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The preceding discussion gives us a conceptual view of the dynamics of the fundamental accounting equation and the basis of modern double entry accounting. We know at any point in time (snapshot) the following is always true:

$$A = L + OE$$

We can maintain this balance for each transaction by changing the **OE** account when the difference between A and L changes. A typical change would be from sales earned or expenses incurred. This would expand our fundamental equation slightly as follows:

**Assets = Liabilities + Owner's Equity + Revenue - Expenses** or:

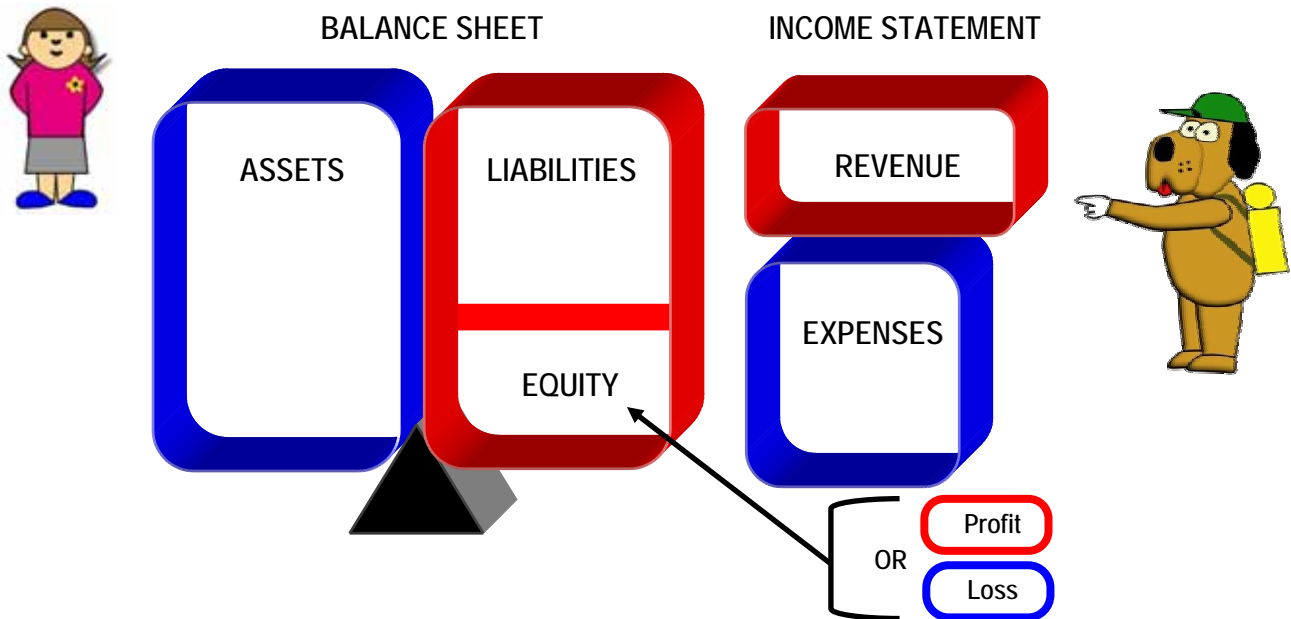
$$A = L + OE + R - E$$

When the fiscal period is closed, the total represented by **R - E** is calculated and **OE** is updated to reflect this change. **R** and **E** are then set back to zero.

A graphic view of this system is shown below:

Remember a \$1 increase in **Revenues** increases **Equity** by \$1 and \$1 increase in **Expenses** decreases **Equity** by \$1.

The income statement is a temporary collection of changes to the equity section primarily from operating activities



Each activity (transaction) that is recorded in this system must be made in a way that always maintains the balance of the equation. That is, at least two accounts are always affected with any recorded transaction. This is the basis for the term “double entry” accounting. The system must **always** be in balance.

