4

RECORDING FINANCIAL TRANSACTIONS

Introduction
Funding of the Business
Forms of the Accounting Equation
  - Assets
  - Proprietorship
  - Liabilities
The Accounting Equation in Use
  - Extended Example
Summarising Transactions
Expansion of the System
Inventory Recording
Worked Problem
Summary

Introduction
The assets of a firm will be funded by a mixture of owners’ equity (proprietors’ funds) and liabilities, the recording of which is based on the dollar value of the transaction at the time it took place, sometimes referred to as the exchange price. All financial accounts are prepared from past transactions and do not include expected but non realised events. Before turning to the actual recording of financial transactions we will review the key elements and flows found in a typical business.

Funding of the Business
The assets which are available to a business entity are funded from four main areas. These are:

1. The proprietors who are the owners of the business and provide initial funds for a business undertaking. The term proprietorship is used for the obligation the business entity has to the owners of the firm. The owners of the firm can be thought of as being entitled to any increase in the value of the resources held by the firm but their interest will be reduced if for any reason there is a diminution of value.
In normal business organisations the proprietorship interest is termed capital. In companies, and usually in partnerships, the accumulated profits are kept separate within the proprietorship section of the Balance Sheet. In not-for-profit organisations, the accumulated resources contributed by the members are normally referred to as accumulated funds.

2. Businesses will borrow from outside interests to purchase specific assets and to provide the funds necessary for working capital. These liabilities will vary in length of time depending on the use to which the funds are put. For example, funding of a building will typically entail long term sources of finance, but a purchase of a motor vehicle will probably only involve a two to three year deal whether by loan or hire purchase.

3. Business firms have a number of dealings with suppliers. These suppliers are legally entitled to a payment of an amount equal to the resources which they have provided. These obligations to outside parties, whether they are for the supply of goods or services, are payable irrespective of whether the firm is operating at a profit or loss. The provision of credit facilities is an important source of revolving funds.

4. The trading activities of a business also provide a flow of funds both in and out of the firm. The sale of goods and services (referred to as revenue) provides an inflow of resources to the firm from the general public. The purchase of goods and services, whether it is goods for resale or overhead costs of the business, is commonly referred to as expenses of the undertaking. The difference between revenue and expenses is the net income (or net loss) of the business entity for the period. The net income is transferred to the ownership interest at the end of the period and the owners may then decide how it should be used, whether as a dividend or extra funds for the growth of the business.

These accounting flows are shown in Exhibit 4.1.
Forms of the Accounting Equation

The entire financial recording system for a business may be evaluated in terms of the accounting equation. This accounting equation sets out the relationship which exists between a firm’s assets, its liabilities and the interest of its owners. It is commonly expressed in one of two different forms.

Firstly,

\[ A = P + L \]

Assets = Proprietorship + Liabilities

Secondly,

\[ P = A - L \]

Proprietorship = Assets - Liabilities
The first form focuses on the assets of the business and treats both liabilities and proprietorship as sources of funds. This view is normally used in corporate situations where there is significant separation of ownership and control. The second focuses on the owner’s interest and may be exemplified by an own-your-own business.

The three elements of the accounting equation are examined below.

**Assets**

Assets can be defined as the economic resources owned by a business entity. They may take the form of:

1. **Current Assets**
   These are items held for conversion to cash within a relatively short time period (commonly within a year). They will include items such as inventories, work in progress and accounts receivable.

2. **Term Assets**
   Term assets (also called fixed assets) are of a long term nature and benefit more than one accounting period and they are held by the firm with the intention of generating revenue. Term assets are part of the revenue producing process but they are not sold for revenue themselves. They include land, buildings, motor vehicles and plant.

3. **Investments**
   These are resources of the firm which have been advanced to others either as a loan or perhaps as part of the equity capital of another business venture. They include shares in other companies, government stock and mortgage advances.

4. **Intangible Assets**
   Intangible assets contribute to the revenue earning capacity of the business but they are not tangible in nature. It is generally difficult to place a monetary value on these items and typically they are only of value while the firm continues in business. As a result, it is common accounting practice to record intangible assets only if they have been purchased (for example, on the acquisition of a business). It is also common accounting practice for intangible assets to be written off or charged against revenue over the expected period that they are going to benefit the business. Intangible assets commonly include:

   **Goodwill**
   The excess purchase price paid for a business over and above the current value or agreed value of tangible assets. If goodwill has been paid it will normally reflect the purchase of expected future profit or profit potential. It can also reflect the synergy of a group of individual assets, where the whole is worth more than the sum of the parts.

