THE ABCs OF Accounting

Lesson 2: Introducing the Accounting Equation

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Lesson Objectives

- After studying this lesson, you will be able to:
  - Explain the parts of the accounting equation
  - Show how business transactions affect the accounting equation
  - Show the balance of the basic accounting equation after a transaction has been recorded
  - Demonstrate understanding of the terms used in accounting

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The Basic Accounting Equation

Assets = Liabilities + Owner's Equity

What is it for?

- Demonstrates the relationship between a business and the rights or claims to that business
- The property or items of value that a business owns are called *assets:*
    - Cash
    - Inventory
    - Office buildings
    - Land

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What is it for?

- Financial claims to those assets are called *equity:*
    - Mortgage payable
    - Accounts payable
    - Owner's investment
- Owner's claim to the assets: Owner's Equity
- Creditors' claims to the assets: Liabilities

The Basic Accounting Equation

Assets	= Liabilities	+ Owner's Equity
Cash	Accounts Payable	Owner, Capital
Accounts Receivable	Mortgage Payable	Owner, Draw
Inventory	Credit Card Payable	
Office Equipment	Taxes Payable	
Building		

Business Transactions

- Events that cause a change in the assets, liabilities, or owner's equity of the business
- Involve the buying and selling of goods or services
- If a business buys a piece of equipment for cash:
  - Cash account goes down in value ↓
  - Equipment account goes up in value ↑
  - Did the accounting equation balance change?

Effects of Business Transactions on the Accounting Equation

Steps in the Analysis of a Business Transaction:

- What happened?
  - What is the property?
  - Who is the owner?
- Determine which accounts were affected and by how much
- Check that the accounting equation is still in balance

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Investment by Owner: Starting a Business

- Dave started his business by taking $75,000 from his savings and depositing it in a checking account for the business
- Analysis:
  - Business received $75,000
  - Dave has an interest in the business equal to $75,000

	Assets	= Liabilities	+ Owner's Equity
Cash	$75,000		
Dave, Capital			$75,000

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Cash Payment Transactions

- Dave bought some office equipment
- He wrote a check for office equipment for $25,000

	Assets	= Liabilities	+ Owner's Equity
Balance	$75,000		$75,000
Cash	$50,000		
Equipment	$25,000		
Dave, Capital			$75,000
Balance	$75,000		$75,000

Credit Transactions: Purchase on Account

- Dave bought some furniture on account
- He promised to pay $5,000

	Assets	= Liabilities	+ Owner's Equity
Cash	$50,000		
Equipment	$25,000		
Furniture	$ 5,000		
Accts Payable		$5,000	
Dave, Capital			$75,000
Balance	$80,000	= $5,000	+ $75,000

Credit Transactions: Payment on Account

- Dave made a payment on account
- He paid Office Furniture Express $2,500

	Assets	= Liabilities	+ Owner's Equity
Cash	$47,500		
Equipment	$25,000		
Furniture	$ 5,000		
Accts Payable		$2,500	
Dave, Capital			$75,000
Balance	$77,500	= $2,500	+ $75,000

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Credit Transactions: Sale on Account

- Dave sold a desk on account for $750
- Furniture went down by $750
- Accounts receivable went up by $750

	Assets	= Liabilities	+ Owner's Equity
Cash	$47,500		
Accts Receivable	$ 750		
Equipment	$25,000		
Furniture	$ 4,250		
Accts Payable		$2,500	
Dave, Capital			$75,000
Balance	$77,500	= $2,500	+ $75,000

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Withdrawal by Owner

- When an owner takes money from the business, it is taken from the capital account (Dave took $500)
  - Capital account goes down $500
  - Cash account goes down $500

	Assets	= Liabilities	+ Owner's Equity
Cash	$47,000		
Accts Receivable	$ 750		
Equipment	$25,000		
Furniture	$ 4,250		
Accts Payable		$2,500	
Dave, Capital			$74,500
Balance	$77,000	= $2,500	+ $77,000

Summary

- Property or items of value a business owns are called assets
- Financial claims against those assets are called equity:
  - Creditors' claims are called Liabilities
  - Owner's claims are called Owner's Equity
- Money coming in is called revenue
- Money going out is called expenses
- When an owner removes money, it is called a withdrawal

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