

CHAPTER FOUR

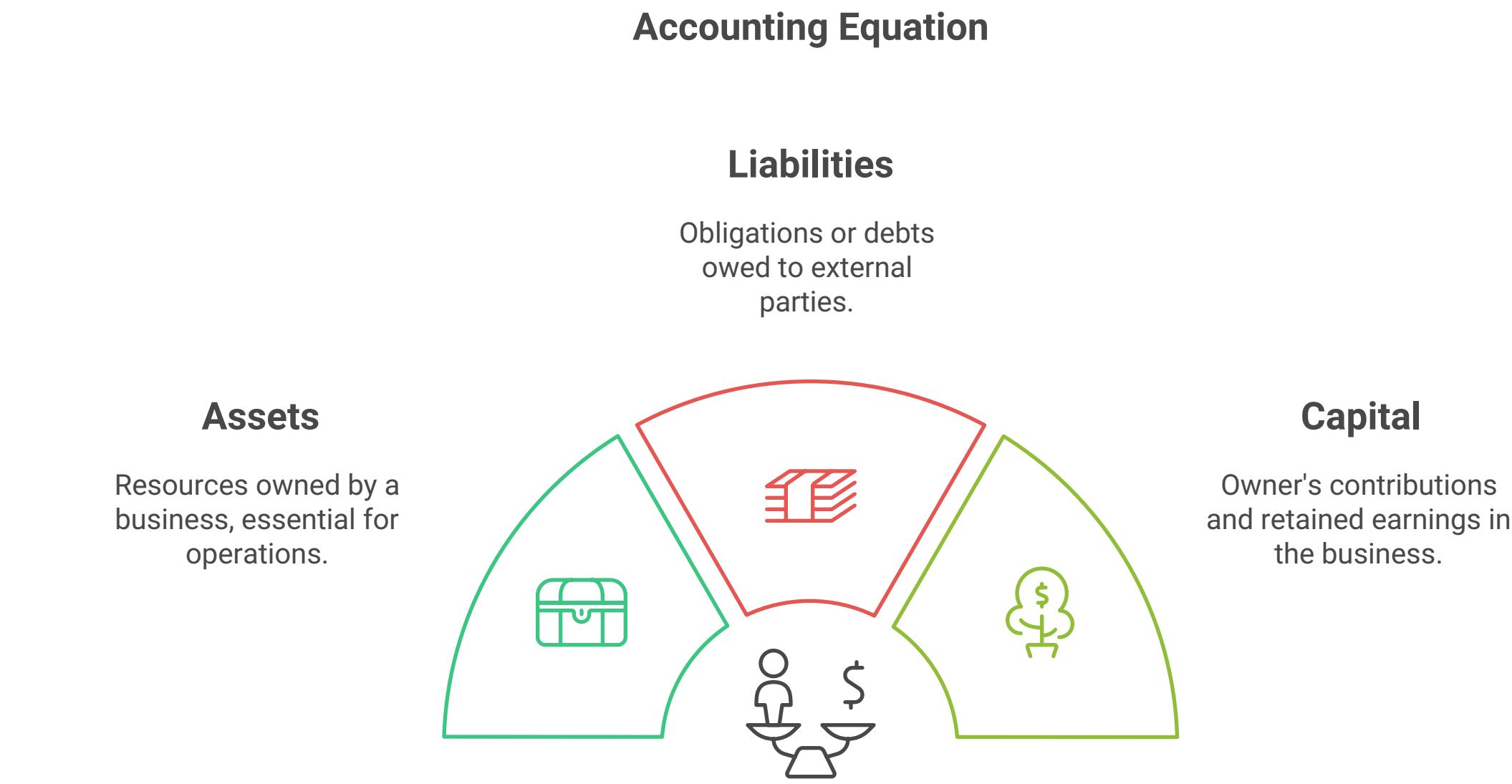
ACCOUNTING EQUATION

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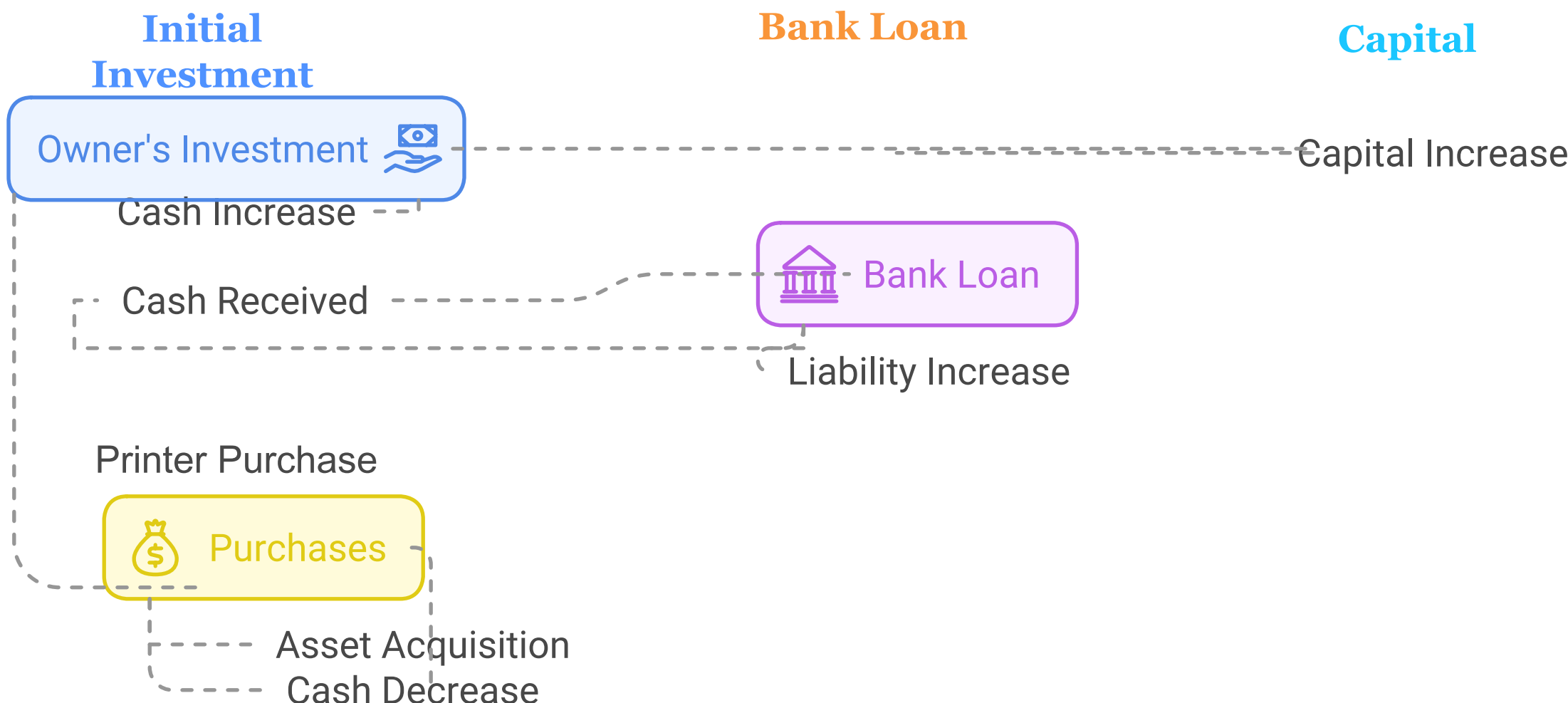
THE ACCOUNTING EQUATION

The accounting equation (how it stays in balance) is the unifying concept in accounting that shows the relationships between and among the accounting elements: assets, liabilities, and capital. Before taking this lesson, be sure to be familiar with the accounting elements. 4.1 Basic Accounting Equation The basic accounting equation is: Assets = Liabilities + Capital When a business is put up, its resources (assets) come from two sources: contributions by owners (capital) and those acquired from creditors or lenders (liabilities). In other words, all assets initially come from liabilities and owners' contributions. As business transactions take place, the values of the accounting elements change. The accounting equation nonetheless always stays in balance. Every transaction has a two-fold effect. Meaning, at least two accounts are affected. Let's illustrate all of that through these examples.



4.1.1 Accounting Equation Illustration Assume the following transactions: How will the transactions affect the accounting equation

Financial Transactions in Mr. Esmael's Business



1. 1. Owner's investment 20,000.00 = + 20,000.00 Again, every transaction has a two-fold effect. In the above transaction, Assets increased as a result of the increase in Cash. At the same time, Capital increased due to the owner's contribution. Remember that capital is increased by contribution of owners and income, and is decreased by withdrawals and expenses. No liability is affected hence, stays at zero. Let's continue with transaction

1. #2: Transaction Assets = Liabilities + Capital 1. Owner's investment 20,000.00 = + 20,000.00 2. Loan from bank 30,000.00 = 30,000.00 +CHAPTER FOUR Gerar Isaac Training CenterIn transaction #2,

1. The company received cash. Thus, the value of total assets is increased. At the same time, it incurred in an obligation to pay the bank. Therefore, liabilities are increased. The liability in this case is recorded as Loans Payable.❖ Notice that the accounting equation is still equal (balanced). Let's add transaction #3: Transaction Assets = Liabilities + Capital

