Accounting Equations

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The fundamental "rule" of the accounting equation is that Assets must always equal Liabilities plus Owner's Equity (A = L + OE). This equation must remain balanced after every business transaction. For every entry on one side, there must be a corresponding entry on the other side to maintain the balance, forming the basis of the double-entry bookkeeping system.

Here's a breakdown of the components:

- **Assets:** Resources a business owns, such as cash, inventory, and equipment.
- **Liabilities:** What a business owes to others, like loans and bills payable.
- **Owner's Equity:** The owner's stake in the business, comprising initial investments and accumulated retained earnings.

How the Equation is Applied (The Rule in Action)

The equation ensures that all financial transactions are accurately recorded by showing how a company's assets are funded:

- **Assets are funded by liabilities (borrowed money) or equity (owner's contributions/retained earnings)** .
- **For every transaction, the equation remains in balance** . For example, if a business acquires a new asset (like equipment), it must be financed either by taking on a new debt (increasing liabilities) or by using the owner's cash (decreasing cash, an asset, but increasing equity if an owner's investment).

- ## How it works with real-world example

- Let's understand these fundamentals through some real-world examples.
  Example 1: Purchasing Equipment with Cash

Imagine you run a small coffee shop and decide to buy a new espresso machine for 70,000 using cash from your business bank account.
Here's how this affects the accounting equation:
Assets: The transaction causes two changes within your assets. Your Equipment (an asset) increases by 70,000. At the same time, your Cash (another asset) decreases by 70,000.
Liabilities & Equity: There is no change to your liabilities or equity.
The equation remains perfectly balanced because one asset went up while another went down by the exact same amount.
Before: Assets (Rs 50,000) = Liabilities (Rs 10,000) + Equity (Rs 40,000)
Transaction: +70,000 Equipment, -70,000 Cash
After: Assets (Rs 50,000) = Liabilities (Rs 10,000) + Equity (Rs 40,000)

Accounting equation rules

The accounting equation connotes two equations that are basic and core to accrual accounting and double-entry accounting system.
The following are two basic rules of accounting equation that distinguishes the accrual system of accounting from cash basis accounting, and single-entry system from the double-entry system:

- The first among them is the basic accounting equation which written as **Assets = Liabilities + Equities.**
- The second one is termed as '**Expanded Accounting Equation**' which is a combination of the basic equation and secondary equation i.e. **Debit = Credit**.

It derives its status only from the accrual system of accounting and thereby, it does not apply in a cash-based, single-entry accounting system.

How the accounting equation connects to financial statements

The accounting equation forms the foundation for key financial reports like the Balance Sheet and Income Statement.
Balance Sheet:
The Balance Sheet is essentially a snapshot of the equation.

It is pertinent to note that the term basic accounting equation is another name for the 'Balance Sheet Equation'. The reason balance sheet always balances is because of the following equation:

Assets = Liabilities + Equity.

It shows what the business owns and owes at a specific point in time. The ingredients of this equation - Assets, Liabilities, and Owner's equities are the three major sections of the Balance sheet. By using the above equation, the bookkeepers and accountants ensure that the "balance" always holds i.e., both sides of the equation are always equal.

Income Statement:

The Income Statement links to equity by tracking revenues and expenses over time. The expanded equation looks like this:

Assets = Liabilities + (Capital + Revenue – Expenses).

As the business earns or spends money, equity is adjusted accordingly.

This connection helps you see how daily transactions feed into larger reports that guide decision-making and growth.

What are the limitations of the accounting equation?

Accounting equation comes with its own limitations. To begin with, it doesn't provide an analysis of how the business is operating.

Furthermore, it doesn't totally keep accounting mistakes from being made. In any event, when the balance sheet report adjusts itself, there is still a chance of a mistake that doesn't include the accounting equation.

What happens if the equation doesn't balance?

It indicates an error in recording or calculation. This must be corrected to maintain accurate financial statements and ensure complianc