# The Simplest and the Wealthiest Equation

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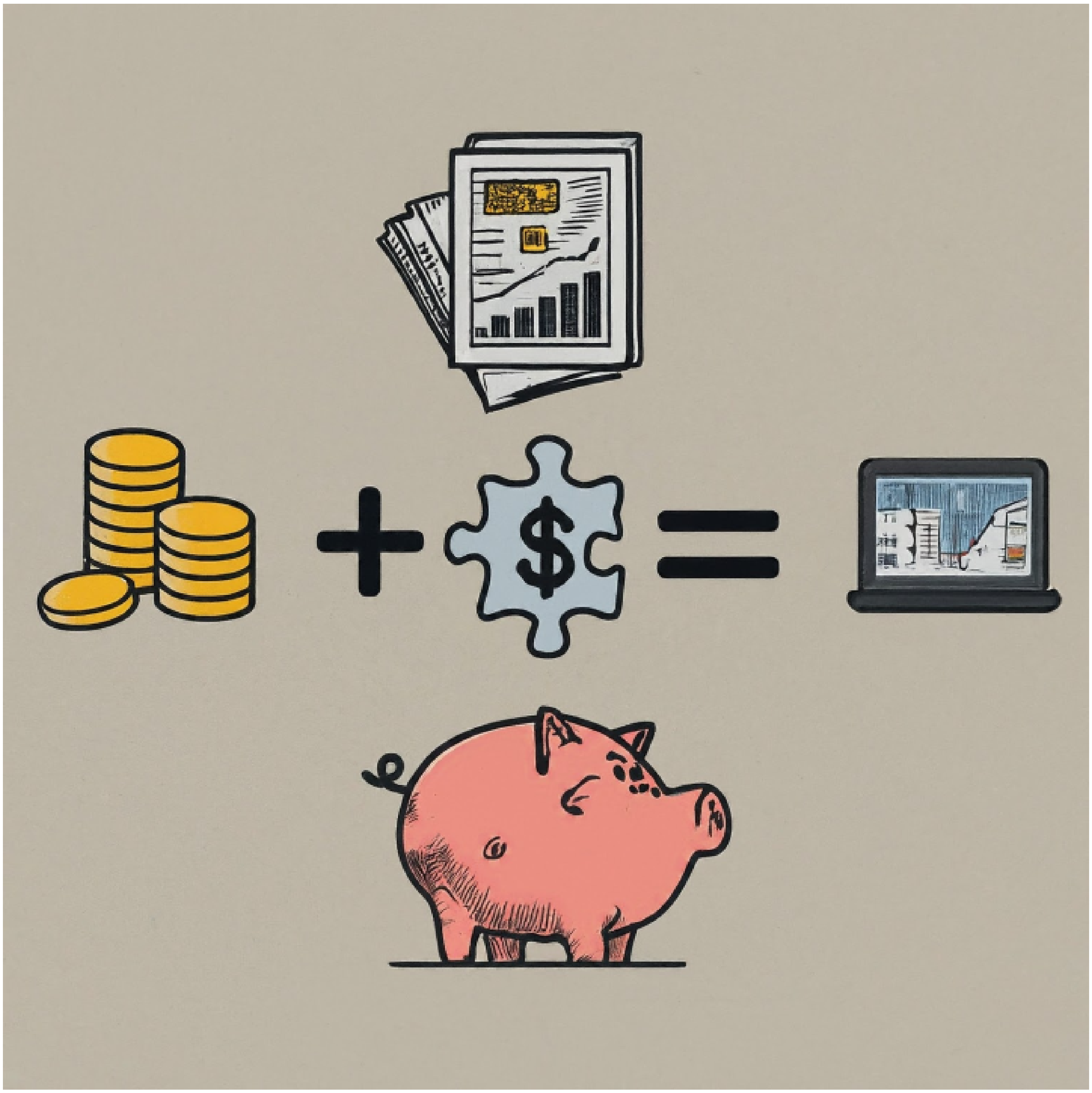


Assets = Capital + Liability

The above equation is one of the most undemanding mathematical equations I have ever encountered. My accounting guru (who unfortunately passed away untimely on 1st Apr 2024), introduced this equation to me and told me – “If you can absorb this to the core, you can enslave money". Really!! I wondered. Now, I was coming across this equation at that juncture of corporate life, when you are pleading and haggling about that last bit of hike during the appraisal cycle. So, the concept of enslaving money seemed intriguing. Later I realized, that absorbing this equation is only a tiny part – the bigger part is your behavioral approach towards each element of this equation – in terms of business and terms of personal finance.

