

CHAPTER 2

The Accounting Information System and Financial Statements

In this chapter, we will discuss the underlying concepts behind any accounting system. We will also begin a discussion of the procedures that companies use to record information about business activities and how this information is ultimately transformed into financial statements. We will discuss the basic concepts and procedures that underlie accounting systems and how the completion of each accounting procedure moves the accounting system toward its end product—the financial statements.

LEARNING OBJECTIVES

LO1. Describe the qualitative characteristics, assumptions, principles, and constraints that underlie accounting.

- The fundamental qualitative characteristics of accounting information are:
 - Relevance—refers to whether information is capable of making a difference in the decision-making process. Relevant information is material that helps predict the future or provides feedback about prior expectations.
 - Faithful representation—refers to whether information faithfully represents the economic event it is intending to portray. Faithfully presented information should be complete, neutral, and free from error.
- The enhancing qualitative characteristics are:
 - Comparability—allows external users to identify similarities and differences between two or more items. Consistency can be achieved by a company applying the same accounting principles for the same items over time.
 - Verifiability—results when independent parties can reach a consensus on the measurement of an activity.
 - Timeliness—available to users before the information loses its ability to influence decisions.
 - Understandability—able to be comprehended (with reasonable effort) by users who have a reasonable knowledge of accounting and business.
- The four assumptions are:
 - Separate entity—each company is accounted for separately from its owners.
 - Continuity (going concern)—assumption that a company will continue to operate long enough to carry out its commitments.
 - Periodicity or time-period—allows the life of a company to be divided into artificial time periods.
 - Unit of measure or monetary unit—requires financial information to be reported in a national monetary unit.
- The three principles are:
 - Historical cost—requires a business activity to be recorded at the exchange price at the time the activity occurs.
 - Revenue recognition—requires revenue to be recognized when it is earned and cash collection is reasonably assured.

- Full disclosure—requires that financial statements include all information required for the financial statement users to make informed decisions (e.g., notes to the financial statements).
- Constraints:
 - Cost—the benefit of users receiving information should exceed the cost of producing the information.
 - Prudence (conservatism)—assets and revenues should not be overstated and liabilities and expenses should not be understated.
- The elements of financial statements are:
 - Assets—economic resources of a business entity that are expected to provide future benefit.
 - Liabilities—existing obligations or debts of a business entity that will be satisfied by payment with assets or the provision of services.
 - Equity—capital provided to the company by its shareholders combined with undistributed earnings of the business entity.

LO2. Explain the relationships among economic events, transactions, and the expanded basic accounting equation.

- A company's business activities (operating, investing, and financing) consist of many different economic events that are both external to the company and internal to the company. Accounting attempts to measure the economic effect of these events. However, not all events are recognized, or recorded, in the accounting system.
- A transaction is an economic event that is recognized in the financial statements. An accounting transaction causes the elements of the accounting equation (assets, liabilities, contributed capital, retained earnings, revenues, expenses, or dividends declared) to change in a way that maintains the equality of their relationship.

LO3. Analyze the effect of business transactions on the basic accounting equation.

- This is Step 1 of the accounting cycle.
- Transaction analysis is the process of determining the economic effects of a transaction on the elements of the accounting equation.
- Transaction analysis involves three steps:
 - Step 1: Write down the accounting equation (basic or expanded version).
 - Step 2: Identify the financial statement elements that are affected by the transaction.
 - Step 3: Determine whether the elements increased or decreased.
- Each transaction will have a dual effect on the accounting equation, and the accounting equation will remain in balance after the effects of the transaction are recorded.

LO4. Discuss the role of accounts and show how debits and credits are used in the double-entry accounting system using T-accounts.

- An account is a record of increases and decreases in each of the basic elements of the financial statements.
- Each financial statement element is made up of a number of different accounts.
- All transactions are recorded into accounts.
- The final account balance, after all changes are recorded, is used in the preparation of the financial statements.
- The left side of an account is referred to as a debit. The right side of an account is referred to as a credit.
- All accounts have a normal balance, which is a positive account balance. Assets, expenses, and dividends have a normal debit balance. Liabilities, shareholders' equity, and revenues have a normal credit balance.

- Increases or decreases to an account are based on the normal balance of an account. Normal debit balance accounts (assets, expenses, and dividends declared) are increased with debits and decreased with credits. Normal credit balance accounts (liabilities, equity, and shareholders' equity) are increased with credits and decreased with debits.

LO5. Prepare journal entries for transactions.

- This is Step 2 of the accounting cycle.
- A journal entry represents the debit and credit effects of a transaction in the accounting records.
- A journal entry is prepared by following three steps:
 - Step 1: Analyzing the transaction.
 - Step 2: Determining which accounts are affected.
 - Step 3: Using the debit and credit procedures to record the effects of the transaction.
- A journal entry is recorded in chronological order and consists of the date of the transaction, the accounts affected, the amount of the transaction, and a brief explanation.

LO6. Explain why transactions are posted to the general ledger.

- This is Step 3 of the accounting cycle.
- To overcome the difficulty of determining account balances listed chronologically in the journal, information in the journal is transferred to the general ledger in a process called posting.
- As a result of posting, the general ledger accumulates the effects of transactions in individual financial statement accounts.

LO7. Prepare a trial balance and explain its purpose.

- This is Step 4 of the accounting cycle.
- The trial balance is a list of all active accounts, in the order they appear in the ledger (assets first, followed by liabilities, shareholders' equity, revenue, and expenses), and each account's debit or credit balance.
- The trial balance is used to prove the equality of debits and credits and helps uncover errors in journalizing or posting transactions.
- The trial balance is a useful tool in preparing the financial statements.

CORNERSTONES

Cornerstone 2.1	<i>Applying the conceptual framework</i>
Cornerstone 2.2	<i>Performing transaction analysis</i>
Cornerstone 2.3	<i>Determining increases or decreases to a statement of financial position account</i>
Cornerstone 2.4	<i>Determining increases or decreases to revenues, expenses, and dividends declared</i>
Cornerstone 2.5	<i>Preparing a journal entry</i>
Cornerstone 2.6	<i>Preparing a trial balance</i>

CHAPTER OUTLINE

Discussion Question: After students read the opening George Weston Limited scenario, ask them whether a company should maintain a single accounting system for its diversified

business. Also ask them how easy or difficult it is to maintain an accounting system and what measures could be taken to keep the accounting system error free.

1. FUNDAMENTAL ACCOUNTING CONCEPTS

Reviewing financial statements means assessing a company's performance, cash flows, and financial position, which in turn is called the accounting cycle.

The *accounting cycle* is a simple and orderly process, based on a series of steps and conventions. Proper operation of the accounting cycle is essential in order to present the effects of a company's activities.

A. The Conceptual Framework

To make it easier to use financial statements over time and across companies, a common set of rules and conventions has been developed to guide the preparation of financial statements called Generally Accepted Accounting Principles (GAAP).

GAAP rests on a conceptual framework of accounting that derives from the fundamental objective of financial reporting, which is to provide information that is useful in making business and economic decisions.

The conceptual framework is designed to support the development of accounting standards and to provide a consistent body of thought for financial reporting that will help in understanding complex accounting standards by providing a logical structure to financial accounting.

B. Qualitative Characteristics of Useful Information

Relevance and faithful representation (the enhancing characteristics are comparability, verifiability, timeliness, and understandability). Two pervasive constraints are cost and prudence constraints.

C. Assumptions

Separate entity assumption, continuity (or going concern) assumption, periodicity (or time-period) assumption, and unit of measure (or monetary unit) assumption.

D. Principles

Historical cost principle, revenue recognition principle, full disclosure principle, and prudence (conservatism) principle.

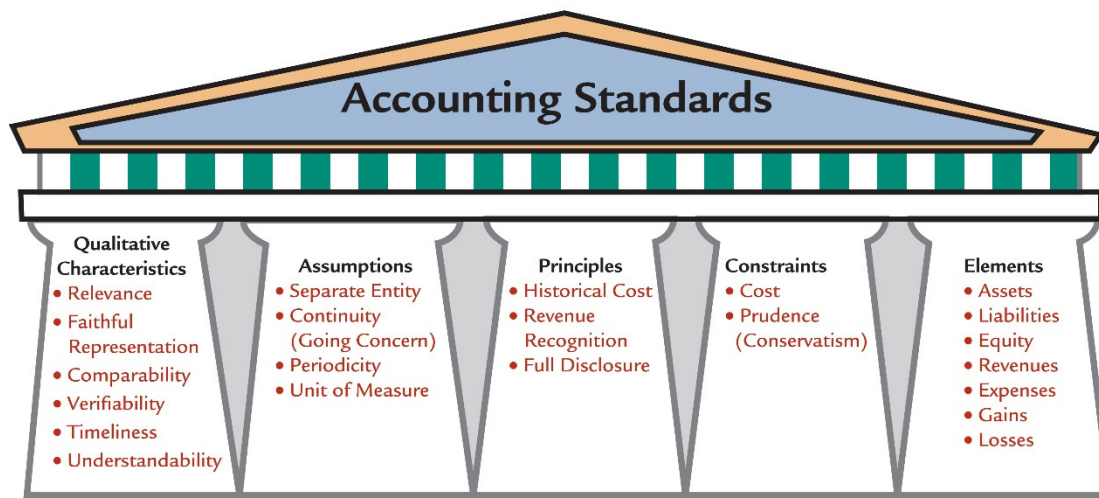
E. Elements of the Financial Statements

- **Assets**—Assets are economic resources of a business entity that are controlled by a business entity and are expected to provide a future benefit.
- **Liabilities**—Liabilities are existing obligations or debts of a business entity that will be satisfied by payment with assets or the provision of services.
- **Equity**—Shareholders' equity in a corporation consists of the capital provided to the company by its shareholders combined with undistributed earnings of the company.

