

## Learning Concept:

- (a) **Meaning of Accounting Equation**
- (b) **Assets = Liabilities + Capital**
- (c) **Format of Accounting Equation**

## Meaning of Accounting Equation

An accounting equation is a mathematical equation which shows that the assets and liabilities (outside liability and capital) of a firm are equal.

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

Chapter - 2 Basic Accounting Terms [Part - 1 & 2]

# (1) Assets



Cash, Bank, Stock, Furniture, Debtors, Shares,  
Prepaid Expenses, Accrued Income, Building,  
Machinery, Computer, Investment, etc.



## (2) Liabilities



Creditors, Outstanding Expenses, Bank Loan, Unearned Income (Advance Income), etc.



### (3) Capital

```
graph TD; A["(3) Capital"] --> B["Increases"]; A --> C["Decreases"]; B --> D["- Introduction of Capital<br/>- Profit/Income/Revenue"]; C --> E["- Drawings<br/>- Loss/Expense"]; D --> F["Sales, Commission Rec.,<br/>Rent Rec., Dividend Rec.,<br/>Discount Rec., Interest Rec."]; E --> G["Cartage, Rent Paid, Wages Paid,<br/>Commission Paid, Depreciation,<br/>Discount Allowed, Interest Paid"];
```

#### **Increases**

- Introduction of Capital
- Profit/Income/Revenue

Sales, Commission Rec.,  
Rent Rec., Dividend Rec.,  
Discount Rec., Interest Rec.

#### **Decreases**

- Drawings
- Loss/Expense

Cartage, Rent Paid, Wages Paid,  
Commission Paid, Depreciation,  
Discount Allowed, Interest Paid

# Capital

Introduction of  
Capital

Add

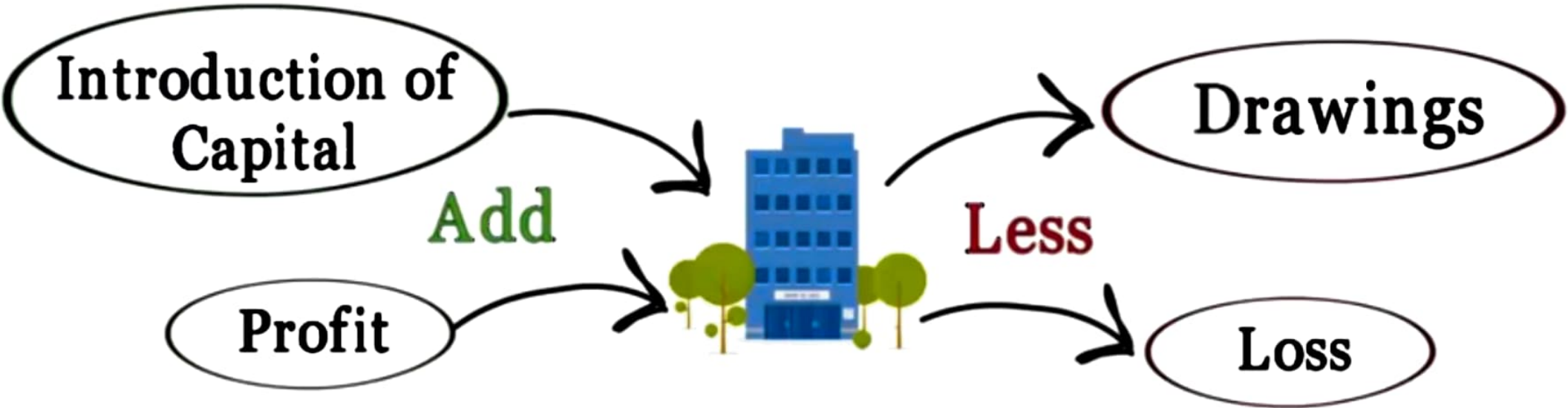
Profit



Less

Drawings

Loss



# CLEAR

C ✓  
L  
E ✓  
A  
R ✓

- Capital {Capital + Revenue - Expenses}
- Liability
- Expenses & Losses
- Assets
- Revenue/Income/Profit



# Format of Accounting Equation

## Accounting Equation

S. No.	Transaction	Assets	= Liabilities	+ Capital



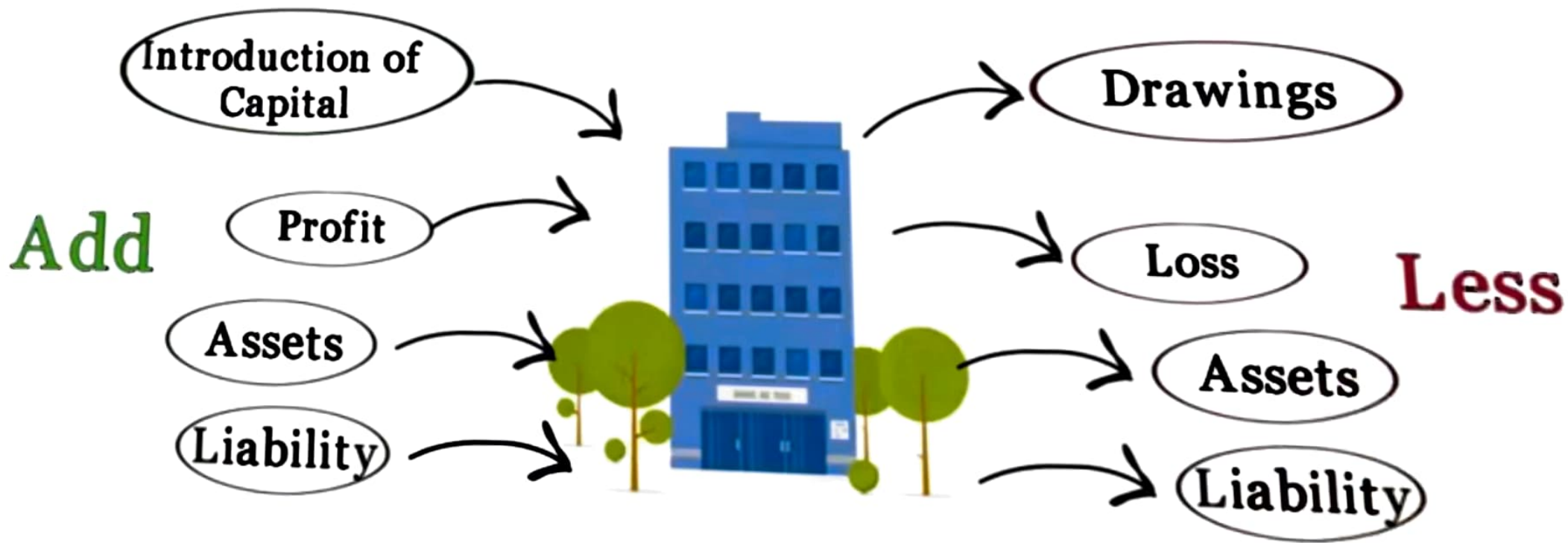
## Question - 1.

