The Accounting Equation

What is accounting?

People and business

Accounting is related to people and business. Firms and individuals need to plan how they are going to spend their money and what quantity to save. We may write down a plan, known as a *budget*.

Recording accounting data

Recording accounting data is an important part of accounting as it is virtually impossible for humans to record all the information needed in their heads. Consequently, systems have to be set up to record cash received and paid out and goods bought and sold.

Classifying and summarising

When the data is being recorded it has to be sorted out so as to be most useful to the business. This is known as *classifying* and *summarising data*.

Communicating information

Finally they should be able to tell or *communicate* their results to the owners of the business, or to others allowed to receive this information.

From the data, someone skilled in accounting should be able to tell whether or not the business is performing well financially. They should also be able to ascertain the strengths and weaknesses of the business.

Users of accounting information

The possible users of accounting information can be:

- *Owner(s)* → The owners of the business want to be able to see whether or not the business is profitable. In addition they want to know what the financial resources of the business are being used for.
- *A prospective buyer(s)* → When the owner wants to sell the business the buyer(s) will want to see the final accounts of the firm.
- *The bank* → If the owner want to borrow money for use in the business, then the bank will need such information.
- *Tax inspectors* → They need it to be able to calculate the taxes payable.
- *A prospective partner* → If the owner wants to share ownership with someone else, then the would-be partner will want such information.
- *Investors* → People wondering whether or not to invest their money in the business.

The accounting equation

The whole of financial accounting is based on the accounting equation. If a firm is to be set up and start trading, then it needs resources to use within the firm (Assets). These resources can be either supplied by the owner (Capital) or by firms from outside the business (Liabilities). Using this concept then the accounting equation follows as:

Resources in the business = Resources Supplied by the owner + Resources supplied by firms from outside the business

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Assets = Capital + Liabilities

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Resources: What are they? (Assets)	**=**	**Resources: Who supplied what? (Capital + Liabilities)**

Assets = The resources in the business
Capital = The amount of resources supplied by the owner
Liabilities = The amount of money owing to people outside the business for the use of their resources e.g. The bank for the use of its money.

It is a fact that the totals of each side will always equal one another, and that will always be true no matter how many transactions there may be. The actual assets, capital and liabilities may change, but the total of the assets will always equal the total of capital plus liabilities.