

2.1: Reviewing and Analyzing Transactions

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Let us assume our business is a service-based company. We use Lynn Sanders' small printing company, Printing Plus, as our example. Please notice that since Printing Plus is a corporation, we are using the Common Stock account, instead of Owner's Equity. The following are several transactions from this business's current month:

1. Issues \$20,000 shares of common stock for cash.
2. Purchases equipment on account for \$3,500, payment due within the month.
3. Receives \$4,000 cash in advance from a customer for services not yet rendered.
4. Provides \$5,500 in services to a customer who asks to be billed for the services.
5. Pays a \$300 utility bill with cash.
6. Distributed \$100 cash in dividends to stockholders.

We now analyze each of these transactions, paying attention to how they impact the accounting equation and corresponding financial statements.

Transaction 1: Issues \$20,000 shares of common stock for cash.

Assets	=	Liabilities	+	Equity
Cash +\$20,000				Common Stock +\$20,000

Analysis: Looking at the accounting equation, we know cash is an asset and common stock is stockholder's equity. When a company collects cash, this will increase assets because cash is coming into the business. When a company issues common stock, this will increase a stockholder's equity because he or she is receiving investments from owners.

Remember that the accounting equation must remain balanced, and assets need to equal liabilities plus equity. On the asset side of the equation, we show an increase of \$20,000. On the liabilities and equity side of the equation, there is also an increase of \$20,000, keeping the equation balanced. Changes to assets, specifically cash, will increase assets on the balance sheet and increase cash on the statement of cash flows. Changes to stockholder's equity, specifically common stock, will increase stockholder's equity on the balance sheet.

Transaction 2: Purchases equipment on account for \$3,500, payment due within the month.

Assets	=	Liabilities	+	Equity
Equipment +\$3,500		Accounts Payable +\$3,500		

Analysis: We know that the company purchased equipment, which is an asset. We also know that the company purchased the equipment on account, meaning it did not pay for the equipment immediately and asked for payment to be billed instead and paid later. Since the company owes money and has not yet paid, this is a liability, specifically labeled as *accounts payable*. There is an increase to assets because the company has equipment it did not have before. There is also an increase to liabilities because the company now owes money. The more money the company owes, the more that liability will increase.

The accounting equation remains balanced because there is a \$3,500 increase on the asset side, and a \$3,500 increase on the liability and equity side. This change to assets will increase assets on the balance sheet. The change to liabilities will increase liabilities on the balance sheet.

Transaction 3: Receives \$4,000 cash in advance from a customer for services not yet rendered.

Assets	=	Liabilities	+	Equity
Cash +\$4,000		Unearned Revenue +\$4,000		

Analysis: We know that the company collected cash, which is an asset. This collection of \$4,000 increases assets because money is coming into the business.

The company has yet to provide the service. According to the revenue recognition principle, the company cannot recognize that revenue until it provides the service. Therefore, the company has a liability to the customer to provide the service and must record the liability as unearned revenue. The liability of \$4,000 worth of services increases because the company has more unearned revenue than previously.

The equation remains balanced, as assets and liabilities increase. The balance sheet would experience an increase in assets and an increase in liabilities.

Transaction 4: Provides \$5,500 in services to a customer who asks to be billed for the services.

Assets	=	Liabilities	+	Equity
Accounts Receivable +\$5,500				Revenue +\$5,500

Analysis: The customer asked to be billed for the service, meaning the customer did not pay with cash immediately. The customer owes money and has not yet paid, signaling an accounts receivable. Accounts receivable is an asset that is increasing in this case. This customer obligation of \$5,500 adds to the balance in accounts receivable.

The company did provide the services. As a result, the revenue recognition principle requires recognition as revenue, which increases equity for \$5,500. The increase to assets would be reflected on the balance sheet. The increase to equity would affect three statements. The income statement would see an increase to revenues, changing net income (loss). Net income (loss) is computed into retained earnings on the statement of retained earnings. This change to retained earnings is shown on the balance sheet under stockholder's equity.

Transaction 5: Pays a \$300 utility bill with cash.

Assets	=	Liabilities	+	Equity
Cash -\$300				Expense -\$300

Analysis: The company paid with cash, an asset. Assets are decreasing by \$300 since cash was used to pay for this utility bill. The company no longer has that money.

Utility payments are generated from bills for services that were used and paid for within the accounting period, thus recognized as an expense. The expense decreases equity by \$300. The decrease to assets, specifically cash, affects the balance sheet and statement of cash flows. The decrease to equity as a result of the expense affects three statements. The income statement would see a change to expenses, changing net income (loss). Net income (loss) is computed into retained earnings on the statement of retained earnings. This change to retained earnings is shown on the balance sheet under stockholder's equity.

Transaction 6: Distributed \$100 cash in dividends to stockholders.

Assets	=	Liabilities	+	Equity
Cash -\$100				Dividends -\$100

Analysis: The company paid the distribution with cash, an asset. Assets decrease by \$100 as a result. Dividends affect equity and, in this case, decrease equity by \$100. The decrease to assets, specifically cash, affects the balance sheet and statement of cash flows. The decrease to equity because of the dividend payout affects the statement of retained earnings by reducing ending retained earnings, and the balance sheet by reducing stockholder's equity.

Let's summarize the transactions and make sure the accounting equation has remained balanced. Shown are each of the transactions.

Assets			=	Liabilities			+	Equity							
	Cash	Accounts Receivable	Equipment	Accounts Payable	Unearned Revenue	Common Stock	Dividends	Revenues	Expenses						
1	+20,000					+20,000									
2			+3,500	+3,500											
3	+4,000				+4,000										
4		+5,500						+5,500							
5	-300								-300						
6	-100						-100								
Total	23,600	+	5,500	+	3,500	+	4,000	+	20,000	-	100	+	5,500	-	300

\$32,600

Balanced

\$32,600

As you can see, assets total \$32,600, while liabilities added to equity also equal \$32,600. Our accounting equation remains balanced.

Your Turn: Debbie's Dairy Farm

Debbie's Dairy Farm had the following transactions:

1. Debbie ordered shelving worth \$750.
2. Debbie's selling price on a gallon of milk is \$3.00. She finds out that most local stores are charging \$3.50. Based on this information, she decides to increase her price to \$3.25. She has an employee put a new price sticker on each gallon.
3. A customer buys a gallon of milk paying cash.
4. The shelving is delivered with an invoice for \$750.

Which events will be recorded in the accounting system?

Answer

1. Debbie did not yet receive the shelving—it has only been ordered. As of now, there is no new asset owned by the company. Since the shelving has not yet been delivered, Debbie does not owe any money to the other company. Debbie will not record the transaction.
2. Changing prices does not have an impact on the company at the time the price is changed. All that happened was that a new price sticker was placed on the milk. Debbie still has all the milk and has not received any money. Debbie will not record the transaction.
3. Debbie now has a transaction to record. She has received cash and the customer has taken some of her inventory of milk. She has an increase in one asset (cash) and a decrease in another asset (inventory.) She also has earned revenue.
4. Debbie has taken possession of the shelving and is the legal owner. She also has an increase in her liabilities as she accepted delivery of the shelving but has not paid for it. Debbie will record this transaction.

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