   **Patents**
   A firm may have paid to have a process licensed or patented giving them unique rights to process in a particular way for a limited time period.
Chapter 4: Recording Financial Transactions

Franchise rights
The right to use a trade name or be an exclusive seller of a named product. For example, McDonalds or Pepsi Cola.

Proprietorship
The proprietorship of a business equals the assets of a business less the liabilities of a business. It is made up of:

1. The amount of the owners’ original investment as well as future contributions by the original owners.
2. Future investment by new owners.
3. Profits retained within the firm, that is, net profit for the period less dividends or drawings which have been returned to owners - capital gains made on the sale of assets, for example, land and buildings.

Liabilities
Liabilities are the obligations owed by the firm to parties outside the business. At any point in time the liabilities of the firm equal the assets less the proprietorship. Liabilities may take several forms including:

1. Current liabilities: those which must be paid within a relatively short time period, typically within twelve months. Current liabilities include short term loans, accounts payable and bank overdraft.
2. Term liabilities: those which will not normally be paid within the current accounting period. Term liabilities provide a major source of long term finance for the business and can often be similar in magnitude to proprietorship. Term liabilities include debentures, long term loans and mortgage advances.

The Accounting Equation in Use
Financial recording systems are based on a system referred to as Double Entry. This takes account of the dual nature of each transaction; for example, cash is given up and in return a commodity is received. The result of this dual nature is that the accounting equation always remains in balance. This is illustrated in the following extended example.

Extended Example
Jane Martin Initial Business Transactions

Transaction 1
Jane Martin pays $100,000 cash into her business bank account. This transaction would be expressed in the books of her business in terms of the accounting equation as:

\[
\text{Assets} \quad - \quad \text{Liabilities} \quad = \quad \text{Proprietorship}
\]

\[
\begin{align*}
\text{Bank} & \quad 100,000 \\
\text{Eqn 1} & \quad - \quad 0 \quad = \quad 100,000
\end{align*}
\]
Jane Martin’s business now has assets of $100,000 which are matched by claims on these assets by the owner of $100,000.

**Transaction 2**
Jane Martin purchased trading stock on credit for $20,000. The new equation for the business is now,

\[
\text{Bank} + \text{Stock} - \text{Liabilities} = \text{Capital}
\]

\[
\begin{array}{cccc}
\text{Eqn 1} & \text{100,000} & - & 0 & = & \text{100,000} \\
\text{Tran 2} & + & 20,000 & - & 20,000 \\
\end{array}
\]

\[
\text{Eqn 2} & \text{120,000} & - & 20,000 & = & \text{100,000}
\]

The total assets of the business are now $120,000 and the business owes $20,000 to creditors and Jane still has her initial investment of $100,000.

**Transaction 3**
The business purchases a second hand delivery van for $25,000, paid by cheque.

\[
\text{Bank} + \text{Stock} + \text{Van} - \text{Liabilities} = \text{Capital}
\]

\[
\begin{array}{cccc}
\text{Eqn 2} & \text{100,000} & - & 20,000 & = & \text{100,000} \\
\text{Tran 3} & + & 25,000 & - & 20,000 \\
\end{array}
\]

\[
\text{Eqn 3} & \text{75,000} & + & 20,000 & + & 25,000 & - & 20,000 & = & \text{100,000}
\]

The total value of the firm’s assets has not changed but the individual components have changed, as the bank balance is now $75,000 and the van is $25,000.

**Transaction 4**
The business pays a creditor $10,000 on account.

\[
\text{Bank} + \text{Stock} + \text{Van} - \text{Liabilities} = \text{Capital}
\]

\[
\begin{array}{cccc}
\text{Eqn 3} & \text{75,000} & - & 2,000 & = & \text{100,000} \\
\text{Tran 4} & + & 20,000 & 25,000 & - & 10,000 \\
\end{array}
\]

\[
\text{Eqn 4} & \text{65,000} & + & 20,000 & + & 25,000 & - & 10,000 & = & \text{100,000}
\]

The assets of the firm have been reduced by $10,000 as have the claims on those assets by creditors.

