CHAPTER 5

Transactions That Affect Revenue, Expenses, and Withdrawals

What You'll Learn

1. Explain the difference between permanent accounts and temporary accounts.
2. List and apply the rules of debit and credit for revenue, expense, and withdrawals accounts.
3. Use the six-step method to analyze transactions affecting revenue, expense, and withdrawals accounts.
4. Test a series of transactions for equality of debits and credits.
5. Define the accounting terms introduced in this chapter.

Why It's Important

► Temporary accounts show the changes in owner's equity during each accounting period.

Before You Read

Predict

1. What does the chapter title tell you?
2. What do you already know about this subject from personal experience?
3. What have you learned about this in the earlier chapters?
4. What gaps exist in your knowledge of this subject?

Exploring the *Real World* of Business

ANALYZING REVENUE AND EXPENSES

Southwest Airlines

While other large airlines lost money after the 9/11 disaster, **Southwest Airlines** was flying high. The airline has posted more than 30 years of consecutive profits and become a model for newer airlines to follow.

Southwest carries more than 65 million passengers every year. Each one-way fare averaged over $88 per passenger.

Like any business, **Southwest** must consider expenses. Operating expenses include the cost of more than 1 billion gallons of jet fuel and payroll expenses for more than 32,000 employees. Don't forget the cost of snacks. **Southwest** serves 85 million bags of peanuts each year.

What Do You Think?

Aside from passenger fares, from what other sources do you think **Southwest Airlines** generates revenues?

SOUTHWEST

Working in the *Real World*

APPLYING YOUR ACCOUNTING KNOWLEDGE

When you receive a paycheck, you probably think about the amount of money you have and the things you would like to buy. Businesses like Southwest Airlines also earn money and spend it on items used to operate the business. In this chapter you will learn to analyze transactions involving the revenue and expenses of a business.

Personal Connection

1. How does your workplace (or the workplace of family or friends) earn revenue?
2. What does the business buy with that revenue?
3. How do these revenue and expense transactions affect the profits of a business?

Online Connection

Go to **glencoeaccounting.glencoe.com** and click on **Student Center.** Click on **Working in the Real World** and select **Chapter 5.**

SECTION 1

Relationship of Revenue, Expenses, and Withdrawals to Owner's Equity

BEFORE YOU READ

Main Idea

Revenues, expenses, and withdrawals are temporary accounts. They start each new accounting period with zero balances.

Read to Learn…

- how temporary account transactions change owner's equity. (p. 104)
- the rules of debit and credit for temporary accounts. (p. 106)

Key Terms

temporary accounts
permanent accounts

In Chapter 4 you learned to record transactions in asset, liability, and owner's capital accounts. In this chapter you will learn to record transactions in revenue, expense, and owner's withdrawals accounts. These accounts provide information about how the business is doing. A pilot for Southwest Airlines would never take off in a 737 equipped with only a speedometer and a gas gauge. These two instruments, although necessary, do not give a pilot all of the information needed to keep such a complex aircraft on course and operating smoothly. Operating a business is a bit like operating a 737. Owners need revenue and expense information to keep the business on course.

Temporary and Permanent Accounts

What Is the Difference Between Temporary Accounts and Permanent Accounts?

You learned earlier that the owner's capital account shows the amount of the owner's investment, or equity, in a business. Owner's equity is increased or decreased by transactions other than owner's investments. For example, the revenue, or income, earned by the business increases owner's equity. Both expenses and owner's withdrawals decrease owner's equity. (Remember that revenue is not the same as an owner's investment, and expense is not the same as an owner's withdrawal.)

Revenue, expenses, and withdrawals could be recorded as increases or decreases directly in the capital account. This method, however, makes classifying information about these transactions difficult. A more informative way to record transactions affecting revenue and expenses is to set up separate accounts for each type of revenue or expense. Such information helps the owner decide, for example, whether some expenses need to be reduced.

As you learned in Chapter 2, the life of a business is divided into periods of time called accounting periods. The activities for a given accounting period are summarized and then the period is closed. A new period starts, and transactions for the new period are entered into the accounting system. The process continues as long as the business exists.

Using Temporary Accounts. Revenue, expense, and withdrawals accounts are used to collect information for a single accounting period. These accounts are called **temporary accounts**. Temporary

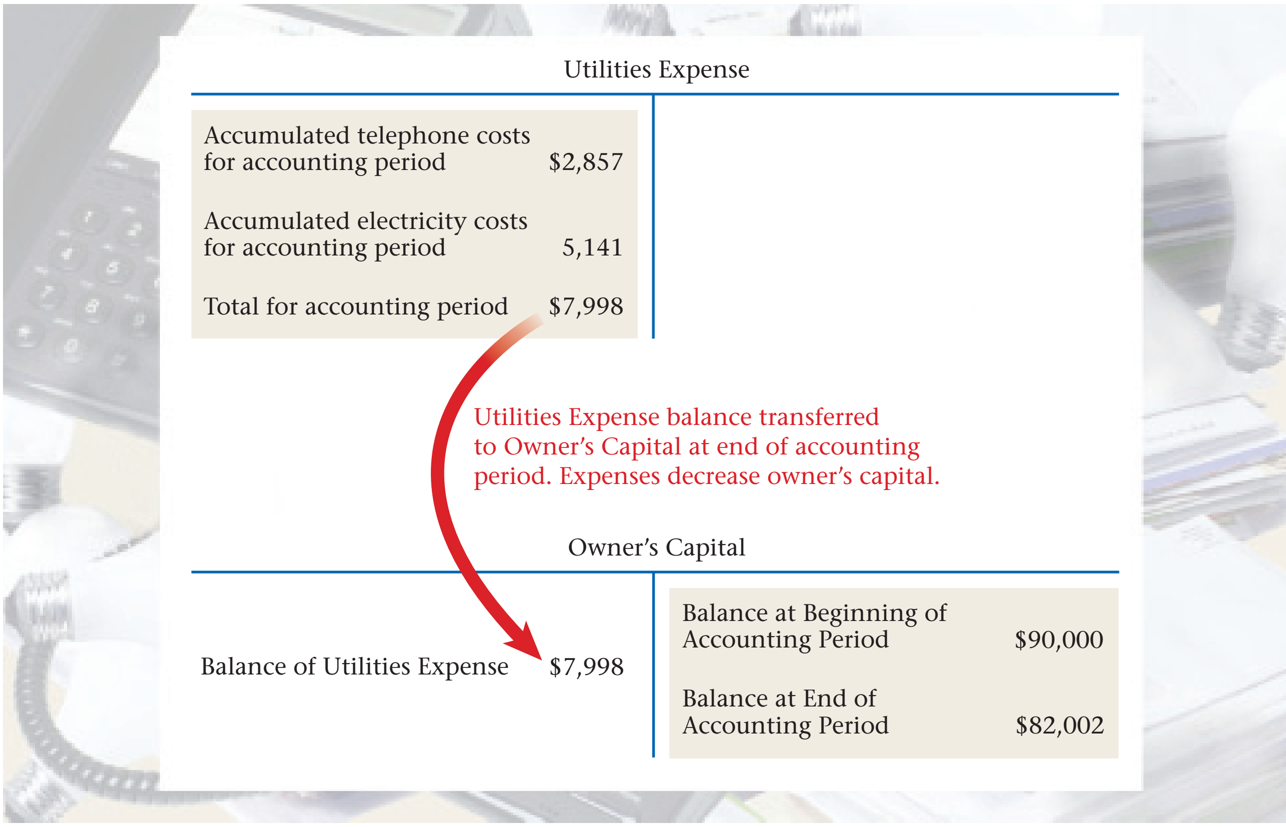


Figure 5–1 The Relationship of Temporary Accounts to the Owner's Capital Account

accounts start each new accounting period with zero balances. That is, the amounts in these accounts are not carried forward from one accounting period to the next. Temporary accounts are not temporary in the sense that they are used for a short time and then discarded. They continue to be used in the accounting system, but the amounts recorded in them accumulate for only one accounting period. At the end of that period, the balances in the temporary accounts are transferred to the owner's capital account. (The procedure for transferring these balances to owner's capital is explained in Chapter 10.)

