

## Accounting

### **Chapter 3: Accounting equation**

The basic accounting equation

All the processes in an accounting system must observe the equality of the accounting equation, which is basically an algebraic equation.

$$\text{ASSETS} = \text{LIABILITIES} + \text{EQUITY}$$

**Assets** - are the economic resources you control that have resulted from past events and can provide you with economic benefits.

#### **Control**

- you have the exclusive right to enjoy those benefits and the ability to prevent others from enjoying those benefits.
- you don't have to necessarily own the economic resource for it to be considered your asset but your control over it is what matters.

#### **Economic benefits**

- To be an asset, the economic resource must have the potential to provide you with economic benefits in at least one circumstance.

**LIABILITIES** - are your present obligations that have resulted from past events and can require you to give up economic resources when settling them.

#### **Obligation**

- A duty or responsibility

**Legal obligation** - an obligation that results from a contract, legislation, or other operation of law

**Constructive obligation** - an obligation that results from your past actions (eg, past practice or published policies) that have created a valid expectation on others that you will accept and discharge certain responsibilities.

#### **Giving up of economic resources**

Settling the obligation necessarily would require you to pay cash to transfer other non-cash assets, or to render a service.

**EQUITY** - is simply assets minus liabilities. Other terms for equity are "capital," "net assets," and "net worth."

#### **The Expanded Accounting Equation**

We can expand the basic accounting equation by including two more elements - income and expenses.

## **ASSETS = LIABILITIES + EQUITY + INCOME - EXPENSES**

Notice that income is added while expenses are deducted in the equation. These are because income increases equity while expenses decrease equity.

**INCOME** - is increases in economic benefits during the period in the form of increases in assets, or decreases in liabilities, that result in increases in equity,

**EXPENSES** - are decreases in economic benefits during the period in the form of decreases in assets, or increases in liabilities, that result in decreases in equity,

The difference between income and expenses represents profit or loss.

## **CHAPTER 4: TYPES OF MAJOR ACCOUNTS**

### **The Account**

Account is the basic storage of information in accounting. It is a record of the increases and decreases in a specific item of asset, liability, equity, income or expense.

### **5 MAJOR ACCOUNTS**

1. **Assets**
2. **Liabilities**
3. **Equity**
4. **Income**
5. **Expenses**

### **BALANCE SHEET ACCOUNTS**

#### **ASSETS**

- **Cash** includes money or its equivalent that is readily available for unrestricted use, e.g., cash on hand and cash in bank.
- **Accounts receivable** - receivables supported by oral or informal promises to pay.
- **Allowance for bad debts** - the aggregate amount of estimated losses from uncollectible accounts receivable. Another term is "allowance for doubtful accounts."
- **Notes receivable** - receivables supported by written or formal promises to pay in the form of promissory notes.
- **Inventory** - represents the goods that are held for sale by a business. For a manufacturing business, inventory also includes goods undergoing the process of production and raw materials that will be consumed in the production process.
- **Prepaid supplies** - represents the cost of unused office and other supplies.
- **Prepaid rent** - rent paid in advance.
- **Prepaid insurance** - cost of insurance paid in advance.

- **Land**- the lot on which the building of the business has been constructed or a vacant lot which is to be used as future plant site. Land is not depreciable.
- **Building** the structure owned by a business for use in its operations. Accumulated depreciation - building - the total amount of depreciation expenses recognized since the building was acquired and made available for use.
- **Equipment**-consists of various assets such as:
  - a. **Machineries and other factory equipment**
  - b. **Transportation equipment**, e.g., vehicles, delivery trucks
  - c. **Office equipment**, e.g., desks, cabinets, chairs
  - d. **Computer equipment**, e.g., server, personal computers, laptops e. Furniture and fixtures, e.g., desks, cabinets, movable partitions
- **Accumulated depreciation equipment** - the total amount of depreciation expenses recognized since the equipment was acquired and made available for use.