**Transaction 5**
Wages of $2,000 are paid.

\[
\text{Bank} + \text{Stock} + \text{Van} - \text{Liabilities} = \text{Capital}
\]

\[
\begin{array}{cccc}
\text{Eqn 4} & \text{65,000} & - & 2,000 & = & \text{100,000} \\
\text{Tran 5} & + & 20,000 & 25,000 & - & 10,000 \\
\end{array}
\]

\[
\text{Eqn 5} & \text{63,000} & + & 20,000 & + & 25,000 & - & 10,000 & = & \text{98,000}
\]
Incurring an operating cost has reduced the firm’s assets as well as the owner’s capital in the firm.

**Transaction 6**
Sold trading stock which cost $5,000 for $12,000 on credit.

<table>
<thead>
<tr>
<th>Eqn 5</th>
<th>Bank + Stock + Debtors + Van - Liabilities = Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tran 6</td>
<td>63,000 20,000 12,000 25,000 -10,000 = 98,000</td>
</tr>
</tbody>
</table>

Stock has been reduced by $5,000, debtors have increased by $12,000 and the profit on the transaction has increased the owner’s capital in the business by $7,000.

**Transaction 7**
Jane Martin draws $1,000 for private living expenses.

<table>
<thead>
<tr>
<th>Eqn 6</th>
<th>Bank + Stock + Debtors + Van - Liabilities = Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tran 7</td>
<td>63,000 15,000 12,000 25,000 -10,000 = 105,000</td>
</tr>
</tbody>
</table>

From this example it is evident that:

- there are two sides to every transaction
- the proprietorship of a firm is always equal to the assets less the liabilities.

It is clearly not possible for all transactions to be recorded in equation form. However, the illustration shows at a glance how the accounting system remains in balance. The other important element shown by the above is that for information to be useful for managerial control and reporting purposes, transactions need to be summarised according to a pre-determined classification which takes into account users’ needs.

**Summarising Transactions**
In a manual bookkeeping system transactions will be recorded by journal entry which is the method for transferring information to the ledger.

Using the previous Jane Martin example, the journal entries would be:

**Transaction 1**

<table>
<thead>
<tr>
<th>Dr Bank</th>
<th>100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr Capital Jane Martin</td>
<td>100,000</td>
</tr>
</tbody>
</table>
Transaction 2
Dr  Inventory (Stock)  20,000
Cr  Creditors  20,000

Transaction 3
Dr  Vehicle - Van  25,000
Cr  Bank  25,000

Transaction 4
Dr  Creditors  10,000
Cr  Bank  10,000

Transaction 5
Dr  Wages  2,000
Cr  Bank  2,000

Transaction 6
Dr  Debtors  12,000
Cr  Sales  12,000
Dr  Cost of Goods Sold  5,000
Cr  Inventory (Stock)  5,000

Transaction 7
Dr  Capital - Drawings  1,000
Cr  Cash  1,000

The transactions affecting Jane Martin can now be entered in the ledger which is a record of all transactions that affect each account. The net balance of the ledger account is the same as Equation 7 shown earlier. For ease of following the entries, ‘T’ accounts (which are a simplified form of ledger) are often used.

<table>
<thead>
<tr>
<th>Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>(7)</td>
</tr>
<tr>
<td>1,000</td>
</tr>
<tr>
<td>100,000</td>
</tr>
<tr>
<td>(1)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
</tr>
<tr>
<td>100,000</td>
</tr>
<tr>
<td>25,000</td>
</tr>
<tr>
<td>(3)</td>
</tr>
<tr>
<td>10,000</td>
</tr>
<tr>
<td>(4)</td>
</tr>
<tr>
<td>2,000</td>
</tr>
<tr>
<td>(5)</td>
</tr>
<tr>
<td>1,000</td>
</tr>
<tr>
<td>(7)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Inventory (Stock)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(2)</td>
</tr>
<tr>
<td>20,000</td>
</tr>
<tr>
<td>5,000</td>
</tr>
<tr>
<td>(6)</td>
</tr>
</tbody>
</table>
Chapter 4: Recording Financial Transactions

Creditors

(4) 10,000 20,000 (2)

Vehicles (Van)

(3) 25,000

Debtors

(6) 12,000

Wages

(5) 2,000

Cost of Goods Sold

(6) 5,000

Sales

12,000 (6)

The last three T accounts for wages, cost of goods sold (COGS) and sales are part of the Income Statement - which shows the trading operations of the business. The three accounts are closed to an Income Summary Account at the end of the accounting period.

