Accounting equation

[Business](#), [Accounting](#)

The basic accounting equation offers us a simple way to understand how assets, liabilities and owner's equity relate to each other (AccountingCoach, 2008). It also represents the relationships on the statement of financial condition (Arkanses State University, n. d.). The accounting equation for sole proprietorship is: Assets = Liabilities + Owner's Equity and the accounting equation for a corporation is Assets = Liabilities + Stockholder's Equity (AccountingCoach, 2008). Based on the accounting equation, the accounts are arranged into three general categories namely asset accounts, liability accounts and equity accounts.

Asset Accounts

Assets are resources owned or controlled by an individual or corporation that have expected future benefits and can be converted to cash (InvestorWords. com, 2008). In most cases it is cash or can be turned into cash and exceptions include prepayments, which may represent payments made for rent or insurance in cases in which the time paid for has not yet expired (Hussey, 1999). Assets are divided into the following categories: current assets, long-term assets, and intangible assets. Current assets are those that change frequently and can be quickly converted to cash within a short term such as cash, stocks, receivables, inventory, investments, and prepaid expenses (Bized, n. d.).

Long term assets are less likely to sell overnight or have the capability of being converted to cash such as property, long-term investments, real estate, machinery, and plant (BusinessTown, 2003). They are not intended to be consumed within one year of the balance sheet date (AccountingCoach, 2008). Intangible assets include trademarks, franchisee rights, patents, copyrights, and goodwill (Hussey, 1999; InvestorWords. com, 2008). These are assets that have value but it cannot be seen or touched (Entrepreneur. com, 2008).

Liabilities Accounts

Liabilities are obligations that arise during the course of business operations and are usually settled over time through the transfer of economic benefits includingmoney, goods or services (Investopedia, n. d.). There are two categories of liabilities namely current liabilities and long-term liabilities.

Current liabilities are debts a company owes which must be paid within one year and this includes short term loans, accounts payable, dividends and interest payable, bonds payable, accrued liabilities, and taxes (About. com, 2008; Investopedia, n. d.). Long-term liabilities are debts payable over a longer period exceeding 12 months or one cycle of operation such as bonds payable, mortgage payable, and notes payable (Entrepreneur. com, 2008; About. com, 2008).

Equity Accounts

Equity or owner’s equity is the owner’s claim on a company’s assets. It is sometimes referred to as the book value of the company or the residual of assets minus liabilities (AccountingCoach, 2008). “ Owner’s Equity” are the words used on the balance sheet when the company is a sole proprietorship but if the company is a corporation, the words “ Stockholder’s Equity” are used instead (ibid.).

This also includes the owner’s drawing account. During the year the income statement accounts, e. g. revenues, expenses, gains, and losses, the owner's drawing account, and the income summary accounts are considered to be temporary owner's equity accounts because at the end of the year, the balances in these temporary accounts will be transferred to the owner's capital account (AccountingCoach, 2008).

References

About. com (2008). Analyzing a balance sheet. Retrieved July 28, 2008 from http://beginnersinvest. about. com/cs/investinglessons/l/bles3curlia. htm

About. com (2008). Financial management worksheets. Retrieved July 28, 2008 from http://inventors. about. com/library/bl/toc/blfinancialworksheets1. htm

AccountingCoach (2008). Accounting equation. Retrieved July 28, 2008 from http://www. accountingcoach. com/online-accounting-course/14Xpg01. html

AccountingCoach (2008). Accounting terms. Retrieved July 28, 2008 from http://www. accountingcoach. com/accounting-terms/accounting-dictionary/accounting-terms-L. html

AccountingCoach (2008). Accounting terms. Retrieved July 28, 2008 from http://www. accountingcoach. com/online-accounting-course/05Xpg03. html

AccountingCoach (2008). Accounting terms. Retrieved July 28, 2008 from http://www. accountingcoach. com/accounting-terms/accounting-dictionary/accounting-terms-O. html

Arkansas State University (n. d.). The accounting equation. Retrieved July 28, 2008 from http://www. clt. astate. edu/Lmoore/tutoria/equation. htm

Bized (n. d.). What are current assets. Retrieved July 28, 2008 from http://www. bized. co. uk/learn/business/accounting/busaccounts/notes/cass-ex. htm

BusinessTown (2003). Accounting basic accounting. Retrieved July 28, 2008 from http://www. businesstown. com/accounting/basic-sheets. asp

Entrepreneur. com (2008). Balance sheet. Retrieved July 28, 2008 from http://www. entrepreneur. com/money/moneymanagement/managingcashflow/article21930. html

Entrepreneur. com (2008). Balance sheet. Retrieved July 28, 2008 from http://www. entrepreneur. com/encyclopedia/term/82186. html

Hussey, R. (1999). Asset. A dictionary of accounting. Oxford University Press. Retrieved July 28, 2008 from http://www. highbeam. com/doc/1O17-asset. html.

Investopedia (n. d.). Liability. Retrieved July 28, 2008 from http://www. investopedia. com/terms/l/liability. asp

InvestorWords. com (2008). Asset. Retrieved July 27, 2008, from http://www. investorwords. com/273/asset. html

InvestorWords. com (2008). Asset. Retrieved July 27, 2008, from http://www. investorwords. com/52/accounts_receivable. html