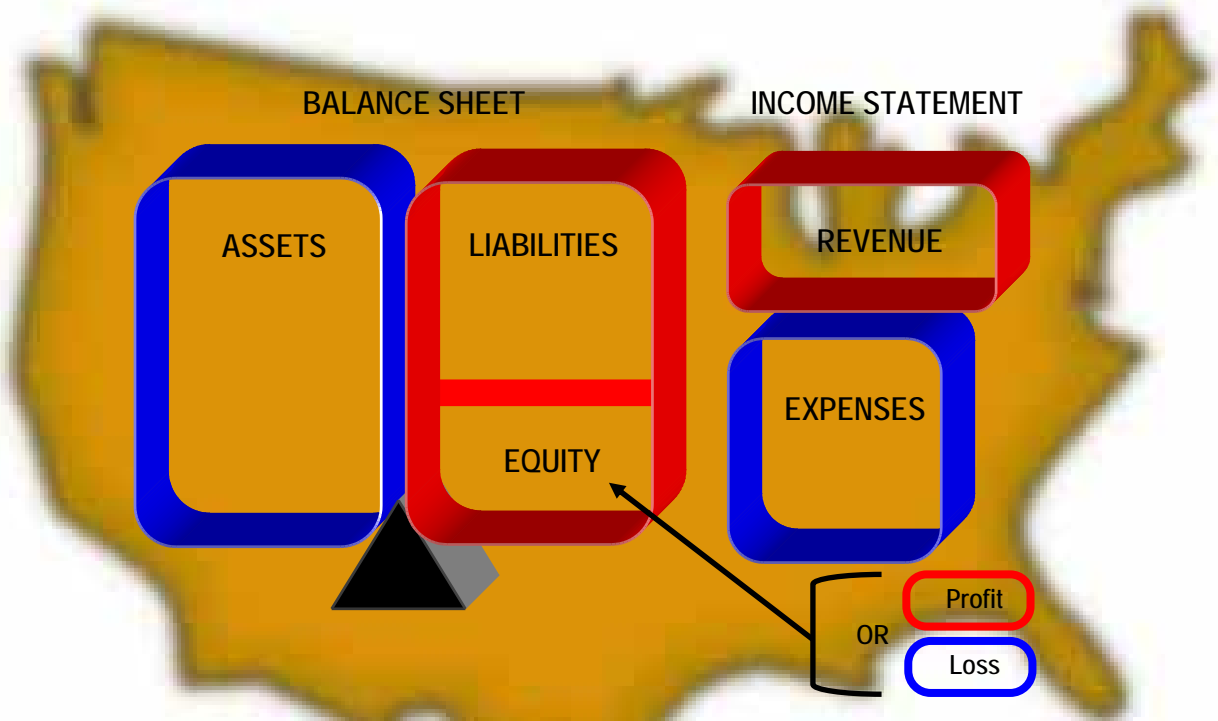
The above graphic is a basic color map we can use throughout this text in our study of accounting. Following the fundamental accounting equation (FAE), this map displays the statements that form the basis of a modern accounting system. It works for the espresso stand and for General Motors. If you accept this conceptual view, we can proceed to develop our understanding of accounting, all within this basic picture.

2

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## COLOR MAP

The graphic representation of the accounting equation from the previous page can be viewed as a map. A central question in the study of accounting is where do various accounts reside on the map? For example, Cash is an **Asset** account and resides in the **blue Asset** territory while **Espresso Sales** is a **Revenue** (or **income**) account and comes from the **red Revenue** territory below.



1. **Liabilities** and **Owner's Equity** are CLAIMS against the **Assets**.
2. **Revenues** and **Expenses** are temporary collections of eventual changes to **Owner's Equity**. **Revenues** increase and **Expenses** decrease **Owner's Equity**.
3. **Liabilities** have a priority as to claims against the **Assets**.
4. The claim of **Owner's Equity** is residual, that is, **Equity** has a right to the remaining **Assets** after the **Liabilities** have been paid.

Remember!!  
When traveling  
through these  
accounting  
territories. . .



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O-1 EXERCISES

Describe and apply the Fundamental Accounting Equation

Answers are at the end of this unit.

**Demonstration:** If the value of all **Assets** of a firm totaled \$45,192 and the **Owner's Equity** totaled \$5,000; what are the total **Liabilities** of the firm?

Answer: Using  $A = L + OE$ ;  $\$45,192 = \text{Liabilities} + \$5,000$

**Liabilities** =  $(\$45,192 - \$5,000)$ ; **Liabilities** =  $\$40,192$

- 1) Answer the question, "What is the fundamental accounting equation?" without using the words asset, liabilities or owner's equity.

- 2) Total **Owner's Equity** of Johnson's Distributing is \$122,500; Johnson's total obligations (**Liabilities**) are \$212,300. What are Johnson's **Assets**?

- 3) Thao's Consulting owns \$2,345 in cash and an office copier valued at \$10,460 from a recent purchase. Thao's only obligation is \$5,325 owed on the copier. What is Thao's **Owner's Equity**?

- 4) Elzbieta's Graphics has **Owner's Equity** totaling \$14,000. **Assets** total \$84,000. What are Elzbieta's **Liabilities**?

- 5) Review the graphic below and determine what is Gunderson's total **Equity**?

- 6) Review the graphic below and determine what are Tom's total **Assets**?

Gunderson's Nursery  
Balance Sheet

<u>Assets</u>		<u>Liabilities</u>	
Cash	18,125	Accounts Payable	14,625
Inventory	46,560	Equip Loan	55,000
Equipment	75,000		
		<u>Equity</u>	
		?	

Tom's Painting  
Balance Sheet

<u>Assets</u>		<u>Liabilities</u>	
?		Accounts Payable	99,685
		Equip Loan	145,000
		<u>Equity</u>	
		Owner Capital	244,685