Income Account

<table>
<thead>
<tr>
<th></th>
<th>COGS</th>
<th>Wages</th>
<th>Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance</td>
<td>5,000</td>
<td>2,000</td>
<td>12,000</td>
</tr>
<tr>
<td>Balance</td>
<td>5,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

12,000 12,000

The balance of $5,000 in the Income Summary is credited to capital. The other T accounts all refer to the Balance Sheet - which shows the position, or residual
balances, that will be carried forward to the next period. It is not the intention here to go into great detail on the precise form of journal entries, closing accounts, etc, since these topics are more properly the place of a bookkeeping course. The objective is to give the reader a feel for how the information is captured and processed. Thus, readers with some bookkeeping knowledge will be aware that some technical steps have been glossed over.

Exhibit 4.2 shows the layout of a column ledger account as used in many computerised systems and also in some manual systems. This form has the advantage of giving a running balance so that the balance is immediately available.

Exhibit 4.2

**Layout of columnar ledger account**

<table>
<thead>
<tr>
<th>Date</th>
<th>Code</th>
<th>Particulars</th>
<th>Debit</th>
<th>Credit</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Exhibit 4.3

**Example of a columnar ledger account**

Income Summary Account

<table>
<thead>
<tr>
<th>Date</th>
<th>Code</th>
<th>Particulars</th>
<th>Debit</th>
<th>Credit</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>(5)</td>
<td></td>
<td>Wages</td>
<td>2,000</td>
<td></td>
<td>2,000 dr</td>
</tr>
<tr>
<td>(6)</td>
<td></td>
<td>COGS</td>
<td>5,000</td>
<td>7,000</td>
<td>5,000 cr</td>
</tr>
<tr>
<td>(6)</td>
<td></td>
<td>Sales</td>
<td>12,000</td>
<td></td>
<td>5,000 cr</td>
</tr>
</tbody>
</table>

As you can see, there is little difference between this ledger account and the ‘T’ accounts used earlier. In ledgers, debits are in the left hand column and credits in the right. As you can see, there is little difference between this ledger account and the ‘T’ accounts used earlier. In ledgers, debits are in the left hand column and credits are in the right hand column.

The general rule for recording transactions in ledger accounts is:

- an increase in an asset will be a debit
- an increase in an expense will be a debit
- an increase in a liability will be a credit
- an increase in proprietorship will be a credit
- an increase in revenue will be a credit.

Thus:

- Assets and Expenses will normally have debit balances.
- Liabilities, Proprietorship and Revenue will normally have credit balances.
Chapter 4: Recording Financial Transactions

The use of these rules and ‘T’ accounts will enable you to complete any bookkeeping problem.

Expansion of the System

So far, transactions have been entered directly into ledger accounts from the General Journal (a Journal where each transaction is kept separate and posted individually to the ledger). All transactions of a firm could be entered in a General Journal. For example, the purchase of a new computer on credit from Computer Essentials Ltd for $3,000 would appear in the General Journal as:

30 April Dr Computer 3,000
Cr Computer Essentials Ltd 3,000
(purchase of XT serial 86124 on credit)

However, it would be possible but very time consuming to record all transactions in this form prior to posting to the ledger. To avoid this, specialised journals are frequently used for types of transactions which occur frequently; the form of these specialised journals varies considerably in practice. Some common specialised journals are:

- Sales Journal - for credit sales only
- Purchases Journal - for credit purchases only
- Cash Receipts Journal - for all cash receipts
- Cash Payments Journal - for all cash payments

In these journals all transactions of the particular category are grouped by date order and at the end of the period the balance is posted to the ledger avoiding the need for individual entries for repetitive transactions. This approach has the added benefit of allowing separation of duties in the office and individuals can be in charge of a particular area. For example, the Control of Debtors must be reconciled with the Sales Journal and the separation of banking, sales and debtors control provides for checks and controls in the office. Such separation of key duties, such as receipts, payments, credit notes, debtors and creditors is also a simple but most important element of business control as fraud would require collusion of staff.

Inventory Recording

Inventory sold may be recorded either as the transaction takes place (or in summary every few days) or, as is more common practice in smaller businesses, as inventory is purchased it is coded to purchases, then a stock take is made at balance date and the stock on hand will be recorded through a closing journal entry. This is called the periodic inventory system.

