

Principles of Accounting

Lecture 2

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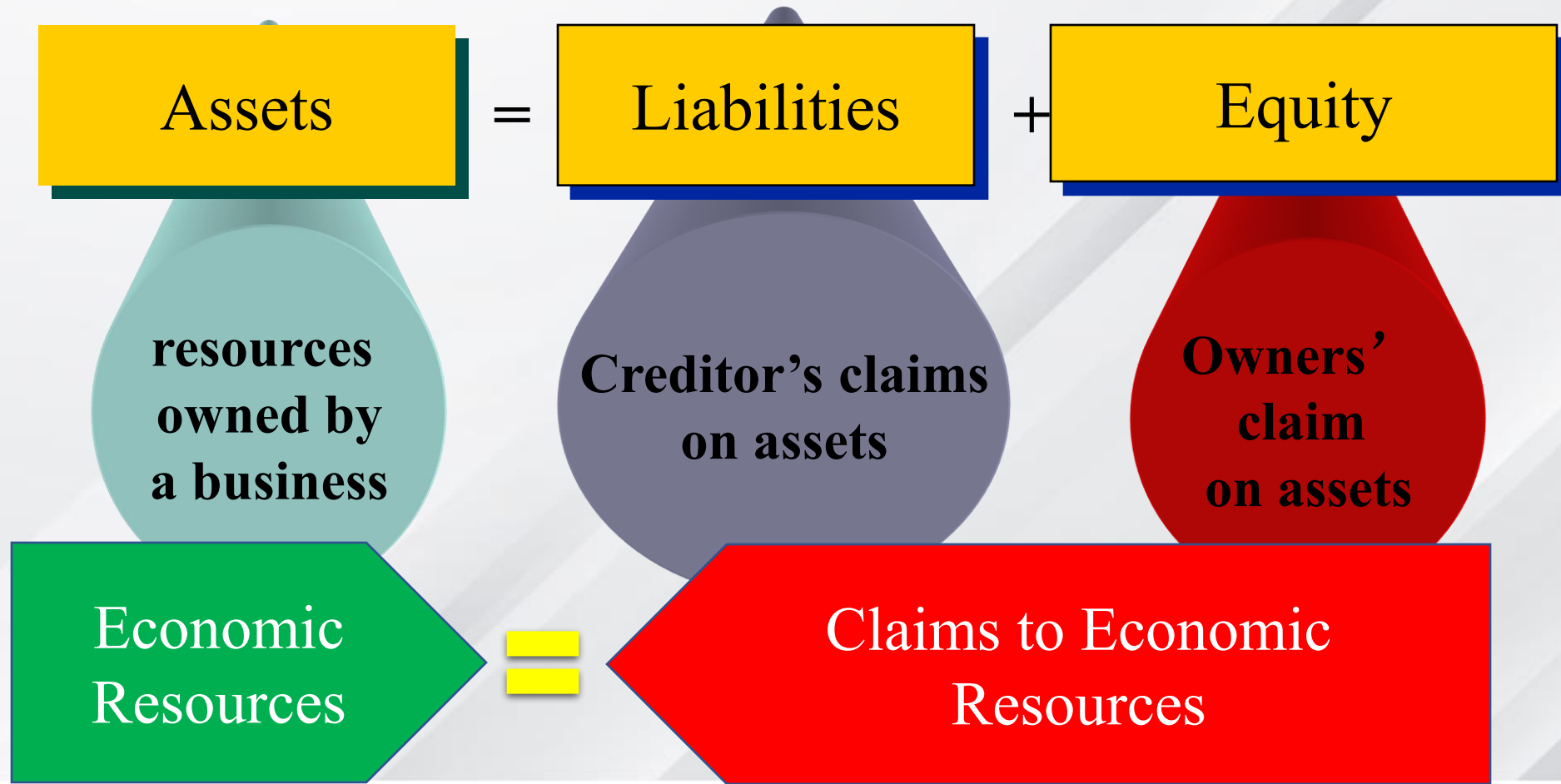
