PRINCIPLES OF ACCOUNTING

CHAPTER 2
ANALYZING TRANSACTIONS

Accounts, Debits, Credits, Journal Entries, Posting and Trial Balances

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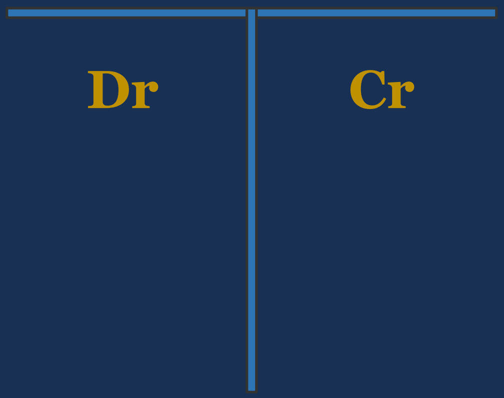

Chapter Introduction

Businesses may process hundreds, thousands or millions of financial transactions.

An effective accounting system must:

- Classify transactions
- Record them accurately
- Organize similar information
- Summarize account balances
- Support financial-statement preparation
- Help identify accounting errors

Opening Case — Apple Inc.

Apple may receive payment through:

- Cash
- Credit cards
- Debit cards
- Gift cards
- Financing arrangements
- Bank transfers

WHY IT MATTERS

To analyze cash transactions separately, Apple must record similar cash movements in a single Cash account — much like organizing email into folders so information can be retrieved and understood efficiently.

From Chapter 1 to Chapter 2

Chapter 1

Transactions were analyzed through:

Assets = Liabilities + Owner's Equity

Chapter 2

Transactions are recorded using:

- Accounts
- Debits and credits
- Journals
- Ledgers
- Trial balances

KEY POINT

The account-based system is more practical for organizations processing large volumes of transactions.

Why Transaction Analysis Matters

Incorrect transaction analysis may cause:

- Wrong account balances
- Misstated revenue
- Misstated expenses
- Incorrect assets and liabilities
- Unbalanced trial balances
- Misleading financial statements

KEY MESSAGE

Accurate financial reporting begins with accurate transaction analysis.

Learning Objectives

By the end of this chapter, students will be able to:

1. Describe an account and a chart of accounts.
2. Apply the double-entry accounting system.
3. Journalize business transactions.
4. Post journal entries to ledger accounts.
5. Prepare an unadjusted trial balance.
6. Identify errors that affect or do not affect the trial balance.

These outcomes reflect the chapter's four formal learning objectives.

Chapter Roadmap

01 Accounts	02 T accounts	03 Ledgers
04 Chart of accounts	05 Debit and credit rules	06 Normal balances
07 Double-entry accounting	08 Journalizing	09 Transaction analysis
10 Posting	11 Trial balance	12 Error detection

Opening Reflection

A business purchases equipment for ETB 100,000. It pays:

- ETB 30,000 in cash
- ETB 70,000 on account

QUESTIONS

- Which accounts are affected?
- Which account is debited?
- Which accounts are credited?
- Why must total debits equal total credits?

SECTION 1

Accounts

What Is an Account?

An account is a separate accounting record used to show:

Increases	Decreases	Current balance

of a specific asset, liability, owner's-equity, revenue or expense item.

Each accounting-equation element is organized into a separate account.

Examples of Accounts

Asset Accounts

- Cash
- Accounts receivable
- Supplies
- Equipment

Liability Accounts

- Accounts payable
- Notes payable
- Wages payable

Equity and Performance

- Owner's capital
- Owner's drawing
- Fees earned
- Rent expense

Why Separate Accounts Are Needed

Separate accounts allow a business to determine:

- How much cash it has
- How much customers owe
- How much it owes suppliers
- How much revenue it earned
- How much it spent
- The owner's current interest in the business

Three Parts of an Account

1	**A title**	Names the item being tracked
2	**A side for increases**	Where additions are recorded
3	**A side for decreases**	Where reductions are recorded

The T Account

A T account is a simplified account form. The account title appears above the horizontal line.

Account Title

DEBIT (left side)	CREDIT (right side)
Debit	Credit
Left side	Right side

Meaning of Debit

A debit is an entry recorded on the LEFT side of an account.

A debit may represent:

- An increase
- A decrease

Which one it is depends on the account type.

Meaning of Credit

A credit is an entry recorded on the RIGHT side of an account.

A credit may represent:

- An increase
- A decrease

The left side of a T account is the debit side; the right side is the credit side.