Let's use **Utilities Expense**, a temporary account, as an example. During an accounting period, business transactions related to utilities such as electricity and telephones are recorded in **Utilities Expense.** By using this separate account, the owner can see at a glance how much money is being spent on this expense. The individual transaction amounts accumulate in the account as the accounting period progresses.

At the end of the period, the total spent is transferred to the owner's capital account and subtracted from the capital account balance. Remember, expenses decrease owner's capital. In **Figure 5–1**, the account, **Utilities Expense**, starts the next accounting period with a zero balance—ready for the transactions in the new period.

Using Permanent Accounts. In contrast to the temporary accounts, the owner's capital account is a permanent account. Asset and liability accounts are also permanent accounts. **Permanent accounts** are continuous from one accounting period to the next. In permanent accounts

As You READ
Instant Recall

Permanent Account Normal Balances

Assets	→	debit
Liabilities	→	credit
Owner's Capital	→	credit

the dollar balances at the end of one accounting period become the dollar balances for the beginning of the next accounting period.

For example, if a business has furniture totaling $2,875 at the end of one accounting period, the business will start with $2,875 in furniture at the beginning of the next accounting period. The ending balances in permanent accounts are carried forward to the next accounting period as the beginning balances.

End of Accounting Period		Beginning of Next Accounting Period	
Furniture		Furniture	
Debit	Credit	Debit	Credit
End Bal. 2,875		Beg. Bal. 2,875	

The permanent accounts show balances on hand or amounts owed at any time. They also show the day-to-day changes in assets, liabilities, and owner's capital.

The Rules of Debit and Credit for Temporary Accounts

What Are the Normal Balances of Revenue, Expense, and Withdrawals Accounts?

As You READ
It's Not What It Seems

Temporary The term *temporary* might make you think of something that lasts for a limited time. A *temporary* account, however, always stays in the ledger. Its balance is reduced to zero at the end of each accounting period.

In Chapter 4 you learned the rules of debit and credit for the asset, liability, and owner's capital accounts. In this chapter we will continue with the rules of debit and credit, this time for revenue, expense, and withdrawals accounts. Before looking at these rules, let's review quickly the T account showing the rules of debit and credit for the owner's capital account.

Owner's Capital Account	
Debit − Decrease Side	Credit + Increase Side Normal Balance

As you will see, the rules of debit and credit for accounts classified as revenue, expense, and withdrawals accounts are related to the rules for the owner's capital account.

Rules for Revenue Accounts

Accounts set up to record business income are classified as revenue accounts. The following rules of debit and credit apply to revenue accounts:

Rule 1: A revenue account is *increased* (+) on the *credit* side.
Rule 2: A revenue account is *decreased* (−) on the *debit* side.
Rule 3: The *normal balance* for a revenue account is the *increase* side, or the *credit* side. Revenue accounts normally have credit balances.

Revenue earned from selling goods or services increases owner's capital. The relationship of revenue accounts to the owner's capital account is shown by the T accounts in **Figure 5–2.** Can you explain why the T account for revenue is used to represent the credit (right) side of the capital account?

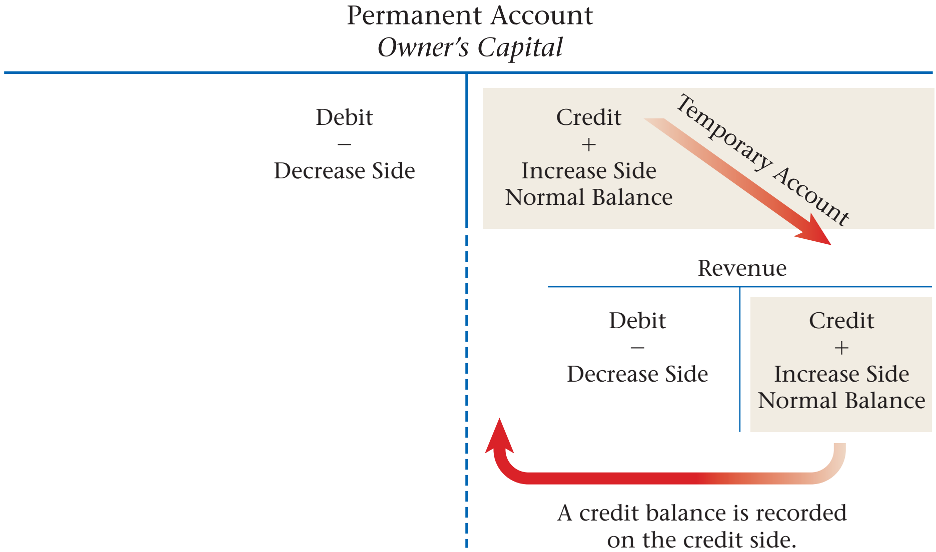


Figure 5–2 Rules of Debit and Credit for Revenue Accounts

Increases in owner's capital are shown on the credit side of that account. Revenue increases owner's capital, so the revenue account is used to represent the credit side of the owner's capital account.

We can summarize the rules of debit and credit for revenue accounts with a T account illustration.

Revenue Accounts	
Debit – (2) Decrease Side	Credit + (1) Increase Side (3) Normal Balance

Let's apply the rules of debit and credit to an actual revenue account. Look at the entries in the T account for the revenue account called **Fees.** The increases to the revenue account are recorded on the right, or credit, side of the T account. The decreases are recorded on the left, or debit, side. To find the balance, subtract total debits ($200) from total credits ($500 + $1,000 + $2,000 = $3,500). You get a balance of $3,300 on the credit side, the normal balance side for a revenue account.

Fees	
Debit – 200	Credit + 500 1,000 2,000 Bal. 3,300

Rules for Expense Accounts

Accounts that record the costs of operating a business are expense accounts. These debit and credit rules apply to expense accounts:

Rule 1: An expense account is *increased* on the *debit* side.
Rule 2: An expense account is *decreased* on the *credit* side.
Rule 3: The *normal balance* for an expense account is the *increase* side, or the *debit* side. Expense accounts normally have debit balances.

As You READ
Key Point
Temporary Account Normal Balances
Revenue → credit
Expense → debit
Owner's Withdrawals → debit

As You READ
In Your Own Words
Temporary and Permanent Explain how the terms *temporary* and *permanent* apply to ledger accounts.

Expenses are the costs of doing business. Expenses decrease owner's capital. Revenues have the opposite impact; revenues increase owner's capital. Look at the T accounts in **Figure 5–3.** Can you explain why the T account for expenses is used to represent the debit (left) side of the capital account?

