

Solution Manual for Financial Accounting Information for Decisions 6th Edition by Wild ISBN 0078025389 9780078025389

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Chapter 02

Analyzing and Recording Transactions

| <u>Student Learning Objectives and Related Assignment Materials*</u> | | | | | |
|--|-----------------------------|----------------------|---|-----------------------------------|----------------------------|
| <i>Student Learning Objectives</i> | <i>Discussion Questions</i> | <i>Quick Studies</i> | <i>Exercises</i> | <i>Problems (A & B set)**</i> | <i>Beyond the Numbers</i> |
| Conceptual objectives: | | | | | |
| C1. Explain the steps in processing transactions and the role of source documents. | 3 | 2-2 | 2-1 | 2-6 | EC, CIP, TIA, HTR |
| C2. Describe an account and its use in recording transactions. | 1, 4, 14, 16 | 2-1 | 2-2 | | CIP, TIA |
| C3. Describe a ledger and a chart of accounts. | 7 | | 2-3, 2-13 | 2-1, 2-2, 2-3, 2-4, 2-5, 2-6 | |
| C4. Define <i>debits</i> and <i>credits</i> and explain double-entry accounting. | 5, 6, 7 | 2-4, 2-5, 2-9 | 2-4 | 2-1, 2-2, 2-4 | TIA |
| Analytical objectives: | | | | | |
| A1. Analyze the impact of transactions on accounts and financial statements. | 1, 2 | 2-3 | 2-5, 2-6, 2-9, 2-11, 2-12, 2-16, 2-18, 2-20, 2-21 | 2-1, 2-2, 2-3, 2-4, 2-5, 2-6 | RIA, CA, CIP, TTN, TIA, ED |
| A2. Compute the debt ratio and describe its use in analyzing company performance. | | | 2-22 | 2-3 | RIA, CA, ED, GD |
| Procedural objectives: | | | | | |
| P1. Record transactions in a journal and post entries to a ledger. | | 2-6 | 2-7, 2-11, 2-12, 2-19 | 2-1, 2-2, 2-4, 2-5 | |

Chapter 02 - Analyzing and Recording Transactions

| | | | | | |
|--|------------------------------------|----------|------------------------------|-------------------------|---------|
| P2. Prepare and explain the use of a trial balance. | 8, 9 | 2-7 | 2-8, 2-10, 2-20, 2-21 | 2-1, 2-2, 2-4, 2-5, 2-6 | |
| P3. Prepare financial statements from business transactions. | 10, 11, 12, 13, 15, 16, 17, 18, 19 | 2-1, 2-8 | 2-13, 2-14, 2-15, 2-17, 2-23 | 2-3 | CIP, ED |

Notes appear on next page.

* Assignment materials that can be completed by students using:

- Serial Problem for Success Systems, which covers numerous learning objectives. (*The serial problem, which began in chapter 1, continues in most of the chapters. Even if previous segments were not assigned, students can begin the segment of the serial problem that is included in this chapter.*)
- _ Excel templates – Problems 2-1A and P2-3A.
- _ McGraw-Hill’s Connect – All of the Quick Studies, all of the Exercises, and Problems in set A.

Synopsis of Chapter Revisions

- CitySlips **NEW opener** with new entrepreneurial assignment
- Reorganized and streamlined learning objectives
- Enhanced introduction of double-entry accounting
- New box on the fraud risks with religious organizations
- New coverage on reading and using an annual report
- Enhanced layout for transaction analysis
- New discussion on accounting quality

PowerPoint® Slides

| <i>Chapter Learning Objective</i> | <i>PowerPoint® Slides</i> |
|-----------------------------------|---------------------------|
| C1 | 6-8 |
| C2 | 9-10 |
| C3 | 11-15 |
| C4 | 16-19 |
| P1 | 20-28 |
| A1 | 29-33 |
| P2 | 34-35 |
| P3 | 36-39 |
| A2 | 40 |

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I. Analyzing and Recording Process

- A. The accounting process identifies business transactions and events, analyzes and records their effects, and summarizes and presents information in reports and financial statements. The steps in the accounting process that focus on *analyzing and recording* transactions and events are: (1) record relevant transactions and events in a journal, (2) post journal information to ledger accounts, and (3) prepare and analyze the trial balance. Accounting records are informally referred to as the *accounting books*, or simply the *books*.
- B. **Source documents** identify and describe transactions and events. Source documents are sources of accounting information and can be either hard copy or electronic. Examples are sales tickets, checks, purchase orders, bills from suppliers, employee earnings records, and bank statements. Source documents provide objective and reliable evidence about transactions and events.