This is shown below, by way of example:
Opening Balance in Inventory $1,500
6 purchases were made during the year $12,000
Stock take at balance date, inventory level $1,800

the purchases account would appear as follows:

<table>
<thead>
<tr>
<th>Financial Management and Decision Making</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening Balance in Inventory $1,500</td>
</tr>
<tr>
<td>6 purchases were made during the year $12,000</td>
</tr>
<tr>
<td>Stock take at balance date, inventory level $1,800</td>
</tr>
</tbody>
</table>

Purchases

| Cash | 2,100 |
| Cash | 2,200 |
| Creditor | 1,500 |
| Creditor | 1,900 |
| Cash | 2,500 |
| Creditor | 1,800 |

12,000 Income Statement

12,000

Under the *perpetual* system the inventory account is adjusted for every purchase or sale of goods. For instance, under the *perpetual* system every time a sale is made it is recorded via:

- Dr Cost of Goods Sold
- Cr Inventory
- Dr Cash/Debtor
- Cr Sales

In theory, when a stock take is made at the period end the stock figure in the books and the actual count should be the same! This is virtually never the case, due to such factors as incorrect recording, theft, and damage. The difference is usually put to cost of goods sold, leaving the inventory figure correct.

In this text we usually use the periodic system because of its simplicity and wide use by small businesses.
Chapter 4: Recording Financial Transactions

Worked Problem

Classy Craft Shop

The following is a simplified Balance Sheet for Classy Craft Shop.

Classy Craft Shop
Balance Sheet
as at 31 March 19A1

$ 20,000

Proprietorship
Capital
Represented by:

Current Assets
Inventory
Bank
16,000

Less Current Liabilities
Accounts Payable
5,000 11,000

Fixed Assets
Shop Fittings
9,000

$20,000

You are also provided with a series of transactions for early April. Transactions to 5 April were:

April 1 Paid accounts payable by cheque 2,000
2 Sold old fittings for cash 1,000
(Book value $2,500)
3 Purchased computer for $4,000. $1,000 deposit and $3,000 on credit
4 Banking for month to date trading 1,200
5 Living expenses drawn 500

Required:
Open T accounts for each of the Balance Sheet accounts shown above as well as any extra accounts necessary to record the above transactions. Enter the above transactions, and prepare a Trial Balance for Classy Craft.

Answer:
The ‘T’ accounts would be:

<table>
<thead>
<tr>
<th>Date</th>
<th>Account</th>
<th>April 1</th>
<th>April 2</th>
<th>April 5</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Proprietorship</td>
<td>Balance</td>
<td>Shop Fittings</td>
<td>Bank</td>
</tr>
<tr>
<td>April 1</td>
<td>Balance</td>
<td>20,000</td>
<td>1,500</td>
<td>500</td>
</tr>
<tr>
<td>April 2</td>
<td>Shop Fittings</td>
<td>1,500</td>
<td>20,000</td>
<td></td>
</tr>
<tr>
<td>April 5</td>
<td>Bank</td>
<td>500</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
This example illustrates the principles of double entry accounting although in practice this mechanical process is commonly carried out on computer. The principles are, however, identical.

Once a series of transactions have been completed, the balances are listed in a schedule known as a Trial Balance. If the sum of the debit balances equals the sum of the credit balances then this merely implies that the Trial Balance balances. However, this state of balance does not guarantee the accuracy of the process. For example, transactions may have been omitted, amounts may have been entered in the wrong ledger account or several errors may have had a compensating effect. A Trial Balance can be drawn up using the balances from the Classy Craft example.
Chapter 4: Recording Financial Transactions

Classy Craft Shop
Trial Balance
as at 5 April 19A1

<table>
<thead>
<tr>
<th>Debit Balances</th>
<th>Credit Balances</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proprietorship</td>
<td>18,000</td>
</tr>
<tr>
<td>Accounts Payable</td>
<td>6,000</td>
</tr>
<tr>
<td>Bank</td>
<td>6,700</td>
</tr>
<tr>
<td>Inventory</td>
<td>8,000</td>
</tr>
<tr>
<td>Shop Fittings</td>
<td>6,500</td>
</tr>
<tr>
<td>Computer</td>
<td>4,000</td>
</tr>
<tr>
<td>Sales</td>
<td>1,200</td>
</tr>
<tr>
<td>Sales</td>
<td>1,200</td>
</tr>
<tr>
<td></td>
<td><strong>$25,200</strong></td>
</tr>
<tr>
<td></td>
<td><strong>$25,200</strong></td>
</tr>
</tbody>
</table>

