Recording Income Statement Transactions: An Illustration

LO3-8

LEARNING OBJECTIVE
Understand how revenue and expense transactions are recorded in an accounting system.

In Chapter 2, we introduced Overnight Auto Service, a small auto repair shop formed on January 20, 2018. Early in this chapter, we journalized and posted all of Overnight's balance sheet transactions through January 27. At this point we will illustrate the manner in which Overnight's January income statement transactions were handled and continue into February with additional transactions.

Three transactions involving revenue and expenses were recorded by Overnight on January 31, 2018. The following illustrations provide an analysis of each transaction.

Jan. 31 Recorded revenue of $2,200, all of which was received in cash.

A=L+LOE
Revenue earned and collected

Assets	=	Liabilities	+	Owners' Equity
+$2,200				+$2,200

ANALYSIS
The asset Cash is increased.
Revenue has been earned.

DEBIT–CREDIT RULES
Increases in assets are recorded by debits; debit Cash $2,200.
Revenue increases owners' equity and is recorded by a credit; credit Repair Service Revenue $2,200.

JOURNAL ENTRY

Jan. 31	Cash	2,200	
	Repair Service Revenue		2,200

ENTRIES IN LEDGER ACCOUNTS

Cash

1/27 Bal. 15,800	
1/31 2,200	

Repair Service Revenue

	1/31 2,200

Jan. 31 Paid employees' wages earned in January, $1,200.

A=L+LOE
Incurred an expense, paying cash

Assets	=	Liabilities	+	Owners' Equity
−$1,200				−$1,200

ANALYSIS
Wages to employees are an expense.
The asset Cash is decreased.

DEBIT–CREDIT RULES
Expenses decrease owners' equity and are recorded by debits; debit Wages Expense $1,200.
Decreases in assets are recorded by credits; credit Cash $1,200.

JOURNAL ENTRY

Jan. 31	Wages Expense	1,200	
	Cash		1,200

ENTRIES IN LEDGER ACCOUNTS

Wages Expense

1/31 1,200	

Cash

1/27 Bal. 15,800	1/31 1,200
1/31 2,200	

Jan. 31 Paid for utilities used in January, $200.

ANALYSIS	The cost of utilities is an expense. The asset Cash is decreased.
DEBIT–CREDIT RULES	Expenses decrease owners' equity and are recorded by debits; debit Utilities Expense $200. Decreases in assets are recorded by credits; credit Cash $200.
JOURNAL ENTRY	Jan. 31 Utilities Expense .... 200 / Cash 200
ENTRIES IN LEDGER ACCOUNTS	**Utilities Expense**: 1/31 200 | — **Cash**: 1/27 Bal. 15,800; 1/31 2,200 | 1/31 1,200; 1/31 200

A=L+OE: Incurred an expense, paying cash

Assets	=	Liabilities	+	Owners' Equity
−$200				−$200

Having analyzed and recorded all of Overnight's January transactions, next we focus upon the company's February activities. Overnight's February transactions are described, analyzed, and recorded as follows.

Feb. 1 Paid *Daily Tribune* $360 cash for newspaper advertising to be run during February.

ANALYSIS	The cost of advertising is an expense. The asset Cash is decreased.
DEBIT–CREDIT RULES	Expenses decrease owners' equity and are recorded by debits; debit Advertising Expense $360. Decreases in assets are recorded by credits; credit Cash $360.
JOURNAL ENTRY	Feb. 1 Advertising Expense .... 360 / Cash 360
ENTRIES IN LEDGER ACCOUNTS	**Advertising Expense**: 2/1 360 | — **Cash**: 1/31 Bal. 16,600 | 2/1 360

A=L+OE: Incurred an expense, paying cash

Assets	=	Liabilities	+	Owners' Equity
−$360				−$360

Feb. 2 Purchased radio advertising from KRAM to be aired in February. The cost was $470, payable within 30 days.

A=L+LOE
Incurred an expense to be paid later

Assets	=	Liabilities	+	Owners' Equity
		+$470		−$470

ANALYSIS

The cost of advertising is an expense.
The liability Accounts Payable is incurred.

