



# Chapter – 6

# ACCOUNTING

# EQUATIONS

## **ACCOUNTING EQUATION**

Accounting equation signifies that the assets of a business are always equal to the total of its liabilities and capital (owner's equity). The equation reads as follows:

$$A = L + C$$

Where,

A = Assets

L = Liabilities

C = Capital

The above equation can also be presented in the following forms as its derivatives to enable the determination of missing figures of Capital (C) or Liabilities (L).

(i)  $A - L = C$

(ii)  $A - C = L$

Since, the accounting equation depicts the fundamental relationship among the components of the balance sheet; it is also called the Balance Sheet Equation. As the name suggests, the balance sheet is a statement of assets, liabilities and capital. At any point of time resources of the business entity must be equal to the claims of those who have financed these resources. The proprietors and outsiders provide the resources of the business. The claim of the proprietors is called capital and that of the outsiders is known as liabilities. Each element of the equation is the part of balance sheet, which states the financial position of the business on a particular date. When we analyse the transactions, we actually try to know that how balance sheet of a business entity gets affected.

Asset side of the balance sheet is the list of assets, which the business entity owns. The liabilities side of the balance sheet is the list of owner's claims and outsider's claims, i.e., what the business entity owes. The equality of the assets side and the liabilities side of the balance sheet is an undeniable fact and this justifies the name of accounting equation as balance sheet equation also.

## **USING DEBIT AND CREDIT**

Every transaction involves give and take aspect. In double entry accounting, every transaction affects and is recorded in at least two accounts. When recording each transaction, the total amount debited must equal to the total amount credited. In accounting, the terms — debit and credit indicate whether the transactions are to be recorded on the left hand side or right hand side of the account. In its simplest form, an account looks like the letter T. Because of its shape, this simple form called a T-account. In a T account, the left side is called debit (often abbreviated as Dr.) and the right side is known as credit (often abbreviated as Cr.). To enter amount on the left side of an account is to debit the account. To enter amount on the right side is to credit the account.

### **Account Title**

(Left Side)

(Right Side)

## **RULES OF DEBIT AND CREDIT**

All accounts are divided into five categories for the purposes of recording the transactions: (a) Asset (b) Liability (c) Capital (d) Expenses/Losses, and (e) Revenues/Gains.

Two fundamental rules are followed to record the changes in these accounts:

(1) For recording changes in Assets/Expenses (Losses):

(i) “Increase in asset is debited, and decrease in asset is credited.”

(ii) “Increase in expenses/losses is debited, and decrease in expenses/ losses is credited.”

(2) For recording changes in Liabilities and Capital/Revenues (Gains):

(i) “Increase in liabilities is credited and decrease in liabilities is debited.”

(ii) “Increase in capital is credited and decrease in capital is debited.”

(iii) "Increase in revenue/gain is credited and decrease in revenue/gain is debited."

### Assets Account

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(Increase) + Debit

(Decrease) – Credit

### Capital Account

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(Decrease) - Debit

(Increase) + Credit

### Revenue / Gains

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(Decrease) - Debit

(Increase) + Credit

### Liabilities

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(Decrease) - Debit

(Increase) + Credit

### Expenses / Losses

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(Increase) + Debit

(Decrease) – Credit