



Università
Cattaneo

Management & Principles of Accounting

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Accounting for business transactions

The basic accounting equation

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Source: Kimmel/Weygandt/Kieso "Financial Accounting"
Seventh Edition Wiley

After this lesson you should be able to:

1. Analyze the effect of business transactions on the basic accounting equation.
2. Explain the expanded Accounting Equation
3. Explain the Stockholders' Equity Relationship
4. Understand the accounting for business transaction

Analyzing Transactions

- The process of identifying the specific effects of economic events on the accounting equation.

Basic Accounting Equation



- The basic accounting equation is always true and is the basis of accounting
- This basic accounting equation states that what is left after satisfying all creditors' claims is due to owners

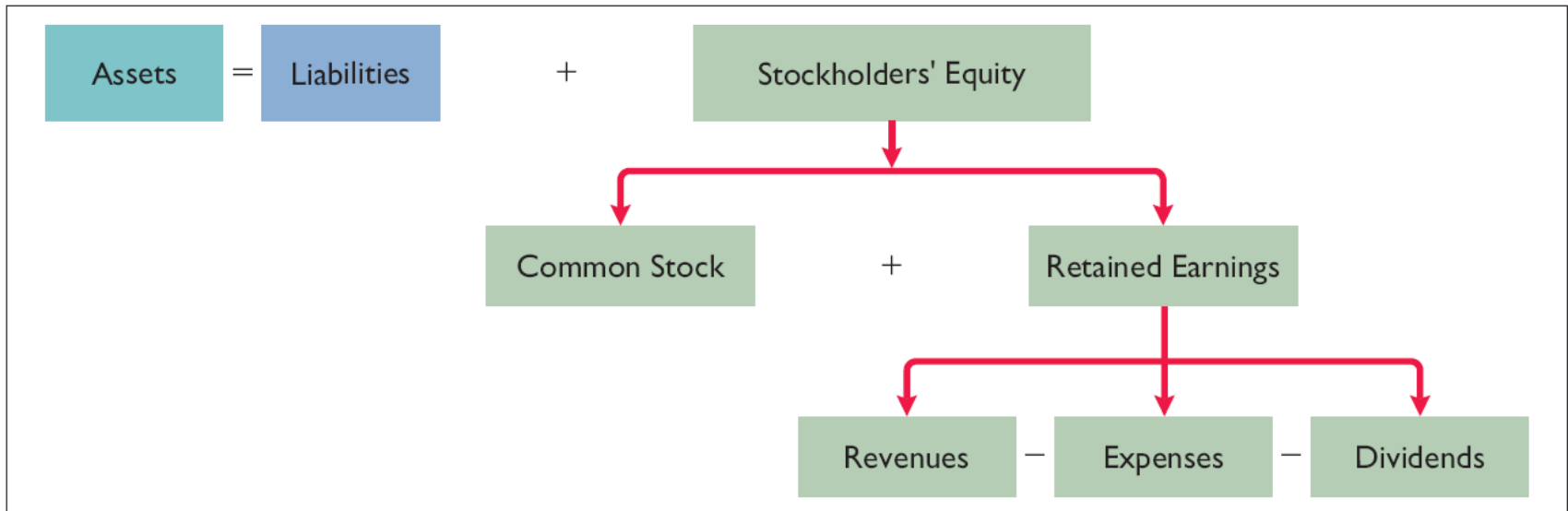
Expanded Accounting Equation

The stockholders' equity is composed of two main items:

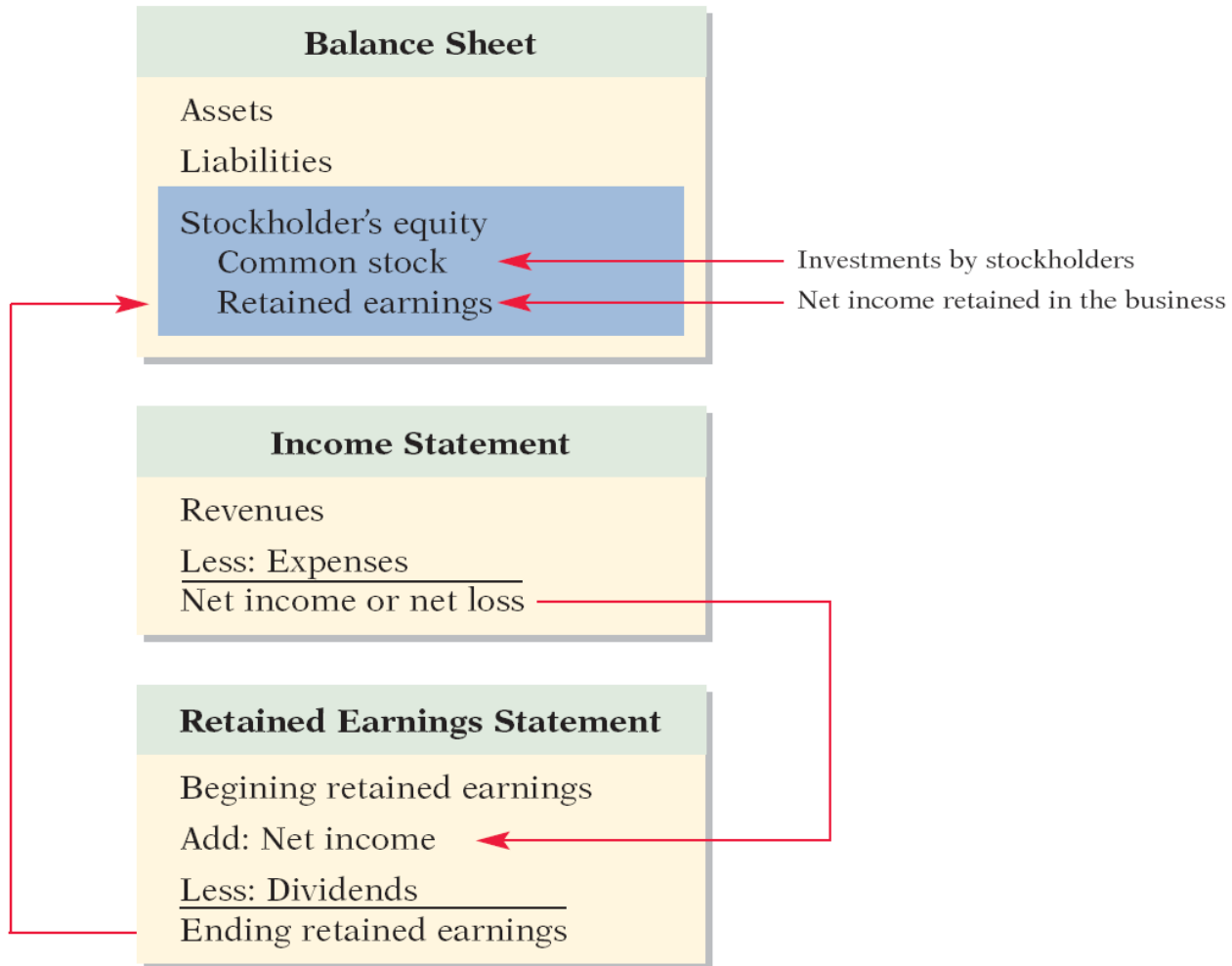
–**Common stocks**, that is the amount invested in the company by the stockholders

