1.9 THE ACCOUNTING EQUATION, ELEMENTS OF THE EQUATION AND BUSINESS TRANSACTIONS

1.8.1 THE FUNDAMENTAL ACCOUNTING EQUATION

The fundamental accounting equation is an equation that expresses the relationship of assets, liabilities, and owner's equity

Assets = Liabilities + Owner's Equity

Assets must equal the sum of liabilities and owner's equity. Liabilities appear before owner's equity in the basic accounting equation because they are paid first if a business is liquidated. The accounting equation applies to all economic entities regardless of size, nature of business, or form of business organization.

1.8.2 ELEMENTS OF THE ACCOUNTING EQUATION

The elements directly related to the measurement of financial position are assets, liabilities, and equity. These are defined as follows.

Asset. - A resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

- Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.
- Assets are properties or things of value, such as cash, land, supplies office, equipment, copyrights, buildings, land, buildings, and other properties. Owned and controlled by an economic unit or a business entity.

Liability. - A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

-Probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

- **Liabilities** A firm may have to borrow money to buy more assets; when it does, it may buy assets on account (buy now, pay later) or on credit. Suppose your firm ABC Company purchases a new computer for $3,000 on account from Dell, and the company is willing to wait 3 months for payment. In this case the firm has created a liability: an obligation to pay that comes due in the future. Dell is called the creditor. This liability—the amount owed to Dell—gives the company (Dell) the right, or the financial claim, to $3,000 of the firm's assets.

-For example, Suppose for example if your company buys an asset (a truck) that costs $35,000. The owner has invested $12,000 for the truck, and the business entity has borrowed the remainder from the bank, which is a creditor (one to whom money is owed). This business transaction or event that created liability can be shown as follows:

Assets	=	Liabilities	+	Owner's Equity
Items owned		*Amounts owed to creditors*		*Owner's investment*
Br. 35,000	=	Br. 23,000	+	Br. 12,000

Equity.- The residual interest in the assets of an entity that remains after deducting all its liabilities. In a business enterprise, the equity is the ownership interest.

- Equities are the rights of financial claim to the assets. Equities belong to those who supply the assets. If you are the only person to supply assets to the firm, you have the sole rights or financial claims to them.

  For example, If you supply your new firm with $6,000 in cash and $8,000 in office equipment, your equity in the firm is $14,000.

Relationship between Assets and Equities

Assets = Equities
6000+8000=14000
14000=14000
(Total value of items *owned* by business) (Total claims of owners against the assets)

The total dollar value of the assets of your firm will be equal to the total dollar value of the financial claims to those assets, that is, equal to the total dollar value of the equities. The total dollar value is broken down on the left-hand side of the equation to show the specific items of value owned by the business and on the right-hand side to show the types of claims against the assets owned.

Determine Assets

Example 1: Ato Aman has $17,000 invested in his company, and the company owes creditors $5,000; that is, the company has liabilities of $5,000. Then,

Assets	=	Liabilities	+	Owner's Equity
Br. ?	=	Br. 5,000	+	Br. 17,000

We can find the amount of the business's assets by adding the liabilities and the owner's equity.

Br. 5,000 Liabilities
+17,000 Owner's Equity
Br.22,000 Assets

The completed equation now reads as follows:

Assets	=	Liabilities	+	Owner's Equity
Br. 22,000	=	Br. 5,000	+	Br. 17,000

Determine Owner's Equity

Example 2: Ato Aman owns a car repair shop. His business has assets of $40,000, and it owes creditors $16,000; that is, it has liabilities of $16,000. Then,

Assets	=	Liabilities	+	Owner's Equity
Br. 40,000	=	Br. 16,000	+	Br. ?

We find the owner's equity by subtracting the liabilities from the assets.

Br. 40,000 Assets
-16,000 Liabilities
Br. 24,000 Owner's Equity

The completed equation now reads as follows:

Assets	=	Liabilities	+	Owner's Equity
Br. 40,000	=	Br. 16,000	+	Br. 24,000

Determine Liabilities

Example 3: Ato Aman's company has assets of $86,000; his investment (his equity) amounts to $46,000. Then,

Assets	=	Liabilities	+	Owner's Equity
Br. 86,000	=	Br. ?	+	Br.46,000

To find the firm's total liabilities, we subtract the equity from the assets.

Br. 86,000 Assets
-46,000 Owner's Equity
Br. 40,000 Liabilities

The completed equation now reads as follows:

Assets	=	Liabilities	+	Owner's Equity
Br. 86,000	=	Br. 40,000	+	Br. 46,000

1.9 . UNDERSTANDING EVENTS AND BUSINESS TRANSACTIONS

Event. An event refers to happenings that affect the accounting equation and are reliably measured. Events may be external or internal. Events include business events such as changes in the market value of certain assets and liabilities and natural events such as floods and fires that destroy assets and create losses. They do not include, for example, the signing of service or product contracts, which by themselves do not impact the accounting equation.