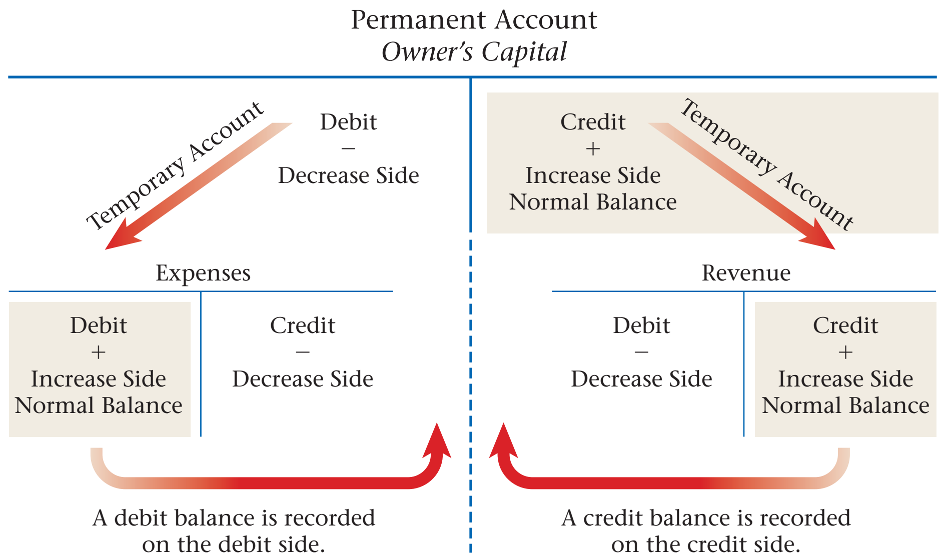


Figure 5–3 Rules of Debit and Credit for Expense Accounts

Decreases in owner's capital are shown on the debit side of that account. Since expenses decrease owner's capital, expense accounts are used to represent the debit side of the owner's capital account.

Let's use a T account to summarize the rules of debit and credit for expense accounts.

Expense Accounts	
Debit + (1) Increase Side (3) Normal Balance	Credit – (2) Decrease Side

Now look at the entries recorded in the T account called **Advertising Expense.** The increases to the expense account are recorded on the left, or debit, side of the T account. The decreases to the account are recorded on the right, or credit, side of the T account. When total credits ($125) are subtracted from total debits ($600), there is a balance of $475 on the debit side, which is the normal balance side for expense accounts.

Advertising Expense	
Debit +	Credit –
400	125
200	
Bal. 475	

Rules for the Withdrawals Account

A withdrawal is an amount of money or an asset the owner takes out of the business. The withdrawals account is classified as a temporary owner's equity account. Recall that the permanent owner's equity account is the owner's capital account. Withdrawals, like expenses, decrease capital, so the rules of debit and credit are the same as for expense accounts.

Withdrawals Account	
Debit + (1) Increase Side (3) Normal Balance	Credit – (2) Decrease Side

Rule 1: The withdrawals account is *increased* on the *debit* side.

Rule 2: The withdrawals account is *decreased* on the *credit* side.

Rule 3: The *normal balance* for the withdrawals account is the *increase* side or *debit* side. The withdrawals account normally has a debit balance.

W. Smith, Withdrawals	
Debit +	Credit –
500	200
1,500	
Bal. 1,800	

Review the entries in the T account **W. Smith, Withdrawals.** The increases are recorded on the left, or debit side, of the T account. The decreases are recorded on the right, or credit, side of the T account. When total credits ($200) are subtracted from total debits ($2,000), there is a balance of $1,800 on the debit side, which is the normal balance side for the withdrawals account.

As You READ

Compare and Contrast

Capital and Withdrawals Consider the owner's capital account and the owner's withdrawals account. How are they similar? How are they different?

Summary of the Rules of Debit and Credit for Temporary Accounts

Figure 5–4 summarizes the rules of debit and credit for the temporary accounts and the basic accounting relationships of these accounts to the owner's capital account.

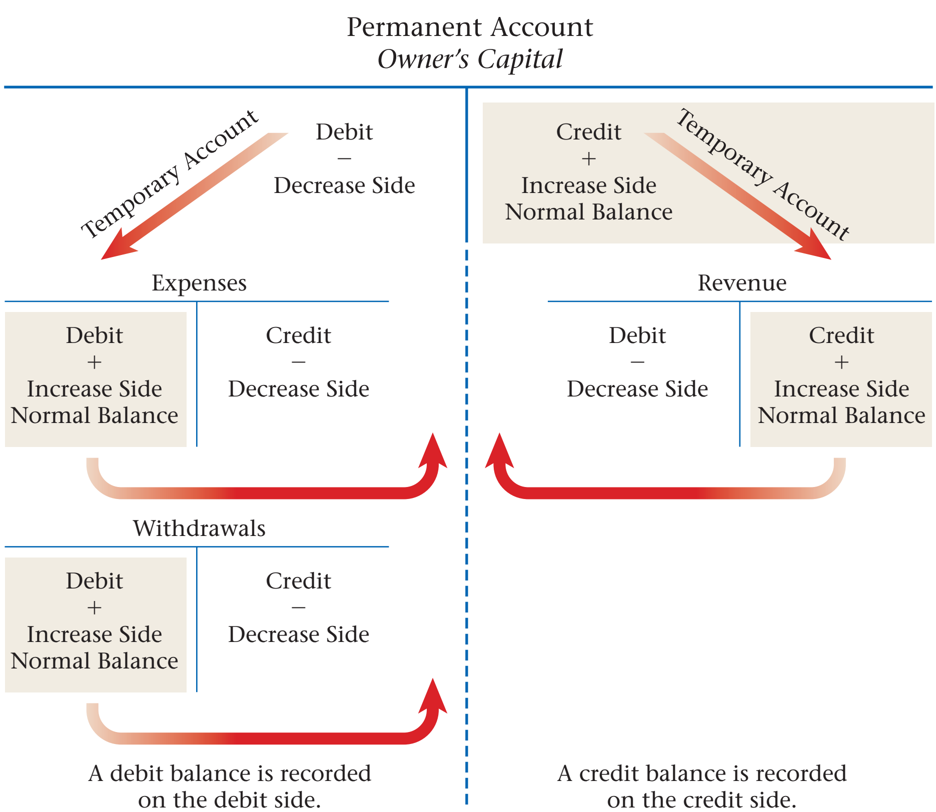


Figure 5–4 Rules of Debit and Credit for Temporary Accounts

SECTION 1 **Assessment**

AFTER YOU READ

Reinforce the Main Idea

Create a chart like this one to illustrate the different types of accounts. Fill in each blank box with one or more of the following terms: *assets, liabilities, owner's capital, revenue, expenses, owner's withdrawals.*

	Normal Debit Balance	Normal Credit Balance
Permanent Accounts		
Temporary Accounts		

Do the Math

A company had the following activity during the accounting period:

Made sales:	$5,000
Incurred advertising expenses:	500
Incurred salaries expenses:	3,000
Deposited a check from the owner's personal savings account:	1,200

Additionally, the owner removed a computer from the business for personal use. The business had paid $650 for the computer. What was the total effect on owner's equity?

Problem 5–1 Applying the Rules of Debit and Credit

Caroline Palmer uses the following accounts in her San Francisco–Los Angeles commuter shuttle service.

General Ledger

Cash in Bank	Caroline Palmer, Capital
Advertising Expense	Accounts Receivable
Caroline Palmer, Withdrawals	Food Expense
Airplanes	Flying Fees
Fuel and Oil Expense	Accounts Payable
Repairs Expense	

Instructions In the form provided in your working papers, provide the following information for each account. The first account is completed as an example.

1. Classify the account as an asset, liability, owner's equity, revenue, or expense account.
2. Indicate whether the increase side is a debit or a credit.
3. Indicate whether the decrease side is a debit or a credit.
4. Indicate whether the account has a normal debit balance or a normal credit balance.