The elements of revenues, expenses, gains, and losses are discussed in Chapters 3 and 4.

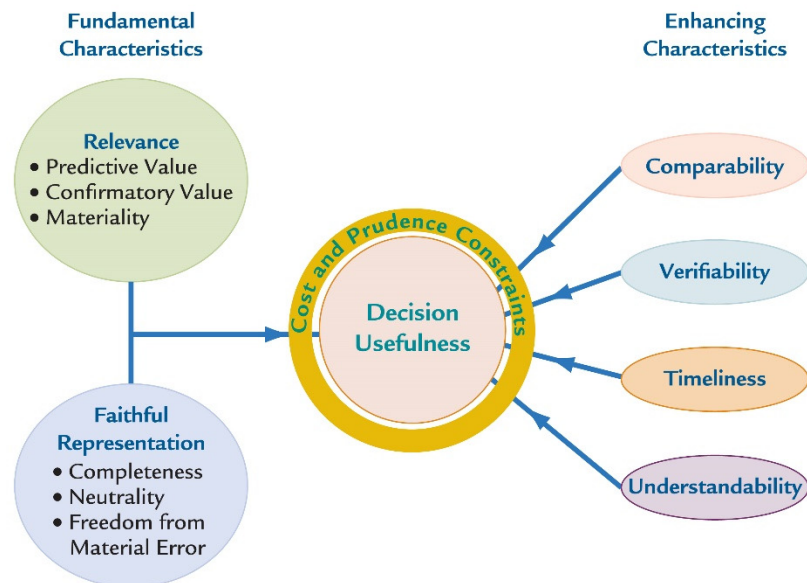
(EXHIBIT 2.1)

The Conceptual Framework



(EXHIBIT 2.2)

Qualitative Characteristics of Accounting Information



© Cengage Learning

Cornerstone 2.1: Applying the Conceptual Framework

The Cornerstones can be implemented in your classes in several different ways:

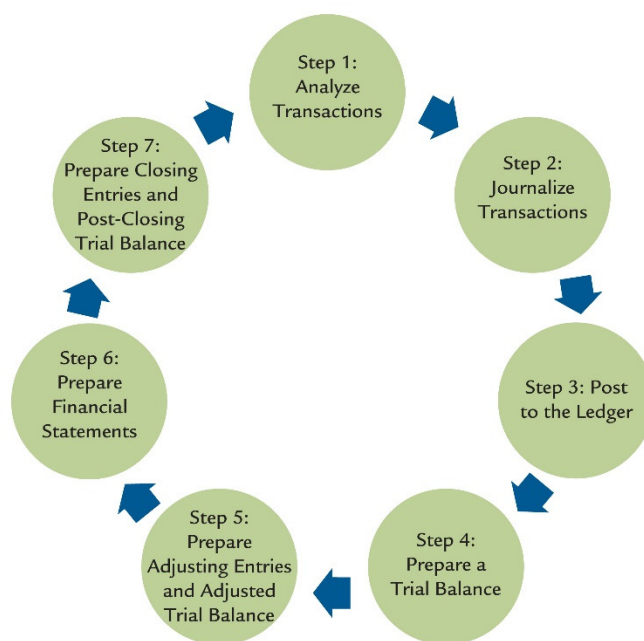
1. Demonstrate Cornerstone 2.1 in the *Cornerstones* text as an example in class.
2. Use Exercises 2-18, 2-19, 2-20, and 2-21 as demo, in-class exercises. Students can work the exercises individually or in teams.
3. Discuss Concept Q&A. Companies assume they are going concerns. Wouldn't the valuation of a company's assets be more relevant if this assumption were relaxed and the net assets valued at their current selling values?

2. MEASURING BUSINESS ACTIVITIES: THE ACCOUNTING CYCLE

The accounting cycle is a sequence of procedures used by companies to transform the effects of business activities into financial statements.

The Accounting Cycle

EXHIBIT 2.3



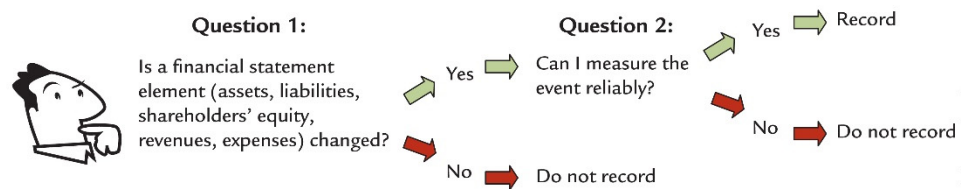
A. Economic Events

An objective of accounting is to measure the effects of events that influence a company and incorporate these events into the accounting system and, ultimately, the financial statements. However, not every event that affects a company is recorded in the accounting records.

For an event to be recorded, or recognized, in the accounting system, the items making up the event must have an impact on a financial statement element (asset, liability, shareholders' equity, revenue, or expense) and be a faithful representation of the event.

EXHIBIT 2.4

Transaction Identification



B. The Expanded Basic Accounting Equation

EXHIBIT 2.5

The Expanded Accounting Equation

$$\begin{aligned}
 &\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity} \\
 &\text{Assets} = \text{Liabilities} + \text{Share Capital} + \text{Retained Earnings} \\
 &\text{Assets} = \text{Liabilities} + \text{Share Capital} + \text{Beginning Retained Earnings} + \text{Revenues} - \text{Expenses} - \text{Dividends Declared}
 \end{aligned}$$

3. STEP 1: ANALYZE TRANSACTIONS

Transaction analysis is the process of determining the economic effects of a transaction on the elements of the accounting equation. It usually begins with the gathering of source documents that describe business activities.

Source documents can be internally or externally prepared and include items such as purchase orders, cash register tapes, and invoices. After gathering the source documents, accountants must analyze these business activities to determine which transactions meet the criteria for recognition in the accounting records.

For a transaction to be recorded in the accounting records it must be reliably measured and must affect a financial statement element.

Two underlying principles of transaction analysis:

1. There was a dual effect on the accounting equation.
2. The accounting equation remained in balance (assets equalled liabilities plus shareholders' equity after the transaction).

Cornerstone 2.2: Performing Transaction Analysis

The Cornerstones can be implemented in your classes in several different ways:

1. Demonstrate Cornerstone 2.2 in the *Cornerstones* text as an example in class.
2. Use Exercises 2-22, 2-23, and 2-24 as demo, in-class exercises. Students can work the exercises individually or in teams.

4. DOUBLE-ENTRY ACCOUNTING

Describes the system used by companies to record the effects of transactions on the accounting equation. Effects of transactions are recorded in accounts; each transaction affects at least two accounts.

In this section, we will explore accounts and the process by which transactions get reflected in specific accounts.

A. Accounts

An account is a record of increases and decreases in each of the basic elements of the financial statements.

The list of accounts used by the company is termed a chart of accounts.

(EXHIBIT 2.7)

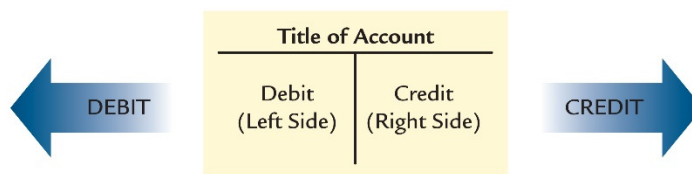
Typical Accounts

Assets	Liabilities	Shareholders' Equity	Revenue	Expense
Cash	Accounts Payable	Common Shares	Sales Revenue	Cost of Goods Sold
Investments	Salaries Payable	Preferred Shares	Interest Income	Salary Expense
Accounts Receivable	Unearned Sales Revenue	Retained Earnings	Dividend Revenue	Rent Expense
Inventory	Interest Payable	Dividends Declared	Rent Revenue	Insurance Expense
Land	Income Tax Payable			Depreciation Expense
Buildings	Notes Payable			Advertising Expense
Equipment	Bonds Payable			Utilities Expense
Patent				Repairs & Maintenance Expense
Copyright				Property Tax Expense
Goodwill				

© Cengage Learning

(EXHIBIT 2.8)

Form of a T-Account



© Cengage Learning

B. Debit and Credit Procedures

Using the accounting equation, we can incorporate debits and credits in order to determine how balance sheet accounts increase or decrease. This procedure is shown in Cornerstone 2.3.

Cornerstone 2.3: Determining Increases or Decreases to a Statement of Financial Position Account

The Cornerstones can be implemented in your classes in several different ways:

1. Demonstrate Cornerstone 2.3 in the *Cornerstones* text as an example in class.
2. Use Exercise 2-25 as a demo, in-class exercise. Students can work the exercise individually or in teams.
3. Discuss Concept Q&A. Why must the accounting equation always remain in balance?

