UNIT 6 — THE ACCOUNTING EQUATION

English4accounting

Reading: The Accounting Equation

Financial accounting is an area which can be explained simply by using the accounting equation, which is assets = liabilities + capital.

But what does that really mean? To understand the significance of the equation, first we must explore the meaning of the three words; assets, liabilities and capital. These terms are often used in accounting but can have very different meanings.

In general, assets are something of value to the company but usually when we think of assets we think of current and fixed assets. However, in the accounting equation we should also take longterm and intangible assets into consideration as they all fall into the category of assets and thus add value to an entity. Intangible assets can be hard to quantify as we are often unable to compare them with the market. Intangible assets include such things as licenses, intellectual property and goodwill which may have a specific value to the entity.

The understanding of liabilities can be even more complicated as the numerous classifications can leave even an experienced accountant scratching his head. These classifications vary by region, but are based along the lines of: fixed, long-term, current, trade, financial and contingent. Many of these appear to be self-explanatory but when it comes to contingent liabilities it is important to remember that this is not an actual liability, it represents a possible liability in an uncertain situation. Of course, you can equate liabilities to negative assets.

Capital is generally understood as the money invested in the entity by the owner / owners, but it can be so much more. Capital is divided into fixed capital which represents the excess between the fixed assets and the fixed liabilities and working capital which is the excess of current assets over current liabilities.

Having cleared up the terminology, we can start to explain the purpose of the accounting equation.

The accounting equation is how double-entry bookkeeping is established. The equation represents the relationship between the assets, liabilities, and owner's equity of a small business. It is necessary to understand the accounting equation to learn how to read a balance sheet.

The accounting equation shows what the firm owns (its assets) are purchased by either what it owes (its liabilities) or by what its owners invest (its shareholder equity or capital). This relationship is expressed in the form of an equation.

This equation must balance because everything the entity owns (assets) has to be purchased with something, either a liability or owner's capital. Assets refer to items like inventory or accounts receivable. Examples of liabilities are bank loans or accounts payable. Owner's capital or equity is the investment or capital the owner has in the firm.

The accounting equation can be shown in two other ways:

Liabilities = Assets - Owner's Equity

Owner's Equity = Assets - Liabilities

If you know any two of the three components of the accounting equation, you can calculate the third component. If you look at a balance sheet, you will see that the balance sheet is basically an extended form of the accounting equation.

There is also an expanded accounting equation which shows the relationship between the income statement and the balance sheet. The expanded accounting equation, after you consider sales revenue and expenses, is:

Assets = Liabilities + Owner's Equity + Revenue - Expenses - Draws

The capital or (owner's equity) part of the accounting equation can be divided into two parts - revenue and expenses. Until now, the accounting equation has focused on the balance sheet components. Now, splitting the owner's equity part of the accounting equation into revenues and expenses highlights the relationship between the balance sheet and the income statement because the key components of the firm's income statement are revenue and expenses.

Revenues are what any given business earns from its product or service. Expenses are what it costs the business to operate and provide the aforementioned product or service. The relationship between revenues and expenses is simple. If revenues are greater than expenses, the business makes a profit. If revenues are less than expenses, the business incurs a loss.

The owner or owners of the entity may also withdraw a salary from the business. If the company is an SME (small or medium enterprise), sole proprietorship, partnership, or limited liability company, then the owner or owners will take a draw from the business as their salaries. These drawings reduce the owner's equity in the entity.

It's vitally important that the accounting equation balance because, if not, your financial reports will not make sense.

Discussion Questions

Why might intangible assets be hard to quantify?

Why is the accounting equation so important?

What are the typical assets and liabilities connected to a SME?