The Accounting Equation and The Balance Sheet

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The Accounting Equation

- The whole of accounting is based upon a very simple idea. This is called the accounting equation.
- It can be explained by sa ying that if a firm is to set up, and start trading then it needs resources. Let us assume that in the first place it is the owner of the business who has supplied all the resources. This can be shown as: **Resources in the business = Resources supplied by the owner**
- In accounting, terms are used to describe things, therefore, the amount of resources supplied by the owner is called **capital**. The actual resources that are then in the business are called **assets.**
- This means that the accounting equation above, when the owner has supplied all the resources, can be shown as: **Assets = Capital**
- Usually however, someone other than the owner has supplied some of the assets. The owner may have borrowed these things, or may have bought them and promised to pay at a later date. In both cases, he or she owes the money for them. **Liabilities** is the name given to the amount owning to these people for these assets. The equation has now changed to: **Assets = Capital + Liabilities.**
- It can be seen that the two sides of the equation will have the same totals. This is because we are dealing with the same thing from two different points of view. It is:

Resources: what they are = Resources: who supplied them
(assets) (Capital & Liabilities)

- It is a fact that the totals of each side will always be equal to each other, and that this will always be true no matter how many transactions there may be. The actual assets will always equal the total of the assets will always equal the total of Capital plus Liabilities.
- **Assets** consist of property of all kinds, such as buildings, machinery, stocks of goods and motor vehicles; also benefits such as debts owed by customers and money in the bank.
- **Liabilities** consists of money owing for goods supplied to the firm and for expenses; also loans made to the firm.
- **Capital** is often called the owner's equity or net worth.

The Balance Sheet

- The accounting equation is shown in a statement called the **Balance Sheet.**
- On May 1st 2014, B. Blake started in business; and put $5000 into a bank account for the business. The Balance would appear:

The Introduction of Capital

B. Blake
Balance Sheet
as at 3 May 2014

Assets	**$**	**Capital**	**$**
Cash at bank	5,000	Capital	5,000
	5,000		5,000

- The purchase of an asset by cheque:
  When Blake has an account, he can use cheques as payment. On 3 May 2014 Blake buys fixtures for $3,000, paying by cheque. The effect of this transaction is that the cash at the bank is reduced and a new asset, Fixtures, appears.

B. Blake
Balance Sheet
as at 3 May 2014

Assets	**$**	**Capital**	**$**
Fixtures	3,000		
Cash at bank	2,000	Capital	5,000
	5,000		5,000

The Accounting Equation and The Balance Sheet

- **<u>The purchase of an asset and the incurring of a liabilitiy</u>**
  On 6 May 2014 Blake buys some goods for $500 from D. Smith and agrees to pay for them some time within the following two weeks. There is now a new asset, the **stock** of goods, and there is also a new liability because Blake owes money to Smith for the goods.

  A person to whom money is owed for goods is known in accounting languages as a **creditor**.

B. Blake
Balance Sheet
as at 6 May 2014

Assets	**$**	**Capital**	**$**
Fixtures	3,000		
Cash at bank	2,000	Capital	5,000
Stock of goods	500	Creditor	500
	5,500		5,500

- **<u>Sale of an Asset on Credit</u>**

  On 10 May 2014 goods that had cost $100 were sold to J. Brown for the same amount, the money to be paid later. This means a reduction in the stock of goods and there will now be a new asset. A person who owes money to the firm is known In accounting language as a **debtor.**

- The balance sheet now appears as:

B. Blake
Balance Sheet
as at 6 May 2014

Assets	**$**	**Capital**	**$**
Fixtures	3,000		
Cash at bank	2,000	Capital	5,000
Stock of goods	400	Creditor	500
Debtor	100		
	5,500		5,500

The Accounting Equation and The Balance Sheet

- **Sale of an asset for immediate payment.**
  On 13 May 2014 goods that had cost $50 were sold to D. Daley for the same amount, Daley paying for them immediately by cheque. Here one asset, Stock of goods, is reduced, while another asset, Cash at bank, is increased.

B. Blake
Balance Sheet
as at 6 May 2014

Assets	**$**	**Capital & Liabilities**	**$**
Fixtures	3,000		
Cash at bank	2,000	Capital	5,000
Stock of goods	400	Creditor	500
Debtor	100		
	5,500		5,500

- **The payment of a liability**
  On 15 May 2014 Blake pays a cheque for $200 to D. Smith in part payment of the amount owing. The asset of Cash at bank is therefore reduced, and the liability of the creditor is also reduced.