Cornerstone 2.4: Determining Increases or Decreases to Revenues, Expenses, and Dividends Declared

The Cornerstones can be implemented in your classes in several different ways:

1. Demonstrate Cornerstone 2.4 in the *Cornerstones* text as an example in class.
 2. Use Exercise 2-25 as a demo, in-class exercise. Students can work the exercise individually or in teams.
-

5. STEP 2: JOURNALIZE TRANSACTIONS

A journal is a chronological record showing the debit and credit effects of transactions on a company.

The process of making a journal entry is often referred to as journalizing a transaction. Because a transaction first enters the accounting records through journal entries, the journal is often referred to as the book of original entry.

A journal entry consists of three parts:

1. Date of the transaction
 2. Accounts and amounts to be increased or decreased
 3. A brief explanation of the transaction
-

Cornerstone 2.5: Preparing a Journal Entry

The Cornerstones can be implemented in your classes in several different ways:

1. Demonstrate Cornerstone 2.5 in the *Cornerstones* text as an example in class.
 2. Use Exercises 2-26 and 2-27 as demo, in-class exercises. Students can work the exercises individually or in teams.
 3. Discuss Concept Q&A. On a bank statement, a credit to a person's account means the account has increased. Similarly, a debit means the account has decreased. Why don't credit and debit always mean "add" and "subtract"?
-

6. STEP 3: POST TO THE LEDGER

A general ledger is a collection of all the individual financial statement accounts that a company uses. In a manual accounting system, a ledger could be as simple as a notebook with a separate page for each account.

Ledger accounts are often shown using the T-account format or the column-balance format. The process of transferring the information from the journalized transaction to the general ledger is called posting.

7. STEP 4: PREPARE A TRIAL BALANCE

To aid in the preparation of financial statements, some companies will prepare a trial balance before they prepare financial statements.

It is a list of all active accounts and each account's debit or credit balance. The accounts are listed in the order they appear in the ledger—assets first, then liabilities, shareholders' equity, revenues, and expenses.

It is used to prove the equality of debits and credits. If debits did not equal credits, the accountant would quickly know that an error had been made.

Cornerstone 2.6: Preparing a Trial Balance

The Cornerstones can be implemented in your classes in several different ways:

1. Demonstrate Cornerstone 2.6 in the *Cornerstones* text as an example in class.
 2. Use Exercise 2-28 as a demo, in-class exercise. Students can work the exercise individually or in teams.
-

ANALYTICAL THINKING

Extra analytical thinking exercises for the chapter that may be directed to the students for discussion include the following:

- Why do we need a conceptual framework in accounting?
 - *The conceptual framework can be defined as “a coherent system of interrelated objectives and fundamentals that is expected to lead to consistent standards.” It is not the rules but guidelines. The “accounting rules” are set in the accounting standards, which are formulated from the framework but take precedence over the framework when there is a conflict of interpretation. The conceptual framework also assists preparers in analyzing new transactions where there is not a particular standard to guide users on the proper treatment of the situation.*
- Define a transaction and give an example of each of the two types of events that are considered to be transactions.
 - *A transaction is an exchange or event that has a direct and measurable financial effect on the assets, liabilities, or shareholders' equity of a business. A transaction is recorded in the accounting records of the company if it changes a financial statement element (assets, liabilities, shareholders' equity, revenues, expenses), and if the transaction/event can be reliably measured. Transactions include two different types of events: (1) external exchanges and (2) internal events. An example of an external exchange is the sale of goods or services to customers or the purchase of goods or services from suppliers. An example of an internal event is the company using up the benefits of assets owned by the company such as equipment through the recording of depreciation.*
- What is meant by the term *double-entry accounting system*?
 - *Because there are two or more accounts affected by every transaction, the accounting system is referred to as double-entry accounting.*
- To obtain financing for her expanding massage therapy practice, Trudy asked you to prepare a statement of financial position for her business. When she sees it, she is disappointed that you did not include a value for the list of loyal, long-term, valuable, and repeat customers who use her massage therapy services regularly. She demands that

you explain why this “asset” has been omitted from the statement of financial position. What should you tell her? Also, knowing this, what should she tell her banker in the meeting that they have scheduled for next week?

- *Because the customer list was not purchased by her massage therapy (it was developed internally over many years of business operation), her massage therapy business does not report it on the statement of financial position. Knowing this, she should be sure to advise her banker that the massage therapy practice has established a loyal group of customers that holds considerable value for generating future service revenues (but is excluded from the statement of financial position for accounting reasons since it was internally generated over time and it would be difficult to obtain an objective, reliable, and verifiable value for the loyal customer list).*
- Faizon believes that the term *debit* means increase and *credit* means decrease. Is Faizon correct?
 - *In accounting terms, debit means “left” side of the T-account and credit means “right” side of the T-account. Assets and expenses have a normal debit balance, whereas liabilities, shareholders’ equity, and revenues have a normal credit balance. The accounts increase when a transaction is posted on their “normal” balance side, and decrease when a transaction is posted on the other side.*
- Mohammad was reviewing the steps in the accounting cycle and suggested eliminating the general journal and recording and summarizing transactions directly into the general ledger instead, as it seemed like a duplication of effort. Comment on this suggestion.
 - *This would not be efficient because the journal provides a record that shows both “sides” of the transaction along with a description of the transaction. This information is essential to the understanding of the transaction. Furthermore, in practice, if there is a large volume of transactions, a company will not post individual transactions to the general ledger; instead, totals of transactions will be posted as batches or groups of transactions so that the detail can only be seen in the journals.*
- If total debits do not equal total credits on the trial balance, list some of the errors that may have occurred.
 - *Some errors that may cause total debits to not equal credits on a trial balance are preparing unbalanced journal entries, posting the correct dollar amount of a transaction from the journal entry to the T-account/general ledger account, errors in calculating the ending balance in an account after posting the transactions, errors in copying the ending balance of an account from the general ledger to the trial balance, and errors in calculating the sum of total debits and total credits in the trial balance.*

APPLICATIONS

Applications for the chapter include the following:

- A. *In-Class Group Practice Tests.* See the end-of-chapter multiple-choice questions provided in the text for an in-class, group test or for use with a personal response system. With a group test, each student takes the quiz or test individually. Then ask students to break into teams of four or five to grade the test and discuss answers.

- B. *End-of-Chapter Exercises, Problems, and Cases.* See the end-of-chapter exercises, problems, and cases provided in the text to further enhance the concepts demonstrated in the chapter.



Chapter 2: **The Accounting** **Information System and Financial** **Statements**

*Cornerstones of Financial Accounting,
Second Canadian Edition*

Learning Objectives

1. Describe the qualitative characteristics, assumptions, principles, and constraints that underlie accounting.
2. Explain the relationships among economic events, transactions, and the expanded basic accounting equation.
3. Analyze the effect of business transactions on the basic accounting equation.
4. Discuss the role of accounts and how debits and credits are used in the double-entry accounting system.
5. Prepare journal entries for transactions.
6. Explain why transactions are posted to the general ledger.
7. Prepare a trial balance and explain its purpose.



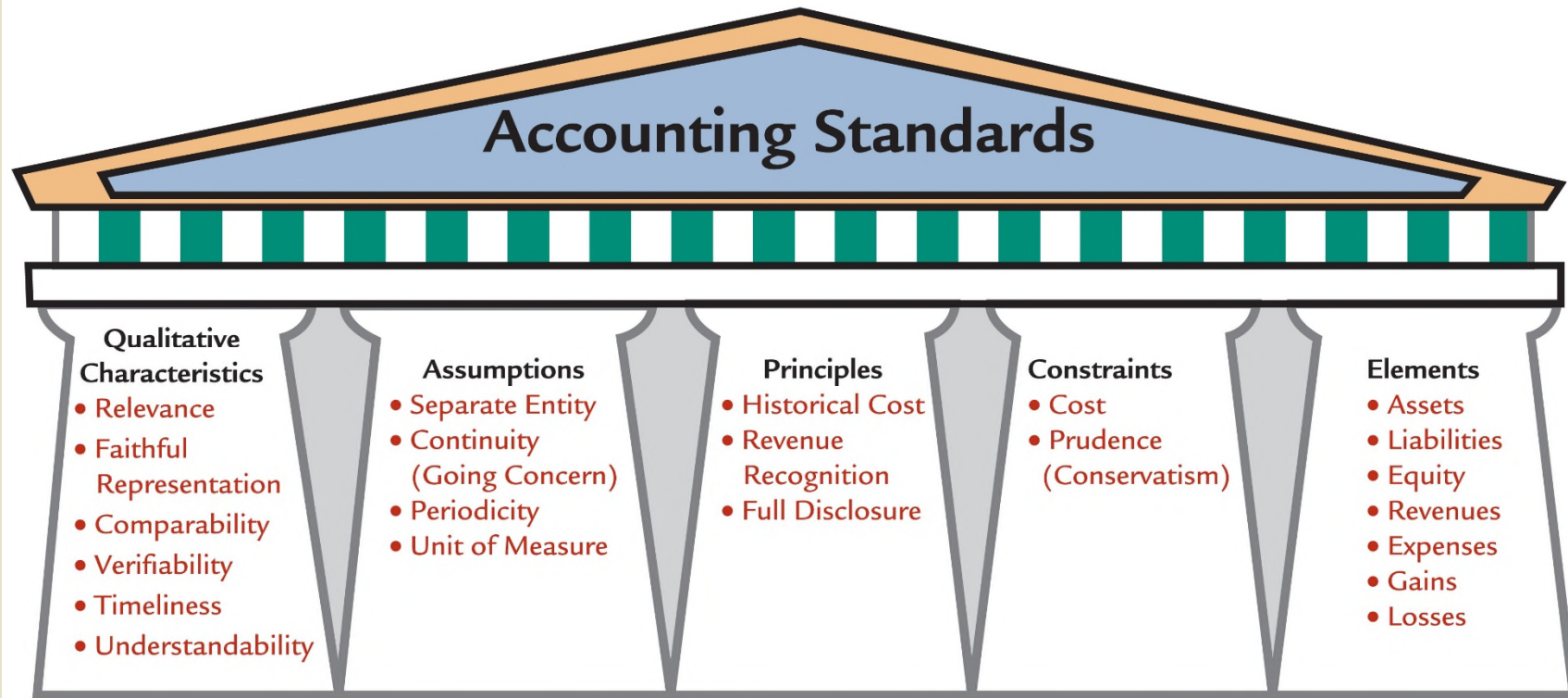
Fundamental Accounting Concepts

In this chapter, we will begin the discussion of the accounting cycle and how the completion of each step of the accounting cycle moves the accounting system toward its end product—the financial statements. We will address the following questions in this discussion:

- ▶ What concepts and assumptions underlie accounting information?
- ▶ How do companies record business activities?
- ▶ What procedures are involved in transforming information about business activities into financial statements?
- ▶ How do business activities affect the financial statements?



Conceptual Framework





Qualitative Characteristics of Useful Information

- ▶ Given the overall objectives of providing useful information, there are **two fundamental characteristics** that useful information should possess—relevance and faithful representation.
 - ▶ **Relevance:** Information is relevant if it is capable of making a difference in a business decision by helping users predict future events (predictive value) or providing feedback about prior expectations (confirmatory value). Materiality is also an aspect of relevance.
 - ▶ **Faithful representation:** Accounting information should be a faithful representation of the real-world economic event that it is intending to portray. Faithfully represented information should be complete (includes all necessary information for the user to understand the economic event), neutral (unbiased), and free from error (as accurate as possible).



Four Enhancing Characteristics

1. **Comparability:** Comparable information allows external users to identify similarities and differences between two or more items. Included within comparability is consistency. **Consistency** can be achieved by a company applying the same accounting principles for the same items over time.
2. **Verifiability:** Information is verifiable when independent parties can reach a consensus on the measurement of the activity.
3. **Timeliness:** Information is timely if it is available to users before it loses its ability to influence decisions.
4. **Understandability:** If users who have a reasonable knowledge of accounting and business can, with reasonable study effort, comprehend the meaning of the information, it is considered understandable.

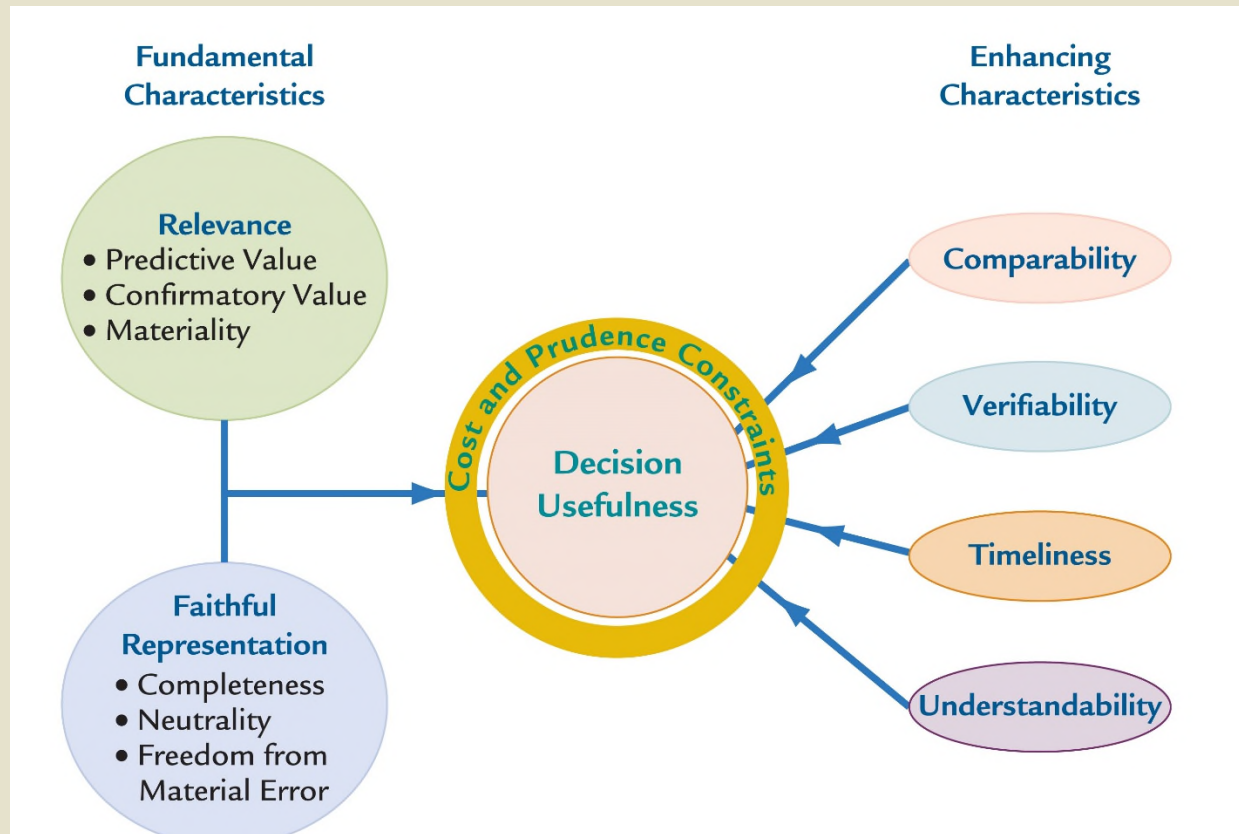


Four Enhancing Characteristics (Continued)

- ▶ Enhancing characteristics should be maximized to the extent possible.
- ▶ These qualitative characteristics are bound by two pervasive constraints—the cost and prudence (conservatism) constraints.
- ▶ The **cost constraint** states that the benefit received from accounting information should be greater than the cost of providing that information.
- ▶ The **prudence constraint** states that extra care should be taken to ensure that assets and revenues are not overstated and that liabilities and expenses are not understated.
- ▶ If the cost exceeds the benefit, the information is not considered useful.



Qualitative Characteristics of Accounting Information





The Four Basic Assumptions Underlying Accounting

1. **Separate entity assumption:** Under this assumption, each company is accounted for separately from its owners.
2. **Continuity (or going-concern) assumption:** This assumption assumes that a company will continue to operate long enough to carry out its existing commitments.
3. **Periodicity or time period assumption:** This assumption allows the life of a company to be divided into artificial time periods so that net income can be measured for a specific period of time (e.g., monthly, quarterly, annually).
4. **Unit-of-measure assumption:** This assumption requires that a company account for and report its financial results in the national monetary unit which is assumed to have a constant purchasing power over time (such as Canadian dollar, euro, Japanese yen).



Accounting Principles

- ▶ Accounting principles are general approaches that are used in the measurement and recording of business activities.
- ▶ The three basic principles of accounting are as follows:
 1. **Historical cost principle:** This principle requires that the activities of a company are initially measured at their cost—the exchange price at the time the activity occurs.
 2. **Revenue recognition principle:** This principle is used to determine when revenue is recorded and reported.
 3. **Full disclosure principle:** This principle requires that financial statements include all information required for the financial statement users to make informed decisions about the company's financial position, operating results, and cash flows.





Cornerstone 2-1

Applying the Conceptual Framework

Information:

Mario is faced with the following questions as he prepares the financial statements of DK Company:

1. Should the purchase of inventory be valued at what DK paid to acquire the inventory or at its estimated selling price?
2. Should information be provided that financial statement users might find helpful in predicting DK's future income?
3. Although DK is profitable, should the financial statements be prepared under the assumption that DK will go bankrupt?
4. Should DK's inventory be reported in terms of the number of units on hand or the dollar value of those units?
5. Should equipment leased on a long-term basis be reported as an asset (the economic substance of the transaction) or should it be reported as a rental (the form of the transaction)?
6. Should DK recognize revenue from the sale of its products when the sale is made or when the cash is received?
7. Should DK record the purchase of a vacation home by one of its shareholders?
8. Should DK report income annually to its shareholders, or should it wait until all transactions are complete?

Required:

Which qualitative characteristic, assumption, or principle should Mario use in resolving the situation?

Why:

The conceptual framework provides a logical structure and direction to financial accounting and reporting and supports the development of a consistent set of accounting standards. An understanding of the conceptual framework is required to analyze complex accounting issues.