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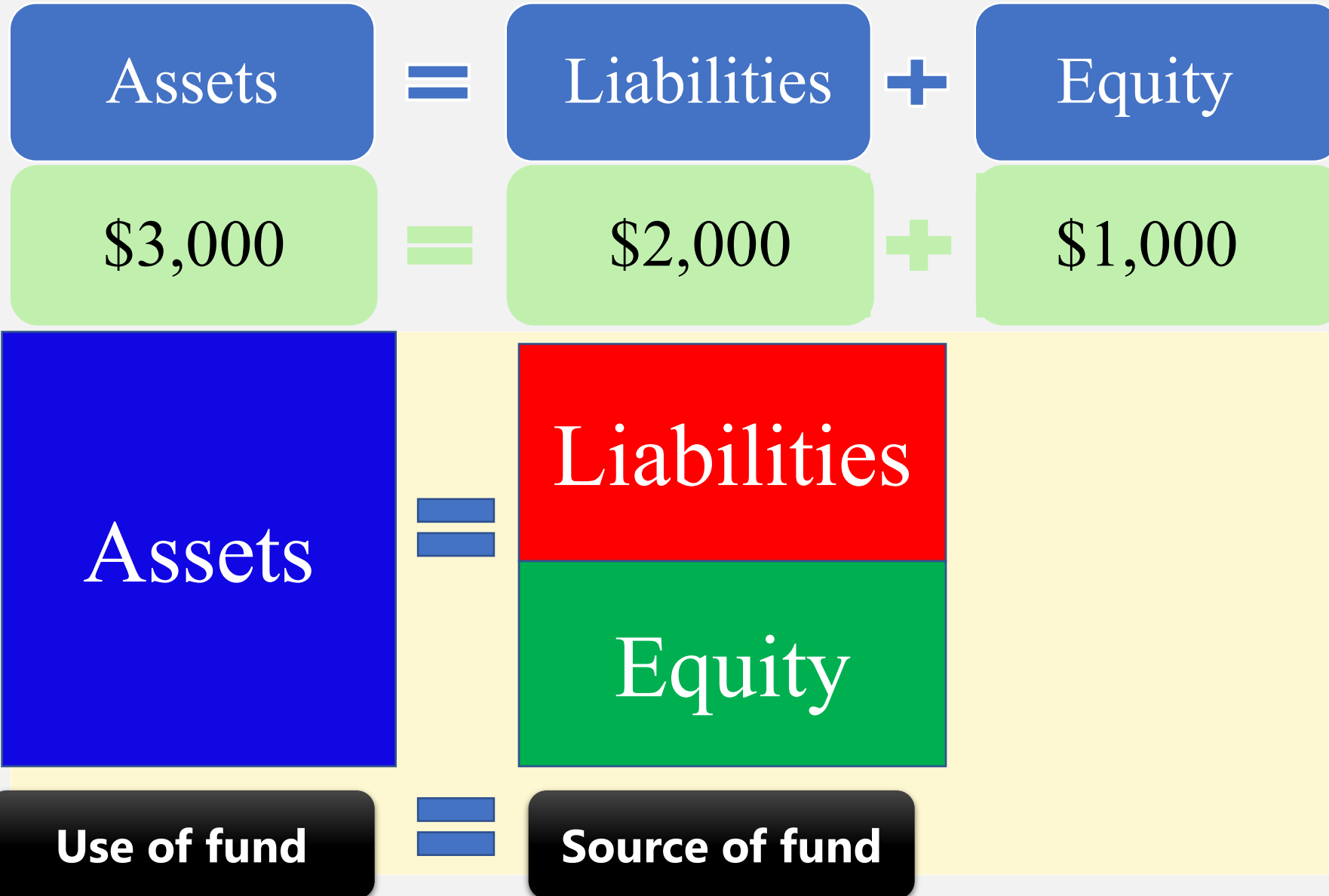