Show the accounting equation on the basis of the following transactions and prepare a balance sheet on the basis of last equation:

1. John started business with cash Rs. 40,000.
2. Purchase goods on Credit Rs. 15,000.
3. Purchased furniture for cash Rs. 10,000.
4. Paid rent Rs. 300 and salary Rs. 700.
5. Sold goods costing Rs. 12,000 on credit Rs. 15,000.
6. Paid to creditors Rs. 8,500.
7. Received Interest Rs. 1,500.
8. Withdrew cash for private use Rs. 4,000
9. Bought goods from Ram for Rs. 8,000 and paid Rs. 5,000 immediately.

## Process of Accounting Equation

- Step - 1 Analyse the transaction to ascertain to which variable of accounting equation it affects by using CLEAR.
- Step - 2 Decide the effect of transaction on components of accounting equation i.e.,  
whether they will increase or decrease asset, liability and capital.
- Step - 3 Finally, record the effect on accounting equation in monetary terms.



## Question - 1.

Show the accounting equation on the basis of the following transactions and prepare a balance sheet on the basis of last equation:

1. John started business with cash Rs. 40,000.
2. Purchase goods on Credit Rs. 15,000.
3. Purchased furniture for cash Rs. 10,000.
4. Paid rent Rs. 300 and salary Rs. 700.
5. Sold goods costing Rs. 12,000 on credit Rs. 15,000.
6. Paid to creditors Rs. 8,500.
7. Received Interest Rs. 1,500.
8. Withdrew cash for private use Rs. 4,000
9. Bought goods from Ram for Rs. 8,000 and paid Rs. 5,000 immediately.