DEBIT–CREDIT RULES

Expenses decrease owners' equity and are recorded by debits; debit Advertising Expense $470.

Increases in liabilities are recorded by credits; credit Accounts Payable $470.

JOURNAL ENTRY

Feb. 2	Advertising Expense	470	
	Accounts Payable		470

ENTRIES IN LEDGER ACCOUNTS

Advertising Expense

2/1	360	
2/2	470	

Accounts Payable

	1/31 Bal.	7,000
	2/2	470

Feb. 4 Purchased various shop supplies (such as grease, solvents, nuts, and bolts) from CAPA Auto Parts; the cost was $1,400, due in 30 days. These supplies are expected to meet Overnight's needs for three or four months.

A=L+LOE
When a purchase clearly benefits future accounting periods, it's an asset, not an expense

Assets	=	Liabilities	+	Owners' Equity
+$1,400		+$1,400		

ANALYSIS

As these supplies will last for several accounting periods, they are an asset, not an expense of February.*
A liability is incurred.

DEBIT–CREDIT RULES

Increases in assets are recorded by debits; debit Shop Supplies $1,400.

Increases in liabilities are recorded by credits; credit Accounts Payable $1,400.

JOURNAL ENTRY

Feb. 4	Shop Supplies	1,400	
	Accounts Payable		1,400

ENTRIES IN LEDGER ACCOUNTS

Shop Supplies

2/4	1,400	

Accounts Payable

	1/31 Bal.	7,000
	2/2	470
	2/4	1,400

* If the supplies are expected to be used within the *current* accounting period, their cost may be debited directly to the Supplies Expense account, rather than to an asset account.

Feb. 15 Collected $4,980 cash for repairs made to vehicles of Airport Shuttle Service.

ANALYSIS

The asset Cash is increased.

Revenue has been earned.

A=L+OE

Revenue earned and collected

Assets	=	Liabilities	+	Owners' Equity
+$4,980				+$4,980

DEBIT–CREDIT RULES

Increases in assets are recorded by debits; debit Cash $4,980.

Revenue increases owners' equity and is recorded by a credit; credit Repair Service Revenue $4,980.

JOURNAL ENTRY

Feb. 15	Cash	4,980	
	Repair Service Revenue		4,980

ENTRIES IN LEDGER ACCOUNTS

Cash

1/31	Bal.	16,600	2/1		360
2/15		4,980			

Repair Service Revenue

	1/31	Bal.	2,200
	2/15		4,980

Feb. 28 Billed Harbor Cab Co. $5,400 for maintenance and repair services Overnight provided in February. The agreement with Harbor Cab calls for payment to be received by March 10.

ANALYSIS

An asset Accounts Receivable is established.

Revenue has been earned.

A=L+OE

Revenue earned but not yet collected

Assets	=	Liabilities	+	Owners' Equity
+$5,400				+$5,400

DEBIT–CREDIT RULES

Increases in assets are recorded by debits; debit Accounts Receivable $5,400.

Revenue increases owners' equity and is recorded by a credit; credit Repair Service Revenue $5,400.

JOURNAL ENTRY

Feb. 28	Accounts Receivable	5,400	
	Repair Service Revenue		5,400

ENTRIES IN LEDGER ACCOUNTS

Accounts Receivable

1/31	Bal.	1,200	
2/28		5,400	

Repair Service Revenue

	1/31	Bal.	2,200
	2/15		4,980
	2/28		5,400

Feb. 28 Paid employees' wages earned in February, $4,900.

A=L+LOE

Incurred an expense, paying cash

Assets	=	Liabilities	+	Owners' Equity
−$4,900				−$4,900

ANALYSIS

Wages to employees are an expense.

The asset Cash is decreased.

DEBIT–CREDIT RULES

Expenses decrease owners' equity and are recorded by debits; debit Wages Expense $4,900.

Decreases in assets are recorded by credits; credit Cash $4,900.

