CHAPTER-6
ACCOUNTING EQUATIONS

Prior to understanding an accounting equation, it is essential to know about a Balance Sheet. An example of a simple Balance Sheet in T form is given below:-

BALANCE SHEET

CAPITAL & LIABILITIES ASSETS	**Rs.**	**ASSETS**	**Rs.**
Capital	60,000	Cash & Bank	1,00,000
Liabilities :-		Debtors	
Creditors	40,000	Stock in Trade	
Bank Overdraft		Furniture	
		Machinery	
		Building	
	1,00,000		1,00,000

In the above Balance Sheet assets are recorded on the right hand side and capital and liabilities are recorded on the left hand side. At any point of time, the total of the both sides of the Balance Sheet is always equal because the assets of a business are purchased either from the funds (capital) supplied by the proprietor or from the funds provided by external parties.

Accounting equation signifies that the assets of a business are always equal to the total of capital and liabilities. A business transaction will result in the change in either of the assets, liabilities or capital of the firm and even after the change the assets will be again equal to the total of capital and liabilities. If a business transaction results in the increase of assets, there will also be a corresponding increase in the amount either capital or liabilities by the same amount.

Meaning of Debit and Credit

All accounts are divided into two sides. The left side of an account is arbitrarily or traditionally called Debit side and the right side of an account is called Credit side. In the abbreviated form, Debit is written as Dr. and Credit is written as Cr.

Rules of Debit and Credit

In order to decide when to write on the debit side of an account and when to write on the credit side of an account. There are two approaches :–

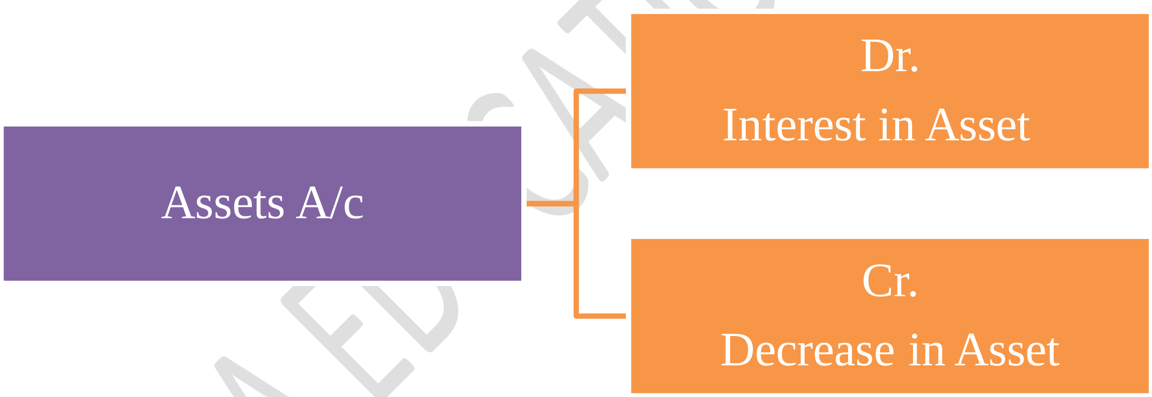
(I) American approach or Modern approach, and
(II) English approach or Traditional approach.

(English approach is also called 'Double Entry System' which has been discussed in the next chapter).