II. The Account and Its Analysis.

- A. An **account** is a record of increases and decreases in a specific asset, liability, equity, revenue, or expense item. The **general ledger**, is a record containing all accounts used by a company.
- B. Accounts are arranged in three basic categories based on the accounting equation. A separate account is kept for each of the following:
 - 1. **Asset Accounts**—resources owned or controlled by a company that have expected future benefits; examples include Cash, Accounts Receivable, Note Receivable, Prepaid Accounts, Supplies, Equipment, Buildings, and Land.
 - 2. **Liability Accounts**—claims by creditors against assets; obligations to transfer assets or provide products or services to others; examples include Accounts Payable, Note Payable, Unearned Revenue, and Accrued Liabilities. **Creditors** are individuals or organizations that have rights to receive payments from a company.
 - 3. **Equity Accounts**—owner’s residual interest in the assets of the business after deducting liabilities; examples include Common Stock, Dividends, Revenues, and Expenses.

III. Analyzing and Processing Transactions

A. Ledger and Chart of Accounts

1. A ledger (or general ledger) is the collection of all the accounts a company uses.
2. The **chart of accounts** is a list of all ledger accounts with their identification numbers.

Chapter Outline

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B. Debits and Credits

1. A **T-account** represents a ledger account and is used to understand the effects of one or more transactions.
2. The *left* side of an account is called the **debit** side. A debit is an entry on the left side of an account.
3. The *right* side of an account is called the **credit** side. A credit is an entry on the right side of an account.
4. Whether a debit or a credit is an increase or decrease depends on the account.
5. In an account where a debit is an increase, the credit is a decrease. In an account where a credit is an increase, the debit is a decrease.
6. The **account balance** is the difference between the total debits and the total credits recorded in an account.

C. Double-Entry Accounting

1. For each transaction, at least two accounts are involved. The total amount that is debited to accounts must equal the total amount credited to accounts for each transaction. The sum of debit account balances in the ledger must equal the sum of credit account balances.
2. Assets are on the left side of the equation; therefore, the left, or debit, side is the *normal balance* side for assets.
3. Liabilities and equities are on the right side; therefore, the right, or credit, side is the *normal balance* side for liabilities and equity.
4. Equity increases from revenues and stock issuances and it decreases from expenses and dividends. Increases (credits) to common stock and revenues *increase* equity; increases (debits) to dividends and expenses *decrease* equity.
5. The normal balance of each account (assets, liability, common stock, dividends, revenue, or expense) refers to the left or right (debit or credit) side where *increases* are recorded.

D. Journalizing and Posting Transactions

1. A **journal** gives a complete record of each transaction in one place; it shows the debits and credits for each transaction. The process of recording each transaction in a journal is called **journalizing**. The process of transferring journal entry information to the ledger is called **posting**.

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2. The **general journal** can be used to record any type of transaction. Steps for recording entries in a general journal include:
 - a. Date the transaction; enter the year at the top of the first column and the month and day on the first line of each journal entry.
 - b. Enter titles of accounts debited (account titles are taken from the chart of accounts and aligned with the left margin of the column), and then enter amounts in the Debit column on the same line.
 - c. Enter titles of accounts credited (account titles are taken from the chart of accounts and indented from the left margin of the column to distinguish them from debited accounts), and then enter amounts in the Credit column on the same line.
 - d. Enter a brief explanation of the transaction on the line below the entry.
3. A blank line is left between each journal entry for clarity.
4. When a transaction is first recorded, the **posting reference (PR) column** is left blank (in a manual system); later, when posting entries to the ledger, the identification numbers of the individual ledger accounts are entered in the PR column.
5. T-accounts are simple and direct means to show how the accounting process works; however, actual accounting systems need more structure and therefore use **balance column accounts**. The balance column account format is similar to a T-account in having columns for debits and credits; it is different in including date and explanation columns.
6. The heading of the Balance column does not show whether it is a debit or credit balance; instead, an account is assumed to have a *normal balance* (that is, the side where increases are recorded). Unusual events can temporarily give an account an *abnormal balance* (that is, the side where decreases are recorded).
7. To ensure the ledger is up-to-date, entries are posted as soon as possible using the following steps:

- a. First, identify the ledger account that is debited in the entry; then, in the ledger, enter the date, the journal and page in its PR column, the debit amount, and the new balance of the ledger accounts.
- b. Second, enter the ledger account number in the PR column of the journal.
- c. Repeat the first two steps for credit entries and amounts.