JOURNAL ENTRY

Feb. 28	Wages Expense	4,900	
	Cash		4,900

ENTRIES IN LEDGER ACCOUNTS

Wages Expense

1/31	Bal. 1,200		
2/28	4,900		

Cash

1/31	Bal. 16,600	2/1	360
2/15	4,980	2/28	4,900

YOUR TURN — You as Overnight Auto Service's Accountant

Your good friend, Fred Jonas, is the manager of Harbor Cab Co. Your family and Fred's family meet frequently outside of your respective workplaces for fun. At a recent barbecue, Fred asked you about the amount of repair services rendered by Overnight Auto to Airport Shuttle Services in February. Airport Shuttle Services competes with Harbor Cab Co. for fares to and from the airport. What should you say to Fred?

(See our comments in Connect.)

Feb. 28 Recorded $1,600 utility bill for February. The entire amount is due March 15.

ANALYSIS

The cost of utilities is an expense.

The liability Accounts Payable is incurred.

DEBIT–CREDIT RULES

Expenses decrease owners' equity and are recorded by debits; debit Utilities Expense $1,600.

Increases in liabilities are recorded by credits; credit Accounts Payable $1,600.

JOURNAL ENTRY

Feb. 28	Utilities Expense	1,600	
	Accounts Payable		1,600

ENTRIES IN LEDGER ACCOUNTS

Utilities Expense

Debit		Credit
1/31	Bal. 200	
2/28	1,600	

Accounts Payable

Debit	Credit	
	1/31	Bal. 7,000
	2/2	470
	2/4	1,400
	2/28	1,600

A=L+OE

Incurred an expense to be paid later

Assets	=	Liabilities	+	Owners' Equity
		+$1,600		−$1,600

Feb. 28 Overnight Auto Services declares and pays a dividend of 40 cents per share to the owners of its 8,000 shares of capital stock—a total of $3,200.[1]

ANALYSIS

The declaration of a dividend reduces owners' equity.

The asset Cash is decreased.

DEBIT–CREDIT RULES

Decreases in owners' equity are recorded by debits; debit Dividends $3,200.

Decreases in assets are recorded by credits; credit Cash $3,200.

JOURNAL ENTRY

Feb. 28	Dividends	3,200	
	Cash		3,200

ENTRIES IN LEDGER ACCOUNTS

Dividends

Debit		Credit
2/28	3,200	

Cash

1/31 Bal.	16,600	2/1	360
2/15	4,980	2/28	4,900
		2/28	3,200

A=L+OE

A Dividends account signifies a reduction in owners' equity—but it is not an expense

Assets	=	Liabilities	+	Owners' Equity
−$3,200				−$3,200

[1] As explained earlier, dividends are not an expense. In Chapter 5, we will show how the balance in the Dividends account eventually reduces the amount of Retained Earnings reported in the owners' equity section of the balance sheet.

THE JOURNAL

In our illustration, journal entries were shown in a very abbreviated form. The actual entries made in Overnight's journal appear in Exhibit 3–7. Notice that these formal journal entries include short explanations of the transactions, which include such details as the terms of credit transactions and the names of customers and creditors.

EXHIBIT 3–7
General Journal Entries: January 31 through February 28

A=L+LOE: Journal entries contain more information than just dollar amounts

OVERNIGHT AUTO SERVICE
GENERAL JOURNAL
JANUARY 31–FEBRUARY 28, 2018

Date	Account Titles and Explanation	Debit	Credit
2018			
Jan. 31	Cash	2,200	
	Repair Service Revenue		2,200
	Repair services rendered to various customers.		
31	Wages Expense	1,200	
	Cash		1,200
	Paid all wages for January.		
31	Utilities Expense	200	
	Cash		200
	Paid all utilities for January.		
Feb. 1	Advertising Expense	360	
	Cash		360
	Purchased newspaper advertising from *Daily Tribune* to run in February.		
2	Advertising Expense	470	
	Accounts Payable		470
	Purchased radio advertising on account from KRAM; payment due in 30 days.		
4	Shop Supplies	1,400	
	Accounts Payable		1,400
	Purchased shop supplies on account from CAPA; payment due in 30 days.		
15	Cash	4,980	
	Repair Service Revenue		4,980
	Repair services rendered to Airport Shuttle Service.		
28	Accounts Receivable	5,400	
	Repair Service Revenue		5,400
	Billed Harbor Cab for services rendered in February.		
28	Wages Expense	4,900	
	Cash		4,900
	Paid all wages for February.		
28	Utilities Expense	1,600	
	Accounts Payable		1,600
	Recorded utility bill for February.		
28	Dividends	3,200	
	Cash		3,200
	Paid cash dividend of 40 cents per share on 8,000 shares of capital stock owned by the McBryan family.		