It is from a Trial Balance that the Income Statement and Balance Sheet are normally prepared. It is important to note that based on the information provided the Trial Balance is not complete, due to the $1,200 of sales made during April. Presumably inventory was sold, yet as we have only recorded the cash received there needs to be an adjustment for April 5 inventory. A stock take showed that the inventory level was $7,400, meaning that $600 of inventory had been sold. The journal entry to record this is:

5 April Dr Cost of Goods Sold $600
Cr Inventory $600

The Adjusted Trial Balance would now read:

Classy Craft Shop
Trial Balance
as at 5 April 19A1

<table>
<thead>
<tr>
<th>Debit Balances</th>
<th>Credit Balances</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proprietorship</td>
<td>18,000</td>
</tr>
<tr>
<td>Accounts Payable</td>
<td>6,000</td>
</tr>
<tr>
<td>Bank</td>
<td>6,700</td>
</tr>
<tr>
<td>Inventory</td>
<td>7,400</td>
</tr>
<tr>
<td>Shop Fittings</td>
<td>6,500</td>
</tr>
<tr>
<td>Computer</td>
<td>4,000</td>
</tr>
<tr>
<td>Cost of Goods Sold</td>
<td>600</td>
</tr>
<tr>
<td>Sales</td>
<td>1,200</td>
</tr>
<tr>
<td>Sales</td>
<td>1,200</td>
</tr>
<tr>
<td></td>
<td><strong>$25,200</strong></td>
</tr>
<tr>
<td></td>
<td><strong>$25,200</strong></td>
</tr>
</tbody>
</table>

Summary

This chapter has looked at the major classifications found in the Balance Sheet and has taken the reader through the major steps in the financial recording process. These are:

- transactions
- journal entry
A business person does not have to be an accountant. However, it is important that people in business know the principles underlying the system of recording financial transactions of firms primarily so that effective control may be maintained over the process. It is also important to have some understanding of the basic accounting system since it is far-reaching in its effect on an organisation’s performance. Thus, an understanding of principles and terminology is essential if business people are to maintain effective control and participation in the firm’s operations.

Glossary of Key Terms

- **Asset**: Economic resource held by an organisation at a point in time.

- **Balance Sheet**: A statement of an organisation’s assets, liabilities, and equity at a point in time.

- **Income Statement**: A statement of revenue less expenses that summarises the operations of an entity over a period of time, commonly one year.

- **Journal Entry**: Books of original entry of transactions.

- **Ledger**: The collection of all individual accounts, both Income Statement and Balance Sheet.

- **Liability**: A debt of the organisation which may include short term items such as bank overdraft through to long term items such as debentures.

- **Special Journal**: A journal that records all entries of a similar type (e.g. sales) thereby achieving economy of operation.

- **Trial Balance**: A listing of the balances of all ledger accounts.

Selected Readings


Questions

4.1
What is meant by double entry accounting? Why is this method considered superior to other basic financial recording systems?

4.2
Explain the meaning of the following terms and give an example of each:

a. Asset
b. Liability
c. Current asset
d. Term liability
e. Fixed asset
f. Proprietorship
g. Investment
h. Intangible asset

4.3
The transactions for Mark Williams Electrical are given below. Analyse each transaction and record the debit amount and credit amount in the appropriate ‘T’ accounts. For example: Transaction a. is completed for you below:

<table>
<thead>
<tr>
<th>Equipment Creditors A. Shaw</th>
</tr>
</thead>
<tbody>
<tr>
<td>2,100</td>
</tr>
<tr>
<td>2,100</td>
</tr>
</tbody>
</table>

   a. Equipment purchased on credit from A. Shaw for $2,100
   b. $1,000 paid to A. Shaw on account
   c. Trading stock bought for $5,000 by cheque
   d. $900 received from W. Wright on account
   e. Equipment which cost $100 returned to A. Shaw
   f. $1,100 paid to G. Ford, a creditor
   g. Equipment bought for $500 by cheque
   h. Trading stock bought for $2,000 on credit from G. Ford
   i. Trading stock bought for $300 on credit from Brown Ltd
   j. $800 received from D.F. Hodge
   k. Goods of $3,000 sold on credit to S. Jones
   l. S. Jones paid $1,000 on account
   m. $3,000 rent paid

