## UNIT 1 THE ACCOUNTING EQUATION

I. ASSETS - LIABILITIES = OWNER'S EQUITY

WHAT IS OWED

ITEMS OF VALUE

NET WORTH

II. DEFINITIONS

ACCOUNT - a storage area for financial information. T ACCOUNT - a simplified account. DEBIT - left side of an account. CREDIT - right side of an account.

### III. BALANCE SHEET ACCOUNTS

ASSETS are items of value.

LIABILITIES are amounts owed.

OWNER'S EQUITY is the net worth of a business.

RETAINED EARNINGS is the account used to store income earned but not distributed by a corporation.

CAPITAL is the Owner's Equity account for

COMMON STOCK is the primary account for tracking the invested equity of a corporation.

sole proprietorships and partnerships.

OWNER'S EOUITY

DR.

## IV. DEBITS AND CREDITS

Please relate the definitions in Part III to the schematic below. Note the accounting equation has been rewritten to better explain debits and credits.

CR.

+

LIABILITIES

DR.

----

ASSETS DR. CR. + -

The DOUBLE ENTRY system of debits and credits facilitates the increasing and decreasing of the amounts stored in the Balance Sheet Accounts. The above schematic summarizes part of the system. After rewriting the accounting equation it should be noted that Assets are on the opposite side of the equation from Liabilities and Owner's Equity and are therefore treated in an opposite manner by the system.

CR.

+

NOTE: The following example will show only the current transaction information in each T account.

# V. ANALYZING TRANSACTIONS - SAMPLE PROBLEM Assets = Liabilities - Sample PROBLEM Owner's Equity Darin Jones, a sophomore at State University, started the Quick Clean Laundry Service with a \$100 cash investment. <u>Cash</u> <u>Capital</u>, <u>Darin Jones</u> 100

2. On Sept. 1, paid \$50 for 5 months of ads in the school newspaper. <u>Prepaid Advertising</u> 50

Cash 50

Cash

25

8

3. On Sept. 1, purchased Laundry Supplies for \$25 cash.

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4. On Sept. 1, purchased \$48 of Laundry Equipment paying \$8 down. <u>Laundry Equipment</u> <u>Accounts Payable</u> 48 | 40 <u>Cash</u>

5. Darin made an additional investment of \$50. <u>Cash</u> 50 | 50

6. Paid one-fourth the amount owed on the Laundry Equipment. <u>Cash</u><u>Accounts Payable</u> 10 10

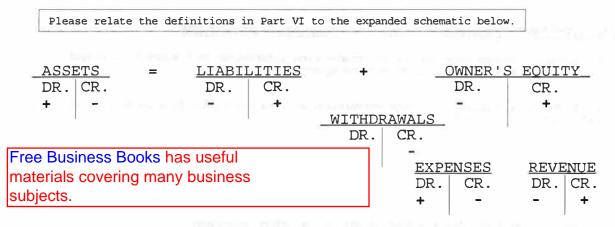
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#### VI. TIMPORARY OWNER'S EQUITY STORAGE ACCOUNTS

WITHDRAWALS is a storage account used to record periodic decreases in Owner's Equity by sole proprietors and partners.

EXPENSES represent a decrease in Owner's Equity caused by a decrease in Assets (usually Cash) or an increase in Liabilities (Salaries Payable, Accounts Payable, etc.) resulting from normal business activity. Examples include Salaries, Advertising, and Interest. REVENUE represents an increase in Owner's Equity caused by an increase in Assets (usually Cash or Accounts Receivable) resulting from normal business activity. Examples include Sales, Interest Income, and Rent Revenue.

### VII. DEBITS AND CREDITS



Expense, Revenue, and Withdrawals are temporary storage accounts used to track changes in Owner's Equity and their positive or normal balance is consistent with the eventual change to be made in Owner's Equity. That is, expenses and withdrawals are debits because they will eventually lower Owner's Equity, and Revenue is a credit because it will eventually increase Owner's Equity. Revenue, Expense, and Withdrawals may also be thought of as changes in Assets and/or Liabilities which cause Owner's Equity to change. The logic of this system will become more apparent as you become more familiar with Part One of **Quick Notes**.