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E. Analyzing Transactions – An Illustration

The illustrations below follow a four step process: Review the transaction and source documents. Analyze the transaction in terms of its effect on the accounting equation. Double-entry accounting is used to record the transaction in journal entry form, and the entry is posted to the general ledger account. (The following abbreviations are used for the financial statements: IS for income statement, BLS for balance sheet, SCF for statement of cash flows, and SRE for statement of retained earning.) The first eleven transactions are from Chapter 1; five additional transactions are included.

Transaction 1: Investment by owner

Analysis:

+ Assets (Cash) = + Equity (Common Stock)

Double entry:

Debit Cash and credit Common Stock

Statements affected:

BLS and SCF

Transaction 2: Purchase supplies for cash

Analysis:

+ Assets (Supplies) = – Assets (Cash)

Double entry:

Debit Supplies and credit Cash

Statements affected:

BLS and SCF

Transaction 3: Purchase equipment for cash

Analysis:

+ Assets (Equipment) = – Assets (Cash)

Double entry:

Debit Equipment and credit Cash

Statements affected:

BLS and SCF

Transaction 4: Purchase supplies on credit

Analysis:

+Assets (Supplies) = + Liability (Account Payable)

Double entry:

Debit Supplies and credit Accounts Payable

Statements affected:

BLS

Transaction 5: Provide services for cash

Analysis:

+ Assets (Cash) = + Equity (Revenues)

Double entry:

Debit Cash and credit Revenue (type of revenue would be identified in account name)

Statements affected:

BLS, IS, SCF, and SRE

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Transactions 6 and 7: Payment of expenses in cash

Analysis:

- Assets (Cash) = - Equity (Expenses)

Double entry:

Debit Expenses (type of expense would be identified in account name) and credit Cash

Statements affected:

BLS, IS, SCF, and SRE

Transaction 8: Provide consulting and rental services on credit

Analysis:

+ Assets (Accts Receivable) = + Equity (Revenues)

Double entry:

Debit Accounts Receivable and credit Revenue (type of revenue would be identified in account name)

Statements affected:

BLS, IS, SCF, and SRE

Transaction 9: Receipt of cash on account

Analysis:

+ Assets (Cash) = - Assets (Accounts Receivable)

Double entry:

Debit Cash and credit Accounts Receivable

Statements affected:

BLS and SCF

Transaction 10: Partial payment of accounts payable

Analysis:

- Assets (Cash) = - Liability (Accounts Payable)

Double entry:

Debit Accounts Payable and credit Cash

Statements affected:

BLS and SCF

Transaction 11: Payment of cash dividend

Analysis:

– Assets (Cash) = – Equity (Dividends)

Double entry:

Debit Dividends and credit Cash

Statements affected:

BLS, SCF, and SRE

Transaction 12: Receipt of cash for future services

Analysis:

+ Assets (Cash) = + Liabilities (Unearned Revenue)

Double entry:

Debit Cash and credit Unearned Revenue (type of unearned revenue is often identified in account name)

Statements affected:

BLS and SCF

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Transaction 13: Pay cash for future insurance coverage

Analysis:

– Assets (Cash) = + Assets (Prepaid Insurance)

Double entry:

Debit Prepaid Insurance and credit Cash

Statements affected:

BLS and SCF

Transaction 14: Purchase supplies for cash

Analysis:

+ Assets (Supplies) = - Assets (Cash)

Double entry:

Debit Supplies and credit Cash

Statements affected:

BLS and SCF

Transactions 15 and 16: Payment of expenses in cash

Analysis:

– Assets (Cash) = – Equity (Expenses)

Double entry:

Debit Expense (type of expense would be identified in account name) and credit Cash

Statements affected:

BLS, IS, SCR, and SRE

IV. Trial Balance

- A. Preparing a Trial Balance
 - 1. A **trial balance** is a list of accounts and their balances at a point in time used to confirm that the sum of debit account balances equals the sum of credit account balances.
 - 2. The three steps to preparing a trial balance are as follows:
 - a. List each account and its amount (from the ledger),
 - b. Compute the total debit balances and the total credit balances, and
 - c. Verify (prove) total debit balances equal total credit balances.
- B. Searching for and Correcting Errors
 - 1. If a trial balance does not balance (the columns are not equal), the error(s) must be found and corrected. Find the errors by checking the following:
 - a. Verify that the trial balance columns are correctly added.
 - b. Verify that the account balances are accurately entered from the ledger.
 - c. See whether a debit (or credit) balance is mistakenly listed in the trial balance as a credit (or debit).
 - d. Recompute each account balance in the ledger.