4.4
Show how each of the following transactions affects the basic accounting equation, \[ A = L + P \].

a. Ann Hotshot paid $10,000 into her business bank account
b. She purchased shop fittings of $2,000 on credit
c. Ann purchased stock for resale of $2,500 on credit
d. Hotshot Enterprises paid creditors $1,000 on account
Chapter 4: Recording Financial Transactions

4.5
Show how each of the following transactions affects the basic accounting equation, \( A = L + P \).

a. Inventory purchased on credit, $2,800
b. Capital contributed by partners in the business, $1,050
c. Rent of $800 paid
d. Paid advertising, $500
e. Goods sold for cash of $2,000 which had cost $1,050
f. Fittings purchased on credit, $5,000
g. Partners took goods for own use, $200
h. Business expenses paid, $250
i. $3,000 borrowed from Finance Company
j. Goods sold on credit, $3,000 which had cost $900
k. Partners drew cash for private living expenses, $300
l. Wages paid, $1,200
m. Inventory purchased for cash, $3,000

4.6
Explain in words the nature of the financial event which is recorded in the following series of journal entries.

Transaction 1.
Dr Bank 10,000
Cr Capital M Jones 10,000

Transaction 2.
Dr Shop Fittings 2,000
Cr Bank 2,000

Transaction 3.
Dr Purchases 1,000
Cr Creditor 1,000

Transaction 4.
Dr Drawings 100
Cr Bank 100

Transaction 5.
Dr Bank 500
Cr Sales 500
<table>
<thead>
<tr>
<th>Transaction</th>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>6.</td>
<td>Dr A. Debtor 200 Cr Sales 200</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7.</td>
<td>Dr Rent 300 Cr Bank 300</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8.</td>
<td>Dr Shop Expenses 350 Cr Bank 350</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9.</td>
<td>Dr Bank 250 Cr Sales 250</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10.</td>
<td>Dr Vehicle Expenses 100 Cr Bank 100</td>
<td></td>
<td></td>
</tr>
<tr>
<td>11.</td>
<td>Dr Bank 1,000 Cr Shop Fittings 1,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12.</td>
<td>Dr Bank 10,000 Cr Mortgage 10,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>13.</td>
<td>Dr B. Debtor 350 Cr Sales 350</td>
<td></td>
<td></td>
</tr>
<tr>
<td>14.</td>
<td>Dr Drawings 200 Cr Bank 200</td>
<td></td>
<td></td>
</tr>
<tr>
<td>15.</td>
<td>Dr Discount Allowed 50 Cr A. Debtor 50</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
For the following transactions, make Journal entries, post these to ‘T’ accounts, complete a Trial Balance and prepare an Income Statement and appropriate Balance Sheet. Closing inventory is $18,000.

1. Cash brought in by proprietor 50,000
2. Purchase of business for cash - plant 5,000
   - inventory 15,000
   20,000
3. Business investment purchase for cash 10,000
4. Sale on credit (i.e. to a debtor) 900
5. Cash from debtor 300
6. Sale for cash 560
7. Purchase inventory for cash 400
8. Purchase of additional plant by cash 1,000
9. Introduction of additional capital in cash 4,000
10. Cash drawn for own use 1,000
11. Goods taken for own use 440
12. Wages paid to staff 1,680
13. Interest on investment received in cash 400
14. Purchase of stock on credit for resale
15. 2,480
16. Goods returned by a customer (debtor) 200
17. Goods returned to a supplier (creditor) 600
18. Cash paid by a debtor 380
19. Discount allowed to a debtor 20
20. Cash paid to a creditor 1,820
21. Discount allowed by creditor on payment of account 60
22. Sale on credit 7,700
23. Purchase of stock on credit for resale 4,360

4.8
Record the following transactions direct to ‘T’ accounts, showing the distinguishing letters and amounts only. On completion of the entries prepare a Trial Balance.

a. Savings paid into business account at Trading Bank (from which all future payments will be made) 10,000
b. Rent of shop paid by cheque 500
c. Shop fittings purchased from Fittings Ltd 2,120
d. Fittings Ltd paid on account 1,000
e. Stock purchased for resale from Wholesaler Ltd 7,770
f. Wages paid to shop assistant 240
g. Cheque drawn for own life insurance premium 480
h. Goods sold for cash 1,680
i. Goods returned to Wholesaler Ltd 860
j. Paid Wholesaler Ltd 4,000
k. Goods sold to A. Consumer on credit 2,560
l. Goods taken for own use 240
m. A. Consumer returned goods 480
n. Paid Wholesaler Ltd 2,760
o. Discount allowed by Wholesaler Ltd 80
p. Loan received from R. Uncle 5,000
4.9
Record the following transactions direct to ‘T’ accounts, showing the distinguishing number and amounts only.