Describe the accounting equation,
and define assets, liabilities, and
equity

THE BASIC ACCOUNTING EQUATION



The Accounting Equation



Assets

- Economic resources
- Benefit the business in the future
- Recorded at cost which is measurable
- Examples:
 - Cash
 - Machine
 - Property, land
 - Furniture
 - Merchandise inventory
 - Accounts receivable

Claims to Assets

Liabilities

- Debts payable mainly to outsiders
- Examples:
 - Bank loans
 - Mortgages
 - Accounts payable
 - wages payable
 - tax payable

Equity

- Owner's claims to the assets of the business
- Residual claim
- Net worth or net asset

The Accounting Equation for proprietorships & partnerships

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

The owner's capital refers to the
owner contribution

profit

Owner's Capital

+ Revenue

- Expense

- Owner's
Withdrawals

Revenues

- Amounts earned in business operation by delivering goods, services to customers, rental of property, lending of money or investment.
 - Sales revenue
 - Service revenue
 - Interest revenue
 - Dividend revenue

Expenses

- Outflows of assets or increasing liabilities in operating business (delivering goods or services to customers)
- Occurred in the process of earning revenue
 - Store or rent expense
 - Salary expense
 - Advertising expense
 - Utilities expense
 - Interest expense
 - Property tax expense

Owner's Withdrawals

- Also called drawings
- Payments of equity to the owner(usually in the form of cash)

Is Owner's Withdrawals an example of expense?

Equity (for a corporation)

- For a corporation, equity is called Stockholders' equity:

Stockholders' equity = Paid-in capital + Retained earnings

● Paid in Capital represents the total **amount invested** by stockholders in a corporation.

- Retained earnings represents **cumulative profits (or losses) retained** in the business over time.
- =beginning retained earning +revenue-expense-dividend
- Dividend is like owner's withdrawals for proprietorship.

E1-16: CHARACTERISTICS OF A CORPORATION, ACCOUNTING CONCEPTS, AND USING THE ACCOUNTING EQUATION

Select financial information for three corporations follows:

	Assets	Liabilities	Equity
New Rock Gas	\$?	\$24,000	\$50,000
DJ Video Rentals	\$75,000	\$?	\$32,000
Corner Grocery	\$100,000	\$53,000	\$?

Requirements:

1. Compute the missing amount in the accounting equation for each entity.
2. If revenue increases, how does it affect owner's equity?
3. If expense increases, how does it affect owner's equity?
4. If drawing increases, how does it affect owner's equity? decrease

E1-16: CHARACTERISTICS OF A CORPORATION, ACCOUNTING CONCEPTS, AND USING THE ACCOUNTING EQUATION

Select financial information for three corporations follows:

	Assets	Liabilities	Equity
New Rock Gas	\$74,000	\$24,000	\$50,000
DJ Video Rentals	\$75,000	\$43,000	\$32,000
Corner Grocery	\$100,000	\$53,000	\$47,000

Requirements:

1. Compute the missing amount in the accounting equation for each entity.
2. If revenue increases, how does it affect owner's equity?
3. If expense increases, how does it affect owner's equity?
4. If drawing increases, how does it affect owner's equity? decrease

TRY IT!

Using the expanded accounting equation, solve for the missing amount.

Assets	\$ 71,288
Liabilities	2,260
Owner's Capital	?
Owner's Withdrawal	14,420
Revenues	53,085
Expenses	28,675



Use the accounting equation to
analyze transactions

Transaction

What is a business transaction?

- An event that affects the financial position of the business and must be recorded by accountants
- Can be measured reliably

In recording transactions:

- The accounting equation balances before and after each transaction
- Every transaction impacts at least two items

Dual effect

Remember: the two sides of the accounting equation must always be equal

TRANSACTION 1

- November 2, 2014, **Sheena Bright** decide to start e-learning agency company as a proprietorship named **Smart Touch Learning, Inc.**
- She invests **\$30,000** cash in exchange for **\$30,000** of capital.

$$\begin{array}{rcl} \text{Assets} & = & \text{Liabilities} + \text{Owner's Equity} \\ \hline \text{Cash} & & \text{Bright, capital} \\ \hline (1) \quad +30,000 & = & +30,000 \end{array}$$

- 1 accounts? types?
- 2 change?
- 3 balanced?

There is an increase in the asset **Cash**, **\$30,000**, and an equal increase in the owner' equity, **Bright ,capital**, **\$30,000**.

TRANSACTION 2

Smart Touch purchases land by **\$20,000** cash.

	Assets		=	Liabilities	+	Owner's Equity
	Cash	Land	=			Bright, capital
Old Bal.	\$30,000		=			\$30,000
(2)	-20,000	+\$20,000	=			
New Bal.	\$ 10,000	\$20,000	=			\$30,000

Asset **Cash** is decreased **\$20,000** and the asset **Land** is increased **\$20,000**.

TRANSACTION 3

Smart Touch purchases office supplies of \$500 from a store.

Smart Touch Learning pay this \$500 now.

