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शक्तिउत्थानआश्रमलखीसरायबिहार

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Recording of Transactions-I

3.2 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 outsides 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.

For example, Rohit started business with a capital of Rs. 5,00,000. From the accounting point of view, the resources of this business entity is in the form of cash, i.e., Rs. 5,00,000. Sources of this business entity is the contribution by Rohit (Proprietor) Rs. 5,00,000 as Capital .

(For the purpose of understanding we will refer this example as example 1, throughout the chapter) .

If we put this information in the form of equality of resources and sources, the picture would emerge somewhat as follows:

Books of Rohit
Balance Sheet as at ....

Liabilities	*Amount Rs.*	*Assets*	*Amount Rs.*
Capital	5,00,000	Cash in hand	5,00,000
	5,00,000		5,00,000

In the above balance sheet, the total assets are equal to the liabilities of the business. Since, the business has not yet started its activities and has not earned any profits; the amount invested in business is still Rs. 5,00,000. In case any profits are earned, it will increase the invested amount in business. On the other hand, if business suffers any losses, it will decrease the invested amount in business.

We will now analyse the transactions listed in example 1 and its effect on different elements and you will observe that the accounting equation always remain balanced:

Example 1.

1. Opened a bank account in State Bank of India with an amount of Rs. 4,80,000.

   Analysis of transaction: This transaction increases the cash at bank (assets) and decreases cash (asset) by Rs. 4,80,000.

2. Bought furniture for Rs. 60,000 and cheque was issued on the same day.

   Analysis of transaction: This transaction increases furniture (assets) and decreases bank (assets) by Rs. 60,000.

3. Bought plant and machinery for the business for Rs. 1,25,000 and an advance of Rs. 10,000 in cash is paid to M/s Ramjee Lal.

   Analysis of transaction: This transaction increases plant and machinery (assets) by Rs. 1,25,000, decreases cash by Rs. 10,000 and increases liabilities (M/s Ramjee lal as creditor) by Rs. 1,15,000.

4. Goods purchased from M/s Sumit Traders for Rs. 55,000.

   Analysis of transaction: This transaction increases goods (assets) and increases liabilities (M/s Sumit Traders as creditors) by Rs. 55,000.

5. Goods costing Rs. 25,000 sold to Rajani Enterprises for Rs. 35,000.

   Analysis of transaction: This transaction decreases stock of goods (assets) by Rs. 25,000 and increases assets (Rajani Enterprises as debtors Rs. 35,000) and capital (with the profit of Rs. 10,000)

The final equation as per the above analysis table can be summarised in the form of a balance sheet as under:

Balance Sheet as at.....2017

Liabilities	*Amount Rs.*	*Assets*	*Amount Rs.*
Outsider's Claims (Creditors)	1,70,000	Cash	10,000
Capital	5,10,000	Bank	4,20,000
		Debtors	35,000
		Stock	30,000
		Furniture	60,000
		Plant & Machinery	1,25,000
	6,80,000		6,80,000

In terms of accounting equation

$A = L + C$

Rs. 6,80,000 = Rs. 1,70,000 + Rs. 5,10,000