expense
8. Supplies

EXERCISE 3-4
(Obj. 3)

Determining T account balances. The following T accounts show transactions that were recorded at Sutton Antique Repair, a firm that specializes in restoring antique furniture. The entries for the first transaction are labelled with the letter **a**, the entries for the second transaction with the letter **b**, and so on. Determine the balance for each account and if a debit or credit.

Cash	
(a) 20,000	(b) 5,000
(d) 2,500	(e) 75
(g) 250	(h) 1,250
	(i) 500

Equipment	
(c) 7,500	

Accounts Receivable	
(f) 1,000	(g) 250

Accounts Payable	
	(c) 7,500

Supplies	
(b) 5,000	

Oliver Sutton, Capital	
	(a) 20,000

Fees Income	
	(d) 2,500
	(f) 1,000

Telephone Expense	
(e) 75	

Oliver Sutton, Drawing	
(i) 500	

Salaries Expense	
(h) 1,250	

EXERCISE 3-5
(Obj. 6)

Record transactions involving assets, liabilities, and owner's equity in the journal. For the following transactions, prepare journal entries (Note: dates and explanations are not required):

1. Joe Gibb invested $5,000 cash into the business.
2. Purchased furniture for $750 in cash.
3. Purchased office supplies in the amount of $1,200 in cash.
4. Purchased furniture on account for $1,150.

PROBLEMS

PROBLEM SET A

PROBLEM 3-1A
(Obj. 4, 5)

Record transactions involving assets, liabilities, and owner's equity in the journal. The following transactions took place at Hill's Remodelling Service.

Instructions

Using Cash, Shop Equipment, Store Equipment, Truck, Accounts Payable, Lynn Hill, Capital and Lynn Hill, Drawing accounts, analyze each transaction carefully. Record the transaction in the journal. (Note: dates and explanations are not required.)

TRANSACTIONS

1. Lynn Hill invested $18,000 cash in the business.
2. Purchased equipment for $900 in cash.
3. Bought store fixtures for $600; payment is due in 30 days.
4. Purchased a used truck for $3,000 in cash.
5. Hill gave the firm his personal set of tools costing $1,000 for use in the shop.
6. Bought a used cash register for $500; payment is due in 30 days.
7. Paid $200 in cash to apply to the amount owed for store fixtures.
8. Hill withdrew $800 in cash for personal expenses.

PROBLEM 3-2A
(Obj. 3)

Record transactions involving assets, liabilities, and owner's equity in the journal. The following transactions occurred at several different businesses and are not related.

Instructions

Analyze each of the transactions. For each transaction, decide what accounts are affected and enter the transactions in the journal. (Note: dates and explanations are not required.)

TRANSACTIONS

1. A firm purchased equipment for $2,000 in cash.
2. The owner, Paul Smith, withdrew $500 in cash.
3. A firm sold a piece of surplus equipment for $250 in cash.
4. A firm purchased a used delivery truck for $2,000 in cash.
5. A firm paid $400 in cash to apply against an account owed.

6. A firm purchased office equipment for $450. The amount is to be paid in 60 days.
7. Sharon Carter, owner of Builders Supply Company, made an additional investment of $2,500 in cash.
8. A firm paid $150 by cheque for office equipment it had previously purchased on credit.

PROBLEM 3-3A
(Obj. 5)

Record transactions involving revenue and expenses in the journal. The following revenue and expense transactions took place at the Industrial Cleaning Service.

Instructions

Analyze each of the transactions. Decide what accounts are affected and enter the transactions in the journal. (Note: dates and explanations are not required.)

TRANSACTIONS

1. Paid $400 for one month's rent.
2. Performed services for $500 in cash.
3. Paid salaries of $600.
4. Performed additional services for $900 on credit.
5. Paid $75 for the monthly telephone bill.
6. Collected $250 from accounts receivable.
7. Received a $15 refund for an overcharge on the telephone bill.
8. Performed services for $600 on credit.
9. Paid $50 in cash for the monthly electric bill.
10. Paid $110 in cash for gasoline purchased for the firm's van during the month.
11. Received $450 from charge account customers.
12. Performed services for $900 in cash.

PROBLEM 3-4A
(Obj. 4, 5)

Record all business transactions in the journal. The accounts and transactions of Ron Kelly, Architect, follow.

Instructions

Analyze the transactions using only the account names listed below. Record each transaction in the journal, without dates or explanations.