Account Name	Account Classification	Increase Side	Decrease Side	Normal Balance
Cash in Bank	Asset	Debit	Credit	Debit

SECTION 2

Applying the Rules of Debit and Credit to Revenue, Expense, and Withdrawals Transactions

In Section 1 you learned the rules of debit and credit for revenue, expense, and withdrawals accounts. Learning to apply these rules to typical business transactions is our next task. In the course of a week, a business might receive money, pay rent, or pay utility bills. Let's look at more transactions for Roadrunner Delivery Service.

BEFORE YOU READ

Main Idea

Double-entry accounting requires that total debits and total credits are always equal.

Read to Learn…

- ➤ how to analyze revenue, expense, and owner's withdrawals transactions. (p. 111)
- ➤ how to confirm that total debits and total credits are equal in the ledger. (p. 115)

Key Term

revenue recognition

Analyzing Transactions

How Do You Analyze Transactions That Involve Temporary Accounts?

In Chapter 4 Roadrunner's transactions dealt with asset and liability accounts and with the permanent owner's equity account, **Maria Sanchez, Capital.** Using the rules of debit and credit, let's analyze several business transactions that affect revenue, expense, and owner's withdrawals accounts. Use the same six-step method you learned in Chapter 4. Refer to Roadrunner's chart of accounts on page 79 to analyze the following transactions.

Business Transaction 8

On October 15 Roadrunner provided delivery services for Sims Corporation. A check for $1,200 was received in full payment.

ANALYSIS — *Identify* / *Classify* / +/−

1. The accounts **Cash in Bank** and **Delivery Revenue** are affected.
2. **Cash in Bank** is an asset account. **Delivery Revenue** is a revenue account.
3. **Cash in Bank** is increased by $1,200. **Delivery Revenue** is increased by $1,200.

DEBIT-CREDIT RULE

4. Increases in asset accounts are recorded as debits. Debit **Cash in Bank** for $1,200.
5. Increases in revenue accounts are recorded as credits. Credit **Delivery Revenue** for $1,200.

T ACCOUNTS

6.

Cash in Bank		Delivery Revenue	
Debit +	Credit −	Debit −	Credit +
1,200			1,200

Business Transaction 9

On October 16 Roadrunner mailed Check 103 for $700 to pay the month's rent.

ANALYSIS *Identify* *Classify* +/−

1. The accounts **Rent Expense** and **Cash in Bank** are affected.
2. **Rent Expense** is an expense account. **Cash in Bank** is an asset account.
3. **Rent Expense** is increased by $700. **Cash in Bank** is decreased by $700.

DEBIT-CREDIT RULE

4. Increases in expense accounts are recorded as debits. Debit **Rent Expense** for $700.
5. Decreases in asset accounts are recorded as credits. Credit **Cash in Bank** for $700.

T ACCOUNTS

6.

Rent Expense		Cash in Bank	
Debit +	Credit −	Debit +	Credit −
700			700

Business Transaction 10

On October 18 Beacon Advertising prepared an advertisement for Roadrunner. Roadrunner will pay Beacon's $75 fee later.

ANALYSIS *Identify* *Classify* +/−

1. The accounts **Advertising Expense** and **Accounts Payable—Beacon Advertising** are affected.
2. **Advertising Expense** is an expense account. **Accounts Payable—Beacon Advertising** is a liability account.
3. **Advertising Expense** is increased by $75. **Accounts Payable—Beacon Advertising** is increased by $75.

DEBIT-CREDIT RULE

4. Increases in expense accounts are recorded as debits. Debit **Advertising Expense** for $75.
5. Increases in liability accounts are recorded as credits. Credit **Accounts Payable—Beacon Advertising** for $75.

T ACCOUNTS

6.

Advertising Expense	
Debit + 75	Credit −

Accounts Payable—Beacon Advertising	
Debit −	Credit + 75

Business Transaction 11

On October 20 Roadrunner billed City News $1,450 for delivery services.

ANALYSIS

Identify 1. The accounts **Accounts Receivable—City News** and **Delivery Revenue** are affected.

Classify 2. **Accounts Receivable—City News** is an asset account. **Delivery Revenue** is a revenue account.

+/− 3. **Accounts Receivable—City News** is increased by $1,450. **Delivery Revenue** is increased by $1,450.

DEBIT-CREDIT RULE

4. Increases in asset accounts are recorded as debits. Debit **Accounts Receivable—City News** for $1,450.
5. Increases in revenue accounts are recorded as credits. Credit **Delivery Revenue** for $1,450.

T ACCOUNTS

6.

Accounts Receivable—City News	
Debit + 1,450	Credit −

Delivery Revenue	
Debit −	Credit + 1,450

In Transaction 11 Roadrunner recorded revenue for services provided, even though the money had not been collected. Following the GAAP principle of **revenue recognition**, revenue is recorded on the date earned, even if cash has not been received.

Business Transaction 12

On October 28 Roadrunner paid a $125 telephone bill with Check 104.

ANALYSIS

Identify 1. The accounts **Utilities Expense** and **Cash in Bank** are affected.

Classify 2. **Utilities Expense** is an expense account. **Cash in Bank** is an asset account.

+/− 3. **Utilities Expense** is increased by $125. **Cash in Bank** is decreased by $125.

DEBIT-CREDIT RULE

4. Increases in expense accounts are recorded as debits. Debit **Utilities Expense** for $125.
5. Decreases in asset accounts are recorded as credits. Credit **Cash in Bank** for $125.

T ACCOUNTS

6.

Utilities Expense	
Debit +	Credit −
125	

Cash in Bank	
Debit +	Credit −
	125

Business Transaction 13

On October 29 Roadrunner wrote Check 105 for $600 to have the office repainted.

ANALYSIS

Identify 1. The accounts **Maintenance Expense** and **Cash in Bank** are affected.

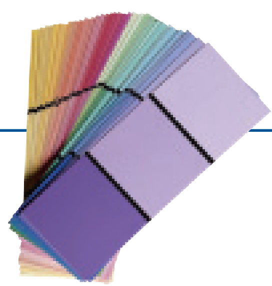
Classify 2. **Maintenance Expense** is an expense account. **Cash in Bank** is an asset account.

+/− 3. **Maintenance Expense** is increased by $600. **Cash in Bank** is decreased by $600.

DEBIT-CREDIT RULE

4. Increases in expense accounts are recorded as debits. Debit **Maintenance Expense** for $600.
5. Decreases in asset accounts are recorded as credits. Credit **Cash in Bank** for $600.

T ACCOUNTS



6.

Maintenance Expense	
Debit +	Credit −
600	

Cash in Bank	
Debit +	Credit −
	600

Business Transaction 14

On October 31 Maria Sanchez wrote Check 106 to withdraw $500 cash for personal use.

ANALYSIS

Identify 1. The accounts **Maria Sanchez, Withdrawals** and **Cash in Bank** are affected.

Classify 2. **Maria Sanchez, Withdrawals** is an owner's equity account. **Cash in Bank** is an asset account.

+/− 3. **Maria Sanchez, Withdrawals** is increased by $500. **Cash in Bank** is decreased by $500.

DEBIT-CREDIT RULE

4. Increases in the owner's withdrawals account are recorded as debits. Debit **Maria Sanchez, Withdrawals** for $500.
5. Decreases in assets are recorded as credits. Credit **Cash in Bank** for $500.

T ACCOUNTS

6.

Maria Sanchez, Withdrawals	
Debit + 500	Credit –

Cash in Bank	
Debit +	Credit – 500

Testing for the Equality of Debits and Credits

Why Should You Make Sure the Ledger Is in Balance?

