COLLEGE OF ACCOUNTING

FINANCIAL REPORTING | BASIC

Video Transcription: The Accounting Equation – Part 2

Welcome to Part 2 of The Accounting Equation video. If you remember, Part 1 focused on understanding that the resources that a business required could be funded either by the owner or outside debt-holders also known as liabilities. Part 2 is going to focus predominantly on understanding the equity. In other words, the portion of the resources that are funded by the owner. Enjoy watching the video.

The assets of the business are equal to the claims that the owners and lenders have on these assets. This relationship can be restated as equity being equal to assets less liabilities. In other words, once assets have been used to settle the liabilities, the remaining or residual assets are equal to the owner's claim.

It is useful to restate this relationship as the owner of the business will be interested, both in whether and why their claim on the assets of the business has changed. The claim the owner has on the assets of the business can change either because of transactions with the owner or because of transactions not with the owner. Let's explore this a little further. We have already dealt with an example of a transaction with the owner that increased the claim the owner had on the assets of the business. Remember, the owner provided cash to the business and the assets and equity increased.

Okay, let's look at some transactions not with the owner and understand when the business makes a profit why does the claim, the owner has on the assets, increase.

Assume the business sells the inventory they have for R50 000 cash. Remember, they purchased the inventory for R30 000. What happens is the following: firstly, the business sells inventory and receives R50 000 cash, secondly, the business no longer has the inventory that cost R30 000. Let's look at the first part of the transaction. The assets cash of the business has increased by R50 000. The total assets of the business have increased. The increase is not due to a transaction with a lender so the liabilities have not changed. However, total assets have increased and if the liabilities claim on the assets is the same, the owner's claim must have increased.

Now, how does this transaction differ from the owner providing resources to the business? This transaction is not a transaction with the owner. Equity, the claim that the owner has on the assets, has increased not due to a transaction with the owner but due to sales to a customer. This increase in equity is referred to as income. So, what is income? Income is an increase in the equity of the business not due to a transaction with the owner, in the capacity as an owner. Remember, this transaction was due to a sale to a customer.

In the second part of the transaction, the business sold the inventory costing R30 000. The assets, inventory of the business, decreased by R30 000. The total assets of the business have decreased. This decrease is not due to a transaction with a lender so liabilities have not changed. However, the total assets have decreased and if the liabilities claim is the same then the owners claim must have decreased. Equity, the owner's claim on the assets, has decreased not due to a transaction with the owner. This decrease in equity is referred to as an expense. So, what is an expense? An expense is a decrease in the equity of a business not due to a transaction with the owner, in their capacity as an owner.

Let's look at the effect of both components of the transaction in equity. The first part increased assets, cash, by R50 000. The claim the owner has on the assets increased and this is recognised as income, called sales income. The second part decreased assets, inventory, by R30 000. The claim the owner has on the assets decreased and this is recognised as an expense. We call this cost of sales. The assets of the business increased by R50 000 and decreased by R30 000, a net increase of R20 000. Equity increased as the business earned income of R50 000 and decreased as the business incurred an expense of R30 000. A net increase of R20 000, this is the profit. The total assets increased by R20 000 and equity increased by R20 000. The business generated a profit and as this profit has remained in the business, we refer to this as retained earnings.

Has the sale transaction changed the owner's wealth? Yes, the owner's claim on the assets has increased and as this increase is due to transactions not with the owner, the owner's wealth has increased. Remember, the owner contributed R50 000, the claim they have on the assets is R70 000 so they are R20 000 wealthier.

The business can choose to return assets to the owner. For example, the owner withdraws R10 000 out of the business, the assets, cash, in the business decrease by R10 000 and the claim the liabilities have on the business has not changed. The owner's claim, equity, will decrease. So, would this decrease in equity be recognised as an expense? Remember, an expense is a decrease in the equity of a business not due to a transaction with the owner. The R10 000 was withdrawn by the owner, so this is a transaction with the owner and will therefore not be recognised as an expense. We refer to this decrease in equity as a dividend. Dividends are accounted for as a direct decrease in equity. So has this transaction changed the owner's wealth? No. Although the owner's claim on the assets in the business decreased by R10 000, the owner's personal assets have increased by R10 000. So the owner's wealth has not changed.

This video has referred to the owner acting in their capacity as an owner. Let's briefly review what this means. The owner as an individual can fund the business as an owner, which is recognised as equity or the same individual can lend funds to the business, which is recognised as a liability. How we recognise the transaction is not based on who the individual is but the relationship that the individual has with the business. Transaction by transaction. In other words, the same person can be both an owner and a lender at the same time.

This video has focused on the relationship between the resources the business has, assets, and how these resources are funded, equity and liabilities. Total resources increase if the owners or lenders fund the business, total resources decrease if the owners withdraw resources from the business, dividends, or resources are used to settle the obligations to the lenders. The total resources of the business can also increase or decrease due to transactions not with the owner, recognised in equity as income or expenses.

The accounting equation or relationship between assets, equity and liabilities really is the foundation of all of your accounting knowledge and before you move on to any of the other videos, this is something you need to understand and be really comfortable with.

Good luck with the rest of the videos and we hope you enjoyed this one. Thanks for watching.