ASSETS
Cash
Accounts Receivable
Office Equipment
Automobile

LIABILITIES
Accounts Payable

OWNER'S EQUITY
Ron Kelly, Capital
Ron Kelly, Drawing

REVENUE
Fees Income

EXPENSES
Rent Expense
Utilities Expense
Salaries Expense
Telephone Expense
Automobile Expense

TRANSACTIONS

a. Ron Kelly invested $27,000 in cash to start the business.
b. Paid $800 in cash for one month's rent.
c. Bought a used automobile for the firm for $8,000 in cash.
d. Performed services for $1,500 in cash.
e. Paid $200 for automobile repairs.
f. Performed services for $1,875 on credit.
g. Purchased office chairs for $1,050 on credit.
h. Received $900 from credit clients.
i. Paid $500 to reduce the amount owed for the office chairs.
j. Issued a cheque for $280 to pay the monthly utility bill.
k. Purchased office equipment for $4,200 and paid half of this amount in cash immediately; the balance is due in 30 days.
l. Issued a cheque for $2,840 to pay salaries.
m. Performed services for $925 in cash.
n. Performed services for $1,300 on credit.
o. Paid $96 for the monthly telephone bill.
p. Collected $800 on accounts receivable from charge customers.
q. Purchased additional office equipment and received a bill for $680 due in 30 days.
r. Paid $150 in cash for gasoline purchased for the automobile during the month.
s. Ron Kelly withdrew $1,000 in cash for personal expenses.

PROBLEM SET B

PROBLEM 3-1B
(Obj. 4)

Record transactions involving assets, liabilities, and owner's equity. The following transactions took place at the legal services business established by Susan Gale.

Instructions

Set up T accounts for these accounts: Cash, Office Furniture, Office Equipment, Automobile, Accounts Payable, and Susan Gale, Capital. Analyze each transaction carefully. Record the transactions in the general journal, then post the journal entries to the T accounts. (Note: dates and explanations are not required.)

TRANSACTIONS

1. Susan Gale invested $7,500 cash in the business.
2. Purchased office furniture for $2,000 in cash.
3. Bought a fax machine for $650; payment is due in 30 days.
4. Purchased a used car for the firm for $2,000 in cash.
5. Gale invested an additional $2,000 cash in the business.

6. Bought a new microcomputer for $2,500; payment is due in 60 days.
7. Paid $650 to settle the amount owed on the fax machine.
8. Gale withdrew $500 in cash for personal expenses.

PROBLEM 3-2B
(Obj. 4, 5)

Record transactions involving assets, liabilities, and owner's equity. The following transactions occurred at several different businesses and are not related.

Instructions

Analyze each of the transactions. Decide what accounts are affected and record the effects of the transaction in the general journal. Enter the proper titles at the top of a pair of T accounts and post from the journal to the T accounts. (Note: dates and explanations are not required.)

TRANSACTIONS

1. Bill White, an owner, made an additional investment of $6,000 in cash.
2. A firm purchased equipment for $3,500 cash.
3. A firm sold some surplus office furniture for $300 in cash.
4. A firm purchased a computer for $2,600, to be paid in 60 days.
5. A firm purchased office equipment for $3,500 on credit. The amount is due in 60 days.
6. Diane Scott, owner of Scott Travel Agency, withdrew $1,000 of her original cash investment.
7. A firm bought a delivery truck for $9,000 on credit; payment is due in 90 days.
8. A firm issued a cheque for $250 to a supplier in partial payment of an open account balance.

PROBLEM 3-3B
(Obj. 5)

Record transactions involving revenues and expenses. The following occurred in April 20X8 at Sloan Tax Service.

Instructions

Analyze each transaction. Record these transactions in the journal, without explanations.

TRANSACTIONS

April 2	Purchased office supplies for $250, cheque number 3454.
2	Delivered tax return, collected fee income of $175.
3	Paid monthly office rent of $575 with cheque number 3455.
3	Completed tax return; billed client for $250.
6	Completed tax return; client paid $125 in cash.
6	Paid office salary of $400 with cheque number 3456.
9	Paid telephone bill of $60 with cheque number 3457.
11	Billed client for $250 fee for preparing return.
12	Purchased office supplies of $125 on account.
13	Paid office salary of $400 with cheque number 3458.

14 Collected $250 from client that was billed on April 3.

14 Clients paid a total of $2,500 cash for tax returns.

16 Paid utility bill of $125 with cheque number 3459.

18 Received $250 from client who was billed on April 11.

PROBLEM 3-4B
(Obj. 3, 4, 5)

Record all business transactions. The accounts and transactions of Steve Jones, Consulting Engineer, are shown below.