1. Paid savings into business account at Trading Bank
   (from which all future payments will be made) 11,000
2. Paid shop rent by cheque 600
3. Purchased shop fittings from Fitout Ltd 8,120
4. Paid Fitout Ltd on account 2,000
5. Purchased goods for resale from Restwood Ltd 8,880
6. Sold goods to A. Customer, on credit 3,670
7. Paid wages to store assistant 350
8. Goods taken for personal use 120
9. Drew cheque for own life insurance premium 590
10. Paid Fitout Ltd 5,000
11. Sold goods for cash 2,790
12. A. Customer returned goods 590
13. Purchased printer ribbons on credit from Office Supplies Ltd 150
14. Paid SmartPrint for advertising 400
15. Drew cheque for personal household rates 550
16. Sold goods for cash 3,650
17. Purchased stock from Easirest Furniture 5,450
18. Paid Restwood Ltd on account 5,000
19. Uplifted a bank term loan 6,000
20. Returned furniture to Easirest Furniture 350

4.10
Record the following transactions direct to ‘T’ accounts, showing the distinguishing numbers and amounts only.

1. Sold shares and banked proceeds in business bank account 21,000
2. Purchased goods from Chem Corp 8,000
3. Paid rent 1,000
4. Banked cash takings for week 7,000
5. Returned damaged goods to Chem Corp 200
6. Paid shop assistant wages 250
7. Paid errand person 50
8. Drew cheque for personal household rates 450
9. Paid Chem Corp on account 3,000
10. Paid for business insurance 900
11. Paid electricity 250
12. Banked cash takings for week  
13. Paid for special security door for shop  
14. Purchased goods on credit from Chem Corp  
15. Purchased shop fittings for cash  
16. Sold goods on credit to Makegood Ltd  
17. Banked cash takings for week  
18. Owner introduced additional capital in cash  
19. Purchased goods for cash  
20. Sold shop fittings for cash

4.11
What is the definition of a liability?

4.12
Given the Balance Sheet equation of \( A = L + P \), which balances would increase and/or decrease given the following transactions?

a. A car bought on credit  
b. A debtor pays an account  
c. A dividend paid to shareholders  
d. Shares issued to pay off a mortgage

4.13
What is the difference between a current asset and a fixed asset?

4.14
Give three examples of an intangible asset.

4.15
Which of the following transactions would decrease an asset and decrease owners’ equity?

a. Purchases made on credit  
b. A vehicle sold for cash  
c. Paying off a mortgage  
d. Owner taking drawings of inventory  
e. Plant purchased for cash

4.16
If Company X takes out a long-term loan of $12,000 and uses some of the money to pay income tax of $7,000, what is the overall effect on the Balance Sheet of the company?

<table>
<thead>
<tr>
<th></th>
<th>Assets</th>
<th>Equity</th>
<th>Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>+12,000</td>
<td>+12,000</td>
<td>+12,000</td>
</tr>
<tr>
<td>b.</td>
<td>-7,000</td>
<td>+12,000</td>
<td>-5,000</td>
</tr>
<tr>
<td>c.</td>
<td>-5,000</td>
<td>-7,000</td>
<td>+12,000</td>
</tr>
<tr>
<td>d.</td>
<td>+12,000</td>
<td>-7,000</td>
<td>+12,000</td>
</tr>
<tr>
<td>e.</td>
<td>+5,000</td>
<td>+12,000</td>
<td>-7,000</td>
</tr>
</tbody>
</table>

4.17
Financial Management and Decision Making

Show how each of the following transactions affects the basic accounting equation, \( A = L + P \).

a. Joe Manager paid savings of $11,000 into his business account at the trading bank.
b. Paid wages to store assistant, $400.
c. Paid shop rent by cheque, $600.
d. Purchased goods for resale from creditor, $8,500
e. Sold goods for cash $2,800.
f. Drew cheque for personal household rates, $600.
g. Sold goods on credit to A. Customer, $1,500.
h. Purchased goods for cash, $5,000.
i. Purchased Shop fittings with cash, $2,000.