

WORLD'S #1 ACCOUNTING EQUATIONS & ANSWERS



Essential Information for Understanding Key Accounting Principles & Methodologies
 Includes Helpful Hints , Useful Tips , Critical Points  & Common Pitfalls 

Balance Sheet

Assets are economic resources, whereas liabilities and stockholders' equity are sources of financing for the economic resources; liabilities are amounts owed to creditors, whereas the financing provided by the owners of the corporation is stockholders' equity; assets, liabilities, and equity are reported on the balance sheet; every balance sheet of a corporation is based on the following equation:

FORMULA: Assets = Liabilities + Stockholders' Equity

 Memorizing the balance sheet formula can help when analyzing business transactions; understanding how a transaction impacts the elements of the balance sheet is fundamental to transaction analysis and the practice of accounting.

Net worth, calculated for both individuals and business entities, is a measure of wealth; the net worth formula is a derivative of the balance sheet equation:

FORMULA: Net Worth = Assets - Liabilities

EX: If you own assets worth \$250,000 and have liabilities of \$250,000, then your net worth is \$0 (i.e., \$250,000 - \$250,000).

 Since a nonprofit organization does not have owners, the third section of the balance sheet is known as **net assets** (instead of owner's equity or stockholders' equity); a nonprofit's balance sheet is represented by the following accounting equation:

FORMULA: Assets = Liabilities + Net Assets

Assets are the resources owned by the business; **current assets** include cash, accounts and notes receivable, inventory, and prepaid expenses; **noncurrent assets** include long-term investments, property and equipment, and intangible assets.

FORMULA: Assets = Current Assets + Noncurrent Assets

Liabilities are the obligations or claims of the business against the assets of that business; **current liabilities** include accounts payable, notes payable, and accrued liabilities payable; **noncurrent liabilities** include all long-term debts.

FORMULA: Liabilities = Current Liabilities + Noncurrent Liabilities

 Sometimes firms have obligations that do not show up on the balance sheet; these "**off balance sheet**" liabilities are footnotes to the balance sheet but can be substantial and may someday impact the financial health of the entity.

Equity, synonymous with net worth, is the ownership interest in a company; part of equity is **contributed capital**, which includes investments made by stockholders in the company's common and preferred stock; another part is **retained earnings**, which is the net income that has been invested in the entity since the start of its existence.

FORMULA: Stockholders' Equity = Contributed Capital + Retained Earnings

Changes to the retained earnings balance (i.e., increases or decreases) can happen whenever a company is profitable (net income), is unprofitable (net loss), or pays dividends; net income increases retained earnings and dividends, which are earnings paid to stockholders, and reduces the balance of retained earnings.

FORMULA: Change in Retained Earnings = Net Income - Dividends

 Net losses reduce retained earnings, as do some prior period adjustments for overstatement of net income; prior period adjustments for understatement of net income increase retained earnings.

In a partnership, the equity is called **partners' capital**, which is increased by capital contributions by partners (investments) and net income and decreased when there is a net loss or when partners withdraw capital (drawings).

FORMULA: Ending Capital = Beginning Capital + Net Income (or - Net Loss) + Investment - Drawings

EX: If the beginning capital is \$500,000, net income for the year is \$100,000 with no new investments, and the owners draw out \$20,000, then the ending capital will be \$580,000 (i.e., \$500,000 + \$100,000 - \$20,000).

Income Statement & Retained Earnings

The **income statement** contains a formula to calculate net income or net loss; revenues are earned from the sale of goods or services to customers, whereas expenses represent the amount of resources the entity used to earn the revenues; if the revenues are greater than the expenses, then the result of the formula is a positive number (**net income**); if the expenses are greater than the revenues, then the result of the formula is a negative number (**net loss**); the income statement—also known as the statement of income, statement of earnings, statement of operations, or the profit and loss statement (P&L)—contains the following formula:

FORMULA: Net Income (or Net Loss) = Revenues - Expenses

Net sales are the true revenue of a business; net sales take into account discounts given to customers for various reasons.