So, let us understand what this equation means through a simple story.

Preeti wants to start a restaurant business in Kolkata. She visits a few places hunting for a space that she can use for her restaurant. She eventually finds a shop space in Garia. The owner of the shop tells Preeti, she can either take the space on lease or buy the space.

Preeti chooses the leasing option. "Well, in that case, you need to make a pre-payment of 1,00,000 INR and pay a monthly rent of 21,500 INR in arrears. I will prepare a lease agreement for 10 years."

Preeti replies – "Okay, I will pay the pre-payment of 1,00,000 INR in two days. Can I do an online transfer?"

The owner of the shop replies – "Yes, but you are going to pay from your business current account, right?"

Well, Preeti quite naively never thought of this part. She never registered a business and created an account for it. Remember - the separate entity concept we spoke about in the first article, Preeti cannot just transfer the pre-payment from her account. Because, Preeti and her business are separate entities, and the payment of the pre-payment is a business transaction between the business entity and the owner of the shop.

Thus, the first activity that Preeti does is register her restaurant as a business entity. Create a current account against it and deposit a capital of 5,00,000 INR required for the execution of the business in the current account of the registered company.

Below is the series of transactional activities which Preeti will perform over the next few days:

5-January-20X1: Payment of 1,00,000 INR pre-payment to the shop owner

7-January-20X1: Purchase of Restaurant's cooking equipment from Jindal Stores for 1,20,000 INR in credit

8-January-20X1: Withdraw 60,000 INR cash from the current account for Business purpose

8-January-20X1: Purchase of Raw materials from Mehar Groceries for 30,000 INR in cash

9-January-20X1 to 15 -January-20X1: Sell Goods in cash for INR 30,000 and in credit for 90,000 INR

20-January-20X1: Received cash of 30,000 INR which was tied in credit

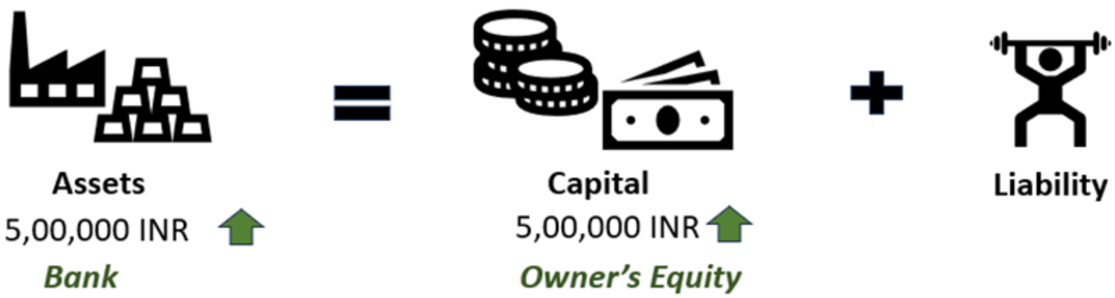
25-January-20X1: Paid back 50,000 INR to Jindal Stores

27-January-20X1: Paid rent of 21,500 INR for the shop.

Let us now look at how the above transactions fit into the equation => Assets = Capital + Liability.

### *Preeti creates a current account and deposits 5,00,000 INR*

Preeti's accountant friend tells her that when she adds 5,00,000 INR to her current account, the liability side of the business increases. This statement leaves Preeti confused as she asks, "How does the liability side of the business go up when I invest 500000 in the business? I didn't understand." The accountant friend explains, "Yes, but this is a special type of liability. It represents the business entity's obligation to the owner, which can be referred to as Shareholder Equity or Capital."