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- e. Verify that each journal entry is properly posted.
- f. Verify that the original journal entry has equal debits and credits.
- 2. If an error in a journal entry is discovered before the entry is posted, it can be corrected in a manual system by drawing a line through the incorrect information and writing in the correct information.
- 3. If an error in a journal entry is not discovered until after it is posted, a *correcting entry* that removes the amount from the wrong account and records it to the correct account should be journalized and posted.

Notes

C. Using a Trial Balance to Prepare Financial Statements

The statements prepared in this chapter are called *unadjusted statements* because further account adjustments need to be made (as described in chapter 3).

1. A balance sheet reports on an organization's financial position at a *point in time*. The income statement, statement of retained earnings, and statement of cash flows report on financial performance over a *period of time*.
2. A one-year, or annual, reporting period is known as the *accounting*, or *fiscal*, *year*. A business whose accounting year begins on January 1 and ends on December 31 is known as a *calendar-year* company. A company that chooses a fiscal year ending on a date other than December 31 is known as a *noncalendar-year* company.
3. Income Statement—reports the revenues earned less the expenses incurred by a business over a period of time.
4. Statement of Retained Earnings—reports information about how retained earnings changes over the accounting period.
5. Balance Sheet—reports the financial position of a company at a point in time, usually at the end of a month, quarter, or year. The *account form* of the balance sheet reports assets on the left and liabilities and equity on the right. The *report form* of the balance sheet reports assets on the top and liabilities and equity on the bottom.
6. Presentation Issues:
 - a. Dollar signs are not used in journals and ledgers; they do appear in financial statements and other reports such as the trial balance. The usual practice is to put dollar signs beside only the first and last numbers in a column.
 - b. Companies commonly round amounts in reports to the nearest dollar, or even to a higher level.

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D. Global View

1. **Analyzing and Recording Transactions** – Both GAAP and IFRS include broad and similar guidance for financial accounting but these differences will fade as they work together toward a common conceptual framework. All of the transactions in this chapter are accounted for identically under these two systems.
2. **Financial Statements** – Both GAAP and IFRS prepare the same four basic financial statements with some differences. Both require balance sheets to separate current and noncurrent items. However, GAAP balance sheets report current items first and IFRS balance sheets present noncurrent items first (and equity before liabilities).
3. **Accounting Controls and Assurance** – Accounting systems depend on control procedures that assure proper principles were applied in processing accounting information. SOX legislation strengthened U.S. control procedures. Global standards for control are diverse which means that their application in different countries can yield different outcomes depending on the quality of their auditing standards and enforcement.

IV. Decision Analysis—Debt Ratio

- A. A company that finances a relatively large portion of its assets with liabilities has a high degree of *financial leverage*. Higher financial leverage involves greater risk because liabilities must be repaid and often require regular interest payments (equity financing does not). The risk that a company might not be able to meet such required payments is higher if it has more liabilities (is more highly leveraged).
- B. One way to assess the risk associated with a company's use of liabilities is to compute the **debt ratio**.
 1. It is calculated as total liabilities divided by total assets.
 2. It tells us how much (what percentage) of the assets are financed by creditors (non-owners) or liability financing; the higher the debt ratio, the more risk a company faces from its financial leverage.

VISUAL #2-1

THREE PARTS OF AN ACCOUNT

| | |
|-------------------|------------|
| (1) ACCOUNT TITLE | |
| Left Side | Right Side |
| called | called |
| (2) DEBIT | (3) CREDIT |

RULES FOR USING ACCOUNTS

Accounts are assigned balance sides (debit or credit).

To increase any account, use the balance side.

To decrease any account, use the side opposite the balance side.

FINDING ACCOUNT BALANCES

If total debits equals total credits, the account balance is zero.

