

7.4: Accounting Basics for Entrepreneurs

LEARNING OBJECTIVES

By the end of this section, you will be able to:

- Explain the accounting equation and define its parts (assets, liabilities, and equity)
- Define revenue, expenses, and income

Although financing and accounting complement and rely on each other, they are distinct. As we have seen, financing is the process of raising money. **Accounting** is the system of recording and classifying financial transactions related to a business, and summarizing and communicating those transactions in the form of financial statements. Accounting is essentially documenting what happens to money once a company receives it and thereby makes that information available for reporting to stakeholders and regulatory agencies, and informing business decisions.

At the most fundamental level, an accounting system accomplishes two goals:

1. It summarizes a business's financial performance
2. It communicates that performance to owners, managers, and outside parties

The most common approach to accounting used in the United States, and around the world, follows the basic formula shown in Figure 7.4.1.

Assets	=	Liabilities	+	Equity
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Figure 7.4.1: The accounting equation provides the foundation of a company's financial status and outlook. (CC BY 4.0; Rice University & OpenStax)

This formula is referred to as the basic **accounting equation**. First, we'll define each of these terms, and then we'll look at an example of a simple transaction recorded using the equation.

Assets are items—such as equipment, cash, supplies, inventory, receivables, buildings, and vehicles—that a business owns and derives future use from. Potential investors want to know what resources a company has at its disposal. Business owners want to see where their money has gone. Let's return to the case of Shanti, the website designer who starts her business by purchasing a new laptop computer. The computer is an asset that Shanti has acquired for her business.

A **liability** is a debt that a company has incurred with another party, as when it borrows money from a bank or purchases materials from other suppliers. The business is required to make a future payment to satisfy that debt. For accounting purposes, we want to be able to see what the business owns (assets) compared with what it owes (liabilities). For example, if Shanti does not have sufficient cash to pay for the laptop, she may have the electronics store charge her credit card for the purchase. In that case, the credit card company pays the store, and Shanti's business now owes the credit card company for the amount of purchase (a liability).

Equity is the owner's claim on the assets of the business, that is, the difference between what they own and what they owe. Essentially, equity tells a business owner or investor how much the firm is worth after all the debt is repaid. Returning to the example of Shanti's website design business, let's compare two scenarios of startup purchases to see the effects on the accounting equation. In both cases, Shanti contributes some of her own money to the initial purchase of a laptop.

In the first scenario, shown in Figure 7.4.2, she contributes \$1,000 to the new business.

Assets	=	Liabilities	+	Equity
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Figure 7.4.2: An initial \$1,000 contribution by the owner is recorded in the accounting equation. (CC BY 4.0; Rice University & OpenStax)

Each element of the accounting equation has its own account in an accounting system or software package, and all changes are tracked within its account. The accounting equation must stay in balance after every transaction with assets equaling liabilities. In this case, Cash is an assets account, and Owner's Capital is an equity account. The \$1,000 cash contributed is a cash asset and becomes equity that is recorded as owner's capital. At this point, Shanti can claim 100 percent of the assets of the business, which right now consist only of the cash.

If she uses all of her cash assets to purchase the laptop, the accounting equation will record this as shown in Figure 7.4.3.

Assets		=	Liabilities	+	Equity
Cash	Computer				Owner's Capital
+1,000			0		+1,000
-1,000	+1,000				
0	1,000		0		1,000

Figure 7.4.3: The purchase of a laptop computer using existing cash is recorded in the accounting equation. (CC BY 4.0; Rice University & OpenStax)

When the cash is spent, reducing the assets column to zero, a new asset account for the computer is created to record the dollar amount paid for the laptop. Again, because Shanti doesn't owe another party at the end of the transaction (because she didn't make any additional contribution), the balance of the owner's equity account remains the same. The equation shows that Shanti still owns 100 percent of the assets.

Now consider how to account for a situation in which Shanti does not have a significant amount of cash to contribute to the business. She can afford to contribute only \$100 and deposits the money into the business's bank account. Fortunately, she also has access to a credit card that can be charged for business purchases, increasing her investment options.

The initial contribution to the business is recorded in the same way but with the new amount, as shown in Figure 7.4.4.

Assets		=	Liabilities	+	Equity
Cash					Owner's Capital
+100			0		100

Figure 7.4.4: An owner contribution of \$100 is recorded in the accounting equation. (CC BY 4.0; Rice University & OpenStax)

The laptop still costs \$1,000, but the business has only \$100 in cash assets. Shanti purchases the laptop with a credit card, and the clerk finalizes the sale. Figure 7.4.5 shows the impact of the sale on the accounting equation.

Assets		=	Liabilities	+	Equity
Cash	Computer		Credit Card		Owner's Capital
+100	0		0		+100
-100	+1,000		+900		0
0	1,000		900		100

Figure 7.4.5: The purchase of the computer asset using cash and a credit card is recorded in the accounting equation. (CC BY 4.0; Rice University & OpenStax)

In both examples, Shanti reports the computer as an asset of the business that is valued at its \$1,000 cost. In the first scenario, she exchanged the cash for the computer. In the second, she exchanged a smaller amount of cash for the laptop and charged the remaining amount of the purchase on a credit card. This creates a liability for the business that Shanti will need to repay in the future. Since this is an equation, both sides must be equal to each other, and this proves to be the case in both scenarios. The total assets are \$1,000, and the total liabilities plus equity are also \$1,000.

ARE YOU READY?

The Accounting Equation

On a sheet of paper, use three columns to create your own accounting equation for your personal assets, liabilities, and expenses. In the first column, list all of the things you own (assets). In the second column, list any amounts owed (liabilities). In the third column, using the accounting equation, calculate the net amount of the asset (equity). When finished, total the columns to determine your net worth.

Here is something else to consider: is it possible to have negative equity? It sure is . . . ask any college student who has taken out loans. At first glance there is no asset directly associated with the amount of the loan. But is that, in fact, the case? You might ask yourself why make an investment in a college education—what is the benefit (asset) to going to college? The answer

lies in the difference in lifetime earnings with a college degree versus without a college degree. This is influenced by many things, including the supply and demand of jobs and employees, and the field in which you plan to work.

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