A Simple Model

The Accounting Equation

NOTES TO ACCOMPANY VIDEOS

These notes are intended to supplement the videos on ASimpleModel.com. They are not to be used as stand-alone study aids, and are not written as comprehensive overviews of the topic detailed. The purpose of these notes is to provide a tangible collection of the visuals used in the videos with comments highlighting the more important aspects covered.

002 The Accounting Equation

This video introduces the accounting equation, which is the most important concept in accounting.

- This relationship between assets, liabilities and stockholders' equity must always hold true. There are no exceptions to this rule.

The Accounting Equation

ASSETS	=	LIABILITIES	+	STOCKHOLDERS' EQUITY
All property owned by the company.		All debts the company currently has outstanding.		Ownership interests in the company after all debts have
The resources a company uses to generate revenue.		The means of acquiring assets.		

After briefly defining the terms and walking through an illustrated example, the equation is expanded upon to introduce double-entry bookkeeping:

DOUBLE-ENTRY BOOKKEEPING: the system most commonly employed by businesses to record financial information. Double-entry bookkeeping requires that a change in one account be matched in another account.

- This is done by recording debits and credits. For every entry the sum of debits must equal the sum of credits.
- Please see video for an example and greater detail on this topic.

The Accounting Equation

Double-entry bookkeeping: most businesses employ a double-entry bookkeeping system to record financial data. Under this system a change in one account must be matched in another account. These changes are made by DEBITS (dr) and CREDITS (cr) to the accounts. For every entry the sum of DEBITS must equal the sum of CREDITS.

ASSETS		=	LIABILITIES		+	STOCKHOLDERS' EQUITY	
+	-		-	+		-	+
dr	cr		dr	cr		dr	cr
$ 5,000,000				$ 5,000,000			

Debits and credits are difficult to grasp at first. The best way to approach this concept is to revisit the definition as your accounting vocabulary grows.

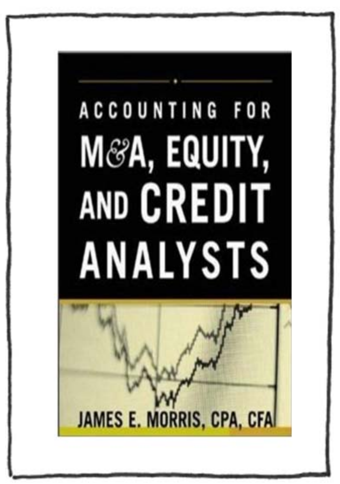
This definition is not included in the video, but can be found under "Reference" on the website. It can be helpful in better understanding debits and credits because it applies the concept to something everyone understands: cash.

DEBIT AND CREDIT REVIEW

In double-entry accounting, the balance sheet is always kept in balance by making debits equal credits. But debits and credits do not seem to be intuitive concepts for many analysts, so let us think of them in the context of something everyone understands: cash.

Rephrasing the original statement, in double-entry accounting, the balance sheet is always kept in balance by making the uses of cash equal the sources of cash. Increasing assets uses cash, and so a DEBIT INCREASES ASSETS (debit = use of cash) because we use cash to "buy" the asset. We get cash from borrowing or increasing liabilities, so a CREDIT INCREASES LIABILITIES (credit = source of cash).

fig. 1



James E. Morris, Accounting for M&A, Equity, and Credit Analysts, (New York: McGraw-Hill, 2004), 144

The video continues to expand upon the accounting equation to show that…

- Stockholders' equity is equal to the sum of contributed capital and retained earnings.
- Net income is equal to revenues less expenses.

ASSETS		=	LIABILITIES		+	STOCKHOLDERS' EQUITY	
+	-		-	+		-	+
dr	cr		dr	cr		dr	cr

STOCKHOLDERS' EQUITY	=	CONTRIBUTED CAPITAL		+	RETAINED EARNINGS	
		-	+		-	+
		dr	cr		dr	cr
					Dividends	Net Income

NET INCOME	=	REVENUES		-	EXPENSES	
		-	+		+	-
		dr	cr		dr	cr

These relationships are important in understanding how financial statements relate to one another and will be elaborated upon in future videos.

The video concludes by pointing out that the balance sheet is simply a more formal presentation of the accounting equation.

To demonstrate this the video organizes the components of the accounting equation vertically, and then details accounts that fall under assets, liabilities and stockholders' equity.

Balance Sheet

Company Name

(000s)

ASSETS	
+	-
dr	cr

LIABILITIES	
-	+
dr	cr

STOCKHOLDERS' EQUITY	
-	+
dr	cr

Balance Sheet

Company Name

(000s)

BALANCE SHEET	20X1
ASSETS	
Current Assets	
Cash	1,773
Accounts Receivable	7,750
Inventory	4,800
Prepaid Expenses	456
Total Current Assets	**14,779**
Fixed Assets	
PP&E, Net of Accum. Depreciation	10,913
TOTAL ASSETS	**25,692**
LIABILITIES	
Current Liabilities	
Accounts Payable	5,665
Line of Credit	792
Current Maturities of Long Term Debt	500
Total Current Liabilities	**6,957**
Long Term Liabilities	
Long Term Debt, Net of Current Maturities	5,000
TOTAL LIABILITIES	**11,957**
EQUITY	
Common Stock	15
Additional Paid In Capital	5,000
Retained Earnings	8,720
TOTAL EQUITY	**13,735**
TOTAL LIABILITIES & EQUITY	**25,692**
Check	**0.0**

Finally, the video points out that in every thorough financial model, for every accounting period, the balance sheet has a check to make certain that the accounting equation holds true.