The Accounting Equation & Transaction Analysis

Economic transactions must be classified into categories: assets, liabilities, and stockholders' equity. **Assets** (A) are resources owned by a business. **Liabilities** (L) and **stockholders' equity** (SE) represent what the business owes to creditors and owners, respectively. A business must always have a balance between what it owns and what it owes. This is shown by the basic accounting equation:

$$\boxed{\text{Assets}} = \boxed{\text{Liabilities}} + \boxed{\text{Stockholders' Equity}}$$

You could make up a mnemonic device to help you remember the equation: AELPS or All Elephants Like Pumpkin Soup (each letter stands for something: assets equals liabilities plus stockholders' equity)

The next step is memorizing the types of accounts that will be categorized as A, L or SE. Assets are anything that will help a business produce future services or benefits (e.g. cash, delivery truck, or inventory). Common asset accounts are cash, accounts receivable (or any receivables), equipment, building, land, accumulated depreciation, inventory, supplies, prepaid expenses. Receivables are usually associated with phrases like "billed on account" or "performed service on account".

Liabilities are basically loans or debts — transactions associated with the phrase "buys on credit, or buys on account". L accounts often have the word "payable" in the name: accounts payable, notes payable, mortgage payable. Long term debt is also a liability.

Stockholders' Equity is the value of the business owned by **stockholders** (people who have shares in the company), or what would remain if all the assets were sold off and creditors were paid off. Stockholder's equity is made up of Paid-in Capital, Revenues, Expenses, and Dividends. Paid-in capital means someone invests money in the company, increasing the value of SE. Revenues also increase the value of SE. Expenses and **dividends** (a proportion of net income paid out to stockholders) reduce the value of SE.

The last thing we need to know is how transactions affect the basic accounting equation. Any change on one side of the equation must be balanced by an equal change on the other side of the equation. You may have to use your algebra skills to figure out one of the unknown categories (A, L or SE) or to figure out the change in one side of the equation or figure out what must happen to A, L, or SE given set information.

Example 1: If assets are valued at $25,000 and stockholders' equity at $10,000 what is the value of liabilities?
Solution: Let's plug the numbers into the equation: A = L + SE
25,000 = L + 10,000 To solve for L, move the $10,000 to the other side.

Authored by Nahoria Rahman & Emily Simpson