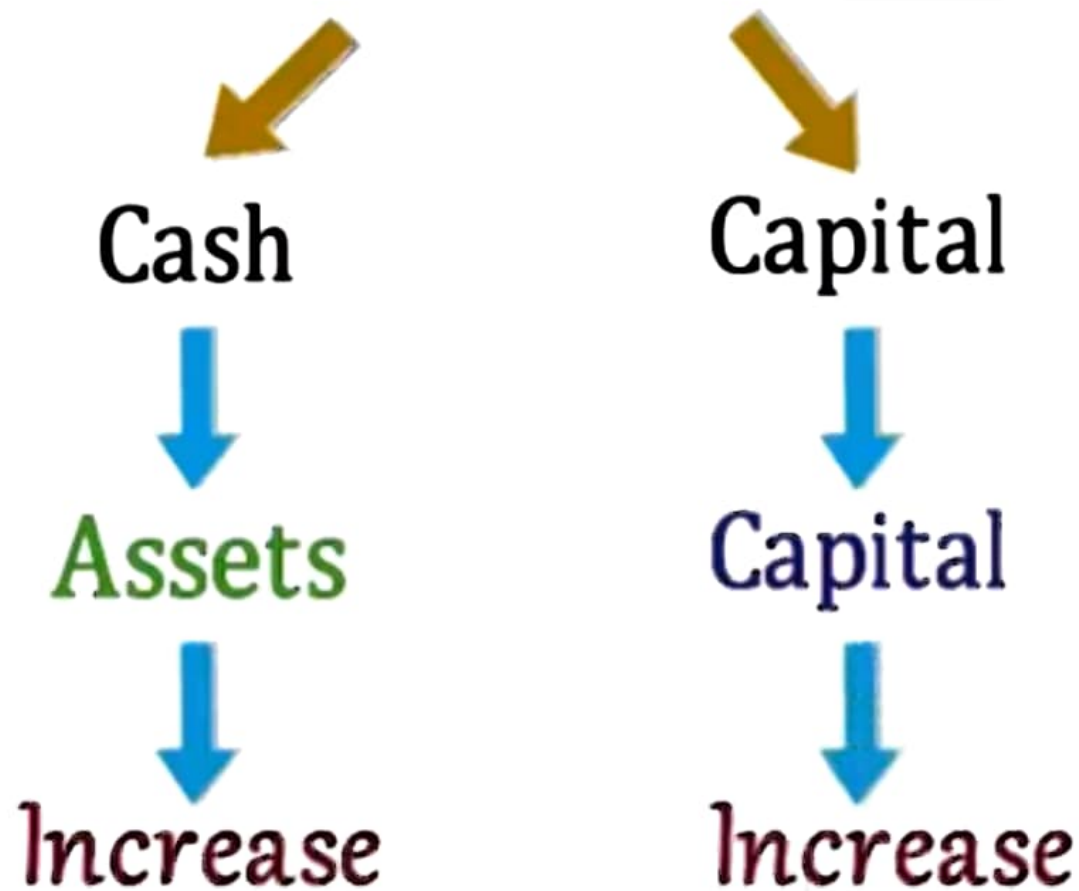
Solution

### Accounting Equation of Mohan

S. No.	Transactions	Assets	= Liabilities + Capital

1. John started business with cash Rs. 40,000.

CLEAR



## Solution

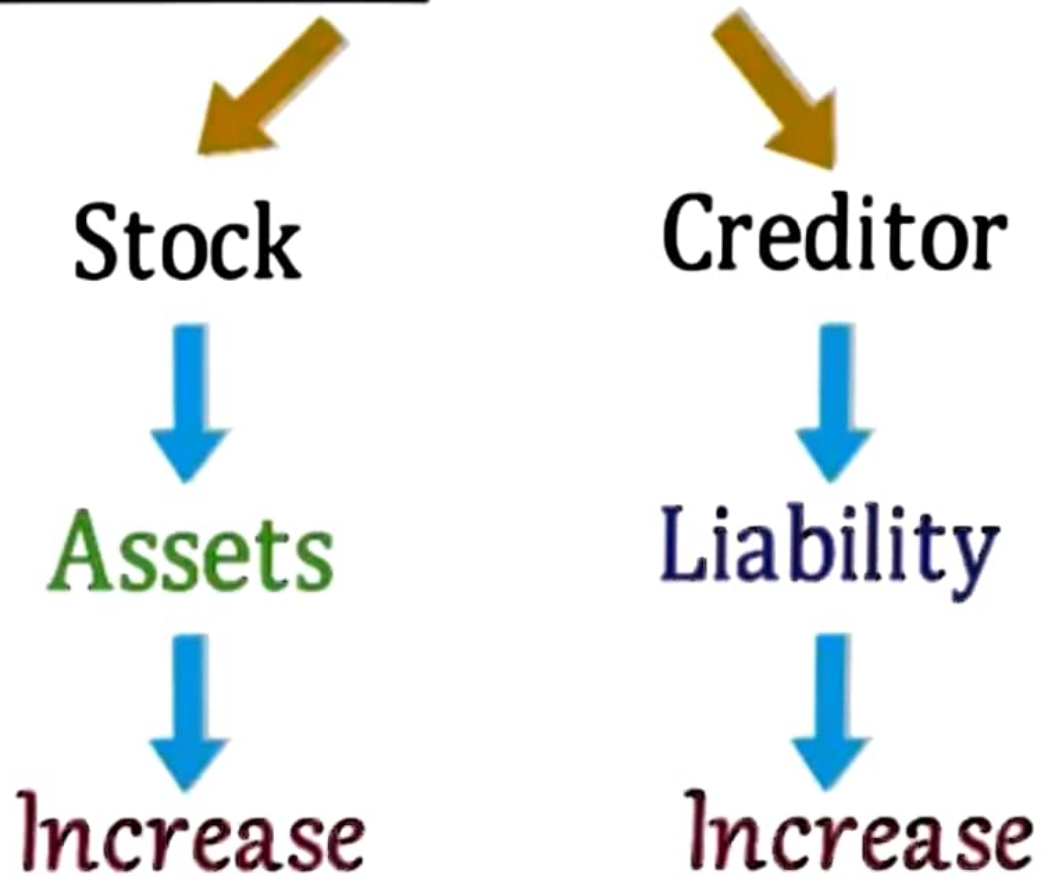
### Accounting Equation of Mohan

S. No.	Transactions	Assets	=	Liabilities + Capital
		Cash	=	+ Capital
1.	Started Business with Cash	40,000	=	+ 40,000



2. Purchase goods on Credit Rs. 15,000.

CLEAR



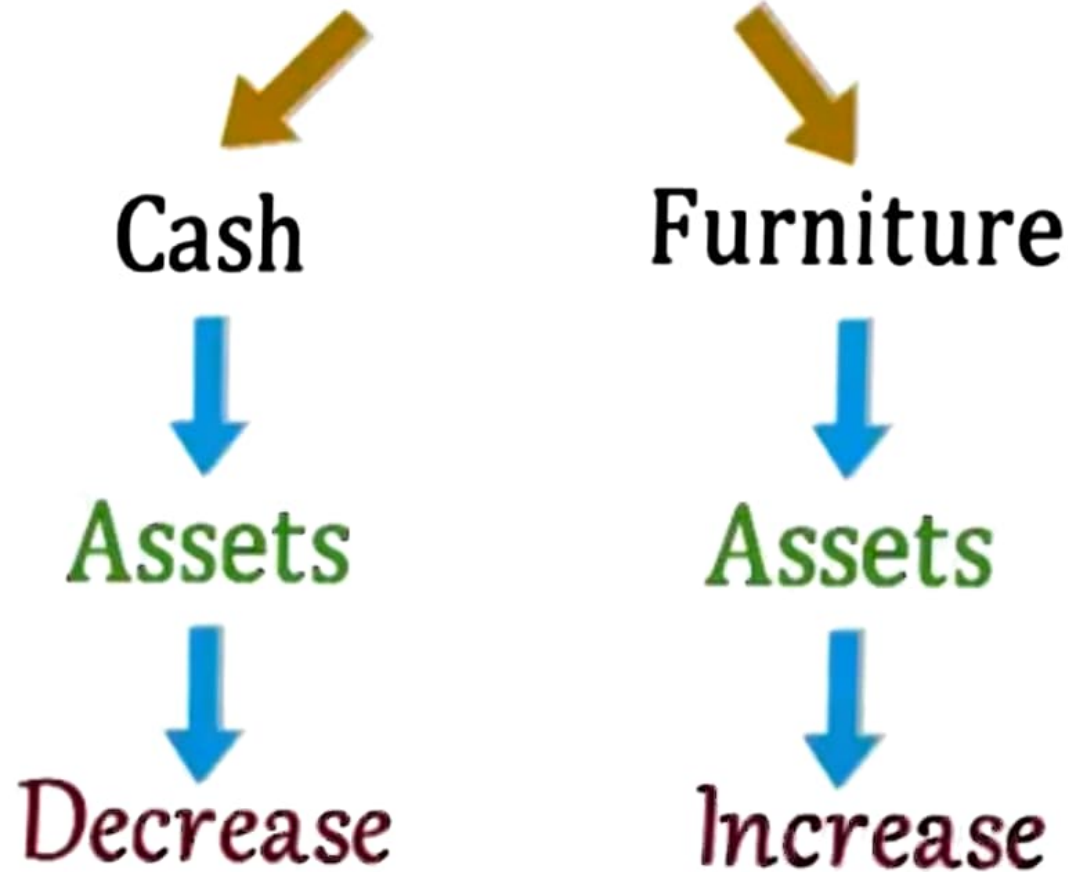
## Solution

### Accounting Equation of Mohan

S. No.	Transactions	Assets	= Liabilities + Capital	
		Cash + Stock	= Creditors	+ Capital
1.	Started Business with Cash	40,000	=	+ 40,000
2.	Purchase goods on credit	0 + 15,000	=	15,000 + 0
	<b>New Equation</b>	40,000 + 15,000	=	15,000 + 40,000

3. Purchased furniture for cash Rs. 10,000.

**CLEAR**



## Solution

### Accounting Equation of Mohan

S. No.	Transactions	Assets		= Liabilities + Capital	
		Cash	Stock + Furniture	= Creditors	+ Capital
1.	Started Business with Cash	40,000		=	+ 40,000
2.	Purchase goods on credit	0	+ 15,000	=	15,000 + 0
	<b>New Equation</b>	40,000	+ 15,000	=	15,000 + 40,000
3.	Purchase furniture	- 10,000	+ 0 + 10,000	=	0 + 0
	<b>New Equation</b>	30,000	+ 15,000 + 10,000	=	15,000 + 40,000