This transaction is often referred to as a **purchase on account** or a **credit purchase**.

	Assets				=	Liabilities	+	Owner's Equity	
	Cash	+	Supplies	+	Land	=	Accounts Payable	+	Bright, capital
Old Bal.	\$10,000				\$20,000				\$30,000
(3)			+\$500				+\$500		
New Bal.	\$10,000	+	\$500	+	\$20,000	=	\$500	+	\$30,000

The asset **Office Supplies** is increased **\$500** and the liability **Accounts Payable** is increased by the same amount.

TRANSACTION 4

Smart Touch receives **\$5,500** cash from customers for services it has provided. It has earned service revenue and collect the cash immediately.

(4)

Assets			=	Liabilities	+	Owner' Equity	
	Cash	Supplies	Land	Accounts Payable	Bright Capital	Service Revenue	
Old Bal.	\$ 10,000	\$500	\$20,000	\$500	\$30,000		
	+5,500					+5,500	
New Bal.	\$15,500	\$500	\$20,000	\$500	\$30,000	\$5,500	

Cash is increased **\$5,500** and **Service Revenue** is increased **\$5,500** because it is earned.

TRANSACTION 5

Smart Touch provides service for a customer and earned service revenue . But the customer does not pay immediately and promise to pay \$3000 cash within one month.

	Assets				=	Liabilities	+	Owner' Equity	
	Cash	Accounts Receivable	Supplies	Land	=	Accounts Payable	+	Bright Capital	Service Revenue
Old Bal.	\$ 15,500		\$500	\$20,000	=	\$500	+	\$30,000	\$5,500
(6)		+3,000					+		+3,000
New Bal.	\$15,500	3,000	\$500	\$20,000	=	\$500		\$30,000	\$8,500

The asset **Accounts Receivable** is increased **\$3,000**; and **Owner's Equity** is increased **\$3,000** because of revenue earned.

TRANSACTION 6

Smart Touch pays \$3,200 cash for expenses:
\$2,000 for office rent and \$1,200 for employee salaries.

Assets						=	Liabilities + Equity							
Cash	+	Accounts Receivable	+	Office Supplies	Land		Accounts Payable	+	Bright, Capital	+	Service Revenue	-	Rent Expense	-
Bal.	\$15,500	+	\$3,000	+	\$500	+	\$20,000	\$500	+	\$30,000	+	\$8,500		
(6)	-3,200											-2,000		-1,200
Bal.	\$12,300	+	\$3,000	+	\$500	+	\$20,000	\$500	+	\$30,000	+	\$8,500	- \$2,000	- \$1,200

Cash is decreased **\$3,200** and **Owner's equity** is decreased by **\$3,200** because of expense occurred.

TRANSACTION 7

Smart touch pays **\$300** in cash for supplies purchased in transaction 3. It is called “**payment on account**”

Assets						=	Liabilities +		Equity							
Cash	+	Accounts Receivable	+	Office Supplies	+		Land	Accounts Payable	+	Bright, Capital	+	Service Revenue	–	Rent Expense	–	Salaries Expense
Bal.	\$12,300	+	\$3,000	+	\$500	+	\$20,000	\$500	+	\$30,000	+	\$8,500	–	\$2,000	–	\$1,200
(7)	–300							–300								
Bal.	\$12,000	+	\$3,000	+	\$500	+	\$20,000	\$200	+	\$30,000	+	\$8,500	–	\$2,000	–	\$1,200

Cash is decreased **\$300** and **Accounts Payable** is decreased by **\$300**.

TRANSACTION 8

Smart Touch collects \$2,000 from the client for which Smart Touch performed services in Transaction #5 .

It is called **“collection on account”**.

Assets						=	Liabilities + Equity									
Cash	+	Accounts Receivable	+	Office Supplies	Land		Accounts Payable	+	Bright, Capital	+	Service Revenue	-	Rent Expense	-	Salaries Expense	
Bal.	\$12,000	+	\$3,000	+	\$500	+	\$20,000	\$200	+	\$30,000	+	\$8,500	-	\$2,000	-	\$1,200
(8)	+2,000		-2,000													
Bal.	\$14,000	+	\$1,000	+	\$500	+	\$20,000	\$200	+	\$30,000	+	\$8,500	-	\$2,000	-	\$1,200

Cash is increased **\$2000** and **Accounts Receivable** is decreased by the same amount.