Transaction. An external event involving a transfer or exchange between two or more entities. Transactions (business transactions) are a business's economic events recorded by accountants. These business transactions are the raw materials of accounting reports, as cotton is a raw material for a textile factory. Transactions may be external or internal.

External transactions are exchanges of value between two entities, which yield changes in the accounting equation. External transactions involve economic events between the company and some outside enterprise.

For example - purchases of cooking equipment from a supplier,

- payment of monthly rent to the landlord,
- Sale of pizzas to customers are external transactions.

Internal transactions are economic events that occur entirely within one company which may or may not affect the accounting equation.

For example – use of cooking and cleaning supplies by a Pizza company, which are reported as expenses when used

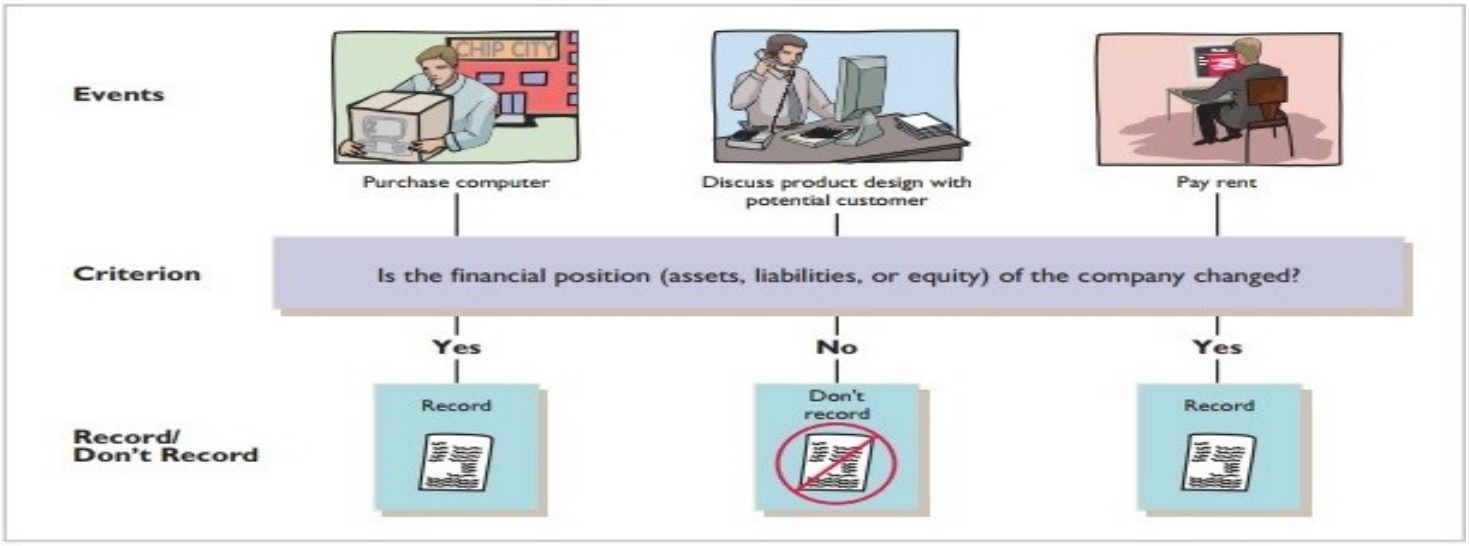
A company must analyze each event to find out if it affects the components of the accounting equation. If it does, the company will record the transaction if not, it will not be recorded. Sometimes there are some events in companies that do not represent business transactions. For example hiring employees, talking with customers, and placing merchandise orders to suppliers and so on but some of these activities may lead to business transactions:

A transaction can be an exchange (such as the purchase or sale of property, payment or collection of a loan etc.) between two or more parties. A transaction can also be an event that has the same effect as an exchange transaction but doesn't involve an exchange transaction. Some examples of "non exchange" transactions are losses from fire, flood; physical wear and tear on equipment; donation of property and so forth.

For a given transaction to qualify to be recorded it has:

1. to be related to the business enterprise
2. to be measurable in terms of money
3. to be completed / happened/ action.

When should an event be recorded?



1.10. RECORDING BUSINESS TRANSACTIONS (ASSET LIABILITY AND EQUITY TRANSACTIONS)

As we have seen the definition of business transaction above, business transactions are events that have a direct effect on the operations of an economic unit or

enterprise and are expressed in terms of money. Each business transaction must be recorded in the accounting records. As business transactions are recorded, the amounts listed under the headings Assets, Liabilities, and Owner's Equity will be affected. However, the total of one side of the fundamental accounting equation must equal the total of the other side.