February's Ledger Balances

After posting all of the January and February transactions, Overnight's ledger accounts appear as shown in Exhibit 3–8. To conserve space, we have illustrated the ledger in T account form and have carried forward each account's summary balance from January 31. For convenience,

EXHIBIT 3–8 Overnight Auto Service's Ledger Accounts

OVERNIGHT AUTO SERVICE
THE LEDGER

Asset Accounts

Cash

	1/31 Bal.	16,600	2/1	360
	2/15	4,980	2/28	4,900
Bal. $13,120			2/28	3,200

Accounts Receivable

	1/31 Bal.	1,200
Bal. $6,600	2/28	5,400

Shop Supplies

	1/31 Bal.	0
Bal. $1,400	2/4	1,400

Tools and Equipment

Bal. $12,000	1/31 Bal.	12,000

Building

Bal. $36,000	1/31 Bal.	36,000

Land

Bal. $52,000	1/31 Bal.	52,000

Liability and Owners' Equity Accounts

Notes Payable

1/31 Bal.	30,000	Bal. $30,000

Accounts Payable

1/31 Bal.	7,000	
2/2	470	
2/4	1,400	
2/28	1,600	Bal. $10,470

Capital Stock

1/31 Bal.	80,000	Bal. $80,000

Dividends

	1/31 Bal.	0
Bal. $3,200	2/28	3,200

Repair Service Revenue

1/31 Bal.	2,200	
2/15	4,980	
2/28	5,400	Bal. $12,580

Advertising Expense

	2/1	360
Bal. $830	2/2	470

Wages Expense

	1/31 Bal.	1,200
Bal. $6,100	2/28	4,900

Utilities Expense

	1/31 Bal.	200
Bal. $1,800	2/28	1,600

we show in red the February 28 balance of each account (debit balances appear to the left of the account; credit balances appear to the right).

The accounts in this illustration appear in *financial statement order*—that is, balance sheet accounts first (assets, liabilities, and owners' equity), followed by the income statement accounts (revenue and expenses).

The Trial Balance

LO3-9

LEARNING OBJECTIVE
Prepare a trial balance and explain its uses and limitations.

Since equal dollar amounts of debits and credits are entered in the accounts for every transaction recorded, the sum of all the debits in the ledger must be equal to the sum of all the credits. If the computation of account balances has been accurate, it follows that the total of the accounts with debit balances must be equal to the total of the accounts with credit balances.

Before using the account balances to prepare a balance sheet, it is desirable to *prove* that the total of accounts with debit balances is in fact equal to the total of accounts with credit balances. This proof of the equality of debit and credit balances is called a **trial balance.** A trial balance is a two-column schedule listing the names and balances of all the accounts in the order in which they appear in the ledger; the debit balances are listed in the left-hand column and the credit balances in the right-hand column. The totals of the two columns should agree. A trial balance taken from Overnight Auto's ledger accounts from Exhibit 3–8 is shown in Exhibit 3–9.

EXHIBIT 3–9
Overnight Auto Service's Trial Balance

OVERNIGHT AUTO SERVICE
TRIAL BALANCE
FEBRUARY 28, 2018

Cash	$ 13,120	
Accounts receivable	6,600	
Shop supplies	1,400	
Tools and equipment	12,000	
Building	36,000	
Land	52,000	
Notes payable		$ 30,000
Accounts payable		10,470
Capital stock		80,000
Retained earnings		0
Dividends	3,200	
Repair service revenue		12,580
Advertising expense	830	
Wages expense	6,100	
Utilities expense	1,800	
	$133,050	$133,050