TRANSACTION 9

Sheena Bright withdraws \$5,000 cash from the business.

Assets					=	Liabilities +		Equity						
Cash	+	Accounts Receivable	+	Office Supplies		Land	Accounts Payable	+	Bright, Capital	-Bright Withdrawals	+ Service Revenue	- Rent Expense	- Salaries Expense	
Ba \$14,000	+	\$1,000	+	\$500	+	\$20,000	=	\$200	+	\$30,000		+ \$8,500	- \$2,000	- \$1,200
(9) -\$5,000														
Bal. \$9,000	+	\$1,000	+	\$500	+	\$20,000		\$200	+	\$30,000		+ \$8,500	- \$2,000	- \$1,200

Cash is decreased **\$5,000** and **Owner's Equity** is decreased by the same amount because of drawings .

Exhibit 1-4 | Analysis of Transactions, Smart Touch Learning



- 1. Smart Touch Learning received \$30,000 cash and gave capital to Sheena Bright, owner.
- 2. Paid \$20,000 cash for land.
- 3. Bought \$500 of office supplies on account.
- 4. Received \$5,500 cash from clients for service revenue earned.
- 5. Performed services for clients on account, \$3,000.
- 6. Paid cash expenses: office rent, \$2,000; employee salaries, \$1,200.
- 7. Paid \$300 on the accounts payable created in transaction 3.
- 8. Collected \$2,000 on the accounts receivable created in transaction 5.
- 9. Owner withdrew cash of \$5,000.

A summary of all nine transactions for Smart Touch Learning is presented in Exhibit 1-4.

Assets					+	Liabilities	Equity				
Cash	Accounts Receivable	Office Supplies	Land			Accounts Payable	Bright, Capital	Bright, Withdrawals	Service Revenue	Rent Expense	Salaries Expense
(1) +30,000							+30,000				
(2) -20,000			+20,000								
Bal. \$10,000			+ \$20,000				\$30,000				
(3)		+500				+500					
Bal. \$10,000		+ \$500	+ \$20,000			\$500	+ \$30,000				
(4) +5,500									+5,500		
Bal. \$15,500		+ \$500	+ \$20,000			\$500	+ \$30,000		+ \$5,500		
(5)	+3,000								+3,000		
Bal. \$15,500	+ \$3,000	+ \$500	+ \$20,000			\$500	+ \$30,000		+ \$8,500		
(6) -3,200										-2,000	-1,200
Bal. \$12,300	+ \$3,000	+ \$500	+ \$20,000			\$500	+ \$30,000		+ \$8,500	- \$2,000	- \$1,200
(7) -300						-300					
Bal. \$12,000	+ \$3,000	+ \$500	+ \$20,000			\$200	+ \$30,000		+ \$8,500	- \$2,000	- \$1,200
(8) +2,000	-2,000										
Bal. \$14,000	+ \$1,000	+ \$500	+ \$20,000			\$200	+ \$30,000		+ \$8,500	- \$2,000	- \$1,200
(9) -5,000								-5,000			
Bal. \$ 9,000	+ \$1,000	+ \$500	+ \$20,000			\$200	+ \$30,000	- \$5,000	+ \$8,500	- \$2,000	- \$1,200
\$30,500						\$30,500					

Using the information provided, analyze the affects of Lawlor Lawn Service's transactions on the accounting equation.

May 1	Received \$1,700 and gave capital to Eric Lawlor.
May 3	Purchased a mower on account, \$1,440.
May 5	Performed lawn services for client on account, \$200.
May 17	Paid \$60 cash for gas used in mower.
May 28	Eric Lawlor withdrew cash of \$300.



Prepare financial statements

Preparing the Financial Statements

After all transactions for the period are recorded, financial data is summarized and that summary data is used to generate the basic financial statements

- used by all companies as the primary means of communicating to stakeholders.
- usually prepared at the end of a fiscal year, season or month
- the final product of the whole accounting process



Statement of owner's equity are prepared for proprietorships and partnerships.

Income STATEMENT



SMART TOUCH LEARNING, INC. Income Statement For the Month Ended November 30, 2013		
Revenues		
Service revenue		\$ 8,500
Expenses		
Rent expense	2,000	
Salaries expense	<u>1,200</u>	
Total expenses		<u>3,200</u>
Net income		<u><u>5,300</u></u>

Reports the success or failure of the company's operations for a period of time.