Debit Does Not Mean Negative

Common misunderstandings:

- Debit does not automatically mean loss.
- Credit does not automatically mean income.
- Debit does not always decrease an account.
- Credit does not always increase an account.

REMEMBER

Their meaning depends on the account classification.

Account Balance

The balance is the difference between total debit entries and total credit entries.

Debits exceed credits

The account has a debit balance.

Credits exceed debits

The account has a credit balance.

Cash Account Example

Cash

DEBIT (left side)	CREDIT (right side)
	Land: ETB 20,000
Owner investment: ETB 25,000	Expenses: ETB 3,650
Service revenue: ETB 7,500	Supplier payment: ETB 950
	Drawing: ETB 2,000
Total debits: 32,500	**Total credits: 26,600**

Calculating the Cash Balance

Cash Balance = Total Debits – Total Credits

32,500 – 26,600

= 5,900

The NetSolutions example produces a debit Cash balance of $5,900.

Uses of T Accounts

T accounts are useful for:

- Understanding debit and credit effects
- Tracing account changes
- Calculating balances
- Analyzing complex transactions
- Explaining accounting relationships
- Preparing adjustments

SECTION 2

Ledger and Chart of Accounts

What Is a Ledger?

A ledger is the entire group of accounts maintained by a business.

It contains a separate account for every significant financial-statement item.

General Ledger

The general ledger commonly includes:

- Asset accounts
- Liability accounts
- Owner's-equity accounts
- Revenue accounts
- Expense accounts

PURPOSE

It provides the balances used to prepare financial statements.

What Is a Chart of Accounts?

A chart of accounts is an organized list of all accounts in the ledger.

The accounts are normally arranged in financial-statement order.

Standard Account Order

- 01 Assets
- 02 Liabilities
- 03 Owner's equity
- 04 Revenue
- 05 Expenses

This order follows the sequence used in the financial statements.

Asset Accounts

Assets are resources owned or controlled by the business.

- Cash
- Accounts receivable
- Supplies

- Prepaid insurance
- Land
- Buildings

- Office equipment
- Patent rights
- Copyrights

Accounts Receivable

Accounts receivable represents amounts owed by customers for:

- Goods delivered
- Services provided
- Other credit transactions

CLASSIFICATION

Asset

NORMAL BALANCE

Debit

Prepaid Expenses

Prepaid expenses are payments made in advance for future benefits.

- Prepaid insurance
- Prepaid rent
- Service contracts paid in advance

CLASSIFICATION

They are assets until the benefit is consumed.

Liability Accounts

Liabilities are debts owed to creditors.

- Accounts payable
- Notes payable

- Wages payable
- Loans payable

- Unearned revenue

Liability account titles frequently include the word "payable."

Accounts Payable

Accounts payable represents amounts owed to suppliers for goods or services purchased on credit.

CLASSIFICATION

Liability

NORMAL BALANCE

Credit

Unearned Revenue

Unearned revenue arises when cash is received before goods or services are provided.

EXAMPLE

A business receives three months' rent in advance.

- Cash increases.
- A liability increases.

Revenue is recognized as the service is provided.

Owner's Capital

The owner's capital account represents the owner's interest in the business.

Increased by

- Owner investments
- Net income

Decreased by

- Net loss
- Owner withdrawals

Owner's Drawing

The drawing account records assets withdrawn by the owner for personal use.

- Is not a business expense
- Reduces owner's equity
- Normally has a debit balance

Revenue Accounts

Revenue results from providing goods or services to customers.

- Fees earned
- Sales revenue

- Rent revenue
- Commission revenue

- Fares earned

EFFECT

Revenue increases owner's equity.

Expense Accounts

Expenses result from consuming assets or services to generate revenue.

- Wages expense
- Rent expense

- Utilities expense
- Supplies expense

- Miscellaneous expense

EFFECT

Expenses decrease owner's equity.

Chart-of-Accounts Numbering

A simple numbering system may use:

Category	Number
Assets	100 series
Liabilities	200 series
Owner's equity	300 series
Revenue	400 series
Expenses	500 series

NetSolutions Account Groups

The NetSolutions chart uses:

First digit	Category
1	Assets
2	Liabilities
3	Owner's equity
4	Revenue
5	Expenses

The second digit identifies the account within each category.

Sample Chart of Accounts

No.	Account
101	Cash
102	Accounts Receivable
104	Supplies
105	Prepaid Insurance
107	Land
108	Equipment

No.	Account
201	Accounts Payable
203	Unearned Revenue
301	Owner, Capital
302	Owner, Drawing
401	Fees Earned
501	Wages Expense

SECTION 3

Double-Entry Accounting

Double-Entry Accounting System

The double-entry accounting system requires every transaction to:

- Affect at least two accounts
- Have at least one debit
- Have at least one credit
- Maintain equality of debits and credits

Fundamental Double-Entry Rule

Total Debits = Total Credits

WHY IT MATTERS

This rule preserves the accounting equation.

