

Preparing Journal Entries

The best way to learn accounting is to work with examples. Let's get started.

Let's first review the rules of debits and credits by working with the accounting equation (Assets = Liabilities + Stockholders' Equity). Assets are increased with debits and decreased with credits.

Liabilities are increased with credits and decreased with debits.

Account	Increase	Decrease	
Common Stock	Cr	Dr	Stockholders' Equity consists of several accounts:
Retained Earnings	Cr	Dr	
Revenues	Cr	Dr	
Expenses	Dr	Cr	
Dividends	Dr	Cr	

Common Stock, Retained Earnings, and Revenues all increase Stockholders' Equity and are increased with credits. Expenses and Dividends are overall decreases to Stockholders' Equity and are increased with debits.

We will work with a two step process.

Step 1 - Analyze the transaction.

Step 2 - Record the transaction in the general journal.

Transaction 1 - A new corporation issues 1,000 shares of common stock and receives \$75,000 cash.

Step 1 -- The corporation is raising capital by issuing shares of its stock.

Accounts Affected:

Assets - Cash is increased.

Stockholders' Equity - Common Stock is increased.

Step 2 -- The journal entry is

Cash 75,000

Common Stock 75,000

Transaction 2 -- The corporation acquires equipment. The purchase price is \$100,000. The corporation pays \$25,000 cash and signs a note for the balance.

Step 1 -- The asset, equipment, is acquired. The note payable represents debt and is a liability which is being increased. Some students want to use Accounts Payable. Accounts Payable is a liability but it reflects informal credit arrangements that are generally due in 30 - 45 days. Notes Payable, however, are formal legal promissory notes that have specific due dates, generally bear interest, and have a higher legal standing in a bankruptcy proceeding. Also, some students do not want to record an asset unless it has been fully paid for. Assets are recorded even if there is related debt. The company still owns the asset. Though the corporation does not have clear title to the asset until the related debt is paid, it is still the owner of the asset.

Accounts Affected:

Assets - Equipment is increased

Liabilities - Notes Payable is increased

Assets - Cash is decreased

Step 2 -- The journal entry is

Equipment	100,000	
Notes Payable	75,000	
Cash	25,000	

This is a compound entry because it has more than one credit. A transaction can affect more than one debit and/or more than one credit account. The important point is that the total of all debits equals the total of all credits for each journal entry.

Transaction 3 -- Services are performed and clients are billed for \$40,000.

Step 1 -- Services have been performed, thus revenue is recorded (to comply with the revenue recognition principle - record revenue when it is earned). Clients have been billed and will pay later. This reflects an increase to the asset, Accounts Receivable. Accounts Receivable represents open, informal credit granted to a company's clients or customers. The amounts are generally due in 30 - 45 days.

Accounts Affected:

Assets - Accounts Receivable is increased

Stockholders' Equity - Service Revenue is increased

Step 2 -- The journal entry is

Accounts Receivable	40,000	
Service Revenue		40,000

Transaction 4 -- Salaries of \$10,000 are paid.

Step 1 - Employees have worked and earned their salaries. This represents an expense of the accounting period. The matching principle requires expenses to be recorded in the period they are incurred to generate revenue.

Accounts Affected:

Stockholders' Equity - Expense is increased

Assets - Cash is decreased

Step 2 -- The journal entry is

Salaries Expense	10,000
Cash	10,000

Transaction 5 - Cash, in the amount of \$20,000, is collected from clients who were previously billed. (Transaction 3 - Services were performed and clients were billed for \$40,000.

Step 1 - Clients are paying on their accounts. Some students want to increase revenue with a credit. This is not correct because revenue is recorded when the services are performed (or when goods are delivered). The revenue was properly recorded in Transaction 3. This transaction is a swap of one asset for another.

Accounts Affected:

Asset - Cash is increased

Assets - Accounts Receivable is decreased

Step 2 -- The journal entry is

Cash	20,000
AR	20,000

Transaction 6 -- \$1,000 of supplies are purchased on account.

Step 1 -- An asset, Supplies, is acquired. There is no expense at this time. The expense will be recorded when these supplies are used up. For now, an asset exists because the supplies represent something of future value (something that will be used at a future date). No cash is being paid. The supplies are acquired on account (an increase to a liability).

Accounts Affected:

Assets - Supplies is increased

Liabilities - Accounts Payable is increased

Step 2 -- The journal entry is

Supplies	1,000
AP	1,000

Transaction 7 -- A contract is signed with a client. The client immediately pays \$15,000 for services to be performed at a later date.

Step 1 - No revenue has been earned because the company has simply worked out an agreement with the client. The asset, Cash, has been received and must be recorded. The credit is to a liability - Unearned Revenue. The company now owes the service or a refund to the client. Revenue will be recorded when the services have been performed.

Accounts Affected:

Assets - Cash is increased

Liabilities - Unearned Revenue is increased

Step 2 -- The journal entry is

Cash 15,000

Unearned Revenue 15,000

Transaction 8 -- \$1,000 is paid for the supplies purchased in Transaction 6.

Step 1 -- This transaction does not affect the asset account -- supplies. The asset, Supplies, was properly increased in Transaction 6. The company now is paying its liability.

Accounts Affected:

Liabilities - Accounts Payable is decreased

Assets - Cash is decreased

Step 2 -- The journal entry is

Accounts Payable 1,000

Cash 1,000

Transaction 9 -- Services are performed and cash of \$2,000 is received.

Step 1 -- The asset, Cash, is received. Services have been performed, thus revenue must be recorded. The revenue recognition principle states that revenues are recorded when they are earned.

Accounts Affected:

Assets - Cash is increased

Stockholders' Equity - Service Revenue is increased

Step 2 -- The journal entry is

Cash 2,000

Service Revenue 2,000

Transaction 10 -- Dividends of \$2,500 are paid to the stockholders.

Step 1 -- Dividends represent a distribution to stockholders. Dividends do not affect net income. The account is a negative component of stockholders' equity. Cash is paid to the stockholders.

Accounts Affected:

Assets - Cash is decreased

Stockholders' Equity - Dividends are increased

Step 2 -- The journal entry is

Dividends	2,500
Cash	2,500

These ten examples have given you an opportunity to work with the rules of debits and credits. (Practice)

In addition, you are now comfortable with the two step process of analyzing transactions and then recording them in the general journal. (Confidence)

This provides a sound foundation that will help you with more complicated transactions. (Building Blocks)