Instructions

Analyze the transactions using only the account names listed below. Record each transaction in the journal, without date or explanation.

ASSETS
Cash
Accounts Receivable
Office Furniture
Office Equipment

LIABILITIES
Accounts Payable

OWNER'S EQUITY
Steve Jones, Capital
Steve Jones, Drawing

REVENUE
Fees Income

EXPENSES
Rent Expense
Utilities Expense
Salaries Expense
Telephone Expense
Miscellaneous Expense

TRANSACTIONS

a. Jones invested $45,000 in cash to start the business.

b. Paid $2,250 for one month's rent.

c. Bought office furniture for $7,800 in cash.

d. Performed services for $3,150 in cash.

e. Paid $675 for the monthly telephone bill.

f. Performed services for $3,825 on credit.

g. Purchased a microcomputer and copy machine for $11,850 on credit; paid $2,850 in cash immediately, with the balance due in 30 days.

h. Received $2,100 from credit clients.

i. Paid $900 in cash for office cleaning services for the month.

j. Purchased additional office chairs for $2,400; received credit terms of 30 days.

k. Purchased office equipment for $16,500 and paid half of this amount in cash immediately; the balance is due in 30 days.

l. Issued a cheque for $9,750 to pay salaries.

m. Performed services for $3,075 in cash.

n. Performed services for $3,450 on credit.

o. Collected $1,800 on accounts receivable from charge customers.

p. Issued a cheque for $1,200 in partial payment of the amount owed for office chairs.

q. Paid $300 to a duplicating company for photocopy work performed during the month.

r. Paid $750 for the monthly electric bill.

s. Steve Jones withdrew $3,000 in cash for personal expenses.

CHALLENGE PROBLEM

Sarah Cohen is an architect who operates her own business. The transactions and accounts for the business are shown below.

Instructions

Analyze the transactions for January 20X6 using only the account names listed below. Record each transaction in the journal, without dates or explanations.

ASSETS
Cash
Accounts Receivable
Office Furniture
Office Equipment

LIABILITIES
Accounts Payable

OWNER'S EQUITY
Sarah Cohen, Capital
Sarah Cohen, Drawing

REVENUE
Fees Income

EXPENSES
Rent Expense
Utilities Expense
Salaries Expense
Telephone Expense
Miscellaneous Expense

TRANSACTIONS

a. Sarah Cohen invested $10,000 in cash to start the business.

b. Paid $500 for one month's rent.

c. Purchased office furniture for $1,500 in cash.

d. Performed services for $1,200 in cash.

e. Paid $135 for the monthly telephone bill.

f. Performed services for $1,080 on credit.

g. Purchased a fax machine for $750; paid $300 in cash with the balance due in 30 days.

h. Paid a bill for $165 from the office cleaning service.

i. Received $540 from clients on account.

j. Purchased additional office chairs for $450; received credit terms of 30 days.

k. Paid $1,000 for salaries.

l. Issued a cheque for $275 in partial payment of the amount owed for office chairs.

m. Received $700 in cash for services performed.

n. Issued a cheque for $240 to pay the utility bill.

o. Performed services for $1,200 on credit.

p. Collected $200 from clients on account.

q. Sarah Cohen withdrew $700 in cash for personal expenses.

r. Paid $150 to Ed's Duplicating Service for photocopy work performed during the month.

CRITICAL THINKING PROBLEM

At the beginning of the summer, Mike Kitay was looking for a way to earn money to pay for his college tuition in the fall. On the advice of several neighbours, he decided to start a lawn-service business in his neighbourhood. To get the business started, Mike used $1,500 from his savings account to open a chequing account for his new business, MK Lawn Care. At a local auction, he was able to purchase two used power mowers and various lawn-care tools for $500. He also paid $900 for a second-hand truck to transport the power mowers.

Several of the neighbours who had encouraged him to start the business hired him to cut their grass on a weekly basis. He sent these customers monthly bills. By the end of the summer, they had paid him $200 in cash and owed him another $350. Mike also cut grass on an as-needed basis for other neighbours who paid him $100.

During the summer, Mike spent $100 for gasoline for the truck and mowers. He paid a friend who helped him on several occasions $250. An advertisement in the local paper cost $30. Now, at the end of the summer, Mike is concerned because he has only $20 left in his chequing account. He says, "I worked hard all summer and have only $20 to show for it. It would have been better to leave the money in the bank."

Prepare an income statement, a statement of owner's equity, and a balance sheet for MK Lawn Care. Explain to Mike whether he is "better off" than he was at the beginning of the summer. (Hint: T accounts may be helpful in organizing the data.)