Cornerstone 2-1

Applying the Conceptual Framework (Continued)

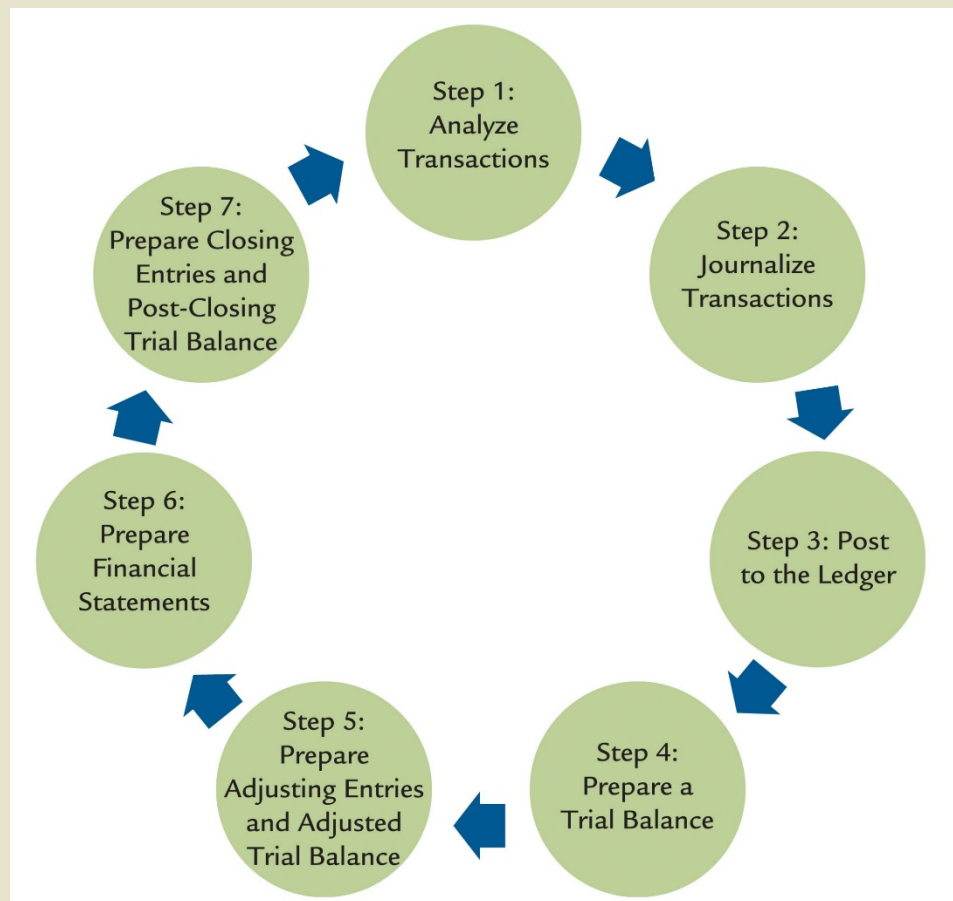
Solution:

1. *Historical cost:* The activities of a company (such as purchase of inventory) should be initially measured at the exchange price at the time the activity occurs.
2. *Relevance:* Material information that has predictive or confirmatory value should be provided.
3. *Continuity (going-concern):* In the absence of information to the contrary, it should be assumed that a company will continue to operate indefinitely.
4. *Monetary unit:* A company should account for and report its financial results in its national monetary unit.
5. *Faithful representation:* Information should portray the economic event that it is intending to portray completely, accurately, and without bias.
6. *Revenue recognition:* Revenue must satisfy five conditions (discussed in Chapter 7) before it can be recognized.
7. *Separate entity:* A company's transactions should be accounted for separately from its owners.
8. *Time period:* The life of a company can be divided into artificial time periods so that income can be measured and reported periodically to interested parties.





Measuring Business Activities: The Accounting Cycle





Economic Events

- ▶ A company engages in numerous activities that can be categorized as financing, investing, or operating activities.
- ▶ Each of these activities consists of different **events** that affect the company.
- ▶ Some of these events are external, resulting from exchanges between the company and another entity outside of the company, and some are internal or due to the company's own actions.
- ▶ Not every event that affects a company is recorded in the accounting records.
- ▶ In order for an event to be recorded, or recognized, in the accounting system, the items making up the event must impact a financial statement element (asset, liability, shareholders' equity, revenue, or expense) and should be a faithful representation of the event.



Transaction Identification

Question 1:



Is a financial statement element (assets, liabilities, shareholders' equity, revenues, expenses) changed?



Yes



No



Question 2:

Can I measure the event reliably?



Yes



Record



No



Do not record





Expanded Accounting Equation

► A starting point in the measurement and recording process is the fundamental accounting equation:

Assets = Liabilities + Shareholders' Equity

Assets = Liabilities + Share Capital + Retained Earnings

Assets = Liabilities + Share Capital + Retained Earnings + Revenues – Expenses – Dividends Declared





You Decide

Recognition of Economic Events

As you are analyzing the most recent financial statements of Essex Oil Company, you question whether the company properly recorded an economic event. You know that Essex owns and operates several offshore oil drilling platforms in the Gulf of Mexico. You also recall from news reports that a hurricane severely damaged two of the platforms, leading to a significant loss in revenue while the platforms were inactive. While you see evidence in the financial statements of the damage and repair to the platforms, you cannot find any evidence of the lost revenue in the financial statements.

Does the loss in revenue from the damaged oil platforms qualify for recognition in the financial statements?

To be recognized in the financial statements, the event must impact a financial statement element and be faithfully represented.

While Essex may have been able to measure the loss in revenue, no financial statement element has been affected. While you may argue that this event affected revenue, revenue is an increase in assets resulting from the sale of products. Because the lost sales did not result in an inflow of assets or reduce liabilities, it is not considered revenue. In addition, expenses are defined as the cost of resources used or liabilities incurred to earn revenues. The lost revenue did not represent a use of resources, nor did it result in a liability being incurred and it is therefore not an expense. Therefore the lost revenue cannot be recognized in the financial statements.

Recognition of events in the financial statements requires analysis of whether the event impacted a financial statement element and can be faithfully represented.





Step 1:

Analyze Transactions

- ▶ **Transaction analysis** is the process of determining the economic effects of a transaction on the elements of the basic accounting equation.
- ▶ Transaction analysis involves three steps:
 1. Write down the basic accounting equation.
 2. Identify the financial statement elements that are affected by the transaction.
 3. Determine whether the elements increased or decreased.



Cornerstone 2-2

Performing Transaction Analysis

Performing Transaction Analysis

Information:

Lee Inc. purchases a \$3,000 computer from Bay Electronics on credit, with payment due in 60 days.

Required:

Determine the effect of the transaction on the elements of the accounting equation.

Why:

The economic effect of a transaction will have a two-part, or dual, effect on the basic accounting equation that results in the equation always being in balance. The basic accounting equation must remain in balance after each transaction to facilitate the preparation of accurate financial statements.

Solution:

A computer is an economic resource, or asset, that will be used by Lee in its business. The purchase of the computer increased assets and also created an obligation, or liability, for Lee. Therefore, the effect of the transaction on the accounting equation is as follows:

Assets	=	Liabilities	+	Shareholders' Equity	
				Share Capital	Retained Earnings
+\$3,000		+\$3,000			





Transaction 1: Issuing Common Shares

- ▶ On March 1, HighTech sold 1,000 shares of common shares to several investors for cash of \$12,000. The effect of this transaction on the accounting equation is:

Assets	=	Liabilities	+	Shareholders' Equity	
				Share Capital	Retained Earnings
+\$12,000				+\$12,000	





Transaction 2: Borrowing Cash

- ▶ On March 2, HighTech raised additional funds by borrowing \$3,000 from the Royal Bank in Winnipeg. HighTech promised to pay the amount borrowed plus 8% interest to Royal Bank in one year.

Assets	=	Liabilities	+	Shareholders' Equity	
				Share Capital	Retained Earnings
+\$3,000		+\$3,000			





Transaction 3:

Purchase of Equipment for Cash

- ▶ On March 3, HighTech purchased office equipment (such as computer equipment) from MicroCentre Inc. for \$4,500 in cash. The effect of this transaction on the accounting equation is:

Assets	=	Liabilities	+	Shareholders' Equity	
				Share Capital	Retained Earnings
+\$4,500					
-\$4,500					





Transaction 4: Purchasing Insurance

- ▶ On March 4, HighTech purchased a six-month insurance policy for \$1,200 cash. The effect of this transaction on the accounting equation is:

Assets	=	Liabilities	+	Shareholders' Equity	
				Share Capital	Retained Earnings
+\$1,200					
-\$1,200					





Transaction 5: Purchase of Supplies on Credit

- ▶ On March 6, HighTech purchased office supplies from Hamilton Office Supply for \$6,500. Hamilton Office Supply agreed to accept full payment in 30 days.
- ▶ As a result of this transaction, HighTech received an asset (supplies) but also incurred a liability to pay for these supplies in 30 days.

Assets	=	Liabilities	+	Shareholders' Equity	
				Share Capital	Retained Earnings
+\$6,500		+\$6,500			





Transaction 6: Sale of Services for Cash

- ▶ On March 10, HighTech sold advertising services to Regina Valley Products in exchange for \$8,800 in cash.

Assets	=	Liabilities	+	Shareholders' Equity	
				Share Capital	Retained Earnings (Sales Revenue)
+\$8,800					+\$8,800





Transaction 7: Sale of Services for Credit

- ▶ On March 15, HighTech sold advertising services to the *Winnipeg Enquirer* for \$3,300. HighTech agreed to accept full payment in 30 days.

