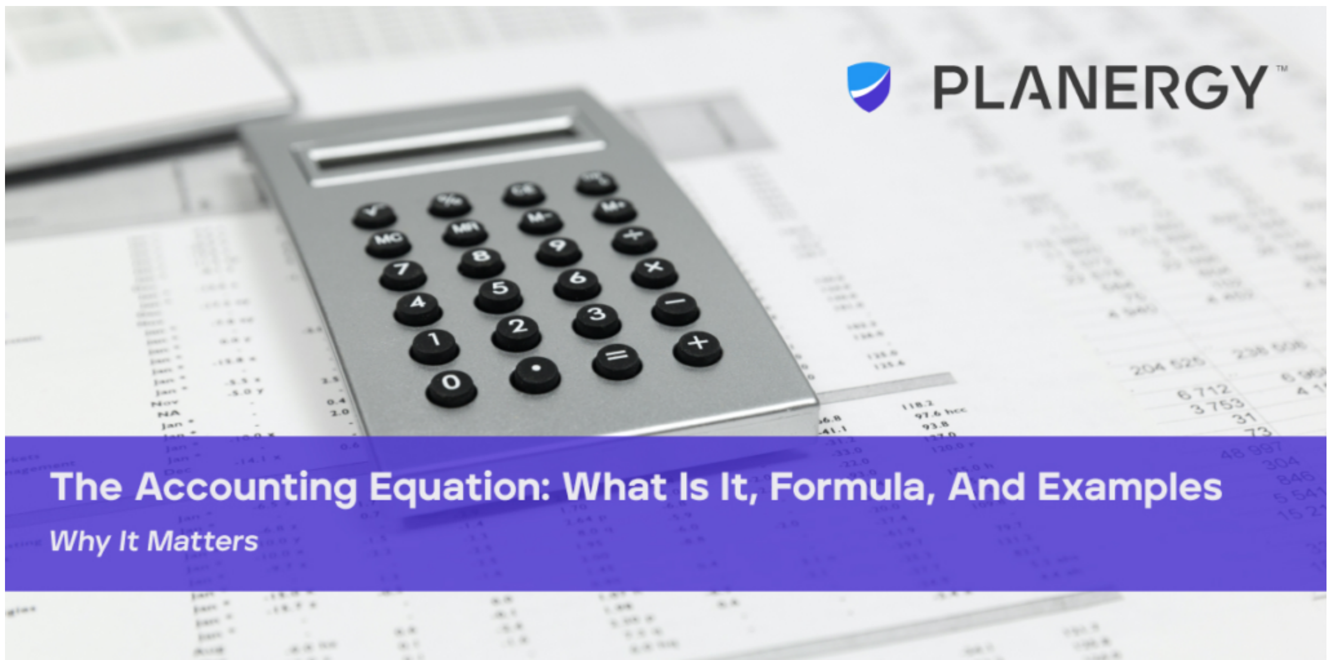
The Accounting Equation: What Is It, Formula, and Examples



The Accounting Equation: What Is It, Formula, and Examples

The accounting equation is a fundamental part of the balance sheet and one of the basic principles of financial accounting. The balance sheet is one of the three fundamental statements, alongside the income statement and the cash flow statement. The balance sheet shows the company's total assets and how the assets are financed. It may also be called the statement of net worth or a statement of financial position.

The accounting equation formula is:

Assets = Liabilities + Shareholder's Equity

This equation is the foundation of double-entry accounting. Double-entry accounting is a method of accounting that means each transaction affects both sides of the accounting equation. For every change there is in an asset account; there has to be an equal change to a related liability or shareholder equity account. It's important to keep the accounting equation in mind when taking care of journal entries.

The Balance Sheet

The balance sheet is made of up three sections and their underlying items: Assets, Liabilities, and Shareholder's Equity.

Total Assets = Current Assets + Non-Current Assets

Total Liabilities = Current Liabilities + Non-Current Liabilities

Total Shareholders' Equity = Share Capital + Retained Earnings

Examples of Items in Each Section

Assets

- **Accounts Receivable:** This represents a business's credit sales that haven't been fully paid by its customers. In simpler terms, it is earned Revenue that has not been paid for with cash yet.
- **Cash:** This is considered a current asset. Current assets are any assets that can reasonably be converted to cash within a year.
- **Equipment:** Part of the property, plant, and equipment or PP &E account, equipment is a tangible capital asset that is used to generate

revenue and profit.

- **Inventory:** This is a current asset account that consists of all raw materials, work-in-progress, and finished goods that a company has accumulated.