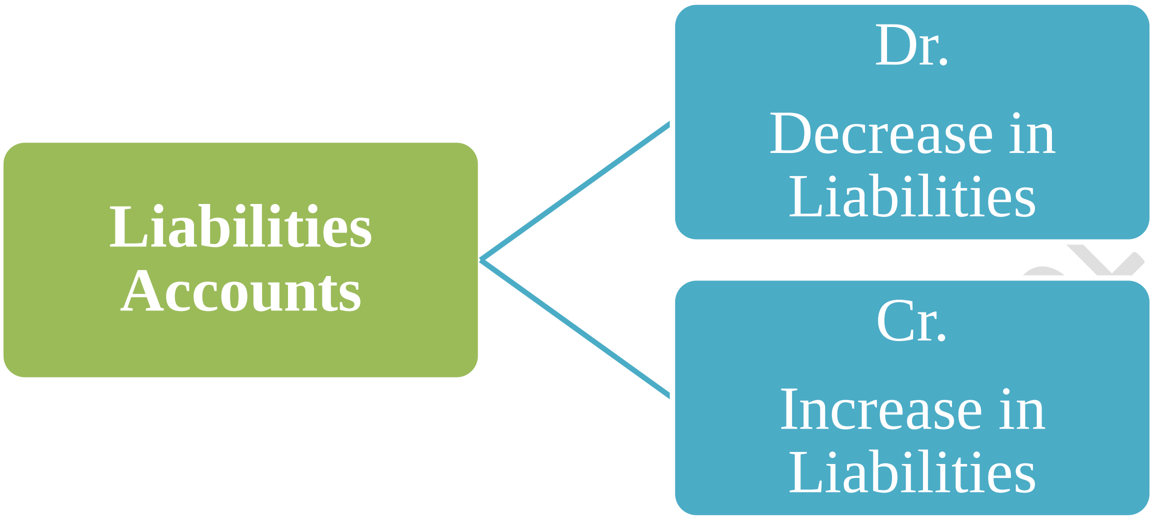
American Approach:-The rules of debit and credit depend on the nature of an account. For this purpose, all the accounts are classified into the following five categories in the American approach

- **I.** Assets Accounts
- **II.** Liabilities Accounts
- **III.** Capital Account or Owner's Equity Account
- **IV.** Revenue or Income Accounts
- **V.** Losses or Expenses Accounts

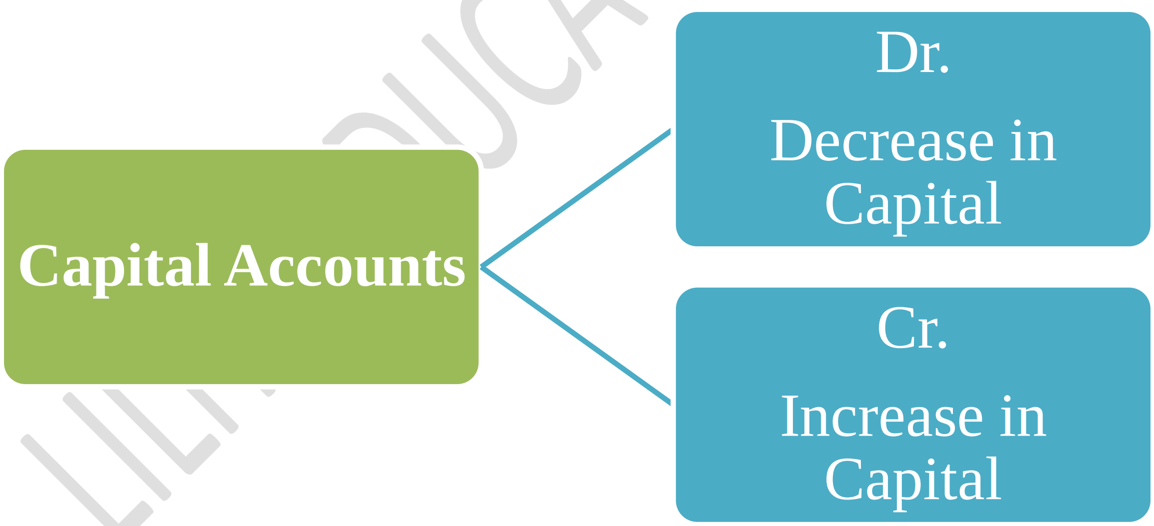
Assets Accounts:-When there is an increase in the amount of an asset, such an increase is recorded on the debit side of the asset account and if there is a reduction in the amount of an asset, such reduction is recorded on the credit side of the asset account.