FORMULA: Net Sales = Gross Sales - Sales Discounts - Credit Card Discounts - Sales Returns and Allowances

WHERE:

Gross Sales = Total sales for a period before subtracting discounts

Sales Discounts = Discounts given because of early payment

Credit Card Discounts = The amount charged by the credit card company (e.g., 2% of sale amount)

Sales Returns and Allowances = A reduction of sales revenue for returns or allowances for unsatisfactory goods.

EX: If gross sales are \$1,000,000 with discounts of \$100,000 granted for early payments and returns of \$20,000, then the net sales would be \$880,000 (i.e., \$1,000,000 - \$100,000 - \$20,000).

 Net income is an important concept, as it is the residual amount after expenses for the owners and stockholders; with corporations, **income available to common stockholders** is a more relevant calculation, as it gives a more refined, accurate picture of profitability.

FORMULA: Income Available to Common Stockholders = Net Income - Dividends on Preferred Stock for the Current Period

Income statements can be presented in various formats; one popular format is the **classified income statement**, which shows the income from operations and the net income for a particular period of time arranged as follows:

+	Net Sales
-	Cost of Goods Sold
=	Gross Margin
-	Operating Expenses
=	Net Operating Income
+	Nonoperating Revenues and/or Expenses and Gains and/or Losses
=	Income before Income Taxes
-	Income Taxes
=	Net Income

The calculation of **net income** is really the result of several formulas, such as gross margin, net operating income, and income before taxes:

FORMULA: Gross Margin = Net Sales - Cost of Goods Sold

Net Operating Income = Gross Margin - Operating Expenses

Income before Income Taxes = Net Operating Income + Nonoperating Revenues and/or Gains - Nonoperating Expenses and/or Losses

Net Income = Income before Income Taxes - Income Taxes

EX: If net sales are \$750,000 and the cost of goods sold is \$600,000, then the gross margin is \$150,000 (i.e., \$750,000 - \$600,000), which must cover the operating expenses in order to break even or produce net income.

 Gross margin is also called gross profit.

An income statement can also be presented in the **contribution margin format**, which is useful to managers for decision-making purposes.

FORMULA: Net Income = Revenues (or Sales) - Variable Expenses - Contribution Margin - Fixed Expenses

 The contribution margin format can also be used to construct a segment income statement.

FORMULA: Segment Revenue (or Sales) - Segment Variable Expenses = Contribution Margin - Segment Traceable Fixed Expenses = Segment Margin

 **Traceable fixed expenses** are those expenses that not only are fixed but also can be associated with the segment with a high degree of accuracy.

 A **segment** can be a division, product, customer, or territory—that is, any part of a business for which management wants to track profitability.

Since a nonprofit's primary purpose is to provide programs that meet certain societal needs, it issues a **statement of activities** (instead of the income statement issued by a for-profit business), which shows the ending balance of net assets.

FORMULA: Ending Net Assets = Revenues - Expenses + Beginning Net Assets

WHERE:

Revenues = Such things as contributions by donors, membership dues, program fees, money earned from fundraising events, grants, and investment income

Expenses = Program expenses, which are the amounts directly incurred by the nonprofit in carrying out its programs and supporting-services expenses, including management, general, and fundraising expenses.

 Nonprofit and governmental agencies practice a form of accounting that is a bit different from GAAP; whereas the annual report is the focus of for-profit companies, the **budget** is the preeminent report for a nonprofit and governmental agency.

Earnings per share (EPS) is the amount of current-period earnings that can be associated with a single share of a corporation's common stock; an entity with a simple capital structure (only common stock outstanding) has **basic earnings per share (BEPS)**.

FORMULA: BEPS =
$$\frac{\text{Income Available to Common Shareholders}}{\text{Weighted-Average Number of Common Shares Outstanding}}$$

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