Accounting Equation & Accounting Concepts
5 Ways to Classify Accounts

1. Assets
2. Liabilities
3. Owner’s Equity
4. Revenue
5. Expense
Asset

- Asset = own
- Anything of value that is owned
- Used to acquire additional assets or to operate a business
- Examples: cash, petty cash, supplies, equipment, accounts receivable, prepaid insurance
Liability

- Liability = Owe

- Amount the business owes to others

- Examples: Accounts payable, notes payable, other bills unpaid
Owner’s Equity

- Amount owned – amount owed
- Amount remaining after the value of liabilities is subtracted from the assets
- Owner’s equity – amount of business actually owned by the owner
Owner’s Equity

2 Most Common Accounts

1. **Capital** – summarize owner’s equity in business

2. **Drawing** – used when an owner withdraws either cash or merchandise for *personal* use.
Revenue

- Any income earned from the sale of goods or services and results in an increase in owner’s equity.

- Examples: Sales, Services
Expense

- Price paid for goods or services used to operate a business, resulting in a decrease in owner’s equity

- Examples: Rent, Utilities, Advertising, Wages
Accounting Equation

Assets = Liabilities + Owner’s Equity
Double Entry-System

- Also called Duel Entry System
- Accounting Equation must always be in balance
Transactions

- Changes in the accounting equation
- Must always change 2 accounts to keep the accounting equation in balance
- Will always have a debit and a credit
T accounts

- Used to keep balances of accounts
- Left side = Debit
- Right side = Credit
Normal Balances

- Side of account which increases
- Assets = Left side increases
- Liabilities = Right side increases
- Owner’s Equity = Right side increases
Accounting Framework

- All businesses must use the same reporting practices to record financial information.
  - **GAAP** – Generally Accepted Accounting Principles
  - **SEC** – Securities and Exchange Commission
  - **FASB** – Financial Accounting Standards Board
AICPA

American Institute of Certified Public Accountants

- National professional organization of CPAs
- Provides CPAs with resources, information, and leadership
- Advocacy, Certification and Licensing, Recruiting and Education, and Standards and Performance
12 Accounting Concepts

1. Entity – Accounting records are kept for entities and not the people who own or run the company.

- Business is considered its own person
- A business can marry (merger), have kids (subsidiary), and die (discontinue operations).
2. Money-Management – for an accounting record to be made, it must be able to be expressed in monetary terms.

- Financial statements show only a limited picture of the business.
Accounting Concepts

3. Going Concern – financial statements are prepared with the expectation that a business will remain in operation indefinitely.

- Assets cost can be (amortized) spread over its expected life.

- Liquidated – how quickly or the ease an asset can be converted to cash
Accounting Concepts

4. Historical Cost – the price paid to acquire the asset.

   “worth” changes over time

5. Dual Aspect (Accounting Equation)

   Assets = Liabilities + Owner’s Equity
6. Objectivity – accounting entries will be recorded on the basis of *objective* evidence.

- Source documents: invoices, receipts, bank statements, calculator tapes
- All information comes from source documents and is based on FACT not opinion.
Source Documents

- A business paper which information is obtained.
- Prove a transaction has occurred.
- Examples: checks, purchase orders, invoice, receipts, calculator tapes, memorandums
Accounting Concepts

7. Time Period – specific interval of time for which an entity’s reports are prepared.
   - Fiscal year (July 1 – June 30) or 12 month period
   - Natural year (January 1 – December 31)
   - Once a time period is set, it must not change
8. Conservatism – understating rather than overstating revenue (income) and expense amounts that have a degree of uncertainty.

- Rule is to recognize revenue when it is reasonably certain and measurable and recognize expenses as soon as reasonably possible.
- Better to err on caution than to inflate or overstate positive results.
Accounting Concepts

9. Realization – Revenue (income) is recognized when earned or realized.
   - Seller receives cash or has a claim to cash (accounts receivable) after a sale of goods or services.
   - Recorded when received, not when awarded.
Accounts Receivable

- Customer has charged on account, “sold on account”
- Normal debit balance
- Asset account because money is owed to the company and will be collected at a later date.
Accounts Payable

- Company buys something on account and will pay at a later date.
- Normal Credit balance
- Liability account because money is owed to a vendor and must be paid later
Accounting Concepts

10. Matching – Revenues and related expenses must be recorded in the same accounting period.
   - Avoids overstatement of income

11. Consistency – Once an entity decides on a method of reporting it must keep the same method for all subsequent events.
12. Materiality – accounting practice that records events that are significant enough to justify the usefulness of the information.

Example: We do not record a transaction each time we use a sheet of paper as an Office Supply Expense; instead we wait until we purchase a large quantity and then expense it.