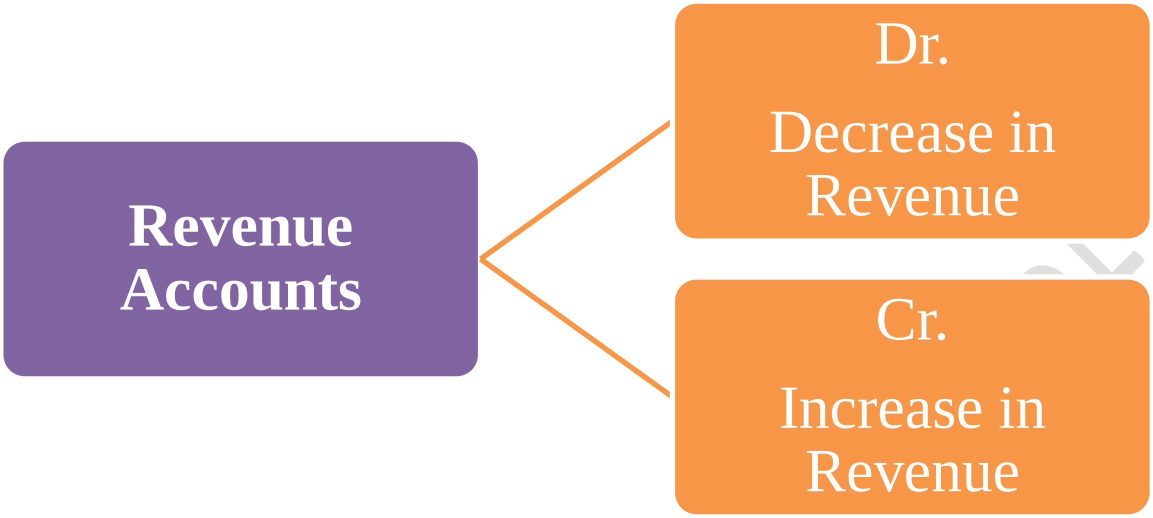
Liabilities Accounts:- When there is an increase in the amount of a liability, such an increase will be recorded on the credit side of the liability account. On the contrary, if there is a reduction in the amount of a liability, it will be recorded on the debit side of the liability account.



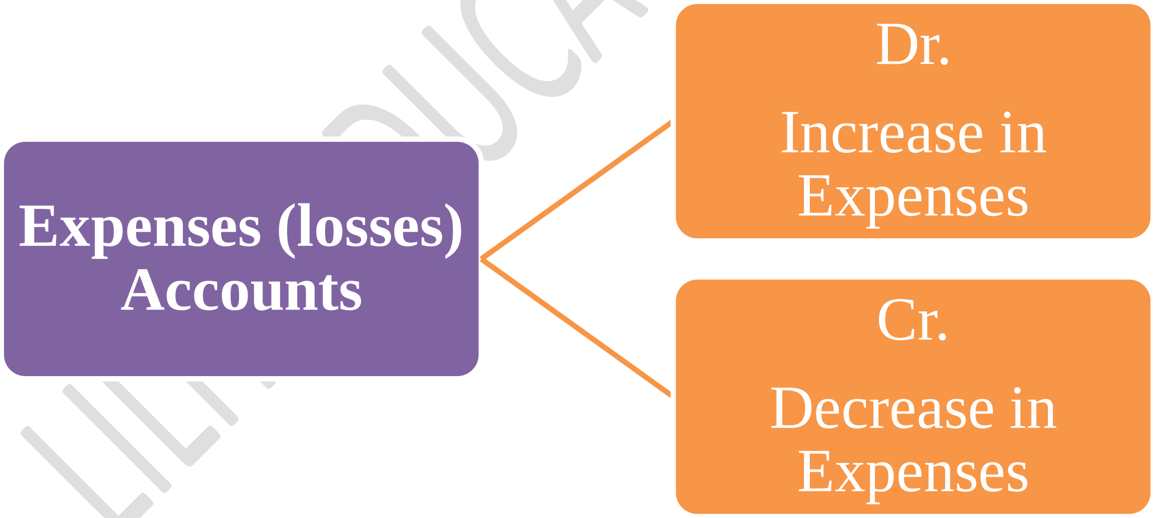
Capital Account:- An increase in the capital is recorded on the credit side and the decrease in the capital is recorded on the debit side. Suppose, the proprietor introduces the additional capital in the business, the capital account will be credited.



Revenue or Income Accounts:- All increases in the gains and incomes are recorded on the credit side of the concerned income account as it leads to increase in the capital. On the contrary, if there is a reduction in any gain or income, the account concerned will be debited, as it leads to decrease in the capital.



Losses or Expenses Accounts:- All increases in the losses and expenses are recorded on the debit side of the concerned expenses account as it leads to decrease in the capital. On the contrary, the reduction in expenses is recorded on the credit side.



