

## 5.2 ► Equity Transactions and Accounting Principles

You now know that revenue, expense, and drawings accounts improve the accounting information system. The highlight of this improvement is the addition of the income statement, which joins the balance sheet as the second major financial statement of accounting.

It is time to turn your attention to getting transaction data into the new equity accounts. This should be familiar because the transactions themselves will be no different than the ones you worked with in Chapter 4. In Chapter 4, you debited or credited the Capital account each time a transaction affected equity. From now on, when a transaction affects equity, expect to debit or credit revenue, expense, or drawings accounts. Except for additional investments and unusual transactions, the capital account will remain the same from one month to the next.

Another reason you should be able to handle transaction data for the new accounts is that you gained experience with their debit and credit natures in Section 5.1. To illustrate, look at the partial trial balance for Eve Boa in Figure 5.6. A “T” has been superimposed on this graphic to give the impression of a T-account.

EVE BOA, LLB TRIAL BALANCE JANUARY 31, 20--		
	Dr	Cr
Bank	2 439	
A/R - H. Geroux	1 420	
A/R - J. McGill	757	
Bank Loan		940
<u>E. Boa, Capital</u>		<u>21 878</u>
<u>E. Boa, Drawings</u>	<u>3 950</u>	
<u>Fees Earned</u>		<u>23 660</u>
<u>Advertising Expense</u>	<u>1 321</u>	
<u>Car Expense</u>	<u>615</u>	
<u>Rent Expense</u>	<u>3 300</u>	
<u>Sundry Expense</u>	<u>385</u>	
<u>Wages Expense</u>	<u>9 830</u>	
	<u>52 078</u>	<u>52 078</u>

*Handwritten notes:*  
 Investment  
 Personal use  
 Revenue  
 Expenses

In Figure 5.6, the “T” and the amounts it contains may remind you of the capital account you used for every equity transaction in Chapter 4. The illustration shows the normal balances of the new equity accounts. Those balances can actually guide you when recording accounting entries. From the new equity account balances shown in Figure 5.6, you can make two conclusions about the new equity transactions:

- \* 1. revenues are normally credited (see Fees Earned) *Capital as well.*
- \* 2. drawings and expenses are normally debited (see E. Boa, Drawings and all the expense accounts)

Revenue Transactions      ↑ Owner's Equity

Consider the following transaction:

Eve Boa, a lawyer, draws up a legal agreement for J. Basso, a client, and for her services is paid a fee of \$450 in cash.

- Bank/Cash ↑ (Dr.)
- Revenue (Fees Earned) ↑ (Cr.)

① <u>BANK</u> 450	<u>Fees Earned</u> 450      ①

If another legal service for \$700 was performed for B. Singh on credit, the debit portion would change from Bank to Accounts Receivable.

- A/R B. Singh ↑ (Dr.)
- Revenue (Fees Earned) ↑ (Cr.)

② <u>A/R B. Singh</u> 700	<u>Fees Earned</u> 700      ②

## The Revenue Recognition Principle

The revenue recognition principle was a longstanding feature of Canadian Generally Accepted Accounting Principles (Canadian GAAP), and it continues to be prominent in the International Financial Reporting Standards (IFRS). The **revenue recognition principle** requires revenue to be recorded in the accounts (i.e., recognized) at the time the transaction is completed.

Usually, this principle simply means crediting the revenue account when the bill or invoice for that revenue is sent to the customer. The seller earns the right to send the bill by providing services or goods. If no significant obligation remains on the seller's part, a credit entry to revenue is made. The corresponding debit will be to Bank if dealing with a cash sale, or to Accounts Receivable if dealing with a credit sale.

When Eve Boa provided legal services to B. Singh for \$700 in the example on page 147, the revenue recognition principle permitted her to credit Fees Earned. She does not have to wait for the customer to send her a cheque in payment before making the entry.

Questions can arise over revenue recognition procedures. For example, what if J. Basso paid cash to Eve Boa for a legal service that she promised to perform three months from now? This transaction would not be recorded as revenue because the seller, Eve Boa, has significant obligations remaining under the agreement. If she failed to live up to those obligations, J. Basso would have a claim on her assets because Eve Boa is holding his cash and has not yet provided a service in return.

Although you will not deal with situations like these until Chapter 8, recording such a transaction is easy once you become comfortable with debit/credit theory and the revenue recognition principle. Simply debit Bank to record the customer's cash deposit. Then create a liability account to recognize J. Basso's claim on assets.