In a double-entry accounting system, correct analysis and recording of business transactions should result in total debits being equal to total credits. Testing for the equality of debits and credits is one way of finding out whether you have made any errors in recording transaction amounts. To test for the equality of debits and credits, follow these steps:

Step 1. Make a list of the account names used by the business.
Step 2. To the right of each account name, list the balance of the account. Use two columns, one for debit balances and the other for credit balances.
Step 3. Add the amounts in each column.

If you have recorded all the amounts correctly, the total of the debit column will equal the total of the credit column. The test for equality of debits and credits for the transactions in Chapters 4 and 5 shows that total debits are equal to total credits, so the ledger is in balance.

ACCOUNT NAME		DEBIT BALANCES	CREDIT BALANCES
101	Cash in Bank	$ 21,125	
105	Accounts Receivable—City News	1,450	
110	Accounts Receivable—Green Company		
115	Computer Equipment	3,000	
120	Office Equipment	200	
125	Delivery Equipment	12,000	
201	Accounts Payable—Beacon Advertising		$ 75
205	Accounts Payable—North Shore Auto		11,650
301	Maria Sanchez, Capital		25,400
302	Maria Sanchez, Withdrawals	500	
303	Income Summary		
401	Delivery Revenue		2,650
501	Advertising Expense	75	
505	Maintenance Expense	600	
510	Rent Expense	700	
515	Utilities Expense	125	
		$ 39,775	$ 39,775

+/- MATH HINTS

Showing Cents When writing amounts of money, be consistent in showing cents. If one amount includes cents, show cents for all the amounts. Be sure to align the amounts on the decimal points.

Incorrect:
$ 21,125
1,450.77

Correct:
$ 21,125.00
1,450.77

SECTION 2 Assessment

AFTER YOU READ

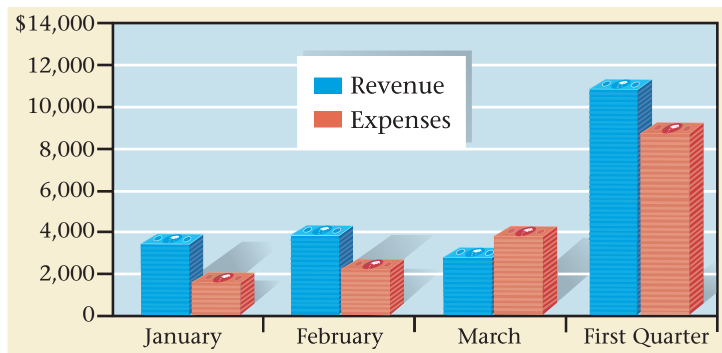
Reinforce the Main Idea

Use a chart like this to organize the test for the equality of debits and credits. Write each of these terms in the appropriate box: *assets, liabilities, owner's capital, owner's withdrawals, revenue, expenses.* (Don't use the shaded boxes.)

Debit Balances	Credit Balances

Do the Math

This bar chart shows the first quarter's revenue and expense. In approximate amounts, what month had the most revenue and what was the amount? What month had the highest expense and what was the amount? Overall, did the business have a profit or loss? What was the amount?



Problem 5–2 Identifying Accounts Affected by Transactions

John Albers uses the following accounts in his business.

General Ledger		
Cash in Bank	John Albers, Capital	Advertising Expense
Accounts Receivable	John Albers, Withdrawals	Rent Expense
Office Equipment	Service Fees	Utilities Expense
Accounts Payable		

Instructions In your working papers:

1. Identify the two accounts affected by each of the following transactions.
2. Indicate whether each account is debited or credited.

Date		Transactions
July	1	**1.** Issued Check 543 to pay the electric bill for the month.
	3	**2.** Billed a customer for services provided on account.
	10	**3.** John Albers took cash from the business for his personal use.
	17	**4.** Issued Check 544 to pay for an advertisement.

CONTENTS

Accounting Careers in Focus

Equity Research Associate

Eaton Vance Management, Boston, Massachusetts
Rukma Raybardhan

Q: What does Eaton Vance Management do?

A: We manage portfolios, or groups of investments.

Q: What are your day-to-day responsibilities?

A: I conduct preliminary research for analysts who cover certain industries and build and maintain financial models. My job involves reviewing and summarizing financial statements and attending meetings.

Q: What do you find exciting about your job?

A: I love the fact that I get to see the results of my work by following the performance of our investments. I enjoy learning about various industries and companies, and I learn something new every day.

Q: What advice do you have for accounting students just beginning their careers?

A: Work hard and get good grades. Also, concentrate on finding internships. The internships I held worked in my favor when I was looking for my first job in finance. Try to network as much as possible. You never know who can help your career advancement and open doors for you.

Tips from . . .

Robert Half International Inc.

When it comes to your job search, knowing the right person can make all the difference. Many job openings are filled by word of mouth or through referrals. Tell everyone you know about your job hunt, including your family, friends, neighbors, and teachers. You might be surprised by who is able to help you.

Career Facts

- **Nature of Work:** Assist analysts with investment research.
- **Training or Education Needed:** A bachelor's degree with a concentration in accounting or finance.
- **Aptitudes, Abilities, and Skills:** An understanding of the stock market; strong analytical skills; attention to detail.
- **Salary Range:** $40,000 and up, depending on experience and employer.
- **Career Path:** Start in an entry-level position. As you gain experience and prepare to move into higher-level roles, consider obtaining a master's degree in business administration or becoming a chartered financial analyst (CFA). The CFA title is an important credential for people working in the investment field.

Thinking Critically What are some of the best ways to network with other accounting professionals?

CHAPTER 5 Summary

Key Concepts

1. The accounts used by a business can be separated into permanent accounts and temporary accounts.

   Permanent accounts carry balances forward from one accounting period to the next. The following types of accounts are permanent accounts:

   - assets
   - liabilities
   - owner's capital

   Temporary accounts accumulate dollar amounts for only one accounting period and then start each new accounting period with a zero balance. The following types of accounts are temporary accounts:

   - revenue
   - expenses
   - owner's withdrawals

2. The rules of debit and credit for permanent accounts are summarized as follows:

ASSETS = LIABILITIES + OWNER'S EQUITY

Permanent Accounts

Asset Accounts		Liability Accounts		Owner's Capital Account	
Debit + Increase Side Normal Balance	Credit – Decrease Side	Debit – Decrease Side	Credit + Increase Side Normal Balance	Debit – Decrease Side	Credit + Increase Side Normal Balance

The rules of debit and credit for temporary accounts are summarized as follows:

Temporary Accounts

Revenue		Expenses		Withdrawals	
Debit – Decrease Side	Credit + Increase Side Normal Balance	Debit + Increase Side Normal Balance	Credit – Decrease Side	Debit + Increase Side Normal Balance	Credit – Decrease Side

Revenue Accounts

Rule 1: A revenue account is *increased* (+) on the *credit* side.
Rule 2: A revenue account is *decreased* (−) on the *debit* side.
Rule 3: The *normal balance* for a revenue account is the *increase* side, or the *credit* side. Revenue accounts normally have credit balances.

Expense Accounts

Rule 1: An expense account is *increased* on the *debit* side.
Rule 2: An expense account is *decreased* on the *credit* side.
Rule 3: The *normal balance* for an expense account is the *increase* side, or the *debit* side. Expense accounts normally have debit balances.

The Withdrawals Account

Rule 1: The withdrawals account is *increased* on the *debit* side.
Rule 2: The withdrawals account is *decreased* on the *credit* side.
Rule 3: The *normal balance* for the withdrawals account is the *increase* side or *debit* side. The withdrawals account normally has a debit balance.