Let's look at a group of business transactions and their effect on the accounting equation. These transactions are typical of those seen in service types of business. In these transactions, let's assume that Ato Aman establishes his own business on January 1, 2009 and calls it MY WAY PLC. The company is a *sole proprietorship* type of business. During the month of January , the business transacts the following transactions:

Transection (a). **Investment by the owner**

The Owner Ato Aman deposited $90,000 in a separate bank account by the name of the business (MY WAY PLC). The transfer of cash from the owner's personal account to the business account is an owner's investment. This separate bank account will help Ato Aman keep his business investment separate from his personal funds. This is an example of the economic entity assumption, which says a business is treated as a separate economic or accounting entity separate from its owners, investors, creditors or customers.

The effect of the transaction is to increase the assets (Cash) on the left hand side of the accounting equation by Birr Br.90,000 and to increase owner's equity by Br.90,000. The Cash account consists of cash deposited in bank and money on hand. The business now has Br.90,000 more in cash than before, and Ato Aman's investment has increased by Br.90,000. The account denoted by the owner's name followed by the word Capital indicates the amount of the owner's investment, or equity, in the business. At this point, the company has no liabilities; the only party having claim over the assets of the company is the owner.

The effect of this transaction on the fundamental accounting equation is as follows:

	Assets	=	Liabilities	+	Owner's Equity
	Items owned		*Amounts owed to creditors*		*Owner's investment*
	Cash	=			Ato Aman, Capital
Transaction. ***(a).***	+ Br. 90,000				+Br. 90,000
Balance	Br. 90,000				Br. 90,000

Accounting, as we said before, is the process of identifying, recording and communicating business transactions in terms of money. Look at transaction (a) above and see if you understand that we have gone through certain steps, which are stated below in question form.

STEP 1. Q - What accounts are involved?
A - Cash and Ato Aman's Capital are involved.

STEP 2. Q- What are the classifications of the accounts involved?
A - Cash is an asset account, and Ato Aman's Capital is an owner's equity account.

STEP 3. Q- Are the accounts increased or decreased?
A - Cash is increased because **MY WAY PLC** has more cash now than it had before.
- Ato Aman's Capital is increased because Ato Aman has a greater investment now than he had before.

STEP 4. Q- Is the accounting equation in balance after the transaction has been recorded?
A -Yes.

We will stress this step-by-step process throughout this chapter. This example serves as an introduction to *double-entry accounting*. The "double" entry method is demonstrated by the fact that each transaction must be recorded in at least two accounts, keeping the accounting equation in balance. For example, transaction (a) resulted in a plus $90,000 and a plus $90,000 on each side of the equation. The left side of the equation must always equal the right side of the equation.

Transaction (b)- <u>Purchase of land for cash</u>

MY WAY PLC bought land for Birr 15,000 in cash, to be used as a future site for the business. This transaction changes the composition of the assets but it doesn't change the total amount of assets. It has no effect on the liability and owner's equity of the business.

<u>Assets</u>			=	<u>Liabilities</u>	+	<u>Owner's Equity</u>
Items owned				*Amounts owed*		*Owner's investment*
	<u>Cash</u>	+ <u>Land</u>		*to creditors*		
<u>Ato Aman, Capital</u>						
Initial investment						90,000
90,000						
Transaction. ***(b).***	- <u>15,000</u>	+ <u>15,000</u>				
__-___						
New Balance	75,000	15,000				90,000
	90,000			90,000		

After the above transaction, the company will have less cash but a new asset (land). The total assets (cash + Land) amount to Birr 90,000, which is equal to the owner's equity balance.

STEP 1. Q - What accounts are involved?
A - Cash and Land are involved.

STEP 2. Q- What are the classifications of the accounts involved?
A - Cash is an asset account, and Land is also an asset account.

STEP 3. Q- Are the accounts increased or decreased?
A - Cash has decrease because **MY WAY PLC** has less cash now than it had before.
- Land is increased because land was purchased now and has a Birr 15000 balance now.

STEP 4. Q- Is the accounting equation in balance after the transaction has been recorded?
A -Yes.

Transaction (c)- <u>Purchase of equipment for cash</u>

MY WAY PLC bought equipment, paying cash, $38,000 to the supplier. Ato Aman's first task is to get his company ready for business; to do that, he needs the proper equipment. Accordingly, Ato Aman buys equipment costing $38,000 and pays cash. Note at this point that Ato Aman does not invest any new money. he simply exchanges part of the business's cash for equipment. Because equipment is a new type of property for the firm, a new account, Equipment, is created. Equipment is included under Assets because it is something of value owned and controlled by the business. As a result of this transaction, the accounting equation changes.