When Eve Boa later provides the legal service, what would you do? The answer is logical. Recognize the revenue by recording a credit and remove the liability by entering a corresponding debit.

Expense Transactions ↓ Owner's Equity

Consider the following transaction:

Eve Boa writes a \$3300 cheque for the monthly rent payment.

- Rent Expense (Dr.)
- Bank (Cr.)

③ <u>Rent Expense</u> 3300	<u>Bank</u> 3300 ③
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Eve Boa receives the monthly utilities bill for \$395 from Municipal Gas. The bill is not paid immediately.

- Utilities Expense (Dr.)
- A/P Municipal Gas (Cr.)

④ <u>Utilities Expense</u> 395	<u>A/P Municipal Gas</u> 395 ④
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### Drawings Transactions ↓ Owner's Equity

Cash is the most common item withdrawn by an owner for personal use. For example,

Eve Boa, the owner of the business, withdraws \$1975 for her personal use.

- Eve Boa Drawings (Dr.)
- Bank (Cr.)

Bank	Eve Boa Drawings
1975 (5)	(5) 1975

## The Fiscal Period

Net income is calculated for a specific length of time, called the fiscal period. The **fiscal period** (also called the **financial period** or **accounting period**) is the period of time over which earnings are measured.

The earnings figure of a business does not mean anything if you do not know how long it took to produce those earnings. You would not be very informed about a business if all you knew about its net income was that it amounted to \$8000. You would not be encouraged if it took one year to earn that amount. On the other hand, if the \$8000 was earned in only one week, you would probably be quite impressed.

The formal fiscal period is usually one year. The fiscal year does not have to be the same as the calendar year. It just has to run for 12 consecutive months. For example, a fiscal year could begin on July 1 and end on June 30 of the following year.

\* Half-yearly, quarterly, or monthly fiscal periods are used by some businesses. Managers can keep a close watch over their business by using short fiscal periods. Even when fiscal periods shorter than one year are used, it is still necessary to produce an annual income statement for income tax purposes.

### **The Time Period Concept**

The **time period concept** is an accounting standard that provides that accounting will take place over specific time periods known as fiscal periods. These fiscal periods are of equal length and are used when measuring the financial progress of a business.



## The Matching Principle

Separating revenues and expenses into specific fiscal periods challenges accountants to follow two important steps.

**Step 1** They must be careful to record the proper amount of revenue in the proper period.

**Step 2** They must subtract only those expenses that helped earn the revenue they recorded in step one.

For most transactions, recording the proper revenue is straightforward. Accountants simply follow the revenue recognition principle that you read about on page 146.

Recording expenses properly may require some effort. Accountants keep in mind the long-standing accounting principle, the matching principle. The **matching principle** states that each expense item related to revenue earned must be recorded in the same period as the revenue it helped to earn. Matching expenses with revenue in a fair manner is the goal. Accountants know that if they fail to reach this goal, net income will be misrepresented. In some cases, reaching the goal is easy. For example, suppose a business purchases \$30 000 of advertising on credit for a Boxing Day sale to be held on December 26, 20–1. If the fiscal period ends December 31, 20–1, the cost of the advertisement will be recorded in December, not in January 20–2 when the bill is paid. Since the entire amount of the Boxing Day revenue was earned in the year 20–1, the entire advertising expense must be recorded in 20–1.

What if the situation were slightly different? Instead of a one-day sale, suppose the advertisement promoted a two-week sale that started on December 26, 20–1. The business's accountant would need to do more work. Now, the advertisement helped earn revenue in two different fiscal periods. Therefore, a portion of the \$30 000 advertising expense must be recorded in each year. If the accountant fails to do this, revenues and expenses will be mismatched. The impact of such a mismatch is that the net income (or net loss) will be inaccurate for both years—20–1 and 20–2.

Accountants follow the matching principle by making a number of mathematical adjustments in the accounts at the end of a fiscal year. You will learn how to do some of these adjustments when you study Chapter 8.