Debit and Credit Rules for Assets

Asset Effect

INCREASE

Debit

DECREASE

Credit

NORMAL BALANCE

Debit

Asset Example

Receives ETB 50,000 from owner

- Cash increases.
- Cash is debited.

Pays ETB 5,000 cash

- Cash decreases.
- Cash is credited.

Debit and Credit Rules for Liabilities

Liability Effect

INCREASE

Credit

DECREASE

Debit

NORMAL BALANCE

Credit

Liability Example

Buys supplies on account, ETB 15,000

- Accounts payable increases.
- Accounts payable is credited.

Later pays ETB 6,000

- Accounts payable decreases.
- Accounts payable is debited.

Debit and Credit Rules for Owner's Capital

Capital Effect

INCREASE

Credit

DECREASE

Debit

NORMAL BALANCE

Credit

Owner investments increase the capital account.

Debit and Credit Rules for Revenue

Revenue Effect

INCREASE

Credit

DECREASE

Debit

NORMAL BALANCE

Credit

Revenue increases owner's equity.

Debit and Credit Rules for Expenses

Expense Effect

INCREASE

Debit

DECREASE

Credit

NORMAL BALANCE

Debit

Expenses decrease owner's equity.

Debit and Credit Rules for Drawing

Drawing Effect

INCREASE	DECREASE
Debit	**Credit**

NORMAL BALANCE

Debit

Drawing decreases owner's equity.

Complete Debit and Credit Summary

Account Type	Increase	Decrease	Normal Balance
Assets	Debit	Credit	Debit
Liabilities	Credit	Debit	Credit
Capital	Credit	Debit	Credit
Drawing	Debit	Credit	Debit
Revenue	Credit	Debit	Credit
Expenses	Debit	Credit	Debit

Memory Aid — DEAD

Accounts increased by debits:

D	Drawings
E	Expenses
A	Assets

Memory Aid — CLER

Accounts increased by credits:

C	Capital
L	Liabilities
E	Equity
R	Revenue

Normal Balance

The normal balance of an account is the side used to record increases.

- Cash normally has a debit balance.
- Accounts payable normally has a credit balance.
- Fees earned normally has a credit balance.
- Rent expense normally has a debit balance.

Abnormal Balances

An abnormal balance may indicate:

- A posting error
- An overpayment
- An incorrect journal entry
- An unusual transaction
- A calculation error

EXAMPLE

A debit balance in Accounts Payable may result from paying a supplier more than the amount owed.

Quick Knowledge Check

Identify the normal balance:

Account	Normal Balance
Cash	Debit
Accounts Payable	Credit
Fees Earned	Credit
Supplies Expense	Debit
Owner, Drawing	Debit
Owner, Capital	Credit

SECTION 4

Journalizing

What Is a Journal?

A journal is the chronological record in which transactions are first formally recorded.

It shows:

- Transaction date
- Accounts affected
- Debit amounts
- Credit amounts
- Explanation

Journalizing

Journalizing is the process of recording transactions in the journal.

TERMINOLOGY

The recorded transaction is called a journal entry.

Benefits of a Journal

A journal provides:

- A chronological transaction history
- A complete debit-and-credit record
- Explanations of transactions
- An audit trail
- A basis for posting to the ledger

Standard Journal Format

Date	Description	Post. Ref.	Debit	Credit
Jan. 1	Cash		50,000	
	Owner, Capital			50,000
	Owner invested cash			

Journalizing Step 1

1 Record the Date

Enter:

Year	Month	Day

Transactions must be recorded in chronological order.

Journalizing Step 2

2 Record the Debit Account

- Enter the debit account at the left margin.
- Enter the amount in the Debit column.

Journalizing Step 3

3 Record the Credit Account

- Enter the credit account below the debit account.
- Indent the account title.
- Enter the amount in the Credit column.

Journalizing Steps 4 and 5

Step 4

Add a brief explanation.

Step 5

Leave the posting-reference column blank until the entry is posted.

These five journalizing steps appear in the initial owner-investment example.

Transaction-Analysis Process

For each transaction:

1. Identify the accounts affected.
2. Classify each account.
3. Determine whether each account increases or decreases.
4. Apply the debit and credit rules.
5. Prepare the journal entry.

Example 1 — Owner Investment

The owner invests ETB 100,000 cash.

