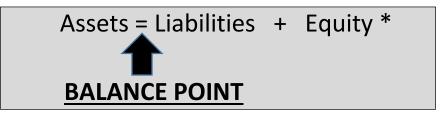
The Basic Accounting Equation



The Three Elements of the Accounting Equation

- 1. Assets (A) Anything owned by a business that has economic value and will help the business earn revenue.
- 2. Liabilities (L) Creditor claims on total assets resulting from past transactions; obligations of the entity to third parties.
- 3. Equity (E) Ownership claims on total assets. * Name will vary depending upon the type of business, i.e. In a corporation the name is Stockholder's Equity; a sole proprietor uses the name Owner's Equity.

When any two elements of the equation are known, the third can always be calculated.

For Example:

If Assets = \$50,000 and Liabilities = \$18,500, what is the amount of Equity?

Using the Accounting Equation, plug in the known amounts:

A=L+E \$50,000 = \$18,500 + E

Subtract the Liabilities from both sides:

A-L=L-L+E \$50,000 - \$18,500 = \$18,500 - \$18,500 + E

Combine amounts:

A-L=E \$31,500 = E

The equation MUST STAY IN BALANCE AT ALL TIMES - A change to any one element requires a corresponding change to at least one other element. Therefore, the purchase of an asset (an increase in asset) requires either a decrease in another asset (cash paid) or an increase in a liability (accounts payable) or an increase in equity (owner put asset into service in business).

For example, a corporation with Assets of \$750,000, Liabilities of \$570,000, and Stockholders equity of \$180,000 purchases equipment at a cost of \$120,000 and borrows the full amount to pay for the purchase. The assets (equipment) will increase by \$120,000 and the liabilities (loan) increase by \$120,000.

Equation before purchase:

The business purchases equipment for \$120,000 obtaining a loan for the full amount:

Assets have increased by \$120,000 and the liabilities have increased by \$120,000, so the equation has stayed in balance.

Equity vs. Liabilities

To illustrate how liabilities and equity work to stay in balance, consider the purchase of a home.

If the cost of the house is \$200,000 and the buyer provides a down payment of \$40,000 and obtains a mortgage for \$160,000, the elements would be entered in the equation as shown below.

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House = Mortgage + Down Payment

$200,000 = $160,000 + $40,000

A = L + E
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After the first mortgage payment of \$1,000 principal, the equation would change as shown. **

Notice that the equation stays in balance; the asset has not changed, but equity increases as the liability decreases.

**Note that this example does not consider the interest that is typically associated with this type of scenario.

PRACTICE:

SECTION I

Calculate the missing amounts.

	Assets	=	<u>Liabilities</u>	+	<u>Equity</u>
1.	410,000.00	=	200,000.00	+	
2.		=	5,400.00	+	7,700.00
3.	24,255.00	=		+	11,150.00
4.	1,150,000.00	=	545,700.00	+	
5.	750,500.00		<u> </u>	+	350,500.00
٦.	730,300.00				330,300.00
6.		=	880,500.00	+	305,250.00

SECTION II

The following are attempts to restate the Basic Accounting Equation. Indicate which attempts are correct and which are incorrect.

1.	Assets	=	Liabilities	+	Equity	Correct / Incorrect
2.	Liabilities	+	Assets	=	Equity	Correct / Incorrect
3.	Assets	-	Liabilities	=	Equity	Correct / Incorrect
4.	Assets	=	Equity	+	Liabilities	Correct / Incorrect
5.	Liabilities	+	Equity	=	Assets	Correct / Incorrect
6.	Equity	-	Assets	=	Liabilities	Correct / Incorrect
7.	Assets	=	Liabilities	-	Equity	Correct / Incorrect

SECTION III

Answer each of the following:

The assets of Some Company are \$250,000 and the total equity is \$95,000. What is the amount of total liabilities?

The liabilities of Some Company are \$45,000 and the total equity is \$21,000. What is the amount of Some Company's total assets?

The total assets of Some Company are \$1,345,000 and its liabilities are equal to one half the assets. What is the amount of total equity?

ANSWERS:

<u>Sectio</u>	<u>n I</u>	Section	<u>II</u>	Section	Section III	
1.	210,000.00	1.	Correct	1.	155,000.00	
2.	13,100.00	2.	Incorrect	2.	66,000.00	
3.	13,105.00	3.	Correct	3.	672,500.00	
4.	604,300.00	4.	Correct			
5.	400,000.00	5.	Correct			
6.	1,185,750.00	6.	Incorrect			
		7.	Incorrect			