Liabilities

- **Accounts Payable:** This represents the companies purchases of goods or services on credit. Accounts payable is expected to be paid off within one year’s time, or a single operating cycle – whichever is longer. AP is one of the most liquid forms of current liabilities on the balance sheet
- **Short-Term Borrowings:** Considered a current liability, these are financial obligations that are due and payable within a year. Liabilities occur when a company has undergone a transaction that has generated the expectation of a future outflow of cash or another economic resource. A liability doesn’t necessarily have to end up resulting in an outflow of value.
- **Long-Term Debt:** Also known as LTD, This refers to any amount of outstanding debt a company holds that has a maturity of 12 months or longer. It is classified as a non-current liability on the balance sheet. The time to maturity can range anywhere from 12 months to 30 years and Beyond depending on the type of debt. It may include bonds, bank loans, mortgages, debentures, etc.

Shareholder’s Equity

- **Retained Earnings:** This refers to the portion of the business’s profits that aren’t distributed to shareholders as dividends. They are reserved for reinvestment back into the business. Typically, These funds are used for working capital and capital expenditures or allotted to pay off debt obligations.

- **Share Capital:** Also known as contributed capital, equity capital, or shareholders capital, this is the amount a company's shareholders invest for used in the business. When a company is created, if its only asset is the cash invested by the shareholders, the balance sheet is balanced through share capital – an equity account.

This equation shows the relationship between all of these items.

Rearranging the Accounting Equation

You can also rearrange the equation like this:

Shareholder's Equity = Assets – Liabilities

This version of the accounting equation shows the relationship between shareholder's equity and debt. The shareholder's equity is what remains after all liabilities are subtracted. Creditors, or the people who lend money, are the ones who have the first claim to a company's assets.

For instance, if a company goes bankrupt, its assets are sold in the funds are used to settle debts first. Only after the debts are settled can the shareholders receive any of the assets in an attempt to recover their Investments.

> *No matter how the accounting equation is represented, it has to always balance.*

Examples of the Accounting Equation

For every transaction, both sides of this equation have to have an equal net effect. Let's take a look at some examples of transactions to demonstrate how they affect the accounting equation.

1. Purchasing Equipment Using Cash

Company ABC wants to purchase a $5,000 machine with cash only. This transaction results in a credit to Equipment (+$50,000) and a debit to Cash (-$50,000).

The result looks like this:

Assets = Liabilities + Shareholder's Equity

+50,000

-50,000

——————————————————————

0 = 0 + 0

A transaction like this affects only the assets of the equation and there is no corresponding effect in liabilities or shareholder equity on the right side of the equation.

2. Purchasing Equipment Using Cash and Credit

ABC wants to purchase a $50,000 machine but it only has $25,000 cash available and its Holdings. The company is therefore allowed to purchase the machine with the initial payment of $25,000 but it owes the vendor the remaining amount. This results in a credit to Equipment (+$50,000), a credit to Accounts Payable (+$25,000), and a debit to Cash (-$25,000). The net effect on the accounting equation looks like this:

Assets = Liabilities + Shareholder's Equity

+50,000   +25,000

-25,000

————————————————————

+25,000   =   +25,000   +   0

This transaction affects both sides of the accounting equation both the left and the right side of the equation increase by $25,000.

The Expanded Accounting Equation

The expanded accounting equation gives more detail for the small business owner's equity amount shown in the basic accounting equation. The expanded accounting equation for a sole proprietorship is:

Assets = Liabilities + Owner's Capital + Revenue – Expenses – Owner's Draws.

In a corporation, the expanded accounting equation provides additional details for the stockholder's equity amount than what is shown in the basic accounting equation. For a corporation the formula is:

Assets = Liabilities + Paid-in Capital + Revenues – Expenses – Dividends – Treasury stock.

Using the expanded version of this equation allows you to see separately:

- The impact on equity from net income (increased by revenues and decreased by expenses)
- The effect of transactions with owners (draws, dividends, sale or purchase of ownership interest)

The balance sheet is used to analyze a company's financial position. Using the

balance sheet, a financial analyst can calculate a number of financial ratios to determine how well a company is performing, how efficient is it is, and how liquid it is. Changes in the balance sheet are used to calculate cash flow in the cash flow statement.

The balance sheet can be a standalone financial statement or it can be looked at in conjunction with other statements to get a full picture of how healthy a company is. Looking at these documents, you can determine where a business stands in terms of four important performance metrics:

- **Liquidity:** If you compare a company's current assets to its current liabilities, you'll be able to see how liquid a company is. The current assets should always be more than the liabilities so the company is able to cover short-term obligations.
- **Leverage:** Examining how a company is finances determines how much leverage it has. This in turn indicates how much risk the company is taking. If you compare debt to equity and debt to total capital, you'll assess leverage on the balance sheet.
- **Efficiency:** Using the income statement with the balance sheet makes it possible to see how efficiently a company is using its assets. For instance, if you divide revenue by the average total assets the company products, you'll have the asset turnover ratio, which indicates how well the company works to convert assets into revenue. You can also look at this to determine the working capital cycle to see how well the company manages its cash in the short term.
- **Rates of Return:** The balance sheet is useful in evaluating how well a company generates returns. You can use returns on equity, returns on assets, and returns on invested capital formulas to see how well a company is doing.

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