

Accounting Equation

Recording of business transactions in books of account is based on a fundamental equation called Accounting Equation.

As an asset is introduced in business, a corresponding liability also emerges. We consider it as liability because assets are financed by proprietor or by outsiders.

$$\text{Assets} = \text{Equity}$$

$$\text{Equity} = \text{Liabilities} + \text{Capital}$$

Increase/decrease in capital will result in corresponding increase/decrease in assets.

$$\text{Assets} = \text{Capital}$$

Or

$$\text{Capital} = \text{Assets}$$

Expenses and Revenue also affect the accounting equation. Their effect is always on capital account.

$$\text{Assets} = \text{Liabilities} + \text{Capital} \text{ Or } A = L + C$$

Or

$$\text{Liabilities} = \text{Assets} - \text{Capital} \text{ Or } L = A - C$$

Or

$$\text{Capital} = \text{Assets} - \text{Liabilities} \text{ Or } C = A - L$$

Rules of Accounting

Using Debit and Credit

Both aspects of transaction are recorded in double Entry accounting. While recording each transaction, total amount debited must be equal to total amount credited. The terms 'Debit' and 'Credit' indicate whether transaction is to be recorded on left or right hand side of account. In its simplest form, an account looks like English Language Letter 'T'. This helps in ascertaining ultimate

position of each item at end of an accounting period.

'T' account

- Left side is called debit (usually abbreviated as Dr.)

- Right side is known as credit (usually abbreviated Cr.)



Image of Specimen of T-Account

Rules of Accounting

All accounts are divided into five categories for purpose of recording of business transactions.

1. Assets
2. Liability
3. Capital
4. Expenses/Losses
5. Revenues/Gains

Two Fundamental Rules are followed to record changes in these accounts

1. For recording changes in Assets/Expenses/Losses

“Increase in Asset is debited, and decrease in Asset is credited.”

“Increase in Expenses/Losses is debited, & decrease in Expenses/Losses are credited.”

2. For recording changes in Liabilities and Capital/Revenue/Gains

“Increase in Liabilities is credited and decrease in Liabilities is debited.”

“Increase in Capital is credited and decrease in Capital is debited.”

“Increase in revenue/gains is credited and decrease in revenue/gain is debited”

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Assets	
(Increase) + Debit	(Decrease) - Credit

Capital	
(Decrease) - Debit	(Increase) + Credit

Revenue/Gains	
(Decrease) - Debit	(Increase) + Credit

liabilities	
(Decrease) - Debit	(Increase) + Credit

Expenses/Losses	
(Increase) + Debit	(Decrease) - Credit

Image of Rules of Accounting