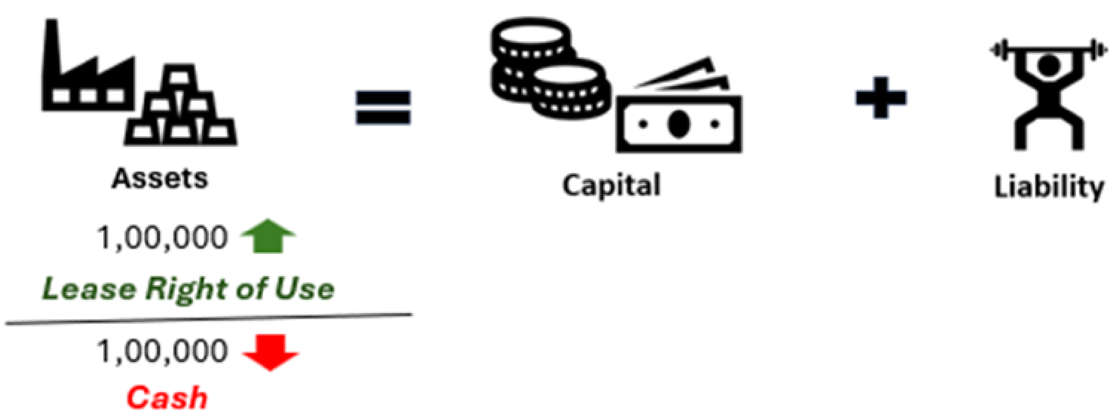

### *5-January-20X1: Payment of 1,00,000 INR pre-payment to the shop owner*

When Preeti makes a prepayment of 1,00,000 INR, the shop owner initiates the lease with Preeti.

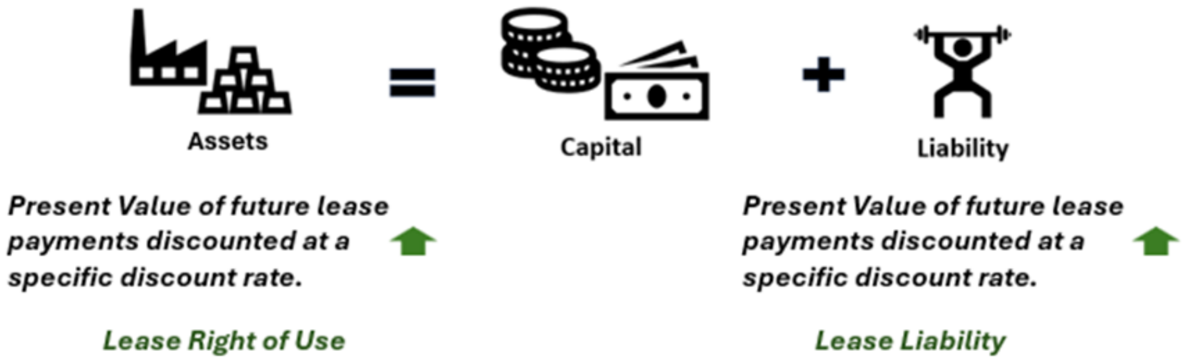
Why is the lease initiation date such a big deal, you ask? Well, the lease initiation/start date is used to calculate the present value of all the future lease payments to determine the lease liability and the Right of Use arising from the lease agreement.

The detailed intricacies of these calculations are a story for another day.

Prepayment:



Lease Liability and Right of Use:

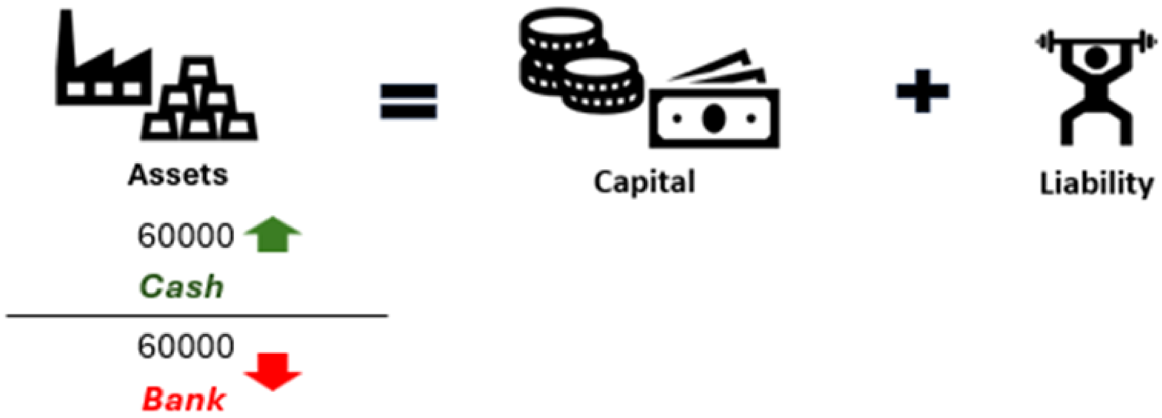



### *7-January-20X1: Purchase of Restaurant's cooking equipment from Jindal Stores for 1,20,000 INR in credit*

During a recent transaction, Preeti's accountant friend once again startled her by remarking, "You need to capitalize this expense." Preeti responded, "Suresh, please understand I am not well-versed in accounting, so please avoid using technical terms." Essentially, Suresh was implying that Preeti's purchase of the restaurant's cooking equipment should not be recorded as a regular expense, but rather as an increase in assets on the balance sheet. This is because the cooking equipment is expected to be used beyond the current accounting period.

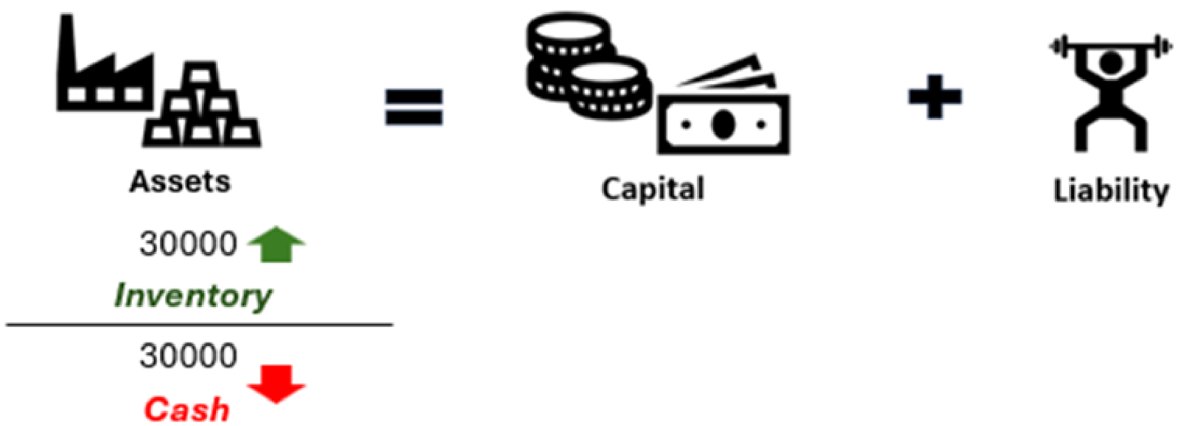

### *8-January-20X1: Withdraw of 60,000 INR cash from current account for Business purpose*

Yes, withdrawal of amount from bank also needs to be recorded as a transaction, as the nature of asset changes.




### *8-January-20X1: Purchase of Raw materials from Mehar Groceries for 30,000 INR in cash*

When cash is used to purchase raw materials such as groceries, the nature of the current asset changes from cash to inventory.




A valid question here is, "What happens when the groceries are used for cooking and the cooked food is sold?" In that case, the specific inventory converts into an expense in the form of cost of goods sold (COGS).

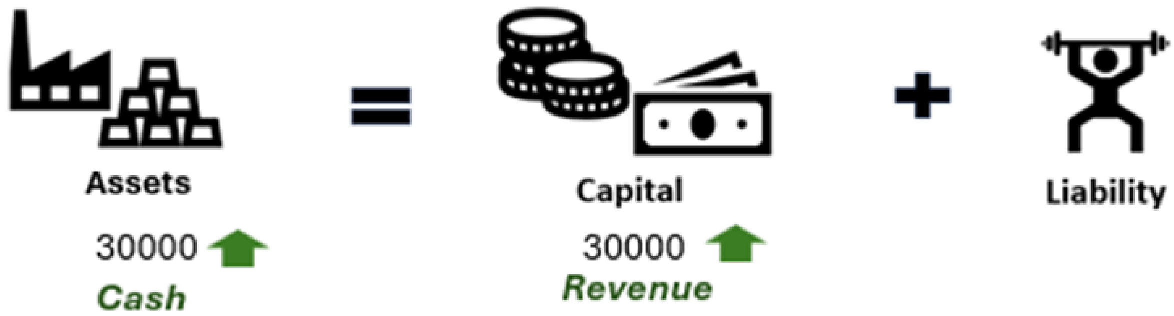
### *9-January-20X1 to 15 -January-20X1: Sell of Goods in cash for Rs 30,000 INR and in credit for 90,000 INR*

When goods are sold and cash is received, revenue increases.