4. Paid rent Rs. 300 and salary Rs. 700.

**CLEAR**

Cash

Expense

Assets

Capital

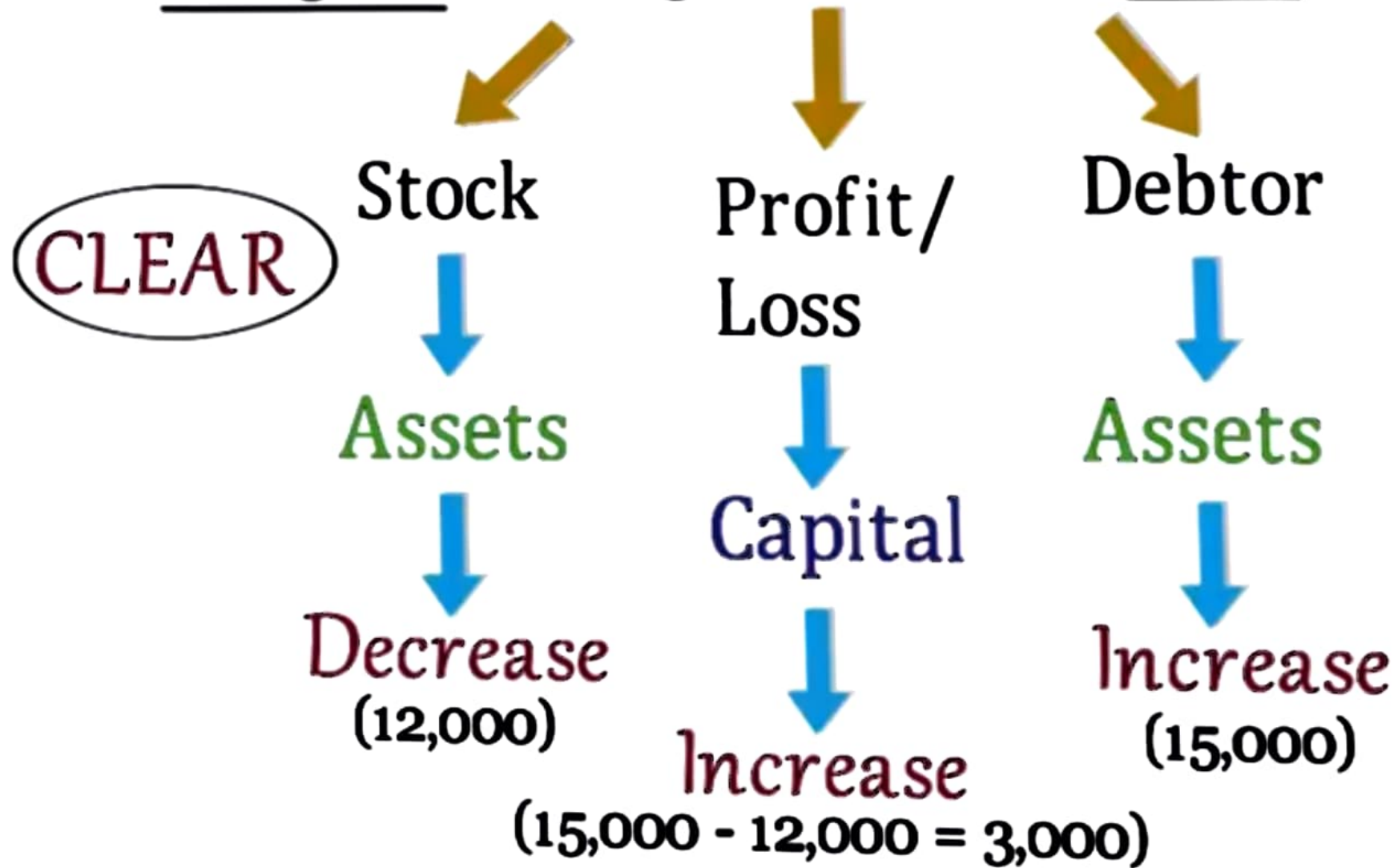
Decrease

Decrease

## Accounting Equation of Mohan

S. No.	Transactions	Assets	= Liabilities + Capital	
		Cash + Stock + Furniture	= Creditors	+ Capital
1.	Started Business with Cash	40,000	=	+ 40,000
2.	Purchase goods on credit	0 + 15,000	=	15,000 + 0
	New Equation	40,000 + 15,000	=	15,000 + 40,000
3.	Purchase furniture	- 10,000 + 0 + 10,000	=	0 + 0
	New Equation	30,000 + 15,000 + 10,000	=	15,000 + 40,000
4.	Paid rent and salary	- 1,000 + 0 + 0	=	0 - 1,000
	New Equation	29,000 + 15,000 + 10,000	=	15,000 + 39,000

5. Sold goods costing Rs. 12,000 on credit Rs. 15,000.





## Accounting Equation of Mohan

S. No.	Transactions	Assets		= Liabilities + Capital	
		Cash + Stock + Furniture + Debtors		Creditors	+ Capital
1.	Started Business with Cash	40,000		=	+ 40,000
2.	Purchase goods on credit	0	+ 15,000	=	15,000 + 0
	<b>New Equation</b>	40,000	+ 15,000	=	15,000 + 40,000
3.	Purchase furniture	- 10,000	+ 0 + 10,000	=	0 + 0
	<b>New Equation</b>	30,000	+ 15,000 + 10,000	=	15,000 + 40,000
4.	Paid rent and salary	- 1,000	+ 0 + 0	=	0 - 1,000
	<b>New Equation</b>	29,000	+ 15,000 + 10,000	=	15,000 + 39,000
5.	Sold goods on credit	0	- 12,000 + 0 + 15,000	=	0 + 3,000
	<b>New Equation</b>	29,000	+ 3,000 + 10,000 + 15,000	=	15,000 + 42,000

6. Paid to creditors Rs. 8,500.



Cash

Creditors



Assets

Liability



Decrease

Decrease

CLEAR

3.	Purchase furniture	- 10,000	+ 0	+ 10,000	=	0	+ 0	
	<b>New Equation</b>	30,000	+ 15,000	+ 10,000	=	15,000	+ 40,000	
4.	Paid rent and salary	- 1,000	+ 0	+ 0	=	0	- 1,000	
	<b>New Equation</b>	29,000	+ 15,000	+ 10,000	=	15,000	+ 39,000	
5.	Sold goods on credit	0	- 12,000	+ 0	+ 15,000	=	0	+ 3,000
	<b>New Equation</b>	29,000	+ 3,000	+ 10,000	+ 15,000	=	15,000	+ 42,000
6.	Paid to Creditors	- 8,500	+ 0	+ 0	+ 0	=	- 8,500	+ 0
	<b>New Equation</b>	20,500	+ 3,000	+ 10,000	+ 15,000	=	6,500	+ 42,000

7. Received Interest Rs. 1,500.



Cash



Revenue

CLEAR



Assets



Capital



Increase



Increase

3.	Purchase furniture	- 10,000	+ 0	+ 10,000	=	0	+ 0	
	<b>New Equation</b>	30,000	+ 15,000	+ 10,000	=	15,000	+ 40,000	
4.	Paid rent and salary	- 1,000	+ 0	+ 0	=	0	- 1,000	
	<b>New Equation</b>	29,000	+ 15,000	+ 10,000	=	15,000	+ 39,000	
5.	Sold goods on credit	0	- 12,000	+ 0	+ 15,000	=	0	+ 3,000
	<b>New Equation</b>	29,000	+ 3,000	+ 10,000	+ 15,000	=	15,000	+ 42,000
6.	Paid to Creditors	- 8,500	+ 0	+ 0	+ 0	=	- 8,500	+ 0
	<b>New Equation</b>	20,500	+ 3,000	+ 10,000	+ 15,000	=	6,500	+ 42,000
7.	Interest received	+ 1,500	+ 0	+ 0	+ 0	=	0	+ 1,500
	<b>New Equation</b>	22,000	+ 3,000	+ 10,000	+ 15,000	=	6,500	+ 43,500