1. ❖ Notice that the accounting equation is still equal (balanced). Let's add transaction #3: Transaction Assets = Liabilities + Capital

1. 1. Owner's investment 20,000.00 = + 20,000.00 2. Loan from bank 30,000.00 = 30,000.00 + 3. Purchased printers 1,000.00 [1,000.00] = + The company acquired printers, hence, an increase in assets. However, the company used cash to pay for the printers. Thus, it also results in a decrease in assets. Transaction #3 results in an increase in one asset [Service Equipment] and a decrease in another asset [Cash].For those who are new to accounting format:

1. ❖ The parentheses "(")" around the 1,000 amount above means "minus" or "less". . Liabilities and capital were not affected in transaction 1. #3. Still, the equation in this transaction is equal. It resulted to a zero effect in both sides.At this point, the balance of total assets is \$50,000. The combined balance of liabilities and capital is also at \$50,000.

1. As illustrated above, the accounting equation is (and should always be) in balance. Here are some more examples below you could study:

- 1. 4.1.2 Accounting equation: Examples and explanation Here are more examples to further illustrate how the accounting equation works. Below are additional transactions following example OF Mr. Esmael in the previous lesson:
- 1. 1. Invested \$20,000 to start a printing business,
- 1. 2. Obtained a loan from a bank, \$30,000
- 1. 3. Purchased printers and paid a total of \$1,000.
- 1. 4. Rendered services and received the full amount in cash, \$500
- 1. 5. Rendered services on account, i.e., receivable from customer, \$750
- 1. 6. Purchased office supplies on account, i.e., payable to supplier, \$200
- 1. 7. Had some equipment repaired for \$400, to be paid after 15 days
- 1. 8. Mr. Alex, the owner, withdrew \$5,000 cash for personal use
- 1. 9. Paid one-third of the loan obtained in transaction #2
- 1. 10. Received customer payment from services in transaction #5
- 1. 11. Paid electric bill birr 150.