B. Blake
Balance Sheet
as at 6 May 2014

Assets	**$**	**Capital & Liabilities**	**$**
Fixtures	3,000		
Cash at bank	1,850	Capital	5,000
Stock of goods	350	Creditor	500
Debtor	100		
	5,300		5,300

The Accounting Equation and The Balance Sheet

- Collection of an Asset:

On 31 May 2014 J. Brown who owes Blake $100, makes a part payment of $75 by cheque. The effort is to reduce one asset, **Debtor** and to increase another asset, **Cash at Bank.**

- This result in the balance sheet as follows:

B. Blake
Balance Sheet
as at 6 May 2014

Assets	**$**	**Capital & L...**	**$**
Fixtures	3,000		
Cash at bank	1,925	Capital	5,000
Stock of goods	350	Creditor	300
Debtor	25		
	5,300		5,300

- It can be seen that EVERY TRANSACTION has affected TWO ITEMS. Sometimes it has changed two assets by reducing one and increasing the other. Other times things have changed differently.

The Accounting Equation and The Balance Sheet

- A Summary of the effect of transactions upon Assets, Liabilities and capital is shown below:

Example of transactions	Effects	
1. Owners buys goods on credit	Increase asset (stock of goods)	Increase liability (creditors)
2. Owner buys goods by cheque	Increase asset (Stock of goods)	Decrease asset (bank)
3. Owner pays creditor by cheque	Decrease asset (bank)	Decrease liability (creditors)
4. Owner pays more capital into the bank	Increase asset (bank)	Increase capital
5. Owner takes money out of the business bank account for own use	Decrease asset (bank)	Decrease (capital)
6. Owner pays creditor from private money outside the firm.	Decrease liability (creditors)	increase capital

The Accounting Equation and The Balance Sheet

- Each transaction has therefore maintained the same total for assets as that of Capital + Liabilities. This is shown below:

Number of transactions above	Assets	Capital & Liabilities	Effect on Balance Sheet totals
1	+	+	Each side added equally
2	+ -		A plus and a minus both on the assets side, cancelling out each other
3	-	-	Each side has equal deductions
4	+	+	Each side has equal addititons
5	_	-	Each side has equal deductions
6		+	A plus and minus both on the assets side, cancelling out each other

ALTERNATIVE FORM OF A BALANCE SHEET PRESENTATION

- Previous slides have presented the Balance Sheets using the following presentations:

K. King
Balance Sheet
as at (Date)

Assets	**$**	**Capital & Liabilities**	**$**
Details of all Assets	xxx	Details of Capital	xxx
		Details of Liabilities	xxx
	Xxx		xxx

- This is called a **HORIZONTAL** or 'side by side' form of presentation. However, accounting standards governing the presentation of financial statements states that Balance Sheet (Satements of Financial Position) are to be prepared using the **VERTICAL form of presentation or Format!**

The Accounting Equation and The Balance Sheet

- The Vertical Format is displayed below:

K. King
Balance Sheet
as at (Date)

Assets	**$**
Details of all Assets	xxx
Less: Liabilities	
Details of all Liabilities	xxx
	xxx
Financed by:	
Details of Capital	xxx

- You are to complete the gaps in the following table:

Assets	**Liabilities**	**Capital**
a) 12,500	1,800	?
b) 28,000	4,900	?
c) 16,800	?	12,500
d) 19,600	?	16,450
e) ?	6,300	19,200
f) ?	11,500	39,750

The Accounting Equation and The Balance Sheet

- Distinguish from the following list the items that are liabilities from those that are assets.

a) Office Machinery
b) Loan from C. Shirley
c) Fixtures & Fittings
d) Motor Vehicles
e) We owe for goods
f) Cash at bank

- Draw up A. Foster's balance sheet from the following as 31 December 2014 using both the horizontal & vertical formats.

Capital	23,750
Debtors	4,950
Motor vehicles	5,700
Creditors	2,450
Fixtures	5,500
Stock of goods	8,800
Cash at bank	1,250

- Smart sets up a business. Before he actually sells anything he has bought motor vehicles $2,000, premises at a cost of $5,000 and goods $1,000. He did not pay in full for his stock of goods and still owes $400 in respect of them. He had borrowed $3,000 from D. Bevan. After the events just described, and before trading starts, he has $1oo cash in hand and $700 cash at bank. You are required to calculate the amount of his capital.