If total debts are greater than total credits, the account has a debit balance equal to the difference of the two totals.

If total credits are greater than total debits, the account has a credit balance equal to the difference of the two totals.

VISUAL #2-2

BALANCE SIDES

ALL ACCOUNTS ARE ASSIGNED BALANCE SIDES.

ASSETS = LIABILITIES + EQUITY

↓
are on the left side of the accounting equation, therefore they increase using the debit or left side.

↓
are on the right side of the accounting equation, therefore they increase using the credit or right side.

DEBIT BALANCE

CREDIT BALANCE

↓
Asset Accounts
Debit + side
Normal Balance

↓
Liability Accounts
Debit - side

↓
Equity Accounts
Credit + side
Normal Balance

VISUAL #2-3

EQUITY ACCOUNTS

Common Stock

(increases equity, which is on the right side of the accounting equation, equity increases with credits)

| | |
|--------------------------------------|--|
| <i>Debit</i> <u>- side</u> | <i>Credit</i> <u>+ side</u> Normal Balance |
|--------------------------------------|--|

Dividends

(decreases equity, equity decreases with debits)

| | |
|---|---------------------------------------|
| <i>Debit</i> <u>+ side</u> Normal Balance | <i>Credit</i> <u>- side</u> |
|---|---------------------------------------|

Each time assets are distributed to stockholders, the dividends account balance increases. As such, its normal balance is a debit.

All Revenue Accounts

(increases equity, equity increases with credits)

| | |
|--------------------------------------|--|
| <i>Debit</i> <u>- side</u> | <i>Credit</i> <u>+ side</u> Normal Balance |
|--------------------------------------|--|

All Expense Accounts

(decreases equity, equity decreases with debits)

| | |
|---|---------------------------------------|
| <i>Debit</i> <u>+ side</u> Normal Balance | <i>Credit</i> <u>- side</u> |
|---|---------------------------------------|

Each time an expense is incurred, the expense account balance increases. As such, its normal balance is a debit.

| |
|---|
| Chapter Two – Alternate Demonstration Problem #1 |
|---|

Wigor Inc. completed the following transactions during the year ended December 31, 2012, its first year of operations:

- a. Bill Wiggins personally invests \$30,000 in the new business in exchange for common stock and deposits the cash in a bank account opened under the name of Wigor Inc.**
- b. Equipment for use in the business was purchased for \$9,000. Two-thirds of the price was paid in cash; the rest was due in a year.**
- c. Service fees earned were \$60,000; \$6,000 of this was on credit.**
- d. Operating expenses incurred were \$35,000; \$4,000 was on credit.**
- e. Wigor Co. collected half the money owed to it.**
- f. Wigor Co. paid off \$2,000 it owed.**
- g. Wiggins bought a car for \$12,000 for his personal use, half paid for now from his personal savings and half to be paid in a year.**

Required:

- 1. Prepare journal entries for each of the events.**
- 2. Prepare a trial balance at the end of the year for Wigor Inc.**

Solution: Chapter Two – Alternate Demonstration Problem #1

1.

| | Dr. | Cr. |
|---|------------|------------|
| a. Cash | 30,000 | |
| Common Stock..... | | 30,000 |
| b. Equipment | 9,000 | |
| Cash | | 6,000 |
| Accounts Payable..... | | 3,000 |
| c. Cash | 54,000 | |
| Accounts Receivable..... | 6,000 | |
| Service Fee Earned..... | | 60,000 |
| d. Operating Expenses | 35,000 | |
| Cash | | 31,000 |
| Accounts Payable..... | | 4,000 |
| e. Cash | 3,000 | |
| Accounts Receivable..... | | 3,000 |
| f. Accounts Payable..... | 2,000 | |
| Cash | | 2,000 |
| g. No entry because this is a personal transactions | | |

2.

WIGOR INC.
Trial Balance
December 31, 2012

| | <u>Dr.</u> | <u>Cr.</u> |
|---------------------------|------------------------|------------------------|
| Cash | \$48,000 | |
| Accounts receivable..... | 3,000 | |
| Equipment | 9,000 | |
| Accounts payable | | \$ 5,000 |
| Common Stock..... | | 30,000 |
| Service fees earned | | 60,000 |
| Operating expenses..... | <u>35,000</u> | |
| Totals | <u>\$95,000</u> | <u>\$95,000</u> |

Chapter 02 - Analyzing and Recording Transactions