–**Earning**, that is the amount earned by the company and kept for use in the business

The total amount of earnings accumulated in past periods through profitable operation and kept in the business (not distributed to owners) is called **retained earnings**



Stockholders' Equity Relationship



Accounting for business transactions

The accounting equation must always balance. One way to remember this rule is to visualize the two sides of the balance sheet.

1. Marco and his friends want to start their own business, called Marco & Co., in order to buy and sell Italian books. To begin, they invest money for 100 Euros

$$\begin{array}{l} \text{Assets} = \text{Liabilities} + \text{Paid-in Capital} + \text{Retained Earnings} \\ +100 \qquad \qquad \qquad +100 \end{array}$$

2. Marco & Co. needs some space to perform its activity. It decides to buy a building whose cost is 50, paid cash

$$\begin{array}{l} \text{Assets} = \text{Liabilities} + \text{Paid-in Capital} + \text{Retained Earnings} \\ +100 \qquad \qquad \qquad +100 \\ +50 \\ -50 \end{array}$$

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3. Marco & Co. decides to buy some furniture. It buys furniture for 30 agreeing to pay the supplier within 30 days

$$\begin{array}{r}
 \text{Assets} = \text{Liabilities} + \text{Paid-in Capital} + \text{Retained Earnings} \\
 +100 \qquad \qquad \qquad +100 \\
 +30 \qquad +30
 \end{array}$$

4. Marco & Co. buys 10 books for a total amount of 10, paid cash

$$\begin{array}{r}
 \text{Assets} = \text{Liabilities} + \text{Paid-in Capital} + \text{Retained Earnings} \\
 +130 \qquad +30 \qquad +100 \\
 +10 \\
 -10
 \end{array}$$

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5. Marco & Co. sells half of the books (5 books) previously bought, earning 7, collected cash

Assets = Liabilities + Paid-in Capital + Retained Earnings			
+130	+30	+100	
+7			+7
-5			- 5

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6. Marco & Co. sells three more books, earning 5, agreeing to collect the amount within 10 days

Assets = Liabilities + Paid-in Capital + Retained Earnings			
+132	+30	+100	+2
+5			+5
-3			-3

7. Marco & Co. pays part of its debt for 20

Assets = Liabilities + Paid-in Capital + Retained Earnings			
+134	+30	+100	+4
-20	-20		

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- Actually we could distinguish, among assets, between the different kinds of items (cash, accounts receivable, supplies, inventories) they are composed of
- We should do the same also for liabilities and shareholders' equity
- Even more important, we should distinguish, among earnings, between revenues and expenses
- In fact, balance sheet and income statement report not only the aggregate, but the detailed items
- Let's try now to prepare the balance sheet and the income statement of Marco & Co., considering the detailed items we find in each of them

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INCOME STATEMENT

Marco & Co.

Expenses		Revenue	
Inventories used	8	Sales	12
Net Income	4		

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BALANCE SHEET Marco & Co.

Assets		Liabilities	
Cash	27	Accounts payable	10
Building	50	Stockholders' equity	
Furniture	30	Paid-in capital	100
Accounts receivable	5	Retained Earnings	4
Inventories	2		

Review Questions

Review Question

a) What is the basic accounting Equation?

Review Question

The effects on the basic accounting equation of performing services for cash are to:

- a) Increase assets and decrease stockholders' equity
- b) Increase assets and increase stockholders' equity
- c) Increase assets and increase liabilities
- d) Increase liabilities and increase stockholders' equity