### ***LIABILITIES***

- **Accounts payable** - obligations supported by oral or informal promises to pay by the debtor.
- **Notes payable** - obligations supported by written or formal promises to pay by the debtor in the form of promissory notes.
- **Interest payable interest** - incurred but not yet paid. Interest payable arises from interest-bearing liabilities. For example, you will incur interest on your bank loan.
- **Salaries payable** - salaries already earned by employees but not yet paid by the business.
- **Utilities payable** - utilities (e.g., electricity, water, telephone, internet, cable TV, etc.) already used but not yet paid.
- **Unearned income** - Items related to income that were collected in advance before they are earned. After the earning process is completed, these items are transferred to income.

### ***EQUITY***

- **Owner's capital (or Owner's equity)** - the residual amount after deducting liabilities from assets.
- **Owner's drawings** - this account is used to record the temporary withdrawals of the owner during the period.

### ***INCOME***

- Service fees** - revenues earned from rendering services (e.g., services of a spa, services of a beauty salon, etc.).
- Sales** - revenues earned from the sale of goods (e.g., sale of barbecue, sale of souvenir items, etc.).
- Interest income** - revenues earned from the issuance of interest-bearing receivables.
- Gains** - income earned from the sale of assets (except inventory) or from enhancements of assets or decreases in liabilities that are not classified as revenue.

### ***EXPENSES***

- **Cost of sales (or Cost of goods sold)** - represents the value of inventories that have been sold during the accounting period.

- **Freight-out** - represents the sellers' costs of delivering goods to customers. Other terms for freight-out are "delivery expense," "transportation-out," and "carriage outwards."
- **Salaries expense** represents the salaries earned by employees for the services they have rendered during the accounting period.
- **Rent expense** represents the rentals that have been used up during the accounting period.
- Utilities expense** represents the cost of utilities (eg. electricity, water, telephone, internet, cable TV, etc.) that have been used during the accounting period.
  - A business can also have separate accounts for each type of utility, e.g., "Electricity expense," "Water expense," "Technology and Communication expense," and the like.
- **Supplies expense** represents the cost of supplies that have been used during the period.
- **Bad debt expense** - the amount of estimated losses from uncollectible accounts receivable during the period. Other term is "doubtful accounts expense."
- **Depreciation expense** - the portion of the cost of a depreciable asset (e.g., building or equipment) that has been allocated to the current accounting period.
- **Advertising expense** - represents the cost of promotional or marketing activities during the period.
- **Insurance expense** represents the cost of insurance pertaining to the current accounting period.
- **Taxes and licenses** - represents the cost of business and local taxes required by the government for the conduct of business (eg. mayor's permit, other percentage taxes, community taxes).

#### **Transportation and travel expense**

> Transportation expenses represent the necessary and ordinary cost of employees getting from one workplace to another which are reimbursable by the business, e.g., reimbursable taxi fares of employees running some errands and those who are working on late shifts.

> Travel expenses represent the costs incurred when traveling on business trips, eg, out-of-town travel costs of employees sent to seminars.

- **Interest expense** - represents the cost of borrowing money. It is the price that a lender charges a borrower for the use of the lender's money. Other terms for interest expense are finance costs and borrowing costs.
  - Interest expense and interest income are opposites. For example, you will incur interest expense on the money you borrowed from Mr. Bombay. On the other hand, Mr. Bombay will earn interest income.
- **Miscellaneous expense** represents various small expenditures which do not warrant separate presentation.
- **Losses** - expenses which may or may not arise from the ordinary course of business activities. Losses may arise from:
  - a. Sale of assets, other than inventory, at a sale price that is less than the carrying amount.
  - b. Decreases in the value of assets due to destruction, damage, obsolescence and other changes in values caused by market factors, e.g., loss on fire, earthquake, storm, and other calamities, decrease in the value of foreign currencies held due to changes in exchange rates.