8. Withdrew cash for private use Rs. 4,000

**CLEAR**

Cash

Drawings

Assets

Capital

Decrease

Decrease

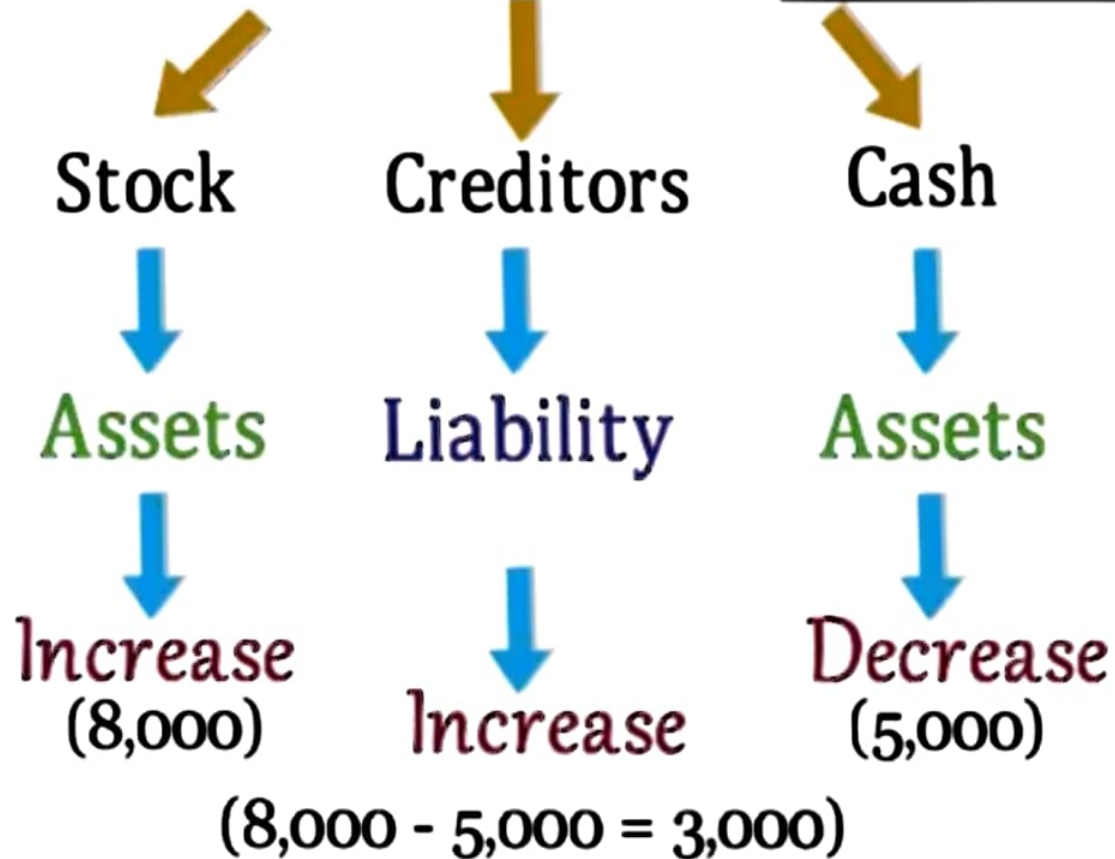


5.	Sold goods on credit	0	- 12,000	+ 0	+ 15,000	= 0	+ 3,000
	<b>New Equation</b>	29,000	+ 3,000	+ 10,000	+ 15,000	= 15,000	+ 42,000
6.	Paid to Creditors	- 8,500	+ 0	+ 0	+ 0	= - 8,500	+ 0
	<b>New Equation</b>	20,500	+ 3,000	+ 10,000	+ 15,000	= 6,500	+ 42,000
7.	Interest received	+ 1,500	+ 0	+ 0	+ 0	= 0	+ 1,500
	<b>New Equation</b>	22,000	+ 3,000	+ 10,000	+ 15,000	= 6,500	+ 43,500
8.	Withdrew cash for private use	- 4,000	+ 0	+ 0	+ 0	= 0	- 4,000
	<b>New Equation</b>	18,000	+ 3,000	+ 10,000	+ 15,000	= 6,500	+ 39,500



9. Bought goods from Ram for Rs. 8,000 and paid Rs. 5,000 immediately.

CLEAR



	<b>New Equation</b>	29,000 + 15,000 + 10,000	=	15,000	+ 39,000
5.	Sold goods on credit	0 - 12,000 + 0	+ 15,000	= 0	+ 3,000
	<b>New Equation</b>	29,000 + 3,000 + 10,000	+ 15,000	= 15,000	+ 42,000
6.	Paid to Creditors	- 8,500 + 0 + 0	+ 0	= - 8,500	+ 0
	<b>New Equation</b>	20,500 + 3,000 + 10,000	+ 15,000	= 6,500	+ 42,000
7.	Interest received	+ 1,500 + 0 + 0	+ 0	= 0	+ 1,500
	<b>New Equation</b>	22,000 + 3,000 + 10,000	+ 15,000	= 6,500	+ 43,500
8.	Withdrew cash for private use	- 4,000 + 0 + 0	+ 0	= 0	- 4,000
	<b>New Equation</b>	18,000 + 3,000 + 10,000	+ 15,000	= 6,500	+ 39,500
9.	Bought goods from Ram and paid cash	- 5,000 + 8,000 + 0	+ 0	= 3,000	+ 0
	<b>Final Equation</b>	13,000 + 11,000 + 10,000	+ 15,000	= 9,500	+ 39,500

## Solution

## Accounting Equation of Mohan

S. No.	Transactions	Assets				= Liabilities + Capital	
		Cash	Stock	Furniture	Debtors	= Creditors	+ Capital
1.	Started Business with Cash	40,000	+ 0	+ 0	+ 0	= 0	+ 40,000
2.	Purchase goods on credit	0	+ 15,000			= 15,000	+ 0
	<b>New Equation</b>	40,000	+ 15,000	+ 0	+ 0	= 15,000	+ 40,000
3.	Purchase furniture	- 10,000	+ 0	+ 10,000	+ 0	= 0	+ 0
	<b>New Equation</b>	30,000	+ 15,000	+ 10,000	+ 0	= 15,000	+ 40,000
4.	Paid rent and salary	- 1,000	+ 0	+ 0	+ 0	= 0	- 1,000
	<b>New Equation</b>	29,000	+ 15,000	+ 10,000	+ 0	= 15,000	+ 39,000
5.	Sold goods on credit	0	- 12,000	+ 0	+ 15,000	= 0	+ 3,000
	<b>New Equation</b>	29,000	+ 3,000	+ 10,000	+ 15,000	= 15,000	+ 42,000
6.	Paid to Creditors	- 8,500	+ 0	+ 0	+ 0	= - 8,500	+ 0
	<b>New Equation</b>	20,500	+ 3,000	+ 10,000	+ 15,000	= 6,500	+ 42,000
7.	Interest received	+ 1,500	+ 0	+ 0	+ 0	= 0	+ 1,500
	<b>New Equation</b>	22,000	+ 3,000	+ 10,000	+ 15,000	= 6,500	+ 43,500
8.	Withdrew cash for private use	- 4,000	+ 0	+ 0	+ 0	= 0	- 4,000
	<b>New Equation</b>	18,000	+ 3,000	+ 10,000	+ 15,000	= 6,500	+ 39,500
9.	Bought goods from Ram and paid cash	- 5,000	+ 8,000	+ 0	+ 0	= 3,000	+ 0
	<b>Final Equation</b>	13,000	+ 11,000	+ 10,000	+ 15,000	= 9,500	+ 39,500

# Balance Sheet

A Balance Sheet is a statement prepared with a view to measure the exact financial position of a business on a certain fixed date.

