

### 3. THE ACCOUNTING EQUATION

The equation is based on the causal relationship principle and expressed as “Each resource has a source.” Thus:

$$\text{ASSETS} = \text{SOURCES}$$

An asset is anything owned by the organization that has value. Sources may be categorized according to whether these were derived from external or internal sources, i.e., liabilities or equity. In NPOs, there is no equity in the real sense since there are no specific owners. The residual amount is then called Net Assets. Thus, the fundamental accounting equation is expressed in NPOs as:

$$\begin{aligned} A &= L + NA \\ \text{Asset} &= \text{Liabilities} + \text{Net Assets} \end{aligned}$$

Net Assets has two nominal accounts, namely, Revenue/Support/Income that add up to the net assets and Expenses that are deducted from the net assets.

Based on the equation, the five major accounts are: assets, liabilities, net assets (also known as real accounts), revenue/income/support, and expense (also called nominal accounts). All financial transactions are analyzed through the fundamental accounting equation:

$$A = L + NA$$

Debit is represented in the left side of the equation, while Credit is in the right side of the equation.

In **increasing** format (when the variables are positive), the equation expressed in Debit and Credit is:

$$A = L + NA$$

Debit	Credit
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In **decreasing** format (when the variables are negative or transposed), the equation expressed in Debit and Credit is:

$$[-L] + [-NA] = [-A]$$

Debit	Credit
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It is very important to express the equation in increasing and decreasing forms because in real life, the variables (A, L, NA) may increase or decrease for every transaction. Hence, assets, liabilities, and net assets always consist of left and right sides or what we call the T-accounts. Combining the two equation formats (increasing and decreasing) above, we come up with the rules of Debit and Credit, as follows:

#### Assets

Debit	Credit
+	–

#### Liabilities

Debit	Credit
–	+

#### Net Assets

Debit	Credit
–	+
Expenses	Income

For every transaction, the fundamental accounting equation is used. Therefore, the rule can be re-stated as “**For every transaction, total debits must equal total credits.**”

#### **Important Note**

We would like to emphasize that the objective of accounting is not simply to have a balanced equation, but to have a proper analysis of transactions. A balanced equation is the result of proper analysis. In other words, balancing becomes automatic, if the analysis is correct.