Assets	=	Liabilities	+	Shareholders' Equity	
				Share Capital	Retained Earnings (Sales Revenue)
+\$3,300					+\$3,300





Transaction 8: Receipt of Cash in Advance

- ▶ On March 19, HighTech received \$9,000 from the *Winnipeg News* for advertising services to be completed in the next three months.

Assets	=	Liabilities	+	Shareholders' Equity	
				Share Capital	Retained Earnings
+\$9,000		+\$9,000			





Transaction 9: Payment to a Supplier

- ▶ On March 23, HighTech pays \$6,000 cash for the supplies previously purchased from Hamilton Office Supply on credit in Transaction 5.

Assets	=	Liabilities	+	Shareholders' Equity	
				Share Capital	Retained Earnings
-\$6,000		-\$6,000			





Transaction 10: Payment of Salaries

- ▶ On March 26 (a Friday), HighTech paid weekly employee salaries of \$1,800.

Assets	=	Liabilities	+	Shareholders' Equity	
				Share Capital	Retained Earnings (Salary Expense)
-\$1,800					-\$1,800





Transaction 11: Collection from a Customer

- ▶ On March 29, HighTech collected \$3,000 cash from the *Winnipeg Enquirer* for services sold earlier on credit in transaction 7.

Assets	=	Liabilities	+	Shareholders' Equity	
				Share Capital	Retained Earnings
+\$3,000					
-\$3,000					





Transaction 12: Payment of Utilities

- ▶ On March 30, HighTech paid its utility bill of \$5,200 for March. Because an asset (cash) is consumed by HighTech as part of the operations of the business, the cost of utilities used during the month is an expense.

Assets	=	Liabilities	+	Shareholders' Equity	
				Share Capital	Retained Earnings (Utilities Expense)
-\$5,200					-\$5,200





Transaction 13: Declaration and Payment of a Dividend

- ▶ On March 31, HighTech declared and paid a cash dividend of \$500 to its shareholders.

Assets	=	Liabilities	+	Shareholders' Equity	
				Share Capital	Retained Earnings
-\$500					-\$500





Summary of Transactions

	Assets	=	Liabilities	+	Shareholders' Equity	
					Share Capital	Retained Earnings
(1)	+ \$12,000				+ \$12,000	
(2)	+ \$3,000		+ \$3,000			
(3)	+ \$4,500					
	- \$4,500					
(4)	+ \$1,200					
	- \$1,200					
(5)	+ \$6,500		+ \$6,500			
(6)	+ \$8,800					+ \$8,800
(7)	+ \$3,300					+ \$3,300
						} Revenue
(8)	+ \$9,000		+ \$9,000			
(9)	- \$6,000		- \$6,000			
(10)	- \$1,800					- \$1,800
(11)	+ \$3,000					
	- \$3,000					
						} Expense
(12)	- \$5,200					- \$5,200
(13)	- \$500					- \$500
						} Dividend
	<u>\$29,100</u>		<u>\$12,500</u>		<u>\$12,000</u>	<u>\$4,600</u>
	\$29,100	=			\$29,100	





Double-Entry Accounting

- ▶ **Double-entry accounting** describes the system used by companies to record the effects of transactions on the accounting equation.
- ▶ The effects of transactions are recorded in accounts.
- ▶ Under double-entry accounting, each transaction affects at least two accounts.



Accounts

- ▶ An **account** is a record of increases and decreases in each of the basic elements of the financial statements.
- ▶ The list of accounts used by the company is termed a **chart of accounts**.
- ▶ Below is a typical list of accounts.

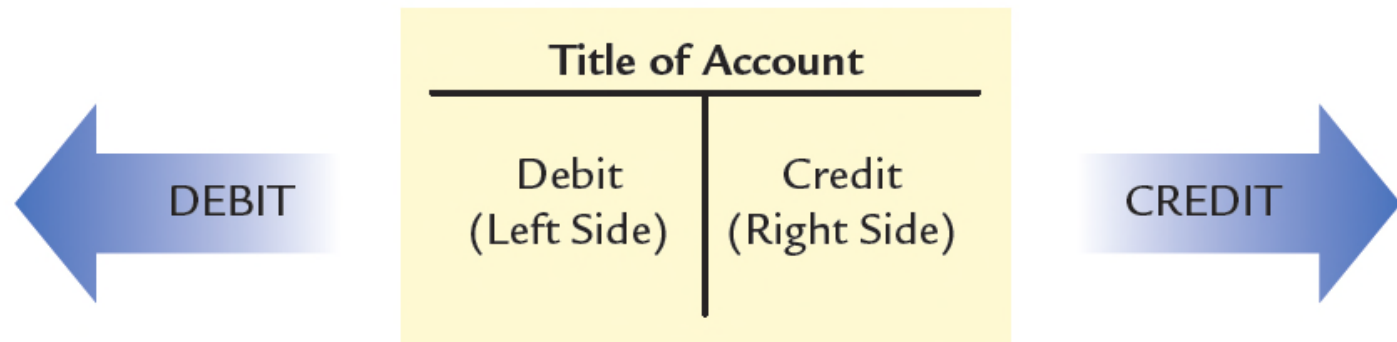
Assets	Liabilities	Shareholders' Equity	Revenue	Expense
Cash	Accounts Payable	Common Shares	Sales Revenue	Cost of Goods Sold
Investments	Salaries Payable	Preferred Shares	Interest Income	Salary Expense
Accounts Receivable	Unearned Sales Revenue	Retained Earnings	Dividend Revenue	Rent Expense
Inventory	Interest Payable	Dividends Declared	Rent Revenue	Insurance Expense
Land	Income Tax Payable			Depreciation Expense
Buildings	Notes Payable			Advertising Expense
Equipment	Bonds Payable			Utilities Expense
Patent				Repairs & Maintenance Expense
Copyright				Property Tax Expense
Goodwill				



T-Account

- ▶ Although an account can be shown in a variety of ways, transactions are frequently analyzed using a **T-account**.
- ▶ The left side is referred to as the **debit** side and the right side is referred to as the **credit** side.

Form of a T-Account





Debit and Credit Procedures

- ▶ Using the basic accounting equation, we can incorporate debits and credits in three steps in order to determine how the statement of financial position accounts increase or decrease.
 1. Step 1: Draw a T-account and label each side of the T-account as either debit (left side) or credit (right side).
 2. Step 2: Determine the normal balance of an account. All accounts have a **normal balance**.
 3. Step 3: Increases or decreases to an account are based on the normal balance of the account.





Cornerstone 2-3

Determining Increases or Decreases to a Statement of Financial Position Account

Information:

The statement of financial position is composed of three fundamental accounts—assets, liabilities, and shareholders' equity.

Required:

Determine how each of the three statement of financial position accounts increases or decreases.

Why:

Increases or decreases to an account are based on the normal balance of the account. Increases or decreases to assets, liabilities, and shareholders' equity must be determined to prepare an accurate statement of financial position.









Cornerstone 2-3

Determining Increases or Decreases to a Statement of Financial Position Account (Continued)

Solution:

- Because assets are located on the left side of the accounting equation, their normal balance is a debit. Therefore, debits will increase assets and credits will decrease assets.
- Because liabilities and shareholders' equity are on the right side of the accounting equation, their normal balance is a credit. Therefore, credits will increase liabilities and shareholders' equity while debits will decrease these accounts.

This is illustrated in the following T-accounts:



Assets		=	Liabilities		+	Shareholders' Equity	
Debit	Credit		Debit	Credit		Debit	Credit
							
Normal Balance				Normal Balance			Normal Balance







Normal Balances of Share Capital and Retained Earnings

- ▶ As shareholders' equity accounts, both share capital and retained earnings have normal credit balances.
- ▶ Because these accounts have normal credit balances, they are increased by credits and decreased by debits.

Share Capital	
Debit	Credit
	
	Normal Balance

Retained Earnings	
Debit	Credit
	
	Normal Balance





Cornerstone 2-4

Determining Increases or Decreases to Revenues, Expenses, and Dividends Declared

Information:

Retained earnings is affected by three accounts—revenues, expenses, and dividends declared.

Required:

Determine how each of these three accounts increases or decreases.

Why:

Increases or decreases to an account are based on the normal balance of the account. Increases or decreases to revenues, expenses, and dividends declared must be determined to prepare an accurate income statement and statement of changes in shareholders' equity.



Cornerstone 2-4

Determining Increases or Decreases to Revenues, Expenses, and Dividends Declared (Continued)

Solution:

- Revenues increase shareholders' equity through retained earnings. Therefore, revenues have a normal credit balance. That means that credits will increase revenues and debits will decrease revenues.
- Expenses decrease shareholders' equity through retained earnings. Therefore, expenses have a normal debit balance. That means that debits will increase expenses and credits will decrease expenses.
- Dividends declared are defined as a distribution of retained earnings. Because dividends declared reduce retained earnings and shareholders' equity, dividends declared have a normal debit balance. That means that debits will increase dividends declared while credits will decrease dividends declared.

These procedures are summarized below.