	<u>Assets</u>			=	<u>Liabilities</u>	+	<u>Owner's Equity</u>
	Items owned				*Amounts owed to creditors*		*Owner's investment*
	<u>Cash</u>	+	<u>Land</u>	+	<u>Equipment</u>	=	<u>Ato Aman, Capital</u>
Previous balances			75,000				15,000 90,000
Transaction. ***(c).***	- 38,000					+	38,000
New Balance	37,000		15,000				38,000 90,000
							90,000

STEP 1. Q - What accounts are involved?
A - Cash and Equipment are involved.

STEP 2. Q- What are the classifications of the accounts involved?
A - Cash is an asset account, and Equipment is also an asset account.

STEP 3. Q- Are the accounts increased or decreased?

A - Cash has decrease because **MY WAY PLC** has used cash to purchase the equipment.it has less cash now than it had before.
- Equipment is increased because land was purchased now and **MY WAY PLC** has more equipment now than it had before.

STEP 4. Q- Is the accounting equation in balance after the transaction has been recorded?
A -Yes.

NB: Remember that the recording of each transaction must yield an equation that is in balance. In this example, the transaction was recorded on the same side. Is that okay? Yes! For example, transaction (b) resulted in a minus $38,000 and a plus $38,000 on the same side, with nothing recorded on the other side. This results in an overall change of $0 ($38,000 – $38,000) for each side. It does not matter whether you change one side or both sides. The important point is that whenever a transaction is properly recorded, the accounting equation remains in balance.

Transaction (d)- <u>Purchase of equipment on account</u>

MY WAY PLC buys equipment costing $4,320 on account (on credit) from a credit supplier called Signal Products. The Equipment account shows an increase because the business now owns $4,320 more in equipment. The terms *on credit* or *on account* means that **MY WAY PLC** does not pay cash for the equipment but instead will owe Signal Products (the supplier) money to be paid in the future. This causes an increase in liabilities because the business now owes $4,320 liability payable in the near future. The liability account Accounts Payable is used for short-term obligations, usually due within 30 days. Because **MY WAY PLC** owes money to Signal Products, Signal Products is called a creditor of **MY WAY PLC**. A total of $94,320 is now on each side of the equal sign.

	<u>Assets</u>			=	<u>Liabilities</u>	+	<u>Owner's Equity</u>
	Items owned				*Amounts owed to creditors*		*Owner's investment*
	<u>Cash</u>	+ <u>Land</u>	+ <u>Equipment</u>	=	Accounts Payable	+	<u>Ato Aman, Capital</u>
Previous balances		37,000	15,000		38,000		90,000
Transaction. ***(d).***	_____	_____	+ <u>4,320</u>		+ <u>4,320</u>		__-___
New Balance	37,000	15,000	42,320		4,320		90,000

94,320

94,320

STEP 1. Q - What accounts are involved?

A - Equipment and Accounts Payable are involved.

STEP 2. Q- What are the classifications of the accounts involved?

A - Equipment is an asset account, and Accounts Payable is a liability account

STEP 3. Q- Are the accounts increased or decreased?

A - Equipment has increased because **the company** has more equipment now than it had before.

- Accounts Payable is increased because Ato Aman owes more to creditors than he owed before.

STEP 4. Q- Is the accounting equation in balance after the transaction has been recorded?

A -Yes.

Transaction (e)- Payment of a creditor on account

The Company paid a creditor on account Br.2,000 to Signal Products to be applied against the firm's liability of $4,320

Assets = Liabilities + Owner's Equity

Items owned *Amounts owed* *Owner's*

to creditors

investment

	Cash	+ Land	+ Equipment	= Accounts Payable	+ Ato Aman, Capital
Previous balances	37,000	15,000	42,320	4,320	90,000
Transaction. ***(e).***	-2000			- 2,000	-
New Balance	35,000	15,000	42,320	2,320	90,000

92,320

92,320

STEP 1. Q - What accounts are involved?

A – Cash and Accounts Payable are involved.

STEP 2. Q- What are the classifications of the accounts involved?
A - Cash is an asset account, and Accounts Payable is a liability account

STEP 3. Q- Are the accounts increased or decreased?
A - Cash has decreased because **the company** has its cash to pay its liability to signal products.
- Accounts Payable has decreased because now since the company has paid some portion of its liability the Ato Aman owes less now than he owed before.

STEP 4. Q- Is the accounting equation in balance after the transaction has been recorded?
A -Yes.

Transaction (f) - Owner invested equipment in the business.

Owner invested equipment in the business. Ato Aman invested his own computer equipment, having a fair market value of $5,200, in the company. **Fair market value is the present worth of an asset.** It is the amount that would be received if the asset were sold on the open market.

	Assets			=	Liabilities	+	Owner's Equity
	Items owned				*Amounts owed to creditors*		*Owner's investment*
	Cash	+ Land	+ Equipment	=	Accounts Payable	+	Ato Aman, Capital
Previous balances	35,000	15,000	42,320		2,320		90,000
Transaction. ***(f).***					+5,200		+5,200
New Balance	35,000	15,000	47,520		2,320		95,200
							97,520
	97,520						

STEP 1. Q - What accounts are involved?