3. Follow the six-step method you learned in Chapter 4 to analyze transactions affecting revenue, expense, and withdrawals.

   Step 1: Identify the accounts affected.
   Step 2: Classify the accounts affected.
   Step 3: Determine the amount of increase or decrease for each account affected.
   Step 4: Determine which account is debited and for what amount.
   Step 5: Determine which account is credited and for what amount.
   Step 6: Use T accounts to describe the entry.

4. In a double-entry accounting system, total debits should always equal total credits. Use these steps to test for the equality of debits and credits.

   Step 1: List the account names the business uses.
   Step 2: To the right of each account name, list its account balance. Use two columns, one for debit balances and the other for credit balances.
   Step 3: Add the amounts in each column.

Key Terms

permanent accounts (p. 105)
revenue recognition (p. 113)
temporary accounts (p. 104)

CHAPTER 5 Review and Activities

AFTER YOU READ

Check Your Understanding

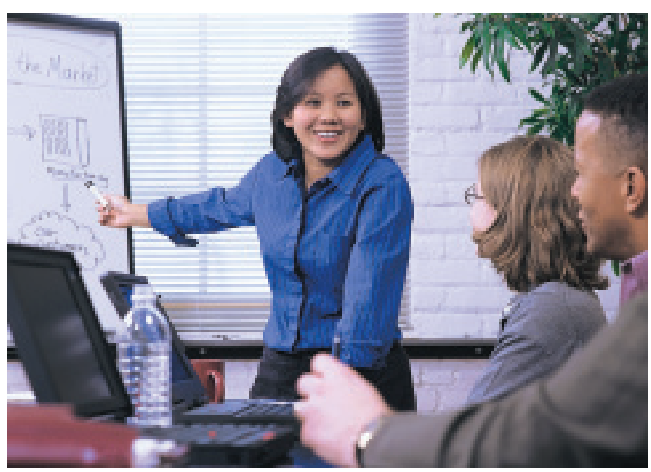
1. **Permanent and Temporary Accounts**
   - **a.** Why are temporary accounts used?
   - **b.** What is the difference between a temporary account and a permanent account?
2. **Debit and Credit Rules**
   - **a.** State briefly the rules of debit and credit for increasing and decreasing each of the following types of accounts:
     - assets
     - liabilities
     - owner's capital
   - **b.** State briefly the rules of debit and credit for increasing and decreasing each of the following types of accounts:
     - revenue
     - expenses
     - owner's withdrawals
3. **Temporary Account Transactions**
   - **a.** Which account classification contains both a permanent account and a temporary account?
   - **b.** If one side of a transaction involves a revenue account, can the other side involve the owner's capital account? Why or why not?
4. **Tests of Equality**
   - **a.** Why should you test for the equality of debits and credits?
   - **b.** How would you test for the equality of debits and credits?

Apply Key Terms

You have been asked to make a presentation to your company's owners. For the owners to understand the difference in the accounts you manage, you must be able to explain the following key terms:

permanent accounts	temporary accounts
revenue recognition	

Create three examples that could be used as overhead transparencies. Each example (master) should show a term, a brief definition, and an illustration or example.



The Chart of Accounts

Making the Transition from a Manual to a Computerized System

Task	Manual Methods	Computerized Methods
Setting up the accounts in a general ledger	• Accounts are set up in the general ledger using general ledger account forms. • Accounts can be set up with or without beginning balances.	• Accounts are set up using defined account numbers and account types. • Accounts can be set up with or without beginning balances. • Accounting software programs offer hundreds of sample companies from which you can copy the chart of accounts instead of creating each account individually.

Chart of Accounts

Assets	**Owner's Equity**
Cash in Bank	Maria Sanchez, Capital
Accounts Receivable	Maria Sanchez, Withdrawals
Computer Equipment	
Office Equipment	**Revenue**
Delivery Equipment	Delivery Revenue
Liabilities	**Expenses**
Accounts Payable	Advertising Expense
	Maintenance Expense
	Rent Expense

Peachtree® Q & A

Peachtree Question	Answer
How do I create general ledger accounts in Peachtree?	1. From the ***Maintain*** menu, select **Chart of Accounts.** 2. Enter the account number in the Account ID box. 3. Enter the account name in the Description box. 4. From the Account Type drop-down list, select the account type. 5. Click **Save.**

QuickBooks Q & A

QuickBooks Question	Answer
How do I create general ledger accounts in QuickBooks?	1. From the ***Lists*** menu, select **Chart of Accounts.** 2. Click the Account pull-down menu and choose **New.** 3. From the Type drop-down list, select the account type. 4. Enter the account number in the *Number* field and account name in the *Name* field. 5. Click **OK.**

For detailed instructions, see your Glencoe Accounting Chapter Study Guides and Working Papers.

Problems

Complete problems using: **Manual Glencoe Working Papers** OR **Peachtree Complete Accounting Software** OR **Spreadsheet Templates**

Peachtree®

SMART GUIDE

Step-by-Step Instructions: Problem 5–3

1. Select the problem set for Wilderness Rentals (Prob. 5–3).
2. Rename the company and set the system date.
3. Print a Chart of Accounts using the **General Ledger** option in the ***Reports*** menu.
4. Review the Chart of Accounts.
5. Complete the Analyze activity manually.
6. End the session.

Problem 5–3 Identifying Increases and Decreases in Accounts

Ronald Hicks uses these accounts in his business, Wilderness Rentals.

General Ledger

101 Cash in Bank	301 Ronald Hicks, Capital
105 Accounts Receivable—Helen Katz	305 Ronald Hicks, Withdrawals
120 Office Equipment	401 Equipment Rental Revenue
125 Camping Equipment	505 Maintenance Expense
	525 Utilities Expense

Instructions Analyze each of the following transactions using the format shown in the example below. Record your answers in your working papers.

a. Explain the debit.
b. Explain the credit.

Example:
On Jan. 2 Ronald Hicks paid the bill for office cleaning, $100.

a. The expense account **505 Maintenance Expense** is increased. Increases in expenses are recorded as debits.
b. The asset account **101 Cash in Bank** is decreased. Decreases in assets are recorded as credits.

Date	Transactions
Jan. 3	1. Ronald Hicks withdrew $500 from his business for his own use, Check 225.
8	2. The business received $1,200 cash in rental fees from various customers.
12	3. The business paid a telephone bill of $85, Check 226.

Analyze Calculate the amount of increase or decrease in the Cash in Bank account.

Peachtree®

SMART GUIDE

Step-by-Step Instructions: Problem 5–4

1. Select the problem set for Hot Suds Car Wash (Prob. 5–4).
2. Rename the company and set the system date.
3. Print a Chart of Accounts using the **General Ledger** option in the ***Reports*** menu.
4. Review the Chart of Accounts.
5. Complete the Analyze activity manually.
6. End the session.

TIP: You will learn how to enter transactions into the accounts in the next chapter.

Problem 5–4 Using T Accounts to Analyze Transactions

Regina Delgado, owner of Hot Suds Car Wash, uses these accounts:

General Ledger

101 Cash in Bank	401 Wash Revenue
125 Office Equipment	510 Maintenance Expense
205 Accounts Payable—O'Brian's Office Supply	520 Rent Expense
301 Regina Delgado, Capital	
305 Regina Delgado, Withdrawals	

CONTINUE

CONTENTS

Problems

Instructions In your working papers:

1. Determine which accounts are affected for each transaction.
2. Prepare T accounts for the accounts affected.
3. Enter the amount of the debit and the amount of the credit in the T accounts.