Revenues	
Debit	Credit
↓	↑
	Normal balance

Expenses	
Debit	Credit
↑	↓
Normal balance	

Dividends Declared	
Debit	Credit
↑	↓
Normal balance	





Summary of Debit and Credit Procedures

ASSETS = LIABILITIES + SHAREHOLDERS' EQUITY

Assets	
Debit	Credit
↑	↓
Normal Balance	

Liabilities	
Debit	Credit
↓	↑
Normal Balance	

Share Capital	
Debit	Credit
↓	↑
Normal Balance	

Retained Earnings	
Debit	Credit
↓	↑
Normal Balance	

Beginning Retained Earnings	
Debit	Credit
↓	↑
Normal Balance	

Revenues	
Debit	Credit
↓	↑
Normal Balance	

Expenses	
Debit	Credit
↑	↓
Normal Balance	

Dividends Declared	
Debit	Credit
↑	↓
Normal Balance	





You Decide

Inferring Activities from T-Accounts

As you examine the accounting records of Weber Inc. you notice that accounts receivable increased from \$4,500 to \$5,200 during the year and that credit sales were \$65,800.

What was the amount of accounts receivable collected?

The primary activities that affect accounts receivable are the sale of goods and services on credit (increases in accounts receivable) and the collection of cash related to these credit sales (decreases in accounts receivable). To help visualize the account activity, prepare a T-account as follows:

Accounts Receivable			
Beginning balance	4,500		
Credit sales	65,800	?	Cash collections
Ending balance	5,200		

Because you know the beginning and ending balances of accounts receivable and the amount of credit sales, you can determine (infer) the cash collections as:

$$\text{Cash collections} = \$4,500 + \$65,800 - \$5,200 = \$65,100$$

An understanding of how business activities affect individual accounts can yield valuable insights into the economic events that occurred during a period.





Step 2: Journalize Transactions

- ▶ A **journal** is a chronological record showing the debit and credit effects of transactions on a company.
- ▶ Each transaction is represented by a **journal entry** so that the entire effect of a transaction is contained in one place.
- ▶ The process of making a journal entry is often referred to as journalizing a transaction.
- ▶ The three parts of a journal entry are:
 1. the date of the transaction
 2. the accounts and amounts to be increased or decreased
 3. a brief explanation of the transaction



Cornerstone 2-5

Preparing a Journal Entry

On January 1, Lee Inc. purchases a \$3,000 computer from Bay Electronics on credit, with payment due in 60 days.

Required:

Prepare a journal entry to record this transaction.

Why:

A journal entry records the effects of a transaction on accounts using debits and credits. Journal entries must accurately reflect increases or decreases to the general ledger accounts in terms of both amount and classification since the general ledger is the source of data used in the preparation of financial statements.

Solution:

First, analyze the transaction using the procedures described in Cornerstone 2.2:

Assets	=	Liabilities	+	Shareholders' Equity	
				Share Capital	Retained Earnings
+\$3,000		+\$3,000			

The purchase of a computer has increased the asset account "Equipment," which is recorded with a debit. In addition, a liability, "Accounts Payable," was created and the increase in this account is recorded with a credit.

Date	Account and Explanation	Debit	Credit
January 1	Equipment	3,000	
	Accounts Payable		3,000
	<i>(Purchased office equipment on credit)</i>		





Other Journal Entry Issues

- ▶ In some instances, more than two accounts may be affected by an economic event.
- ▶ If this occurs, a compound journal entry that affects more than two accounts is made.
- ▶ For example, Lee Inc. purchases a \$3,000 computer from Bay Electronics by paying \$1,000 cash with the remainder due in 60 days. The journal entry would be:

Date	Account and Explanation	Debit	Credit
Jan. 1	Equipment	3,000	
	Cash		1,000
	Accounts Payable		2,000
	<i>(Purchased office equipment for cash and on credit)</i>		





Journal Entries: Transactions 1 & 2

- **Transaction 1:** On March 1, HighTech sold 1,000 shares of common shares to several investors for cash of \$12,000.

Date	Account and Explanation	Debit	Credit
March 1	Cash	12,000	
	Common Shares		12,000
	<i>(Issued common shares)</i>		

Assets	=	Liabilities	+	Shareholders' Equity
+12,000				+12,000

- **Transaction 2:** On March 2, HighTech raised additional funds by borrowing \$3,000 on a one-year, 8% note payable to the Royal Bank in Winnipeg.

Date	Account and Explanation	Debit	Credit
March 2	Cash	3,000	
	Notes Payable		3,000
	<i>(Borrowed cash from bank)</i>		

Assets	=	Liabilities	+	Shareholders' Equity
+3,000		+3,000		





Journal Entries: Transactions 3 & 4

- **Transaction 3:** On March 3, HighTech purchased office equipment (computer equipment) from MicroCentre Inc. for \$4,500 in cash.

Date	Account and Explanation	Debit	Credit	
March 3	Equipment	4,500		Assets = Liabilities + Shareholders' Equity
	Cash		4,500	+4,500
	(Purchased equipment)			-4,500

- **Transaction 4:** On March 4, HighTech purchased a six-month insurance policy for \$1,200 in cash.

Date	Account and Explanation	Debit	Credit	
March 4	Prepaid Insurance	1,200		Assets = Liabilities + Shareholders' Equity
	Cash		1,200	+1,200
	(Purchased insurance in advance)			-1,200





Journal Entries: Transactions 5 & 6

- **Transaction 5:** On March 6, HighTech purchased office supplies from Hamilton Office Supply for \$6,500. Hamilton Office Supply agreed to accept full payment in 30 days.

Date	Account and Explanation	Debit	Credit	Assets = Liabilities + Shareholders' Equity
March 6	Supplies Accounts Payable <i>(Purchased supplies on account)</i>	6,500	6,500	+6,500 +6,500

Transaction 6: On March 10, HighTech sold advertising services to Regina Valley Products in exchange for \$8,800 in cash.

Date	Account and Explanation	Debit	Credit	Assets = Liabilities + Shareholders' Equity
March 10	Cash Service Revenue <i>(Sold advertising services)</i>	8,800	8,800	+8,800 +8,800





Journal Entries: Transactions 7 & 8

- **Transaction 7:** On March 15, HighTech sold advertising services to the *Winnipeg Enquirer* for \$3,300. HighTech agreed to accept full payment in 30 days.

Date	Account and Explanation	Debit	Credit											
March 15	Accounts Receivable Service Revenue <i>(Sold advertising services)</i>	3,300	3,300											
				<table><tr><td>Assets</td><td>=</td><td>Liabilities</td><td>+</td><td>Shareholders' Equity</td></tr><tr><td>+3,300</td><td></td><td></td><td></td><td>+3,300</td></tr></table>	Assets	=	Liabilities	+	Shareholders' Equity	+3,300				+3,300
Assets	=	Liabilities	+	Shareholders' Equity										
+3,300				+3,300										

- **Transaction 8:** On March 19, HighTech received \$9,000 in advance for advertising services to be completed in the next three months.

<table><tr><td>Assets</td><td>=</td><td>Liabilities</td><td>+</td><td>Shareholders' Equity</td></tr><tr><td>+9,000</td><td></td><td>+9,000</td><td></td><td></td></tr></table>					Assets	=	Liabilities	+	Shareholders' Equity	+9,000		+9,000			Date	Account and Explanation	Debit	Credit
Assets	=	Liabilities	+	Shareholders' Equity														
+9,000		+9,000																
					March 19	Cash	9,000											
						Unearned Service Revenue		9,000										
						<i>(Sold advertising services in advance)</i>												





Journal Entries: Transactions 9 & 10

- **Transaction 9:** On March 23, HighTech paid \$6,000 cash for the supplies previously purchased from Hamilton Office Supply (transaction 5).

Assets = Liabilities + Shareholders' Equity			Date	Account and Explanation	Debit	Credit
Assets	=	Liabilities +	March 23	Accounts Payable	6,000	
-6,000		-6,000		Cash		6,000
				(Paid accounts payable)		

- **Transaction 10:** On March 26, HighTech paid employees their weekly salary of \$1,800 cash.

Assets = Liabilities + Shareholders' Equity (Salary Expense)			Date	Account and Explanation	Debit	Credit
Assets	=	Liabilities +	March 26	Salaries Expense	1,800	
-1,800		-1,800		Cash		1,800
				(Paid employee salaries)		



Journal Entries: Transactions 11 & 12

- **Transaction 11:** On March 29, HighTech collected \$3,000 cash from the *Winnipeg Enquirer* for services sold earlier on credit (transaction 7).

Assets = Liabilities + Shareholders' Equity			Date	Account and Explanation	Debit	Credit
+3,000			March 29	Cash	3,000	
-3,000				Accounts Receivable		3,000
				(Collected accounts receivable)		

- **Transaction 12:** On March 30, HighTech paid its utility bill of \$5,200 for March.

Assets = Liabilities + Shareholders' Equity (Utilities Expense)			Date	Account and Explanation	Debit	Credit
-5,200			March 30	Utilities Expense	5,200	
				Cash		5,200
				(Paid for utilities used)		





Journal Entries: Transaction 13

- **Transaction 13:** On March 31, HighTech declared and paid a cash dividend of \$500 to its shareholders.

Assets	=	Liabilities	+	Shareholders' Equity
-500				-500

Date	Account and Explanation	Debit	Credit
March 31	Dividends	500	
	Cash		500
	<i>(Declared and paid a cash dividend)</i>		





You Decide

Detecting Journal Entry Errors

You have been asked to inspect a delivery company's journal. Upon doing so, you find the following entry:

Date	Account and Explanation	Debit	Credit
June 29	Equipment, Delivery Truck	11,000	
	Prepaid Rent		11,000
	<i>(Purchased delivery truck)</i>		

Is this journal entry correct?