A – Equipment and Ato Aman, Capital are involved.

STEP 2. Q- What are the classifications of the accounts involved?

A - Equipment is an asset account, and Ato Aman, Capital is an owner's equity account.

STEP 3. Q- Are the accounts increased or decreased?

A - Equipment is increased because the company now has more equipment than it had before.

- Ato Aman, Capital is increased because Ato Aman has a greater investment now than he had before.

STEP 4. Q- Is the accounting equation in balance after the transaction has been recorded?

A -Yes

Summary of Transactions (a) through (f)

Let's summarize the business transactions of **MY WAY PLC** in summary form.

	Assets			=	Liabilities	+	Owner's Equity
	Items owned				*Amounts owed to creditors*		*Owner's investment*
	Cash	+ Land	+ Equipment	=	Accounts Payable	+	Ato Aman, Capital
Transaction. ***(a).***			+90,000				+90,000
Balance	90,000			=		+	90,000
Transaction. ***(b).***	- 15,000		+ 15,000	=		+	-
Balance	75,000		+ 15,000				90,000
Transaction. ***(c).***	- 38,000		+ 38,000	=		+	-

Balance		37,000	+	15,000	+	38,000
90,000						
Transaction. ***(d).***		+ 4,320	=			+ 4,320
-						
Balance	37,000 +	15,000 +	42,320			4,320
+ 90,000						
Transaction. ***(e).***	-2000		=			- 2,000
-						
Balance	35,000 +	15,000 +	42,320			2,320
+ 90,000						
Transaction. ***(f).***			+5,200	=		
+5,200						
Balance	35,000 +	15,000 +	47,520	=		2,320
+ 95,200						

97,520

97,520

The following are the general rule to apply to all types of business transactions:

1. Every transaction is recorded as an increase and/or decrease in two or more accounts.

2. One side of the equation is always equal to the other side of the equation.

REVENUE AND EXPENSE ACCOUNTS

Revenues Inflows or other enhancements of assets of an entity or settlement of its liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations. Revenues are simply the amounts earned by a business. For examples fees earned for performing services, income from selling merchandise, rent income from tenants for the use of property, and interest income for banks. Revenues may be in the

form of cash or electronic transaction receipts. Revenues may also result from credit sales to charge customers, in which case cash will be received at a later time.

Expenses Outflows or other using up of assets or incurrences of liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations. (or the costs of doing business) are the costs that relate to earning revenue. For example wages expense for labor performed, rent expense for the use of property, interest expense for the use of money, and advertising expense for the use of various media (for example, newspapers, radio, direct mail, and the Internet). Expenses may be paid in cash either when incurred or at a later time. Expenses to be paid at a later time involve Accounts Payable.

Revenues and expenses directly affect owner's equity. If a business earns revenue, an increase in owner's equity occurs. When a business incurs expenses, owner's equity decreases. If the company has to pay out money for the costs of doing business, the owner's equity is decreased. Revenues and expenses fall under the umbrella of owner's equity: in general, revenues increases owner's equity; expenses decrease owner's equity.

1.11. RECORDING BUSINESS TRANSACTIONS (REVENUE, EXPENSE AND DRAWING TRANSACTIONS)

Transaction (g) – sales of service by the company.

The Company receives cash revenue of $8,000 in return for providing services for cash. Revenue has the effect of increasing owner's equity, but because the company wants to know how much revenue is earned, we set up a special column for revenue. The revenue account for the company is called Income from Tours. The accounting equation is affected as follows.

Assets = Liabilities + Owner's Equity

Items owned *Amounts owed to creditors* *Owner's investment*

	Cash	+ Land	+ Equipment	= Accounts Payable	+ Ato Aman, Capital	+ Revenue
Prev. bal.	35,000	15,000	47,520	2,320	95,200	

Trans. ***(g).*** +8,000

+8,000

New Bal. 43,000 15,000 47,520 2,320

95,200 8,000

105,520

105,520

STEP 1. Q - What accounts are involved?
A – Cash and income from tour are affected.

STEP 2. Q- What are the classifications of the accounts involved?
A - Cash is an asset account, and Income from Tours is a revenue account and part of owner's equity

STEP 3. Q- Are the accounts increased or decreased?
A - Cash is increased because the company has received cash.
- Income from Tours (revenue) is increased.

STEP 4. Q- Is the accounting equation in balance after the transaction has been recorded?
A -Yes.

Transaction (h) – payment of rent expense

The Company paid rent (an expense) for the month, $1,250. Rent is payment for the privilege of occupying property. It seems logical that if revenue is added to owner's equity, expenses (the opposite of revenue) must be subtracted from owner's equity. To be consistent, a separate column is set up for expenses.

