Takin' Care of Business

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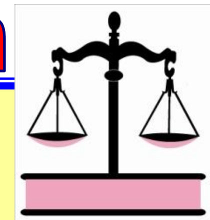
Getting Started: Accounting Equation



Double Entry Bookkeeping

The fundamental concept underlying present-day bookkeeping and accounting. **double entry accounting** is based on the fact that every financial transaction has equal and opposite effects in at least two different accounts. It is used to satisfy the equation **Assets = Liabilities + Equity**, whereby each entry is recorded so as to maintain the relationship.

In the double entry system, transactions are recorded in terms of debits and credits. Since a debit in one account will be offset by a credit in another account, the sum of all debits must therefore be exactly equal to the sum of all credits. The double-entry system of bookkeeping or accounting makes it easier to accurately prepare financial statements directly from the books of account and detect errors.

Double entry accounting provides a method for quickly checking accuracy because the sum of all accounts with debit balances should equal the sum of all credit balance accounts.

The best accounting software for business uses double entry accounting; without that feature an accountant will have difficulty preparing year end and tax records. Personal finance software does not necessarily require double entry accounting, although some personal finance titles provide this feature but hide it from the user to prevent confusion.

From the large, multi-national corporation down to the corner beauty salon, every business transaction will have an effect on a company's financial position. The financial position of a company is measured by the following items:

1. Assets (what it owns)
2. Liabilities (what it owes to others)
3. Owner's Equity (the difference between assets and liabilities)

The accounting equation (or basic accounting equation) offers us a simple way to understand how these three amounts relate to each other. The accounting equation for a sole proprietorship is:

Assets - Liabilities = Owner's Equity

The accounting equation for a corporation is:

Assets - Liabilities = Stockholders' Equity

[*The accounting equation for a corporation is more complex and we will not work with this in Accounting I.*]

Assets are a company's resources—things the company owns. Examples of assets include cash, accounts receivable, inventory, prepaid insurance, investments, land, buildings, equipment, and goodwill. From the accounting equation, we see that the amount of assets must equal the combined amount of liabilities plus owner's (or stockholders') equity.

Liabilities are a company's obligations—amounts the company owes. Examples of liabilities include notes or loans payable, accounts payable, salaries and wages payable, interest payable, and income taxes payable (if the company is a regular corporation). Liabilities can be viewed in two ways:

1. As claims by creditors against the company's assets
2. A source—along with owner or stockholder equity—of the company's assets.

Owner's equity or stockholders' equity is the amount left over after liabilities are deducted from assets:

Assets - Liabilities = Owner's Equity

We can use Algebra to rearrange the accounting equation so that we can always solve for any of the three terms when we are given 2 terms. Usually, we know what our liabilities are when we incur them. It is rarely necessary to solve the accounting equation when given the values for **Assets** & **Owner's Equity**. If we want to check that our equation is in balance, however, we may want to solve our equation for Liabilities

Assets - Owner's Equity = Liabilities

If a company keeps accurate records, the accounting equation will always be "in balance," meaning the left side should always equal the right side. The balance is maintained because every business transaction affects at least two of a company's accounts.

For example, when a company borrows money from a bank, the company's assets will increase and its liabilities will increase by the same amount. When a company purchases inventory for cash, one asset will increase and one asset will decrease. Because there are two or more accounts affected by every transaction, the accounting system is referred to as double-entry accounting.

Source: http://www.accountingcoach.com/