Because delivery trucks cannot be exchanged for prepaid rent, you conclude that an error was made in preparing this journal

entry. Given the explanation contained in the journal entry, it's likely that the error was in the credit side of the entry. Instead of prepaid rent, the credit could be either to cash (if the purchase of the truck was for cash) or to note payable (if the purchase was on credit). Had the same data been entered directly into the accounts, this error would have been much more difficult to detect and correct. To correct the journal entry, a correcting journal entry should be recorded in June as (Debit) Prepaid Rent \$11,000, (Credit) Note Payable \$11,000 (assuming the purchase was on credit).

The use of a journal helps prevent the introduction of errors in the recording of business activities.





Step 3: Post to the Ledger

- ▶ Because the journal lists each transaction in chronological order, it can be quite difficult to use the journal to determine the balance in any specific account.
- ▶ Step 3 in the accounting cycle is to post to a ledger.
- ▶ Using a general ledger helps keep track of the balances of specific accounts.
- ▶ A **general ledger** is simply a collection of all the individual financial statement accounts that a company uses.
- ▶ The process of transferring the information from the journalized transaction to the general ledger is called **posting**.



The Posting Process

GENERAL JOURNAL				
				Page: 2
Date	Account and Explanation	Post. Ref.	Debit	Credit
Mar. 31	Dividends declared	3900	500	
	Cash	1000		500
	(Declared and paid cash dividend)			

GENERAL LEDGER					
Account: CASH			Account Number: 1000		
Date	Explanation	Post. Ref.	Debit	Credit	Balance
Mar. 1	Issued shares	1	12,000		12,000
2	Borrowed from bank	1	3,000		15,000
3	Purchased equipment	1		4,500	10,500
4	Purchased insurance	1		1,200	9,300
10	Sold advertising services	1	8,800		18,100
19	Sold advertising services in advance	1	9,000		27,100
23	Paid accounts payable	1		6,000	21,100
26	Paid salaries	1		1,800	19,300
29	Collected receivable	2	3,000		22,300
30	Paid utilities	2		5,200	17,100
31	Paid dividend	2		500	16,600





General Ledger

Assets	Liabilities	Shareholders' Equity																												
<table><tr><th colspan="2">Cash</th></tr><tr><td>(T1) 12,000</td><td>(T3) 4,500</td></tr><tr><td>(T2) 3,000</td><td>(T4) 1,200</td></tr><tr><td>(T6) 8,800</td><td>(T9) 6,000</td></tr><tr><td>(T8) 9,000</td><td>(T10) 1,800</td></tr><tr><td>(T11) 3,000</td><td>(T12) 5,200</td></tr><tr><td></td><td>(T13) 500</td></tr><tr><td>16,600</td><td></td></tr></table>	Cash		(T1) 12,000	(T3) 4,500	(T2) 3,000	(T4) 1,200	(T6) 8,800	(T9) 6,000	(T8) 9,000	(T10) 1,800	(T11) 3,000	(T12) 5,200		(T13) 500	16,600		<table><tr><th colspan="2">Accounts Payable</th></tr><tr><td>(T9) 6,000</td><td>(T5) 6,500</td></tr><tr><td></td><td>500</td></tr></table>	Accounts Payable		(T9) 6,000	(T5) 6,500		500	<table><tr><th colspan="2">Common Shares</th></tr><tr><td></td><td>(T1) 12,000</td></tr><tr><td></td><td>12,000</td></tr></table>	Common Shares			(T1) 12,000		12,000
Cash																														
(T1) 12,000	(T3) 4,500																													
(T2) 3,000	(T4) 1,200																													
(T6) 8,800	(T9) 6,000																													
(T8) 9,000	(T10) 1,800																													
(T11) 3,000	(T12) 5,200																													
	(T13) 500																													
16,600																														
Accounts Payable																														
(T9) 6,000	(T5) 6,500																													
	500																													
Common Shares																														
	(T1) 12,000																													
	12,000																													
<table><tr><th colspan="2">Accounts Receivable</th></tr><tr><td>(T7) 3,300</td><td>(T11) 3,000</td></tr><tr><td>300</td><td></td></tr></table>	Accounts Receivable		(T7) 3,300	(T11) 3,000	300		<table><tr><th colspan="2">Unearned Service Revenue</th></tr><tr><td></td><td>(T8) 9,000</td></tr><tr><td></td><td>9,000</td></tr></table>	Unearned Service Revenue			(T8) 9,000		9,000	<table><tr><th colspan="2">Service Revenue</th></tr><tr><td></td><td>(T6) 8,800</td></tr><tr><td></td><td>(T7) 3,300</td></tr><tr><td></td><td>12,100</td></tr></table>	Service Revenue			(T6) 8,800		(T7) 3,300		12,100								
Accounts Receivable																														
(T7) 3,300	(T11) 3,000																													
300																														
Unearned Service Revenue																														
	(T8) 9,000																													
	9,000																													
Service Revenue																														
	(T6) 8,800																													
	(T7) 3,300																													
	12,100																													
<table><tr><th colspan="2">Supplies</th></tr><tr><td>(T5) 6,500</td><td></td></tr><tr><td>6,500</td><td></td></tr></table>	Supplies		(T5) 6,500		6,500		<table><tr><th colspan="2">Notes Payable</th></tr><tr><td></td><td>(T2) 3,000</td></tr><tr><td></td><td>3,000</td></tr></table>	Notes Payable			(T2) 3,000		3,000	<table><tr><th colspan="2">Salaries Expense</th></tr><tr><td>(T10) 1,800</td><td></td></tr><tr><td>1,800</td><td></td></tr></table>	Salaries Expense		(T10) 1,800		1,800											
Supplies																														
(T5) 6,500																														
6,500																														
Notes Payable																														
	(T2) 3,000																													
	3,000																													
Salaries Expense																														
(T10) 1,800																														
1,800																														
<table><tr><th colspan="2">Prepaid Insurance</th></tr><tr><td>(T4) 1,200</td><td></td></tr><tr><td>1,200</td><td></td></tr></table>	Prepaid Insurance		(T4) 1,200		1,200			<table><tr><th colspan="2">Utilities Expense</th></tr><tr><td>(T12) 5,200</td><td></td></tr><tr><td>5,200</td><td></td></tr></table>	Utilities Expense		(T12) 5,200		5,200																	
Prepaid Insurance																														
(T4) 1,200																														
1,200																														
Utilities Expense																														
(T12) 5,200																														
5,200																														
<table><tr><th colspan="2">Equipment</th></tr><tr><td>(T3) 4,500</td><td></td></tr><tr><td>4,500</td><td></td></tr></table>	Equipment		(T3) 4,500		4,500			<table><tr><th colspan="2">Dividends Declared</th></tr><tr><td>(T13) 500</td><td></td></tr><tr><td>500</td><td></td></tr></table>	Dividends Declared		(T13) 500		500																	
Equipment																														
(T3) 4,500																														
4,500																														
Dividends Declared																														
(T13) 500																														
500																														





Step 4: Prepare a Trial Balance

- ▶ To aid in the preparation of financial statements, some companies will prepare a trial balance before they prepare financial statements.
- ▶ The **trial balance** is a list of all active accounts and each account's debit or credit balance.
- ▶ The accounts are listed in the order they appear in the ledger—assets first, followed by liabilities, shareholders' equity, revenues, and expenses.
- ▶ A trial balance whose debits equal credits does not mean that all transactions were recorded correctly.
- ▶ A trial balance will not detect errors of analysis or amounts.
- ▶ It will only prove the equality of debits and credits.



Cornerstone 2-6

Preparing a Trial Balance

Information:

Refer to the general ledger for HighTech in Exhibit 2.12.

Required:

Prepare a trial balance for HighTech Communications Inc. at March 31, 2018.

Why:

A trial balance is prepared at the end of each accounting period to provide a source for initial review and potential adjustment prior to the preparation of final financial statements for the period.

Solution:

HighTech Communications Inc. Trial Balance March 31, 2018		
Account	Debit	Credit
Cash	\$16,600	
Accounts Receivable	300	
Supplies	6,500	
Prepaid Insurance	1,200	
Equipment	4,500	
Accounts Payable		\$ 500
Unearned Service Revenue		9,000
Notes Payable		3,000
Common Shares		12,000
Dividends Declared	500	
Service Revenue		12,100
Salaries Expense	1,800	
Utilities Expense	5,200	
	<u>\$36,600</u>	<u>\$36,600</u>



Significant Differences Between IFRS and ASPE

- The following significant differences exist between IFRS and ASPE with respect to the accounting information system:
1. Accounting standards used by Canadian private companies may differ from IFRS. Significant difference may arise in the reporting of assets, liabilities, and shareholders' equity.
 2. IFRS terminology can differ from ASPE terminology. IFRS uses the term *depreciation* to refer to the process that allocates the cost of depreciable tangible capital assets. The term *amortization* is used in IFRS to refer to the process that allocates the costs of certain intangible assets (such as patents and franchises) over their useful lives to the statement of earnings. By contrast, ASPE uses the term *amortization* to refer to the process of allocating the cost of both depreciable tangible and certain intangible assets over their useful lives to the statement of earnings.