Date	Transactions
Jan. 7	1. Received a check for $1,675 for car wash services.
12	2. Paid the monthly rent of $450 by writing Check 212.
15	3. Regina Delgado withdrew $250 for her personal use, Check 213.
29	4. Had the computer repaired at O'Brian's Office Supply for $245 and was given until next month to pay.

Analyze Identify the transactions that affect expense accounts.

Problem 5–5 Analyzing Transactions into Debit and Credit Parts

Abe Shultz, owner of Kits & Pups Grooming, uses the following accounts to record transactions for the month.

General Ledger

101	Cash in Bank	401	Boarding Revenue
105	Accounts Receivable—Juan Alvarez	405	Grooming Revenue
140	Grooming Equipment	501	Advertising Expense
205	Accounts Payable—Dogs & Cats Inc.	505	Equipment Repair Expense
301	Abe Shultz, Capital	510	Maintenance Expense
305	Abe Shultz, Withdrawals	520	Rent Expense
		530	Utilities Expense

Instructions For each transaction:

1. Prepare a T account for each account listed.
2. Enter a balance of $15,000 in the **Cash in Bank** account; also enter a balance of $15,000 in the **Abe Shultz, Capital** account.
3. Analyze and record each of the following business transactions, using the appropriate T accounts. Identify each transaction by number.
4. After all the business transactions have been recorded, write the word *Balance* on the normal balance side of each account.
5. Compute and record the balance for each account.

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SMART GUIDE

Step-by-Step Instructions: Problem 5–5

1. Select the problem set for Kits & Pups Grooming (Prob. 5–5).
2. Rename the company and set the system date.
3. Add new general ledger accounts using the **Chart of Accounts** option in the ***Maintain*** menu.
4. Enter beginning balances using the **Chart of Accounts** option in the ***Maintain*** menu.
5. Print a Chart of Accounts using the **General Ledger** option in the ***Reports*** menu.
6. Proof your work.
7. Complete the Analyze activity manually.
8. End the session.

TIP: When a report list appears, double-click a report title to go directly to that report.

QuickBooks

PROBLEM GUIDE

Step-by-Step Instructions: Problem 5–5

1. Restore the Problem 5-5.QBB file.
2. Add new general ledger accounts using the **Chart of Accounts** option in the ***Lists*** menu.
3. Enter beginning balances using the **Chart of Accounts** option in the ***Lists*** menu.
4. Print a Chart of Accounts by selecting **Print List** in the ***File*** menu.
5. Proof your work.
6. Complete the Analyze activity manually.
7. Back up your work.

CONTINUE

CONTENTS

Date		Transactions
Jan.	1	1. Purchased grooming equipment for $12,700, Check 283.
	10	2. Wrote Check 284 for advertising, $125.
	12	3. Received $1,850 cash for dog boarding services.
	15	4. Paid $150 for equipment repair, Check 285.
	17	5. Purchased a dog cage on account from Dogs & Cats Inc. for $75.
	20	6. Abe Shultz withdrew $150 for personal use, Check 286.
	22	7. Billed Juan Alvarez for $775 covering grooming services for all of the dogs boarded at the kennels he owns. Payment will be received later.
	23	8. Paid the first two weeks' rent by writing Check 287 for $325.
	25	9. Paid the electric bill at a cost of $115, Check 288.

Analyze Identify the transactions that affect owner's equity.

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SMART GUIDE

Step–by–Step Instructions: Problem 5–6

1. Select the problem set for Outback Guide Service (Prob. 5–6).
2. Rename the company and set the system date.
3. Add new general ledger accounts using the **Chart of Accounts** option in the ***Maintain*** menu.
4. Print a Chart of Accounts using the **General Ledger** option in the ***Reports*** menu.
5. Proof your work.
6. Complete the Analyze activity manually.
7. End the session.

TIP: You can use General Ledger Navigation Aid to access the Maintain Chart of Accounts window.

Problem 5–6 Analyzing Transactions into Debit and Credit Parts

Juanita Ortega operates Outback Guide Service. She uses the following accounts to record and summarize her business transactions.

General Ledger

101	Cash in Bank	301	Juanita Ortega, Capital
105	Accounts Receivable—Mary Johnson	302	Juanita Ortega, Withdrawals
150	Rafting Equipment	401	Guide Service Revenue
205	Accounts Payable—Peak Equipment Inc.	505	Maintenance Expense
		515	Rent Expense
		520	Utilities Expense

Instructions For each transaction:

1. Prepare a T account for each account the business uses.
2. Analyze and record each of the following transactions using the appropriate T accounts. Identify each transaction by number.
3. After recording all transactions, compute and record the account balance on the normal balance side of each T account.
4. Test for the equality of debits and credits.

Date		Transactions
Jan.	2	1. Juanita Ortega invested $12,000 cash in her business.
	7	2. Purchased two new whitewater rafts on account for $3,750 from Peak Equipment Inc.
	10	3. Billed, but did not collect, $750 for guide services provided to Mary Johnson.

CONTINUE

CONTENTS

Date	Transactions (cont.)
12	**4.** Repaired a raft at a cost of $123, Check 411.
14	**5.** Wrote Check 412 to pay the electric bill of $95.
17	**6.** Received $225 for guide service fees.
21	**7.** Paid the $225 rent for the month, Check 413.
24	**8.** Paid $1,750 toward the rafts bought on account, Check 414.
27	**9.** Juanita Ortega withdrew $250 cash for personal use, Check 415.
29	**10.** Received guide service fees of $250.

Analyze Calculate the amount of revenue earned.

Problem 5–7 Analyzing Transactions

Greg Failla owns Showbiz Video. He uses the following accounts to record business transactions.

General Ledger

101 Cash in Bank
105 Accounts Receivable—Gabriel Cohen
110 Accounts Receivable—James Coletti
140 Computer Equipment
145 Video Tapes
205 Accounts Payable—Computer Horizons
207 Accounts Payable—New Media Suppliers
301 Greg Failla, Capital
305 Greg Failla, Withdrawals
401 Video Rental Revenue
405 VCR Rental Revenue
505 Equipment Repair Expense
520 Rent Expense
530 Utilities Expense

Instructions For each transaction:

1. Prepare a T account for each account listed above.
2. Analyze and record each of the following transactions using the appropriate T accounts. Identify each transaction by number.
3. After recording all transactions, compute a balance for each account.
4. Test for the equality of debits and credits.

Date	Transactions
Jan. 1	**1.** Greg Failla invested $17,500 cash in Showbiz Video.
3	**2.** Purchased computer equipment on account from Computer Horizons for $2,400.
8	**3.** Purchased videos on account from New Media Suppliers for $375.
10	**4.** Paid monthly rent of $750, Check 1183.

CONTINUE

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SMART GUIDE

Step–by–Step Instructions: Problem 5–7

1. Select the problem set for Showbiz Video (Prob. 5–7).
2. Rename the company and set the system date.
3. Add a new record for each of the general ledger accounts.
4. Print a Chart of Accounts.
5. Proof your work.
6. Complete the Analyze activity manually.
7. End the session.

TIP: Peachtree requires that you group accounts by type: asset, liability, equity, income, and expense.

Date	Transactions (cont.)
13	5. Wrote Check 1184 to pay for new videos, $265.
14	6. Sent a bill for $67 to Gabriel Cohen for a VCR rental.
16	7. Deposited the receipts from video rentals, $233.
19	8. Paid the gas and electric bill of $125, Check 1185.
21	9. Sent Check 1186 for $375 to New Media Suppliers as payment on account.
22	10. Greg Failla withdrew $150 for his personal use, Check 1187.
25	11. Paid $45 for VCR repair, Check 1188.
30	12. Deposited VCR rental receipts of $264 in the bank.