Net income of \$5,300 will be added to Equity.

Statement of Owner's Equity

Shows amounts and causes of changes in owner's capital during the period.

SMART TOUCH LEARNING Statement of Owner's Equity Month Ended November 30, 2014

Bright Capital, November 1, 2014	\$	-
Owner Contribution		30,000
Net income for the month		5,300
		<u>35,300</u>
Owner Withdrawal		<u>(5,000)</u>
Bright Capital, November 30, 2014	\$	<u><u>30,300</u></u>

Statement of Equity Month ended Dec31,2014

Bright capital, Dec1, 2014 30,300

owner contribution

Net income

withdrawal

Bright capital, Dec31, 2014

Balance Sheet



MIDOCEAN
UNIVERSITY

SMART TOUCH LEARNING

Balance Sheet

November 30, 2014

Assets

Cash	\$ 9,000
Accounts Receivable	1,000
Office Supplies	500
Land	20,000
Total assets	\$ 30,500

Liabilities

Accounts Payable	\$ 200
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Owner's Equity

Bright Capital, November 30, 2014	30,300
Total Liabilities and Owner's Equity	\$ 30,500

balance

1.equality

2.leftover

Note that the Balance Sheet follows the **Accounting Equation**.

P1-36A: PREPARING FINANCIAL STATEMENTS

Studio Photography is a proprietorship . The **balance of Ansel, capital was \$45,000 at November 31, 2012.** At December 31, 2012, the business's accounting records show these balances:

Insurance expense	\$ 8,000	Accounts receivable	\$ 8,000
Cash	37,000	Note payable	12,000
Accounts payable	7,000	Ansel, capital, Dec 31, 2012	?
Advertising expense	3,000	Salary expense	25,000
Service revenue	80,000	Equipment	50,000
Ansel, drawing	13,000		

Prepare the following financial statements for Studio Photography, Inc. (a proprietorship) for the month ended December 31, 2012:

- Income statement
- Statement of owner's equity
- Balance sheet

P1-36A: CONTINUED

Studio Photography			
Income Statement			
For the Month Ended December 31, 2012			
	Revenue:		
	Service revenue		\$ 80,000
	Expenses:		
	Salary expense	\$ 25,000	
	Insurance expense	8,000	
	Advertising expense	3,000	
	Total expenses		36,000
	Net income		\$ 44,000

P1-36A: CONTINUED

Studio Photography		
Statement of Owner's Equity		
For the Month Ended December 31, 2012		
	Ansel, capital, December 31, 2011	\$ 45,000
	Net income	44,000
	Subtotal	\$ 89,000
	Less: Drawings	(13,000)
	Ansel, capital, December 31, 2012	\$ 76,000

P1-36A: CONTINUED

Studio Photography, Inc.					
Balance Sheet					
December 31, 2012					
	Assets			Liabilities	
	Cash	\$37,000		Accounts payable	\$ 7,000
	Accounts receivable	8,000		Note payable	12,000
	Equipment	50,000		Total liabilities	\$19,000
				Owner's Equity	
				Ansel, capital	76,000
	Total assets	\$95,000		Total liabilities and owner's equity	\$95,000

Using the following information, complete the income statement, statement of owner's equity, and balance sheet for DR Painting for the month of March 2015. The business began operations on March 1, 2015.

Accounts Receivable	\$ 1,400	Salaries Expense	800
Accounts Payable	1,000	Service Revenue	7,000
Cash	22,300	Office Supplies	1,800
Owner contribution during March	40,000	Truck	20,000
Owner withdrawal during March	1,500	Utilities Expense	200
Richardson, Capital, March 1, 2015	0		

> Quick Check

1. Which of the following is not true about accounting?
 - a. Accounting is the language of business.
 - b. Accounting measures business activities.
 - c. Accounting processes information into reports.
 - d. Accounting is not used to make wise investments.
2. Managerial accounting provides information for
 - a. customers.
 - b. investors.
 - c. managers.
 - d. the Federal Government.
3. Generally Accepted Accounting Principles (GAAP) are currently formulated by the
 - a. Financial Accounting Standards Board (FASB).
 - b. Securities and Exchange Commission (SEC).
 - c. Institute of Management Accountants (IMA).
 - d. American Institute of Certified Public Accountants (AICPA).