(Match Revenues with Expenses over a given period of time)

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## Homework

Section 5.2 on page 149

Review Questions # 1-9

Exercises # 1-5

**SECTION 5.2 REVIEW QUESTIONS** (page 149)

1. *From their normal account balances, two conclusions you can make about equity transactions are that revenues are normally credited and expenses and drawings are normally debited.*

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2. *You can be reasonably certain that revenue accounts will have a credit balance at the end of the year because debits to a revenue account are rare. Once a sale amount is recorded in the account, it usually remains there until year-end.*

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3. *You might want to debit a revenue account when recording a sales return.*

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4. *The revenue recognition principle requires a transaction to be recorded in the accounts of a business at the time the transaction is completed.*

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5. *Before sending an invoice to a customer, the seller must fulfill its obligations to provide the promised goods or services.*

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6. *The IFRS allow a seller to record a sale without having delivered the goods so long as it is probable that delivery will be made; the item is on hand, identified, and ready for delivery; the buyer is aware of delayed delivery; and the usual payment terms apply.*

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7. *When purchasing advertising on credit, equity decreases from the debit to the Advertising Expense account even though no assets have left the business. This is due to the creditor having an increased claim on the business's assets. The owner's claim on those assets has less priority than the creditors', so the owner's claim must decrease.*

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8. *Fiscal period is the period of time over which earnings are measured.*

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9. *The student's statement is accurate in the sense that expenses are expired costs—they have no future value or role. They have "given up their lives." Additionally, the mission of these expired costs was to produce revenue or support revenue-making activities. When they are subtracted from, or matched against, the revenues they produced or supported, net income or loss is revealed.*

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**SECTION 5.2 EXERCISES** (page 150)

**Exercise 1, p. 150**

ASSETS		=	LIABILITIES		+	EQUITY	
1.	<b>Supplies</b>		<b>Bank</b>				
	Dr   Cr		Dr   Cr		Dr   Cr	Dr   Cr	Dr   Cr
	400		400				

2.			<b>Bank</b>		<b>Bank Loan</b>		
	Dr   Cr		Dr   Cr		Dr   Cr	Dr   Cr	Dr   Cr
			1 000		1 000		

ASSETS		=	LIABILITIES		+	EQUITY	
3.	<i>Bank</i>		<i>A/R—J. Cheung</i>				
	Dr   Cr		Dr   Cr		Dr   Cr	Dr   Cr	Dr   Cr
	<i>800</i>		<i>800</i>				

4.	<i>Bank</i>					<i>Fees Earned</i>	
	Dr   Cr		Dr   Cr		Dr   Cr	Dr   Cr	Dr   Cr
	<i>900</i>					<i>900</i>	

5.	<i>A/R—B. Hull</i>					<i>Fees Earned</i>	
	Dr   Cr		Dr   Cr		Dr   Cr	Dr   Cr	Dr   Cr
	<i>1 500</i>					<i>1 500</i>	

6.			<i>Bank</i>			<i>Utilities Expense</i>	
	Dr   Cr		Dr   Cr		Dr   Cr	Dr   Cr	Dr   Cr
			<i>125</i>			<i>125</i>	

7.			<i>Bank</i>			<i>M. Hartman, Drawings</i>	
	Dr   Cr		Dr   Cr		Dr   Cr	Dr   Cr	Dr   Cr
			<i>750</i>			<i>750</i>	

8.			<i>Bank</i>			<i>Wages Expense</i>	
	Dr   Cr		Dr   Cr		Dr   Cr	Dr   Cr	Dr   Cr
			<i>600</i>			<i>600</i>	

9.	<i>Truck</i>		<i>Bank</i>				
	Dr   Cr		Dr   Cr		Dr   Cr	Dr   Cr	Dr   Cr
	<i>20 000</i>		<i>20 000</i>				

10.			<i>Supplies</i>			<i>M. Hartman, Drawings</i>	
	Dr   Cr		Dr   Cr		Dr   Cr	Dr   Cr	Dr   Cr
			<i>250</i>			<i>250</i>	

11.				<i>A/P— Advance News</i>		<i>Advertising Expense</i>	
	Dr   Cr		Dr   Cr	Dr   Cr	Dr   Cr	Dr   Cr	Dr   Cr
				<i>2 000</i>		<i>2 000</i>	