Assets = Liabilities + Owner's Equity

Items owned *Amounts owed to creditors* *Owner's investment*

Cash + Land + Equipment = Accounts Payable + Ato Aman, Capital + Revenue - Expense

Prev. bal.	43,000	15,000	47,520		2,320	95,200
8,000						
Trans.	***(h).***					-1,250
=	+1,250					
New Bal.	41,750	+ 15,000 +	47,520		2,320 +	95,200 +
8,000 -	1,250					
		104,270				104,270

STEP 1. Q - What accounts are involved?
A – Cash and Rent Expense are involved.

STEP 2. Q- What are the classifications of the accounts involved?
A - Cash is an asset account, and Rent Expense is an expense account and part of owner's equity.

STEP 3. Q- Are the accounts increased or decreased?
A - Cash is decreased because after the payment the company has less cash than before.
- Rent Expense is increased because now the company has more rent expense than before.

STEP 4. Q- Is the accounting equation in balance after the transaction has been recorded?
A -Yes. Notice that in this equation, it looks as though the account doesn't balance—there is a negative entry on the left and a positive entry on the right. This is deceiving. The entry to Rent Expense is a positive entry in a negative column, thus creating an overall negative entry. It looks like this: (+1,250) = -1,250.

Transaction (i) – <u>cash withdrawal by the owner from the company.</u>

At the end of the month, Ato Aman withdraws $3,500 in cash from the business for his personal living costs. A withdrawal (or drawing) may be considered the opposite of an investment in cash by the owner and is treated as a decrease in owner's equity. Withdrawals are different from expenses. Expenses are paid to someone else for the cost of goods or services used in the business. On the other hand, withdrawals are paid directly to the owner and do not involve the cost of goods or services used in the business. A withdrawal may consist of cash or other assets. Because the owner takes cash out of the business, there is a decrease of $3,500 in Cash. This withdrawal of cash also decreases owner's equity and is denoted in the account labeled with the owner's name followed by the word Drawing. We record $3,500 under Ato Aman's, drawing.

The accounting equation is affected as follows.

<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Owner's Equity</u>
Items owned		*Amounts owed*		*Owner's*

to creditors

investment

	Cash	+	Land	+	Equipment	=	Accounts Payable	+	Ato Aman, Capital	-	Ato Aman, Drawing	+	Revenue	+	Expense
Prev. bal.	41,750	+	15,000	+	47,520		2,320	+	95,200						
										-	1,250				
+8,000															
Trans.															
(i).															
-3,500															
+3500															
New Bal.	38,250	+	15,000	+	47,520		2,320	+	95,200	-	3,500				
+ 8,000															
- 1,250															
	100,770										100,770				

STEP 1. Q - What accounts are involved?
A – Cash and Ato Aman drawing are affected.

STEP 2. Q- What are the classifications of the accounts involved?
A - Cash is an asset account, and Ato Aman drawing is a drawing account and part of owner's equity

STEP 3. Q- Are the accounts increased or decreased?
A - Cash is decreased because the company has paid cash to the owner .
- Ato Aman drawing account has increased but the owners' equity has decreased.

STEP 4. Q- Is the accounting equation in balance after the transaction has been recorded?
A -Yes.

Summary of Transactions (g) through (i)

Let's summarize the business transactions of **MY WAY PLC** in summary form.

Assets	=	Liabilities	+	Owner's Equity
Items owned		*Amounts owed*		*Owner's*

											to creditors investment	
	Cash	+	Land	+	Equipment	=	Accounts Payable	+	Ato Aman, Capital	-	Ato Aman, Drawing	+ Revenue - Expense
Prev. bal.	35,000		15,000		47,520		2,320		95,200			
Trans. ***(g).***	+8,000											= +8,000
Balance.	43,000	+	15,000	+	47,520		2,320		95,200			8,000
Trans. ***(h).***	-1,250					=						= +1,250
Balance.	41,750	+	15,000	+	47,520		2,320	+	95,200			+ 8,000 - 1,250
Trans. ***(i).***	-3,500					=						+3500
Balance	38,250	+	15,000	+	47,520		2,320	+	95,200	-	3,500	+ 8,000 - 1,250
	100,770											100,770

The following Observations, which apply to all types of Businesses, should be noted:

1. The effect of every transaction can be stated in terms of increases and /or decreases in one or more of the elements of the accounting equation.
2. The equality of the two sides of the accounting equation is always maintained.
3. The owner's investment and revenues increase the owner's equity. Withdrawals and expenses during the period decrease the owner's equity.

