Financials Statement Elements v/s Accounts

• When a transaction happens it is first recorded in its related Account
  – For example each account for each expenditures- wages, postage, stationary etc
• These accounts are then grouped and divided into 5 elements of financial statements namely
  – Assets
  – Liabilities
  – Owners’ equity
  – Revenue
  – Expenses
• Contra accounts are used for contra entries which offset some part of the value of another account (like accounts receivable and provision for bad debts)
Assets

• **Current Assets**
  – Cash and cash equivalents: includes liquid securities with maturities of < 90 days
  – Accounts receivable – adjusted for "allowance for bad debt expense" as contra a/c
  – Inventory
  – Prepaid expenses. Items that will be expenses on future income statements.
  – Financial assets such as marketable securities

• **Long Lived Assets and Other assets**
  – Property, plant, and equipment includes a contra-asset account for accumulated depreciation
  – Intangible assets economic resources without physical existence such as patents, trademarks, licenses, and goodwill
  – Investment in affiliates (accounted for using the equity method)
  – Deferred tax assets
# Liabilities

- **Current Liabilities**
  - Accounts payable
  - Short Term Notes payable.
  - Unearned revenue: Revenue received but not earned (related to future periods)
  - Income taxes payable

- **Long Term Liabilities**
  - Long-term debt such as bonds payable
  - Deferred tax liabilities
Owners' equity

- Capital - Par value of common stock.
- Additional paid-in capital: proceeds received over par value
- Retained earnings - Cumulative net income till date
- Other comprehensive income
  - Changes resulting from foreign currency translation of subsidiary
  - Minimum pension liability adjustments
  - Unrealized gains and losses on investments.
Revenue

• **Sales:**
• **Gains:**
  – Increases in assets or equity from transactions incidental to day-to-day activities
  – Like Gain on sale of assets
• Investment income
  – Interest and dividend income.
Expenses

- Cost of goods sold
  - Opening inventory + Purchases – Closing Inventory
- Selling, general and administrative expenses
  - Advertising, management salaries, rent and utilities.
- Depreciation and amortization
- Interest expense.
- Losses
  - Decreases in assets / equity from incidental transactions related to normal activities
- Tax expense
Accounting equation in its basic and expanded forms

- **Basic Equation**
  - Assets = liabilities + owners’ equity

- Can be expanded as
  - Equity can be broken into contributed capital (preferred and common both) and retained earnings
    - Assets = Liabilities + Contributed capital + Retained earnings

- Retained earnings can be further broken as
  - Retained earnings = Beginning retained earnings + Net profits during the year – dividends
    - Net profits = Revenue – Expenses
Double entry accounting

- **Each transaction effects two accounts** so that assets and liabilities are balanced
- For example:
- A) An increase in an asset account must be balanced by either a
  - Increase in a liability or owners' equity account
  - Decrease in another asset account or
- B) An expenses incurred (causing reduced earning leading to low retained earning to low equity hence lower liability) must be balanced by either
  - Reduction in cash (if expenses is incurred in cash)
  - Increase in liability (if expenses is incurred on credit)
Examples

- Purchase furniture for $1,000 cash.
  - Furniture (an asset) increases by $1,000
  - Cash (an asset) decreases by $1,000.
  - Now both assets and liabilities are balanced

- Purchase furniture for $1,000 through raising $1,000 notes
  - Furniture (an asset) increases by $1,000
  - Notes (liability) increases by $1,000

- Pay $1,000 for salary in cash
  - Salary (expenses) reduces net income, leading to low equity and lower liabilities by $1,000
  - Cash reduces by $1,000 (Now both assets and liabilities are balanced)