**Accounting in Action**

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**Accounting** is the language of business or an **information system** that accountants use to communicate the firm’s financial and economic information to its **stakeholders** such as shareholders and creditors. The system includes identifying the transactions, recording, classifying, summarizing, preparing financial statements and communicating the financial reports to the firm’s external users.

There are several terms here that merit a bit more discussion.

* **Information system** simply refers to software.
* **Shareholders** refer to anyone who has bought a share. There are partial owners of the company and they receive dividends.
* **Creditors** refer to anyone who has given a loan and will receive interest on that loan.
* **External users** also refer to stakeholders.

The above definition applies specifically to **financial accounting**. There are other forms of accounting, such as cost accounting and management accounting, which are for **internal users**, such as managers in the company. Those are used to make business decisions, such as what the price of a product should be or whether to make a certain product ourselves or obtain it from a different company. We will be looking into those later on.

The major parts of financial accounting include:

1. Identifying transactions, which are the events that affect the financial state of the company.
2. Recording transactions, called a **journal**.
3. Classifying transactions, called a **ledger**.
4. Summarizing transactions, called a **trial balance**.

In financial accounting, an annual report is published. This contains 5 types of **financial statements**:

1. Statement of Financial Position, also called a **balance sheet**
2. Statement of Comprehensive Income, also called an **income statement**
3. Statement of Owners Equity
4. Statement of Cash Flows
5. Notes of Financial Statements, which essentially contains specific details of items from the other statements if required.

## Balance Sheet

The **balance sheet** contains 3 parts, assets, liabilities and owners’ equity.

### Assets

**Assets** can be of two types:

1. Current Assets
2. Long-Term Assets

**Current assets** refer to either cash or something which can be converted to cash within a year. This includes:

1. **Liquid Assets**, such as cash or a bank balance, which can be used instantly,
2. **Short-Term Investments**
3. **Accounts Receivables** (debtors), which, if they have specific terms and conditions, such as an interest rate, become Notes Receivable
4. **Inventory**, which includes raw materials, work-in-progress and finished goods

**Long-Term Assets** are things like land, equipment and furniture.

There is a third category of assets that are not included in the balance sheet, **intangible assets**. There are assets which cannot be measured in monetary value, such as:

1. Trademarks
2. Patents
3. Goodwill

The last of these is a bit confusing. When a company acquires another for a value that is greater than the company is worth, goodwill becomes involved. Essentially, goodwill is used to place a monetary value on things like the value of the company’s brand name, its customer base, good customer/employee relations, patents and proprietary technology.

### Liabilities

**Liabilities** can also be of two types:

1. Current Liabilities
2. Long-Term Liabilities

**Current Liabilities** are **accounts payable**, such as money owed to suppliers. These must be paid within a year. If the accounts payable involves a formal agreement, such as a specified interest rate, they become **notes payable**. Notes payable can in fact even be from banks, and they can be for more than one year, in which case they become a long-term liability.

There are other forms of accounts payable, such as salaries payable or interest payable.

**Long-Term Liabilities** include **bonds payable**. Bonds are essentially loans given by creditors. The creditors buy the bonds for a certain price and with a certain interest rate.

### Owner’s Equity

The **Owner’s Equity** includes whatever the owner of the company owns and the capital that was invested. It increases when the company makes a profit and decreases when the company makes a loss.

## Income Statement

The **Income Statement** is basically a tally of revenues and expenses.

Revenues include things like sales revenue, service revenue, interest revenue (revenue gained as interest from loans given out) and rent revenue (revenue gained from properties rented out).

Expenses include things like salaries expense, rent expense, utilities expense, insurance expense, advertisement expense, interest expense, etc.

Subtracting the total expenses from the total revenues gives us the **net profit** or **net loss**. This value is taken to the **owner’s equity statement**.

## Owner’s Equity Statement

We will be looking into the **Owner’s Equity Statement** for a **Sole Proprietorship Company**.

This statement starts with the **Beginning Capital** at the start of the fiscal year. On top of this, we add any **additional investments**, add or subtract the **net profit** or **net loss** and subtract any **withdrawals** made by the owner. This gives us the **Ending Capital** at the end of the fiscal year, which in turn becomes the Beginning Capital of the next fiscal year.

## Basic Equation

In accounting, there is a basic equation, . This basically means that the total assets will always be equal to the total liabilities and the total owner’s equity.

This equation can be further broken down into the constituent parts. For example, we can break down to Owner’s Capital Revenue Expenses Owner’s Withdrawals.

Consider a few examples:

* If we provide service worth , our Revenue will increase on the Owner’s Equity side. Similarly, Cash or Accounts Receivable will increase on the Assets side.
* If we pay salaries worth , Expenses will increase, causing the Owner’s Equity to decrease. This change will be reflected on Cash under Assets.
* If we buy furniture, Accounts Payable will increase under Liabilities, while the furniture itself is added under Assets.