MEANING OF ACCOUNTING EQUATION

Accounting equation is based on dual aspect concept of accounting. Accordingly, the assets of a business are always equal to total of its liabilities and capital (owner's equity). In equation form, this relationship is expressed as:

Assets = Liabilities + Capital

Where

Liabilities = amount due to outsiders or creditors' equity

Capital = Owner's capital or owner's equity

From the above equation, we have:

Liabilities = Assets - Capital
and
Capital = Assets - Liabilities

The accounting equation always depicts the relationship among different components of the balance sheet so it is also called as Balance Sheet Equation.

Types of Transactions Affecting Accounting Equation

From the point of view of accounting equation, transactions are of two types:

1. Transactions affecting two items.

2. Transactions affecting more than two items.

1. Transactions affecting two items: They are of two types:

(A) Transactions affecting both the sides of accounting equation:

(i) Increase in assets, Increase in liabilities: Examples may be:

Transactions	Affects
- Started business with cash	Cash & Capital
- Credit Purchase of goods	Stock & Liabilities
- Credit Purchase of Asset	Asset & Liabilities
- Bank Loan	Bank & Liabilities
- Received Commission	Cash & Capital

(ii) Decrease in Assets, Decrease in Liabilities: Examples may be:

Transactions	Affects
- Payment to Creditors	Cash & Liabilities
- Drawing	Cash & Capital
- Bought furniture for personal use	Cash & Capital
- Rent paid	Cash & Capital
- Depreciation on machine	Machine & Capital

(B) Transactions affecting one side of accounting equation: Transactions may affect in opposite direction on one side of equation. Examples may be:

(i) Increase in asset, decrease in asset:

Transactions	Affects
- Cash purchases	- Cash + Stock
- Cash received from debtors	+ Cash - Debtors
- Withdrew cash from bank	+ Cash - Bank
- Deposited into bank	+Bank - Cash
- Furniture purchased for cash	+Furniture - Cash
- Purchase of Investment	+ Investment - Cash
- B/R drawn	+ B/R - Debtors

(ii) Increase in Liability, Decrease in Liability:

Transactions	Affects
- Acceptance of Bills Payable	+ B/P, - Creditors

(iii) Increase or decrease in Liability &Cappital:

Transactions	Affects
- Conversion of debentures into shares	- Liability,+ Capital
- Proposed Dividend	-Profits (Capital), + Liability

2. Transactions affecting more than two items-Even if a transaction affects more than two items, accounting equation will balance. For example, goods costing Rs.10,000 is sold for Rs.12,000. Here, cost of goods reduces stock by Rs.10,000, sales will increase cash by 12,000 but profit of Rs.2,000 will increase capital by Rs.2,000. On the other hand, loss will reduce the capital of the owner.

VERY SHORT ANSWER QUESTION

1. **What is an accounting equation ?**

   Ans : An accounting equation is a formula of accounting which shows that the assets of a business are always equal to the total of capital and liabilities
2. **Give fundamental accounting equation.**

   Ans : Assets=Liabilities + Capital
3. **If the Capital of a business is Rs 5,00,000 and Outside liabilities are Rs 2,00,000 calculate total asset of the business**

   Ans: Total Assets Rs 7,00,000
4. **If total assets of business is Rs 10,00,000 and is Rs 4,00,000 ,calculate creditors**

   AnsCreditors Rs 6,00,000
5. **'X' commenced business on 1st April , 2013 with a capital of Rs 6,00,000 on 31st March , 2014 his assets were worth Rs 8,00,000 and liabilities Rs 50,000 . find out his closing capital and profits earned during the year .**

   Ans: Closing capital Rs 7,50,000 ; Profit Rs 1,50,000..
6. **What is debit ?**

   Ans: when an amount is entered on the left –hand side of an account , it is a debit and the account is said to be debited
7. **What is credit?**

   Ans :. When an amount is entered on the right –hand side of an account , it is a credit and the amount is side to be credited .
8. **Why are the rules of debit and credit same for both liability and capital?**

   Ans: Because according to business entity concept capital is also treated as liability of the business .
9. **Name the side on which increase in capital is recorded**

   Ans: Credit Side .