Analyze Identify the permanent accounts that have normal credit balances.

SPREADSHEET SMART GUIDE

Step–by–Step Instructions: Problem 5–8

1. Select the spreadsheet template for Problem 5–8.
2. Enter your name and the date in the spaces provided on the template.
3. Complete the spreadsheet using the instructions in your working papers.
4. Print the spreadsheet and proof your work.
5. Complete the Analyze activity manually.
6. Save your work and exit the spreadsheet program.

CHALLENGE PROBLEM

Problem 5–8 Completing the Accounting Equation

With the addition of temporary accounts, the basic accounting equation can be expressed as follows:

$$\text{Assets} = \text{Liabilities} + \underbrace{\text{Owner's Capital} - \text{Withdrawals} + \text{Revenue} - \text{Expenses}}_{\text{Owner's Equity}}$$

Instructions Using the expanded equation shown above, determine the missing amounts for the following accounting equations. Use the form in your working papers. The first equation is completed as an example.

	Assets	= Liabilities	+ Owner's Capital	− Withdrawals	+ Revenue	− Expenses
1.	$64,400	$8,200	$56,300	$ 500	$10,000	$ 9,600
2.	$22,150	525	18,800	1,200	12,100	?
3.	17,500	75	21,650	?	4,115	3,250
4.	49,450	?	47,840	1,500	20,300	17,610
5.	21,900	1,150	20,005	950	?	16,570
6.	72,640	2,790	?	10,750	67,908	39,749
7.	?	1,988	41,194	6,196	52,210	42,597
8.	?	3,840	61,774	?	40,163	21,637
	(Expenses plus withdrawals equal $27,749.)					
9.	64,070	?	49,102	4,875	53,166	?
	(Total owner's equity after adding revenue and subtracting expenses and withdrawals is $50,643.)					

Analyze For equation 7, calculate the sum of owner's equity.

Winning Competitive Events

Practice your test-taking skills! The questions on this page are reprinted with permission from national organizations:

- Future Business Leaders of America
- Business Professionals of America

Use a separate sheet of paper to record your answers.

Future Business Leaders of America

Multiple Choice

1. Which of the following statements is incorrect?
   a. The normal balance of the receivable account is a debit.
   b. The normal balance of the owner's personal account is a debit.
   c. The normal balance of an unearned revenues account is a credit.
   d. The normal balance of an expense account is a credit.
   e. All of the above statements are correct.

2. If Tim Jones, the owner of Jones Hardware proprietorship, uses cash of the business to purchase a family automobile, the business should record this use of cash with an entry to
   a. debit Salary Expense and credit Cash.
   b. debit Tim Jones, Salary and credit Cash.
   c. debit Cash and credit Tim Jones, Withdrawals.
   d. debit Tim Jones, Capital and credit Cash.
   e. none of the above.

Business Professionals of America

Multiple Choice

3. Accounts that are continuous from one accounting period to the next and balances are carried forward are referred to as
   a. permanent accounts.
   b. fiscally continuous.
   c. post-closing assets.
   d. signature accounts.

4. Each of the following is a business expense except a payment for
   a. equipment
   b. advertising
   c. rent
   d. utility bills

5. If the owner of a company takes merchandise for personal use, what account is debited?
   a. Owner's capital
   b. Owner's withdrawals
   c. Purchases
   d. Cash

Need More Help?

Go to glencoeaccounting.glencoe.com and click on **Student Center.** Click on **Winning Competitive Events** and select **Chapter 5.**
- **Practice Questions and Test-Taking Tips**
- **Concept Capsules and Terminology**

CHAPTER 5 Real-World Applications and Connections

CRITICAL Thinking

Temporary and Permanent Accounts

1. What is the normal balance of the owner's withdrawals account?
2. What is the difference between *owner's equity* and the *owner's capital account?*
3. Your business receives a refund check from the utility company because it overcharged your business in the past. Which account is debited? Which account is credited?
4. Which temporary accounts affect profit or loss for an accounting period?
5. Write an equation for owner's equity at the end of an accounting period. Start the equation with "Beginning Owner's Capital" and end the equation with "Ending Owner's Equity."
6. Evaluate the practice of using temporary accounts for recording certain transactions, as opposed to using the owner's capital account.

CASE STUDY

Service Business: Web Site Design

Colleen Chapelli owns Web Design Source, a service that creates Web sites for local businesses. While Colleen is an expert with computers and software programming, her business finance expertise is limited. She has hired you as her accountant to organize her business information and suggest business accounts. Here are some of the items Colleen uses in the business:

- Computer
- Printer
- Software
- Desk and chair
- Bookcases
- Computer supplies

Colleen has been advertising in the local newspaper to find new clients. She manages the business from her home and has a separate telephone line for the business.

INSTRUCTIONS

1. Prepare a chart of accounts for Web Design Source.
2. Explain to Colleen why it is important to collect and organize the financial information resulting from business transactions.

a matter of ETHICS

Using a Toll-Free Number

Many businesses offer a toll-free telephone line for customers and business associates. Suppose you're an accountant for Procter & Gamble in Cincinnati, Ohio. Your friend Mike just moved to Houston and asks if your company has an 800 number he can use to call you. Your company does offer an 800 number, and you would like to hear from Mike. However, you also know that your company pays for each incoming call.

ETHICAL DECISION MAKING

1. What are the ethical issues?
2. What are the alternatives?
3. Who are the affected parties?
4. How do the alternatives affect the parties?
5. What would you do?

Real-World Applications and Connections

CHAPTER 5

COMMUNICATING ACCOUNTING

Promoting an Idea

As Southside Ballet Company's financial director, you think Southside should open a ballet supply and dancewear shop. Use word processing software to write a memo to the ballet director and owner, Jonathan Booth, asking him to consider it. Explain how you view the impact of additional revenue on his capital account. Use the rules for revenue accounts in your explanation.

SKILLS BEYOND NUMBERS

Acquiring and Analyzing Data

To make a decision, whether business or personal, you must be able to acquire and analyze data (information).

On the Job

You are a senior at Highland College, a small liberal arts college. Eighty percent of the students live in campus dorms or in apartments within one mile of the college. The student activities center closes at 9:00 p.m. during the school week, and students complain about the lack of food and beverage service for late night study sessions. You decide to analyze the market potential of a limited food and beverage delivery service.

Instructions

1. Develop a market survey of 5–10 questions related to the opening of an off-campus food and beverage delivery service.
2. Decide what type of food and beverage you can provide in a delivery service. How much investment would you need to begin? What do you anticipate your customer base to be?

INTERNATIONAL ACCOUNTING

Global E-Business

When you think about revenue and expenses for a company, consider how the Internet makes it faster and cheaper to do business. Business is conducted using Web sites, e-mail, and videoconferencing. Companies like Gap and K-Mart use Web sites to sell products at lower costs than store locations. Managers can communicate online with vendors or branch locations to avoid the high costs of travel.

Instructions If you owned a small business and wished to expand your market to a global audience, discuss how you might use the Internet.

Making It Personal

Your Credit Card

Do you have a credit card? If you do not use a credit card yet, it is likely you will use one in the future. In either case, you need to know how to use your credit card wisely.

Personal Finance Activity Suppose your friend used a credit card unwisely and lost the use of the card. You want to help your friend avoid future mistakes. Conduct research at the library, on the Internet, or at your local bank. Write some suggestions that will be helpful to your friend.

Personal Finance Online Log on to **glencoeaccounting.glencoe.com** and click on **Student Center.** Click on **Making It Personal** and select **Chapter 5.**