## Exercise 2, p. 150

	<b>Debits</b>		<b>Credits</b>	
1.	<u><i>Chemical Supplies</i></u>		<u><i>A/P—Pesticide Products</i></u>	
	Dr	Cr	Dr	Cr
	<i>125</i>			<i>125</i>
2.	<u><i>Equipment</i></u>		<u><i>A/P—Pro Hardware</i></u>	
	Dr	Cr	Dr	Cr
	<i>150</i>			<i>150</i>
3.	<u><i>Wages Expense</i></u>		<u><i>Bank</i></u>	
	Dr	Cr	Dr	Cr
	<i>100</i>			<i>100</i>
4.	<u><i>Bank</i></u>		<u><i>Landscaping Revenue</i></u>	
	Dr	Cr	Dr	Cr
	<i>50</i>			<i>50</i>
5.	<u><i>A/R—G. Yung</i></u>		<u><i>Landscaping Revenue</i></u>	
	Dr	Cr	Dr	Cr
	<i>100</i>			<i>100</i>
6.	<u><i>Advertising Expense</i></u>		<u><i>A/P—Banner News</i></u>	
	Dr	Cr	Dr	Cr
	<i>50</i>			<i>50</i>
7.	<u><i>E. Inahaba, Drawings</i></u>		<u><i>Bank</i></u>	
	Dr	Cr	Dr	Cr
	<i>175</i>			<i>175</i>
8.	<u><i>Interest Expense</i></u>		<u><i>Bank</i></u>	
	Dr	Cr	Dr	Cr
	<i>90</i>			<i>90</i>
9.	<u><i>E. Inahaba, Drawings</i></u>		<u><i>Landscaping Revenue</i></u>	
	Dr	Cr	Dr	Cr
	<i>100</i>			<i>100</i>

**Exercise 3, p. 151**

A., B.

**ASSETS**

Bank		A/R—S. McNeil	Supplies
① 6 000	1 500 ②	⑦ 2 500	④ 800
③ 4 000	160 ⑥		
⑤ 1 200	1 800 ⑧		
	1 400 ⑨		
<u>11 200</u>	<u>4 860</u>		
⑥ 340			

**LIABILITIES**

Bank Loan	A/P—Northern Utilities	A/P—Percy's Office Outfitters
6 000 ①	400 ⑩	800 ④

**EQUITY**

A. Dodds, Capital	A. Dodds, Drawings	Fees Earned
4 000 ③	⑨ 1 400	1 200 ⑤
		2 500 ⑦
		<u>3 700</u>

  

Rent Expense	Telephone Expense	Utilities Expense
② 1 500	⑥ 160	⑩ 400

  

Wages Expense
⑧ 1 800

**Exercise 3, p. 151** (continued)

C.

*SPALDING CONSULTANTS*

*TRIAL BALANCE*

*NOVEMBER 30, 20–*

ACCOUNTS	DEBIT	CREDIT
<i>Bank</i>	6 3 4 0 –	
<i>A/R—Sarah McNeil</i>	2 5 0 0 –	
<i>Supplies</i>	8 0 0 –	
<i>Bank Loan</i>		6 0 0 0 –
<i>A/P—Percy’s Office Outfitters</i>		8 0 0 –
<i>A/P—Northern Utilities</i>		4 0 0 –
<i>A. Dodds, Capital</i>		4 0 0 0 –
<i>A. Dodds, Drawings</i>	1 4 0 0 –	
<i>Fees Earned</i>		3 7 0 0 –
<i>Rent Expense</i>	1 5 0 0 –	
<i>Telephone Expense</i>	1 6 0 –	
<i>Utilities Expense</i>	4 0 0 –	
<i>Wages Expense</i>	1 8 0 0 –	
	14 9 0 0 –	14 9 0 0 –

**Exercise 4, p. 152**

- A. The Bank account normally has a debit balance.
- B. A revenue account normally has a credit balance.
- C. An expense account normally has a debit balance.
- D. Paying a creditor involves a debit entry to the creditor's account.
- E. The Drawings account receives a debit entry when the owner withdraws money for personal use.
- F. A lawyer gives a cash refund to a customer. The Bank account will receive a credit entry and the Revenue account will receive a debit entry.
- G. Supplies are bought on credit. The Supplies account will receive a debit entry and the supplier's account payable will receive a credit entry.
- H. The Drawings account will not normally receive credit entries.
- I. An increase in equity can be thought of as a credit to the Capital account.
- J. Net income can be thought of as a credit to the Capital account.
- K. Net loss can be thought of as a debit to the Capital account.
- L. The owner takes a computer from the business for his personal (permanent) use. The Drawings account will receive a debit entry.



Exercise 5, p. 152

No.	ASSET		LIABILITY		Revenue	EQUITY	
	Increase	Decrease	Decrease	Increase	Increase	Expense Decrease	Drawings Decrease
1.	✓				✓		
2.	✓				✓		
3.	✓	✓					
4.	✓	✓				✓	
5.	✓			✓			
6.		✓				✓	
7.		✓					✓
8.		✓				✓	
9.		✓					✓
10.		✓	✓				