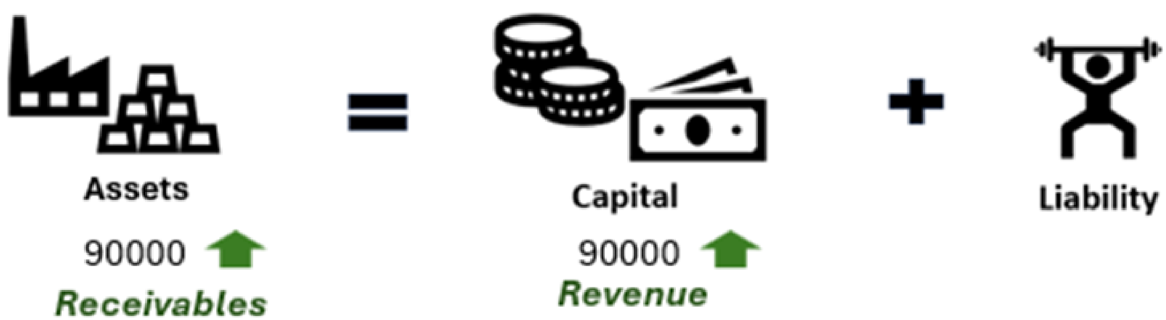
However, this is where it can become confusing - where does revenue fit into the entire equation? Isn't it all about Assets, Liability, and Owner's Equity?

From a purely accounting perspective - not from a financial statements perspective - when revenue increases, it results in an increase in owner's equity.

Therefore, it would be appropriate to represent the transaction as follows:



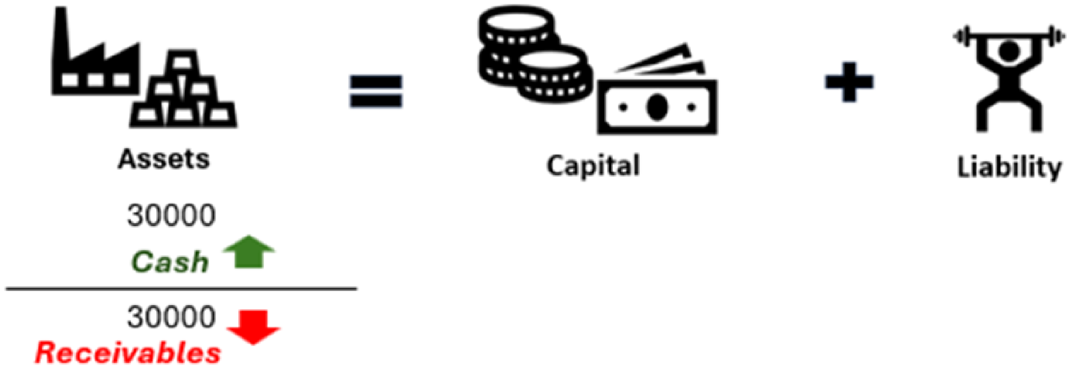

Similarly, when customers buy product or services in credit, revenue increases, but assets increase in the form of receivables




### *20-January-20X1: Received cash of 30,000 INR which was tied in credit*

It's worth noting that recovering receivables is crucial for enhancing the business's working capital cycle and freeing up cash flow, even though it doesn't directly affect revenue.

The recovery of receivables can be illustrated using the accounting equation:




### *25-January-20X1: Paid back 50,000 INR to Jindal Stores*

Preeti purchased the restaurant's cooking equipment on credit from Jindal Stores on 7th January.

She is making a partial payment on 25th January towards the amount she owes


### *27-January-20X1: Paid lease payment of 21,500 INR for the shop.*

When Preeti makes the lease payment on January 27th, the amount paid reduces the lease liability. However, not the entire amount goes towards the principal. A portion of it is used to pay off the interest expense that has accrued since the beginning of the lease (5th January 20X1). This is where finance and accounting become intriguing! ■

If the lease payment of INR 21500 includes INR 2500 towards interest expense and INR 19000 towards the principal, the transaction of the lease payment can be illustrated as follows:


Assets
21500
Cash
Capital
2500
Interest Expense
Liability
19000
Lease Liability