4. A partnership is a business
 - a. with a single owner.
 - b. with two or more owners and not organized as a corporation.
 - c. organized under state law that is a separate legal entity.
 - d. in which members are liable for only their own actions.

5. The entity will remain in operation for the foreseeable future. This is the
 - a. economic entity assumption.
 - b. cost principle.
 - c. faithful representation concept.
 - d. going concern assumption.

6. Which of the following requires accounting information to be complete, neutral, and free from material error?
 - a. Faithful representation concept
 - b. Cost principle
 - c. Economic entity assumption
 - d. Going concern assumption

7. At the end of a recent year, Global Cleaning Service, a full-service house and office cleaning service, had total assets of \$3,630 and equity of \$2,280. How much were Global Cleaning Service's liabilities?
 - a. \$5,910
 - b. \$3,630
 - c. \$1,350
 - d. \$2,280

8. Consider the overall effects on Global Cleaning Service from selling and performing services on account for \$6,400 and paying expenses totaling \$2,500. What is Global Cleaning Service's net income or net loss?
- a. Net income of \$3,900
 - b. Net loss of \$3,900
 - c. Net income of \$6,400
 - d. Net income of \$8,900
9. Assume that Global Cleaning Service performed cleaning services for a department store on account for \$180. How would this transaction affect Global Cleaning Service's accounting equation?
- a. Increase both assets and liabilities by \$180
 - b. Increase both assets and equity by \$180
 - c. Increase both liabilities and equity by \$180
 - d. Decrease liabilities by \$180 and increase equity by \$180

10. Which one of the following is true about the income statement?
- a. Net income means total revenues are greater than total expenses
 - b. Net loss means total expenses are less than total revenues
 - c. Only revenues are reported in the income statement
 - d. The income statement focuses only on the net loss
11. Assume Global Cleaning Service had net income of \$570 for the year. Global Cleaning Service's beginning and ending total assets were \$4,520 and \$4,180, respectively. Calculate Global Cleaning Service's return on assets (ROA).
- a. 12.6%
 - b. 13.6%
 - c. 13.1%
 - d. 7.63%

> **Quick Check Answers**

1. d 2. c 3. a 4. b 5. d 6. a 7. c 8. a 9. b 10. a 11. c

Chapter 1 Summary

- Accounting is the language of business. Financial statements report a company's activities in monetary terms.
- Different users—including individuals, business owners, managers, investors, creditors, and tax authorities—review a company's financial statements for different reasons. Each user's goal will determine which pieces of the financial statements he or she will find most useful.
- Most U.S. businesses follow generally accepted accounting principles (GAAP). If the company is publicly traded, then it must also follow SEC guidelines. If the company operates internationally, then international financial reporting standards (IFRS) will apply. The goal is that, eventually, all public U.S. companies will report using IFRS rules.
- There are five main forms of business organizations: proprietorships, partnerships, corporations, LLPs/LLCs, and not-for-profits. Each is unique in its formation, ownership, life, and liability exposure.

Chapter 1 Summary

- Proprietorships are formed when one person creates a business. One person owns the proprietorship. Although the proprietorship is a separate entity, it has no continuous life, and the owner has unlimited liability for the business's debts. Proprietorships have a more difficult time raising capital, but have the advantage of reduced regulation and less taxes than the corporate form of business.
- The accounting concepts are the underlying assumptions used when recording financial information for a business. Think of the concepts like rules of a game. You have to play by the rules.

Chapter 1 Summary

- The accounting equation must always equal. That is, Assets (what you own) must equal Liabilities (what you owe) + Equity (net worth).
- The accounting equation is $\text{Assets} = \text{Liabilities} + \text{Equity}$. Every business transaction affects various parts of the equation, but after each transaction is recorded, the equation must ALWAYS balance (equal).
- Financial statements are prepared from the ending balances of each account. Each financial statement shows a different view of the company's overall results
- Financial statements are prepared from the transaction analyses (summary of events) reported in each account (Exhibit 1-6) in the order shown in Exhibit 1-7. No one financial statement shows everything about a company. It is the financial statements AND the relationships the statements show that give users the overall picture for a specific company



Thank You