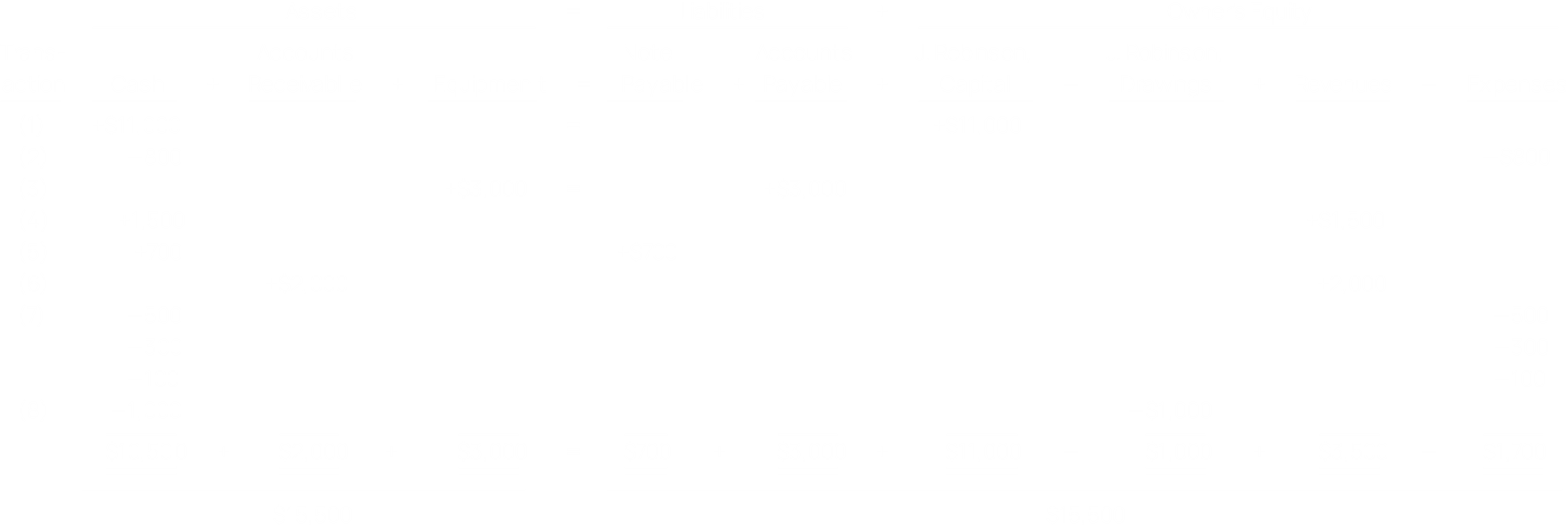
## Statement Formats

### Summary of Transactions

The **Summary of Transactions** is not really an accounting statement, but it makes creating the actual statements a lot easier. For a given series of transactions, we prepare a table to show how the two sides of the basic accounting equation are affected.

In the example below, we look at the transactions for a company owned by Joan Robinson.

1. Joan invested in cash in the law practice.
2. Paid for July rent on office space.
3. Purchased office equipment on account .
4. Provided legal services to clients for cash .
5. Borrowed cash from a bank on a note payable.
6. Performed legal services for client on account .
7. Paid monthly expenses: salaries , utilities , and telephone .
8. Joan withdraws cash for personal use.



Notice that the owner’s name is in the table with the Capital and the Drawings columns. If we are preparing the summary for a sole proprietorship and the name of the owner is known, we must do this.

### Income Statement

The **Income Statement** will contain 2 sections, for the **Revenues** and **Expenses** respectively. These will include all the entries from the summary of transactions that affected the Revenues and Expenses. The sum of the two sections should match the corresponding columns from the summary of transactions.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Joan Robinson, Attorney | | | | |
| Income Statement | | | | |
| For the month ended, July 31, 2010 | | | | |
| Particulars | | | Amount () | Amount () |
| Revenues | | |  |  |
|  | Service Revenues | |  | 3,500 |
| Expenses | | |  |  |
|  | Rent Expense | | 800 |  |
|  | Salaries Expense | | 500 |  |
|  | Utilities Expense | | 300 |  |
|  | Telephone Expense | | 100 |  |
|  |  | Total Expenses |  | (1,700) |
| Net Income | | |  | 1,800 |

Subtracting the expenses from the revenues, we will have our **Net Income** or **Net Loss**.

### Statement of Owner’s Equity

The **Statement of Owner’s Equity** is similar to the Income Statement except that it shows the investment total and net income total on one side and the drawings total on the other side. The starting and ending capital are marked as the owner’s capital on the corresponding dates.

|  |  |  |  |
| --- | --- | --- | --- |
| Joan Robinson, Attorney | | | |
| Statement of Owner’s Equity | | | |
| For the month ended, July 31, 2010 | | | |
| Particulars | | Amount () | Amount () |
| J. Robinson, Capital, July 1 | |  | 0 |
| Add: | Investments | 11,000 |  |
|  | Net Income | 1,800 |  |
|  |  |  | 12,800 |
| Less: | J. Robinson, Drawings |  | (1,000) |
| J. Robinson, Capital, July 31 | |  | 1,800 |

### Balance Sheet

The **Balance Sheet** shows the total of each of the columns from the Summary of Transactions in two sections, Assets and Liabilities and Owner’s Equity. Unlike the previous statements, the balance sheet is created for a particular day, not for a month or year.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Joan Robinson, Attorney | | | | |
| Balance Sheet | | | | |
| July 31, 2010 | | | | |
|  | | | Amount () | Amount () |
| Assets | | |  |  |
| Cash | | | 10,500 |  |
| Accounts Receivable | | | 2,000 |  |
| Equipment | | | 300 |  |
|  | Total Assets | |  | 15,500 |
|  | | |  |  |
| Liabilities and Owner’s Equity | | |  |  |
| Liabilities | | |  |  |
|  | Accounts Payable | | 3,000 |  |
|  | Notes Payable | | 700 |  |
|  |  | Total Liabilities |  | 3,700 |
| Owner’s Equity | | |  |  |
|  | J. Robinson, Capital, July 31 | |  | 11,800 |
|  |  | Total Liabilities & Owner’s Equity |  | 15,500 |

Notice that the Owner’s Equity simply shows the owner’s capital at the end of the month.

Also note that all the statements we see above are not generally prepared monthly. This is only done for internal use. The annual report that is published will show the same statements for the entire year.