

## WEEK 3 Notes & Activity

### **Sub-strands 12.1.1.4: ACCOUNTING ELEMENTS:**

**Revenue:** - revenues are increases in assets or reductions in liabilities, other than contributions by the owner, which increase owner's equity.

Revenue can only be recognized when (or as) the entity satisfies a performance obligation. This occurs when it transfers a promised good or renders a promised service to its customer.

Substance over form principles are particularly relevant at this point because essentially a good or service is transferred or rendered when the customer obtains control of that good or service. In the broadest sense, therefore, revenue is recognized when the customer receives control over the associated asset. (Income arising in the ordinary course of the entity's ordinary activities).

**Expenses:** - expenses are reductions in assets or increase in liabilities, other than drawings, which decrease owner's equity.

Costs that are matched with revenues on the income statement. For example, Cost of Goods Sold is an expense caused by Sales. Insurance Expense, Wages Expense, Advertising Expense, Interest Expense are expenses matched with the period of time in the heading of the income statement. Under the accrual basis of accounting, the matching is NOT based on the date that the expenses are paid.

Expenses associated with the main activity of the business are referred to as operating expenses. Expenses associated with a peripheral activity are non-operating or other expenses. For example, a retailer's interest expense is a non-operating expense. A bank's interest expense is an operating expense.

Generally, expenses are debited to a specific expense account and the normal balance of an expense account is a debit balance. When an expense account is debited, the account credited might be Cash (if cash was paid at the time of the expense), Accounts Payable (if cash will be paid after the expense is recorded), or Prepaid Expense (if cash was paid before the expense was recorded.)

**Liability:** - liabilities are the future sacrifices of assets that the entity is presently obliged to make as a result of a past transaction.

Liability is 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 resources.

A liability is defined by the following characteristics:

- Any type of borrowing from persons or banks for improving a business or personal income that is payable during short or long time;
- A duty or responsibility to others that entails settlement by future transfer or use of assets, provision of services, or other transaction yielding an economic benefit, at a specified or determinable date, on occurrence of a specified event, or on demand;
- A duty or responsibility that obligates the entity to another, leaving it little or no discretion to avoid settlement; and,
- A transaction or event obligating the entity that has already occurred.

Liabilities in financial accounting need not be legally enforceable; but can be based on equitable obligations or constructive obligations. An **equitable obligation** is a duty based on ethical or moral considerations. A **constructive obligation** is an obligation that is implied by a set of circumstances in a particular situation, as opposed to a contractually based obligation.

**Assets:** - assets are service potential or future economic benefits controlled by the entity as a result of a past transaction.

Assets are resources controlled by the entity as a result of past events and from which future economic benefits are expected to flow to entity.

The definition of assets can be divided into:

- Resource controlled
- Result of past events
- Future economic benefit

Asset accounts are debited in nature if increased and credited if decreased.

**Proprietorship:** - Equity is the residual interest in the assets of the entity after deducting all the liabilities

Equity is what the owners of an entity have invested in an enterprise. It represents what the business owes to its owners. It is also a reflection of the capital left in the business after assets of the entity are used to pay off any outstanding liabilities

Activity: Accounting elements.

1. **Define** these accounting elements and **state** each examples.

a) Asset (A) :

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b) Liabilities (L) :

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c) Owner's Equity (OE) :

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d) Revenues (R) :

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e) Expenses (E) :

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2. **Explain** the application of financial elements in the preparation of Profit and Loss Statement.

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3. **Explain** how financial elements are applied in the preparation of the Balance Sheet Statement.

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4. **Link** the financial elements to the construction of a trial balance.

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