COLLEGE OF ACCOUNTING

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Video Transcription: The Accounting Equation – Part 1

Hello there! My name is Jacqui and today I am going to be chatting to you about the relationship between the resources that a business has and how these resources are funded. This relationship is often referred to as the accounting equation and it is really important that you understand it because it is the foundation of everything that you are going to need to understand in the accounting world.

So, where do we start? Well, by thinking about a business, in fact, let's be a bit more specific: let's imagine that the business is a retailer. In other words, a business that buys goods and resells them to customers for a profit. The business we will use in this video buys and resells T-shirts. Now, what does this business need to operate? The business may need property to operate from, shelves to display its goods, a till system to process payments from customers and cash for daily requirements. The business will also need T-shirts to sell and may in fact need a delivery vehicle. In other words, the business needs things that it can use and/or sell in the business. These resources are referred to as assets.

Okay, so a business will need resources to use or sell in the business. Remember, these are assets. But how will the business acquire these resources? The business will need funding to be able to acquire the resources. So where can that funding come from? There are two sources of funding available to a business: namely the owner, in their capacity as an owner, or lenders could provide funding. The first source of funding, funds received from the owner or owners, acting in the capacity as an owner, is called equity.

Let's assume that the owner contributes R50 000 cash into the business. From the business point of view, and remember whenever we record information it is always from the business point of view, what is actually happening?

Well, two things actually happened. Firstly, the business received resources or assets in the form of cash to use in the business. At the same time and of the same amount, the business recognises that the owner provided the funding. In other words, the owner has a claim on the resources equal to the amount of funding they provided. So, has this transaction changed the owner's wealth? No. The owner has taken personal funding of R50 000 from a personal bank account or hidden under a bed, not the best option of course, and funded a business to the value of R50 000. The owner's wealth has not changed and is still only R50 000.

We could present this information differently by saying that the assets, cash of R50 000, are equal to the equity. R50 000 provided by the owner. It is important to note that the business only has R50 000 cash. The equity does not represent cash. It represents the claim the owner has on the assets, which in this case happens to be cash. The business can also source funding from people, who lend funds to the business. The business has an obligation to repay this funding in the future and we refer to this form of funding as liabilities. Now, let's assume that the business borrows R20 000. The business has received additional resources in the form of R20 000 cash. The total resources of the business now amount to R70 000. The owner funded R50 000 of these resources. So, although the total resources or assets of the business has increased, the equity or the claim the owner has on the assets has not increased.

The debt-holders or liabilities also have a claim on the resources. The claim is equal to the amount of funding that they have provided. In other words, assets are equal to equity plus liabilities. Assets are funded either by the owner or by lenders, so it follows that assets, the resources of the business, will always equal the amount of funding provided by the owner plus the lenders.

Our business currently has resources in the form of cash. But think about this, in order to operate the business is going to need different types of resources. Things like inventory, we sometimes refer to this as trading stock, or shelves to put the inventory on, a vehicle to mention but a few. Now, let's assume that our business purchases inventory is valued at R30 000. Where do you think they are going to get the resources from to be able to acquire this inventory?

There are two options: the business could use some of the resources it already has, cash in the bank or the business could purchase the inventory on credit, increasing the funding from a lender, referred to as a creditor. Let's look at option one. All that has happened is that the types of assets or resources have changed. The business still has a total of R70 000 in assets. R40 000 in cash and R30 000 inventory and a total funding of R70 000. In this option, the total amount of assets has not changed. So the amount of funding provided to the business will also not have changed.

Let's look at option two. The total resources have increased. The business has total assets of a R100 000: R70 000 cash and R30 000 inventory. The owner's claim of R50 000 has not changed. But the liabilities now have a claim of R50 000: R30 000 loan and R20 000 creditors. The total resources of the business have increased. The business acquired additional inventory but has not paid for the inventory yet so the cash in the business has not decreased. In this option, the total resources increased from R70 000 to R100 000. Any increase in resources will need to be funded. So if the resources have increased, the funding will have increased. Liabilities increased as the inventory was purchased on credit.

As the inventory was purchased on credit, at some point in the future the business will pay the supplier to settle the obligation. Now, how will this payment affect the resources as well as the claims on the resources. The business will use existing resources in the form of cash to pay the debt to the supplier. The business is not receiving any additional inventory for the cash that it is paying but is reducing an existing debt. The cash assets will decrease by R30 000, so the total assets of the business have decreased from R100 000 to R70 000. Remember, the total assets will be equal to the total amount of funding provided by owners and lenders.

Let's think about this. The business used cash to pay the creditors and once the creditors have received the R30 000, their claim on the assets decrease because they received R30 000 worth of resources to settle their claim of R30 000. The liabilities now have a claim of R20 000 and the equity holders still have a claim of R50 000. The assets of the business are equal to the claims that the owners and lenders have on these assets.

Part 1 of The Accounting Equation video focused on understanding that the resources that a business requires can be funded either by the owner or by outside debt holders known as liabilities. Please continue and watch Part 2, where we focus specifically on understanding the equity portion of The Accounting Equation.

Thanks for watching.