1.12 FINANCIAL STATEMENTS OF SOLE PROPRIETORSHIPS

After the effect of the individual transactions has been determined, the essential information is communicated to users at certain intervals. The ***accounting reports,*** which communicate this information, are called ***financial statements.*** Financial statements are said to be the central features of accounting because they are the primary means of communicating important accounting information to users.

Preparation of financial statements for sub periods such as quarters or months improves the timeliness of the information

The financial statements most frequently provided are

(1) The statement of financial position,

(2) Statement of comprehensive income,

(3) The statement of cash flows, and

(4) The statement of changes in equity.

Note disclosures are an integral part of each financial statement

Since these financial statements are in a sense the end products of the accounting process, a student who acquires a clear understanding of the content and meaning of financial statements will be in an excellent position to appreciate the purpose of the earlier steps of recording and classifying business transactions.

1.12.1 Statement of comprehensive income

The income statement is a financial statement that summarizes the amount of revenues earned and expenses incurred by a business over a period of time. It reports the profitability of the business by comparing revenues and expenses for a stated period of time such as a month or a year. In accounting profitability is measured for a period of time than on a daily basis. Though measuring daily could be possible, it will not be practical and beneficial to the business enterprise.

If the revenue of a period exceeds the expenses of that same period, net income results. If expenses are greater than the revenues of a period, we say there is a net loss, that is, the business has operated unprofitably.

All financial statements have a heading that you can find in any kind of a report. The heading of these statements identifies the company, the type of statement, and the time period covered by the statement. Note that the primary focus of the income statement is reporting the success or profitability of the company's operations over a specified period of time. To indicate that it applies for a period of time, the Statement of comprehensive income is dated "For the month ended…"

The following is the Statement of comprehensive income for MY WAY PLC for the month ended JANUARY 31, 2009.

MY WAY PLC

Statement of comprehensive income

For the Month Ended January 31,2009

Revenues:		
Service Fee		Birr 8,000.00
Expenses:		
Rent Expense	1,250.00	
Total Expenses		1,250.00
Net Income		Birr 6,750.00

1.12.2 Statement of changes in equity

This is a statement that summarizes the changes in owner's equity for a specific period of time. Data for the preparation of owner's equity statement are obtained from the owner's equity column of the statement of financial position and from the statement of comprehensive income. The heading of this statement identifies the company, the type of statement, and the time period covered by the statement. The time period is the same as that covered by the statement of comprehensive income and therefore is dated "For the Month Ended January 31, 2009."

The information provided by this statement indicates the reasons why owner's equity has increased or decreased during the period. The Owner's equity statement for MY WAY PLC for the month of January is shown below:

MY WAY PLC

Statement of changes in equity

For the Month ended January 31, 2009

Ato Aman. Capital, January 1..... Birr -0-

Add: initial Investments..... Birr 90,000.00

Addition Investments..... 5,200.00

Net income..... 6,750.00 101,950.00

Subtotal 101,950.00

Less: Drawings..... 3,500.00

Ato Aman. Capital, September 30..... Birr 98,450.00

1.12.3 Statement of financial Position

The statement of financial Position, lists the company's assets, liabilities and owner's equity as of a specific date- usually at the end of a month or year.

Shown below is the statement of financial Position for MY WAY PLC as of January 31, 2009. The statement of financial Position heading contains the name of the company, the type of statement, and the specific date on which assets; liabilities and owner's equity are identified and measured. The total assets must equal the total liabilities and owner's equity.

MY WAY PLC

Statement of financial Position

January 31, 2009

Assets	**Liability**
Cash..... Birr 38,250.00	Accounts payable ..... Birr 2,320.00
Property, Plant and Equipment:	
Equipment 47,520.00	**Owner's Equity**
Land.....15,000.00	Ato Aman, Capital ..... Br 98,450.00
Total property, plant, and equipment...	

62,520.00 Total Assets…… 100,770.00	Total Liabilities and Owner's equity ... Birr 100,770.00

Interrelationships between financial statements

Each statement provides management, owners, and other interested parties with relevant financial data. The financial statements are interrelated: (1) Net income of Birr. 6,750.00 shown on the income statement is added to the beginning balance of owner's capital in the owner's equity statement. (2) Owner's capital of Birr 98,450.00 at the end of the reporting period shown in the Owner's equity statement is reported on the balance sheet as the Ato Aman, Capital balance.

1.12.1 Statement of cash flows

The statement of cash flows provides information on the cash receipts and payments for a specific period of time. The statement of cash flows reports (1) the cash effects of a company's operations during a period, (2) its investing activities, (3) its financing activities, (4) the net increase or decrease in cash during the period, and (5) the cash amount at the end of the period. Reporting the sources, uses, and change in cash is useful because investors, creditors, and others want to know what is happening to a company's most liquid resource. The statement of cash flows provides answers to the following simple but important questions.

1. Where did cash come from during the period?
2. What was cash used for during the period?
3. What was the change in the cash balance during the period?