## Balance Sheet as at 31st March, .....

Liabilities	Amount	Assets	Amount

**Balance Sheet**  
as at 31st March, .....

<b>Liabilities</b>	<b>Amount</b>	<b>Assets</b>	<b>Amount</b>
Creditors	9,500	Cash	13,000
Capital	39,500	Stock	11,000
		Furniture	10,000
		Debtors	15,000
	<b>49,000</b>		<b>49,000</b>



# Outstanding Expense and Prepaid Expense.

## Outstanding Expense

Outstanding expenses are those expenses which have been incurred but not paid during the current accounting period.

Total Rent = Rs. 12,000

Rent Paid = Rs. 11,000

1 April,  
2019

Outstanding Rent = Rs. 1,000 (12,000 - 11,000)

31 March,  
2020

Total Rent = Rs. 12,000

Rent Paid = Rs. 11,000

1 April,  
2019

Outstanding Rent = Rs. 1,000 (12,000 - 11,000)

31 March,  
2020

Outstanding Rent = Rs. 1,000

Expense

Outstanding Expense

Capital (Less)

Liability (Show)



## Prepaid Expense

Prepaid expenses are those expenses which have been paid in advance, i.e., they are not yet due but paid.

Total Rent = Rs. 12,000

Rent Paid = Rs. 13,000

1 April,  
2019

Prepaid Rent = Rs. 1,000 (13,000 - 12,000)

31 March,  
2020

Total Rent = Rs. 12,000

Rent Paid = Rs. 13,000

1 April,  
2019

Prepaid Rent = Rs. 1,000 (13,000 - 12,000)

31 March,  
2020

Prepaid Rent = Rs. 1,000

Cash

Prepaid Expense

Less

Assets (Show)

# Accrued Income and Unearned Income

## Accrued Income

Accrued income is that income which has been earned but not received during the current accounting period.

Total Rent = Rs. 12,000

Rent Received = Rs. 11,000

↓  
1 April,  
2019

Accrued Rent = Rs. 1,000 (12,000 - 11,000)

↓  
31 March,  
2020

**Total Rent = Rs. 12,000**

**Rent Received = Rs. 11,000**

**1 April, 2019**      **Accrued Rent = Rs. 1,000 (12,000 - 11,000)**      **31 March, 2020**

**Accrued Rent = Rs. 1,000**

**Income**

**Accrued Income**

**Capital (Add)**

**Assets (Show)**

## Unearned Income or Income Received in Advance

Unearned income is that income which has been received but not earned during the current accounting period.

Total Rent = Rs. 12,000

Rent Received = 13,000

1 April,  
2019

Unearned Rent = 1,000 (13,000 - 12,000)

31 March,  
2020

**Total Rent = Rs. 12,000**

**Rent Received = 13,000**

**1 April, 2019**      **Unearned Rent = 1,000 (13,000 - 12,000)**      **31 March, 2020**

**Unearned Rent = Rs. 1,000**

**Cash**

**Unearned Income**

**Add**

**Liability (Show)**

## Question - 2.

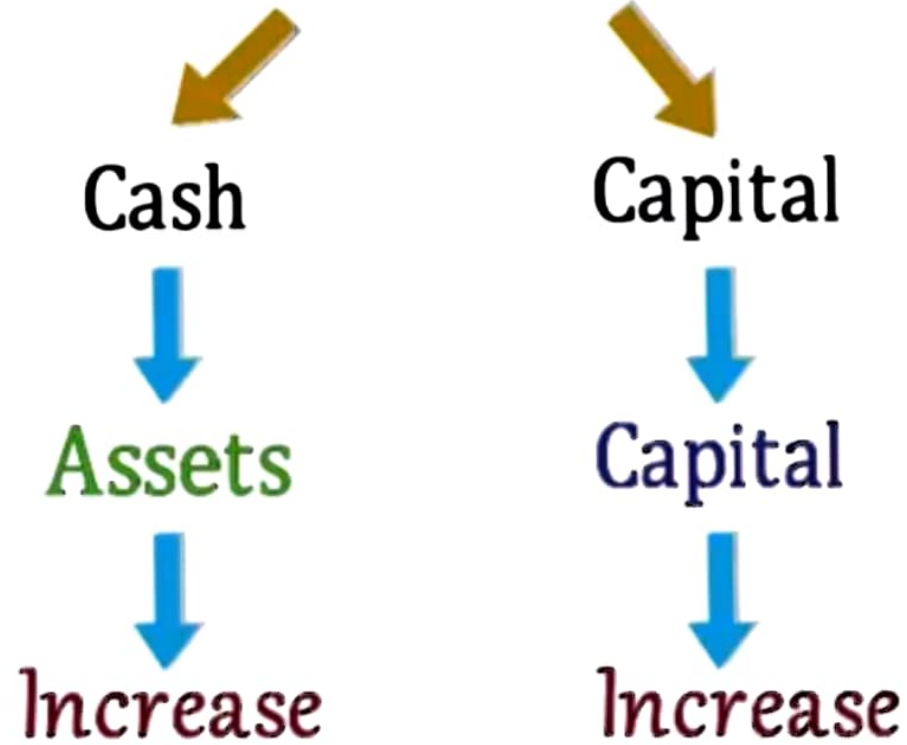
Show the accounting equation on the basis of the following transactions and also prepare Balance Sheet on the basis of last equation.

