Chapter 2: The Accounting Elements

Topic Outline:

1. Cash vs Credit Transactions

2. Accounting Elements
    - Assets
    - Liabilities
    - Owner's equity

3. The Accounting Equation
    - basic accounting equation
    - expanded accounting equation

4. Measurement of Financial Performance

Chapter 2: The Accounting Elements

2.1 Cash vs Credit Transactions

- **Cash transactions** : when cash or cheque is received or paid for a transaction.

- **Credit transactions** : when cash or cheque is not received or paid at the time of the transaction, but at a later date

- Transactions must be **analysed and classified** to measure the effects on the business.

2.2 Accounting Elements

Assets:

- things of value owned by a business

- they are resources which a business has and can use to carry out its activities

- assets provide future benefits to a business

- e.g. building, furniture, office equipment, debtors, cash, stocks, prepaid expenses, etc

* Debtors – refer to money owing to the business by customers for goods or services provided on credit.

Liabilities:

- are amounts owed by the business to other parties

- e.g. trade creditors, bank overdraft, accrued expenses etc

* Creditors – refer to money owing by the business to suppliers for goods or services provided on credit.

<u>Owner’s Equity:</u>

- refers to the owners’ claims on the assets of the business i.e. the owners’ investment
- known as **owner’s capital**
- goods or other assets withdrawn from the business by the owners for their personal use are called ‘**drawings**’ and separately recorded

<u>Income:</u>

- refers to the **earnings** of a business from carrying out its activities
- it is also known as ‘**revenue**’
- eg sales, discount received, interest received, rent revenue, etc

<u>Expenses:</u>

- refers to the goods or services which are used up to earn income in a given period
- eg purchases, discount allowed, interest expense, rent expense, rates, stationery, wages & salaries, etc

<u>2.3 The Accounting Equation</u>

The Accounting Equation

- shows <u>the relationship between assets, liabilities and owner’s equity</u>
- shows the financial position of a business at a particular point of time i.e. how much the business owns, owes and the owner’s interest in the business
- The basic accounting equation:

Assets = Liabilities + Owner’s Equity

<u>Effects of Transactions on the Accounting Equation</u>

Transactions	Effects	
The business bought a delivery van for $15 000 paid by cash.	*Motor Vehicles + $15 000*	*Cash - $15 000*
The business bought furniture for $4 000 on credit.	*Furniture + $4 000*	*Creditors + $4 000*
The business paid the creditor $2 000 in cash.	*Cash - $2 000*	*Creditors - $2 000*
The business borrowed $1 000 to pay the creditor.	*Creditor - $1 000*	*Loan + $1 000*
The owner brought in furniture worth $1 000 for office use.	*Furniture +$1 000*	*Capital + $1 000*
The owner withdrew cash of $500 for personal use	*Capital -$500 Drawings +$500*	*Cash - $500*

Worked Example

Note:

1. Each transaction has at least 2 effects on the accounting equation.
2. Equality of the accounting equation is always maintained.

2.4 Measurement of Financial Performance

The Expanded Accounting Equation

- Revenue increases ➔ <u>increase</u> in assets → <u>increase</u> in owner's equity
- Expenses increases ➔ <u>decrease</u> in assets → <u>decrease</u> in owner's equity

Assets = Liabilities + Owner's Equity + Revenue – Expenses

Profits (Losses) = Income - Expenses

Effects of Transactions on the Expanded Accounting Equation

	Assets	Liabilities	Owner's Equity
Transaction 1: *Business received cash of $500 as commission revenue*	Cash +$500		Commission Revenue +$500
Transaction 2: *Business paid $300 wages in cash*	Cash - $300		Wages - $300
Transaction 3: *Business earns revenue (no cash involved).* *Business paid creditors $400 & received discount of $20*	Cash - $400	Creditors - $420	Discount Received + $20
Transaction 4: *Business incurs expenses (no cash involved.* *Business received $800 from debtors & allowed discount of $80*	Debtors - $880 Cash + $800		Discount Allowed - $80