A=L+OE

A trial balance proves the equality of debits and credits—but it also gives you a feel for how the business stands; but wait—there's more to consider

This trial balance proves the equality of the debit and credit entries in the company's accounting system. Notice that the trial balance contains both balance sheet and income statement accounts. Note also that the Retained Earnings balance is zero. It is zero because no debit or credit entries were made to the Retained Earnings account in January or February. Overnight, like most companies, updates its Retained Earnings balance only once each year. In Chapter 5, we will show how the Retained Earnings account is updated to its proper balance at year-end on December 31.[2]

[2] The balance of $0 in the Retained Earnings account is a highly unusual situation. Because the company is still in its first year of operations, no entries have ever been made to update the account's balance. In any trial balance prepared after the first year of business activity, the Retained Earnings account may be expected to have a balance other than $0.

USES AND LIMITATIONS OF THE TRIAL BALANCE

The trial balance provides proof that the ledger is in balance. The agreement of the debit and credit totals of the trial balance gives assurance that:

1. Equal debits and credits have been recorded for all transactions.
2. The addition of the account balances in the trial balance has been performed correctly.

Suppose that the debit and credit totals of the trial balance do not agree. This situation indicates that one or more errors have been made. Typical of such errors are (1) the posting of a debit as a credit, or vice versa; (2) arithmetic mistakes in determining account balances; (3) clerical errors in copying account balances into the trial balance; (4) listing a debit balance in the credit column of the trial balance, or vice versa; and (5) errors in addition of the trial balance.

The preparation of a trial balance does *not* prove that transactions have been correctly analyzed and recorded in the proper accounts. If, for example, a receipt of cash were erroneously recorded by debiting the Land account instead of the Cash account, the trial balance would still balance. Also, if a transaction were completely omitted from the ledger, the error would not be disclosed by the trial balance. In brief, the trial balance proves only one aspect of the ledger, and that is the equality of debits and credits.

Concluding Remarks

THE ACCOUNTING CYCLE IN PERSPECTIVE

LO3-10

LEARNING OBJECTIVE
Distinguish between accounting cycle procedures and the knowledge of accounting.

We view the accounting cycle as an efficient means of introducing basic accounting terms, concepts, processes, and reports. This is why we introduce it early in the course. As we conclude the accounting cycle in Chapters 4 and 5, please don't confuse your familiarity with this sequence of procedures with a knowledge of accounting. The accounting cycle is but one accounting process—and a relatively simple one at that.

Computers now free accountants to focus upon the more analytical aspects of their discipline. These include, for example:

- Determining the information needs of decision makers.
- Designing systems to provide the information quickly and efficiently.
- Evaluating the efficiency of operations throughout the organization.
- Assisting decision makers in interpreting accounting information.
- Auditing (confirming the reliability of accounting information).
- Forecasting the probable results of future operations.
- Tax planning.

We will emphasize such topics in later chapters of this text. But let us first repeat a very basic point from Chapter 1: The need for some familiarity with accounting concepts and processes is not limited to individuals planning careers in accounting. Today, an understanding of accounting information and of the business world go hand in hand. You cannot know much about one without understanding quite a bit about the other.

ETHICS, FRAUD, & CORPORATE GOVERNANCE

As discussed in Chapter 2, the Sarbanes-Oxley Act (SOX) potentially increases the civil and criminal penalties associated with securities fraud, including fraudulent financial reporting. The increased penalties—which can be substantial—are intended to reduce illegal behaviors. For example, in 2006, Jeffrey Skilling, former chief executive officer of **Enron**, was convicted of several fraud-related criminal charges for which he was sentenced to a prison term exceeding 24 years.

Businesspeople are sometimes told by their superiors to commit actions that are unethical and in some instances even illegal. The clear message of management is "participate in this behavior or find a job elsewhere." Management pressure and intimidation can make it difficult to resist demands to engage in unethical behavior. Employees sometimes believe that they are insulated from responsibility and liability because "they were just following orders."

As you encounter ethical dilemmas during your business career, remember that obeying orders from your superiors that are unethical, and certainly those that are illegal, may expose you to serious consequences, including criminal prosecution and incarceration.

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