THE ACCOUNTING EQUATION

Learning Objective

- To define the accounting equation

Key Understanding

- Knowledge that the accounting equation is essential in accountancy

Key Question

- What is the accounting equation?

The Basic Accounting Equation

- The equation has two elements which equally divide the entity into two parts. The left side of the equation represents what the entity owns. On the other hand, the right side represents those that the company owes.

Assets = Liabilities + Equity

The Basic Accounting Equation

- The left side of the equation represents what the company owns. These are resources that the entity controls in order to attain future benefits. On the other hand, the right side represents the claims of the different parties to the company's assets. *Liabilities* represent the claims of the entity's creditors while the *equity* represents the residual interest of the owners of the entity.
- Also, remember that just like in any equation, the two sides of the equation should always be balanced. Hence, what the company owns should always equal what it owes to its owners.

Elements of the Accounting Equation

Assets

- As we have learned earlier, *assets* are resources that an entity owns in order to derive some future benefit. These assets are used by the company in its normal operations such as the manufacture of goods or delivery of services. The main feature of these assets is their capability to give benefits to the entity. These benefits are usually in the form of their ability to directly or indirectly increase the inflow of cash to the entity or a reduction of its outflows.

Elements of the Accounting Equation

Assets

Some examples of these assets are the following:

1. ***Cash***

   We all know what cash is. Generally, it is the money that we use comprising of the bills and coins we use in our everyday lives in order to buy the goods that we want and also avail the services that we need. However, when accounting for cash, we also consider cash as the money that is deposited in the banks and even undeposited checks from customers.

2. ***Accounts Receivable***

   This represents amounts that are collectible from customers. They arise when a business sell its goods or services on account or on credit.

Elements of the Accounting Equation

Assets

3.Inventories

If you go to a *sari-sari* store, you will notice piles of assorted products being offered for sale. Chances are, you may easily find various items that you need or want such as food and household items. Such products are normally owned by the *sari-sari* store. These products are inventory which are normally held for sale by the store in its normal operations.

4.Equipment

Pandesal shops would need ovens and furnaces in order to properly and actually create their goods. The product of these ovens are the *pandesals* which would be sold later on and eventually increase the cash of the shop.

Elements of the Accounting Equation

Assets

5.Land and Building

In most businesses, a physical store is necessary for them to operate. For example, how can a local *carenderia* function without an actual store? Where will a barber shop operate without its building? Such buildings are also assets of the businesses. These buildings are owned by the company so that they can use them for their business to operate normally.

6.Intangible Assets

When we think of the things we can own, we normally think of tangible things or those that can be seen and touched. However, assets also encompass intangible things that can neither be seen nor touched. For example, the software used by computer shops are actually assets that they own. Even though one cannot actually touch the software, it is still an asset of the computer shop that will earn the shop future benefits.

Elements of the Accounting Equation

Liabilities

Liabilities are one of the claims of external parties from the entity. Basically, they are the debts of the entity to external creditors. These debts do not always have to be paid in money. Some of these liabilities are in the form of obligations to do some service or even give something.

Elements of the Accounting Equation

Liabilities

These liabilities can take the form of the following:

1. ***Accounts Payable***

   When a local supermarket or convenience store like 7-Eleven buys its goods, it is unusual for it to immediately pay cash for such goods. Normally, it would only incur an obligation to pay its supplier after a certain number of days.

   For example, when it gets a delivery of milk, it might have an agreement to pay its supplier only after 30 days. Thus, in the meantime that the product has not been paid yet, it would only carry a “payable” in its books.

Elements of the Accounting Equation

Liabilities

2. Unearned Revenue

Telecommunication companies such as Globe and Smart normally offer prepaid load to customers. These load credits can be later on used by customers for text messages or to call other people. On the other hand, when Globe or Smart receive payments from customers, it creates an obligation for them to actually deliver their services. Such obligations to give their service are recorded as liabilities.

Elements of the Accounting Equation

Equity

The equity reflects the residual claims or net assets of the owners of the entity. This is similar to the "net worth" part of the SALN of our public servants. Take note that these are only residual claims of the owners since the creditors get their share of the entity first before the owners are given their share. This is also why the "net worth" of individuals is computed by subtracting their liabilities from their assets.

Elements of the Accounting Equation

Equity

Generally, equity comes from two sources. The first one comes directly from the owners in the form of investments of capital. The other comes from the income of the business from its normal operations. The net income or net loss of the business from its operations can be determined by using the following equation:

Revenues – Expenses = Net Income / (Net loss)

Elements of the Accounting Equation

Equity

A business will have net income if its revenues exceed expenses and will have a net loss if its revenues are less than its expenses.

1. Revenues

A business earns revenue when it sells its products or its services. When you go to a store and buy a phone, the store earns revenue. When you get a haircut from a barber shop, the shop also earns revenue. Generally, we can say that it is that a business earns revenue when it expects to earn an economic benefit in the form of an increase in assets such as cash or a decrease in liabilities. Other terms used for revenue are sales, rent, fees, etc.

Elements of the Accounting Equation

Equity

2. Expenses

Matching principle states that no revenue can be earned without incurring corresponding expenditures. As such, when a store sells a phone, aside from getting cash for the phone, it also incurs costs for the goods it has sold. On the other hand, such is also true when services are also rendered. In the barber shop, when someone gets a haircut, the barber shop incurs costs in the form of salary for its employees.

Elements of the Accounting Equation

Equity

3. Capital

The capital account of the equity represents the net investments of the business. This means that any contribution of the owner which increases the assets of the business or decreases its liabilities will increase the capital account.

For example, when creating a business, an owner normally contributes a significant amount of cash to kick-start the business. Such transaction increases the capital account of the business. Note that it does not only have to be cash to increase the capital account. An owner may even contribute equipment or land to increase his or her capital.

Moreover, since capital represents the net investments of the investments, withdrawals by the owner are also taken into consideration. As such, when an owner gets cash from the business to use for its personal use, its capital accounts are deducted.

Elements of the Accounting Equation

Equity

3. Capital

Lastly, at the end of each accounting period, the net profit or net loss of a business is also "closed" to this account.

Moreover, the equity portion of the accounting equation is where the revenues and losses incurred by the company are taken into consideration. Thus, when a company sells its products, the company earns revenues and therefore increases its equity as well. On the other hand, when it pays its bills or even just loses some assets, the entity incurs expenses and losses, thereby decreasing its total equity.