1. John started business with cash Rs. 40,000.
2. Interest due but not received Rs. 500.
3. Rent received in advance Rs. 1,000.
4. Insurance premium paid in advance Rs. 1,500.
5. Salaries due but not paid Rs. 2,000.



1. John started business with cash Rs. 40,000.

CLEAR



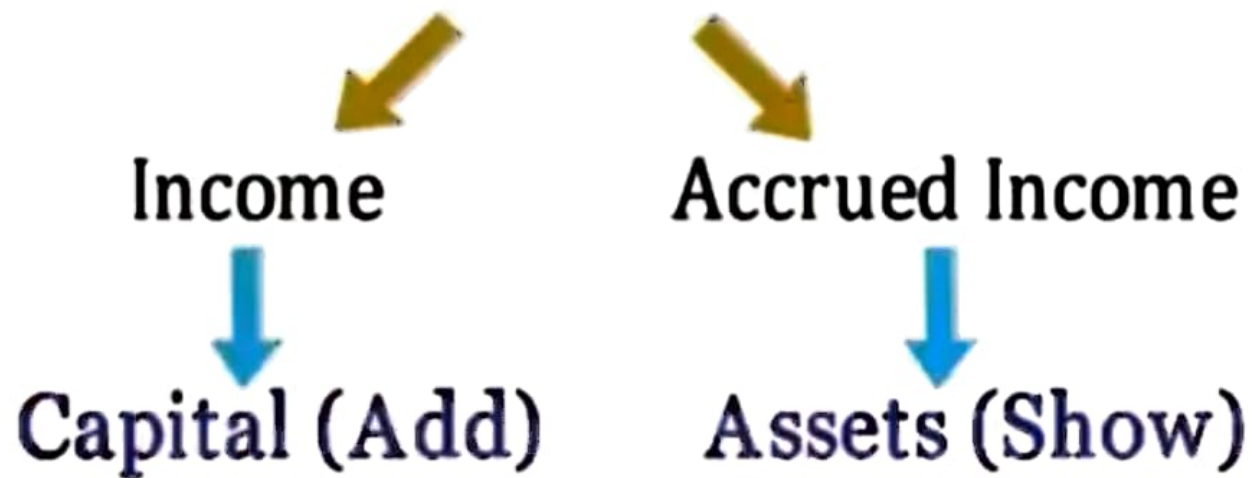
**Accrued Interest = Rs. 500**

**Income**

**Accrued Income**

**Capital (Add)**

**Assets (Show)**



## Solution

### Accounting Equation

S. No.	Transactions	Assets	=	Liabilities	+Capital
		Cash + Accrued Int.	=		+ Capital
1.	Started Business with Cash	40,000	=		+ 40,000
2.	Accrued Interest	0 + 500	=		+ 500
	<b>New Equation</b>	40,000 + 500	=		+ 40,500

Unearned Rent = Rs. 1,000



Cash



Add ✓



Unearned Income



Liability (Show) ✓

## Solution

### Accounting Equation

S. No.	Transactions	Assets	= Liabilities	+Capital
		Cash + Accrued Int.	= Un. Rent	+ Capital
1.	Started Business with Cash	40,000	=	+ 40,000
2.	Accrued Interest	0 + 500	=	+ 500
	<b>New Equation</b>	40,000 + 500	=	+ 40,500
3.	Unearned Rent	1,000 + 0	= 1,000	+ 0
	<b>New Equation</b>	41,000 + 500	= 1,000	+ 40,500

Prepaid Insurance = Rs. 1,500

Cash

Less ✓

Prepaid Expense

Assets (Show) ✓

## Solution

### Accounting Equation

S. No.	Transactions	Assets		=	Liabilities	+Capital	
		Cash	Accrued Int. + Pre. Ins.	=	Un. Rent	+ Capital	
1.	Started Business with Cash	40,000		=		+ 40,000	
2.	Accrued Interest	0	+ 500	=		+ 500	
	<b>New Equation</b>	40,000	+ 500	=		+ 40,500	
3.	Unearned Rent	1,000	+ 0	=	1,000	+ 0	
	<b>New Equation</b>	41,000	+ 500	=	1,000	+ 40,500	
4.	Prepaid Insurance	(-) 1,500	+ 0	+ 1,500	=	0	+ 0
	<b>New Equation</b>	39,500	+ 500	+ 1,500	=	1,000	+ 40,500



Outstanding Salaries = 2,000

Expense

Outstanding Expense

Capital (Less) ✓

Liability (Show) ✓

# Solution

## Accounting Equation

S. No.	Transactions	Assets		=	Liabilities		+Capital	
		Cash	Accrued Int. + Pre. Ins.		Un. Rent	O/s Salary	+Capital	
1.	Started Business with Cash	40,000		=			+ 40,000	
2.	Accrued Interest	0	+ 500	=			+ 500	
	<b>New Equation</b>	40,000	+ 500	=			+ 40,500	
3.	Unearned Rent	1,000	+ 0	=	1,000		+ 0	
	<b>New Equation</b>	41,000	+ 500	=	1,000		+ 40,500	
4.	Prepaid Insurance	(-) 1,500	+ 0	+ 1,500	=	0	+ 0	
	<b>New Equation</b>	39,500	+ 500	+ 1,500	=	1,000	+ 40,500	
5.	Outstanding Salaries	0	+ 0	+ 0	=	0	+ 2,000	
	<b>Final Equation</b>	39,500	+ 500	+ 1,500	=	1,000	+ 2,000	+ 38,500

**Balance Sheet**  
as at 31st March, .....

Liabilities	Amt.	Assets	Amt.
Unearned Rent	1,000	Cash	39,500
Outstanding Salaries	2,000	Accrued Interest	500
Capital	38,500	Prepaid Insurance	1,500
	41,500		41,500