MY WAY PLC
Statement of cash flows
For the Month ended January 31, 2009

Cash flows from operating activities
Cash received from selling services $8,500
Cash paid for rent . . . . . (1,250)
Net cash provided by operating activities . . . . . $ 6,750
Cash flows from investing activities
Cash paid for Land. . . . . (15,000)
Cash paid for Land. . . . . (38,000)
Net cash provided by investing activities. . . . . .$ (53,000)
Cash flows from financing activities
Cash investments by owner 90,000
Cash withdrawals by owner. . . . . (3,500)
Partial repayment of short term liability . . . . . (2,000)
Net cash provided by financing activities. . . . . $ 84,500
Net increase in cash $38,250
Cash balance, January 1 . . . . . . 0 .
Cash balance, January 31 . . . . . $38,250

Be sure to carefully examine the **format and content** of each statement.

Accounting and Technology

Before the invention of computers, all business transactions were recorded by hand. Now computers perform routine recordkeeping operations and prepare financial reports. Computers are used today in all types of businesses, both large and small. All accounting positions now require workers to use computers, have knowledge of word processing and spreadsheet

software, and possess an understanding of accounting software, such as QuickBooks and Peachtree®.

Even though virtually all businesses now use computers to do their accounting, the nature of accounting is the same. The computer is a powerful tool of the accountant. However, as a tool, the computer is only as useful as the operator's ability and understanding of accounting. The operator must be skilled to key the correct information into the computer program; otherwise, as the saying goes, "garbage in, garbage out."

Basic Terminologies

Event. A happening of consequence. An event generally is the source or cause of changes in assets, liabilities, and equity. Events may be external or internal.

Transaction. An external event involving a transfer or exchange between two or more entities.

Account. A systematic arrangement that shows the effect of transactions and other events on a specific element (asset, liability, and so on). Companies keep a separate account for each asset, liability, revenue, and expense, and for capital (owners' equity). Because the format of an account often resembles the letter T, it is sometimes referred to as a T-account. (see Illustration 3.3)

Real and Nominal Accounts. Real (permanent) accounts are asset, liability, and equity accounts; they appear on the statement of financial position.

Nominal (temporary) accounts are revenue, expense, and dividend accounts; except for dividends, they appear on the income statement. Companies periodically close nominal accounts; they do not close real accounts.

Ledger. The book (or computer printouts) containing the accounts. A general ledger is a collection of all the asset, liability, equity, revenue, and expense accounts. A subsidiary ledger contains the details related to a given general ledger account.

Journal. The "book of original entry" where the company initially records transactions and selected other events. Various amounts are transferred from the book of original entry, the journal, to the ledger. Entering transaction data in the journal is known as journalizing.

Posting. The process of transferring the essential facts and figures from the book of original entry to the ledger accounts.

Trial Balance. The list of all open accounts in the ledger and their balances. The trial

balance taken immediately after all adjustments have been posted is called an adjusted trial balance. A trial balance taken immediately after closing entries have been posted is called a post-closing (or after-closing) trial balance. Companies may prepare a trial balance at any time.

Adjusting Entries. Entries made at the end of an accounting period to bring all accounts up to date on an accrual basis, so that the company can prepare correct financial statements.

Financial Statements. Statements that reflect the collection, tabulation, and final summarization of the accounting data. Four statements are involved: (1) The statement of financial position shows the financial condition of the enterprise at the end of a period. (2) The income statement (or statement of comprehensive income) measures the results of operations during the period. (3) The statement of cash flows reports the cash provided and used by operating, investing, and financing activities during the period. (4) The statement of retained earnings (or retained earnings statement) reconciles the balance of the Retained Earnings account from the beginning to the end of the period.

Closing Entries. The formal process by which the enterprise reduces all nominal accounts to zero and determines and transfers the net income or net loss to an equity account. Also known as “closing the ledger,” “closing the books,” or merely “closing.”

Investments by Owners. Increases in net assets of a particular enterprise resulting from transfers to it from other entities of something of value to obtain or increase ownership interests (or equity) in it. Assets are most commonly received as investments by owners, but that which is received may also include services or satisfaction or conversion of liabilities of the enterprise.

Distributions to Owners. Decreases in net assets of a particular enterprise resulting from transferring assets, rendering services, or incurring liabilities by the enterprise to owners. Distributions to owners decrease ownership interests (or equity) in an enterprise.

Comprehensive Income. Change in equity (net assets) of an entity during a period from transactions and other events and circumstances from non-owner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.

Revenues. Inflows or other enhancements of assets of an entity or settlement of its liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.

Expenses. Outflows or other using up of assets or incurrences of liabilities (or a

combination of both) during a period from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.

Gains. Increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from revenues or investments by owners.

Losses. Decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from expenses or distributions to owners.