Cash increases → Debit

Owner's capital increases → Credit

Account	Debit	Credit
Cash	**100,000**	
Owner, Capital		**100,000**

Example 2 — Purchase Land for Cash

The business purchases land for ETB 60,000 cash.

Land increases → Debit

Cash decreases → Credit

Account	Debit	Credit
Land	**60,000**	
Cash		**60,000**

The same treatment applies when NetSolutions purchases land for a future building site.

Example 3 — Purchase Supplies on Account

Supplies costing ETB 12,000 are purchased on account.

Supplies increase → Debit

Accounts payable increases → Credit

Account	Debit	Credit
Supplies	**12,000**	
Accounts Payable		**12,000**

Example 4 — Earn Revenue for Cash

The business provides services and receives ETB 25,000 cash.

Cash increases → Debit

Fees earned increases → Credit

Account	Debit	Credit
Cash	**25,000**	
Fees Earned		**25,000**

Example 5 — Pay Multiple Expenses

The business pays:

- Wages: ETB 8,000
- Rent: ETB 4,000
- Utilities: ETB 1,500

Total Cash Payment = ETB 13,500

Compound Journal Entry

Account	Debit	Credit
Wages Expense	**8,000**	
Rent Expense	**4,000**	
Utilities Expense	**1,500**	
Cash		**13,500**

DEFINITION

A compound entry contains more than two accounts, but total debits must still equal total credits.

Example 6 — Pay a Creditor

The business pays ETB 5,000 on account.

Accounts payable decreases → Debit

Cash decreases → Credit

Account	Debit	Credit
Accounts Payable	**5,000**	
Cash		**5,000**

Example 7 — Supplies Used

Supplies purchased

ETB 12,000

Supplies remaining

ETB 4,500

Supplies used = 12,000 − 4,500 = ETB 7,500

Supplies-Expense Entry

Account	Debit	Credit
Supplies Expense	**7,500**	
Supplies		**7,500**

The entry recognizes the cost of supplies consumed during the accounting period.

> *The same approach applies when NetSolutions identifies supplies used during November.*

Example 8 — Owner Withdrawal

The owner withdraws ETB 10,000 for personal use.

Drawing increases → Debit

Cash decreases → Credit

Account	Debit	Credit
Owner, Drawing	**10,000**	
Cash		**10,000**

SECTION 5

Posting and Trial Balance

Posting to the Ledger

Posting is the process of transferring journal-entry amounts to individual ledger accounts.

Posting Steps

1. Record the date in the ledger.
2. Enter the debit or credit amount.
3. Record the journal page in the ledger.
4. Record the account number in the journal.
5. Calculate the updated balance.

The posting diagram shows the cross-references between the journal and individual ledger accounts.

Unadjusted Trial Balance and Error Detection

An unadjusted trial balance lists all ledger accounts and balances before adjusting entries.

Main Purposes

- Verify total debits equal total credits
- Summarize ledger balances
- Identify certain recording and posting errors
- Support adjustments and statements

Errors That Affect It

- Unequal debit and credit amounts
- Posting only one side
- Posting a debit as a credit
- Incorrect addition
- Incorrect balance transfer

Errors That May Not

- Entire transaction omitted
- Correct amount, wrong account
- Equal incorrect amounts
- Transaction recorded twice
- Compensating errors

IMPORTANT

An equal trial balance does not prove that all transactions are correct.

Chapter Summary

- An account records increases, decreases and balances.
- A T account has a debit side and a credit side.
- The ledger contains all business accounts.
- The chart of accounts lists those accounts systematically.
- Assets, expenses and drawing normally have debit balances.
- Liabilities, capital and revenue normally have credit balances.
- Double-entry accounting requires total debits to equal total credits.
- Journalizing records transactions chronologically.
- Transaction analysis identifies accounts and debit/credit effects.
- Posting transfers entries from the journal to the ledger.
- The trial balance summarizes ledger balances.
- Trial-balance equality detects some, but not all, errors.

The Transaction-Recording Cycle

1	2	3	4	5	6	7
Analyze Transaction	Identify Accounts	Apply Debit and Credit Rules	Journalize	Post to Ledger	Prepare Trial Balance	Investigate Errors

KEY MESSAGE

Reliable financial statements begin with disciplined transaction analysis, balanced journal entries, accurate posting and systematic verification of ledger balances.

THANK YOU

Questions and Discussion

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Double-entry accounting creates a structured link between every transaction and the financial statements. When debits and credits are correctly analyzed, recorded and posted, the accounting system produces information that is organized, traceable and useful for decision-making.