We can continue our exercise with several transactions and enter them in this accounting equation. You can also try couple of more accounting entries yourself. Normally, I ask students to tell few more accounting entries in the class. I ask them to think some complex accounting transactions and show them how we can enter recent transactions. In many sessions, students ask me how to enter bad debts, that is customer not paying the amount. It is very easy. How do you enter a credit sales of Rs 40 lakhs? We put Sales +40; Receivables +40. Suppose, we collected Rs 38 lakhs. Our accounting entry is Cash +38 lakhs and Receivables -38 lakhs. Suppose, the balance Rs 2 lakhs is not receivable. The person to whom we supplied goods is not traceable. We now decide to write off this amount from our books of accounts as bad debts. Why should we write off? Otherwise, we will be showing Rs 2 lakhs as Receivables on the Asset side. It is no more an asset. We can’t give a wrong picture about our financial health. We need to remove this asset from the books. We can’t take an eraser and remove it or delete an Excel row. We can remove the asset by reversing the accounting entry. Our original sales entry related to this Rs 2 lakhs is Receivables +2 lakhs, Sales +2 lakhs. We need to reverse this entry as Receivables –2 and Expenses –2. Our receivable value is now zero. You may now ask what will happen if the person turns up and pays that amount. That’s good. Accounting entry is also simple: Cash +2 lakhs, as we get the money; Expenses +2 lakhs—that is, we are just reversing our previous write-off entry. Actually, we don’t enter bad debt entries like this. We will discuss the actual entries later, but this approach would be useful for us to understand the mechanics. Another entry, which is of general interest to the students, is sales return. Many e-commerce companies like Flipkart today allows you to return the goods if you are not happy with that. The original sales entry has to be reversed now, that is, Sales minus Cash minus. When explaining various accounting concepts, we will be often using this accounting equation at a later point of time.

Let us now go back to our Excel, and prepare a Financial Statement. So far, we recorded the statement. Now, we need to use this recording to prepare a financial statement. First, let us prepare an Income Statement or Profit and Loss Account. We need to pick up the values from the Revenue and Expenses to prepare the Income Statement. Our Sales is Rs 50 lakhs. Our expenses are Cost of Sales of Rs 40 lakhs, Salary of Rs 2 lakhs, Advertisement of Rs 2 lakhs, Rent of Rs 1 lakh, and interest payable Rs 20,000 or Rs 0.20 lakhs. Our total expense is Rs 45.20 lakhs. Our Profit before tax is Rs 4.80 lakhs—that is, Rs 50 lakhs Revenue, Rs 45.20 lakhs Expenses, gives you Rs 4.80 lakhs profit. Let us assume there is no tax to keep our exercise simple. We paid Rs 1 lakh as dividend. If we deduct the dividend, we retain profit worth of Rs 3.80 lakhs in our business. This is called Reserves and Surplus.

Let us now prepare Balance Sheet of this company. Balance sheet has two sides. On the one side, we have Liabilities and Equity and the other side, we have Assets. First, let us complete Equity and Liability. Our original equity is Rs 30 lakhs. We retained a profit of Rs 3.80 lakhs, and it is also equity. Equity means owners’ capital. We, as owners, invested Rs 30 lakhs, and we allowed the business to retain our Rs 3.80 lakhs inside the business. This makes our total equity as Rs 33.80 lakhs. Let us now list down our liabilities. We have totally three liabilities. Our Bank Loan of Rs 20 Lakhs is one liability. We also need to pay to our suppliers Rs 30 lakhs, and we have a Interest Payable of Rs 0.20 lakhs. Our total liabilities is Rs 50.20 lakhs. Our Equity plus Liability together is Rs 84 lakhs.
Let’s move to the other side, asset side of the balance sheet and list down the assets. We have Furniture worth of Rs 5 lakhs. We also have a Rent Deposit worth of Rs 5 lakhs. Our Receivables is worth of Rs 20 lakhs. We also have an inventory worth of Rs 20 lakhs. We purchased inventory worth of Rs 60 lakhs but sold Rs 40 lakhs and, therefore, we have another Rs 20 lakhs with us. Our next asset item is Cash and Bank Balance. This is slightly difficult to get this value. We need to cull out all cash transactions and find the balance. Let us go back to our accounting entries, and pick up all cash items. Our Cash Inflow includes Rs 30 Lakhs worth of Equity, Rs 20 lakhs worth of Loan, collection from our customers worth of Rs 30 lakhs. Our total cash collection is Rs 80 lakhs. Our cash outflow includes Rs 5 lakhs towards rent advance; we also purchased Rs. 5 lakhs worth of furniture; we paid to our suppliers worth of Rs 30 lakhs; salary, rent, and advertisement all put together is Rs 5 lakhs; and finally, dividend of Rs 1 lakh. If we add up all these things, our total cash outflow is Rs 46 lakhs. Our cash and bank balance is Rs 34 lakhs; that is, Rs 80 lakhs inflow, Rs 46 lakhs outflow—that gives you Rs 34 lakhs as a balance value. The total asset side is also now equal to Rs 84 lakhs. This consists of Furniture of Rs 5 lakhs, Inventory of Rs 20 lakhs, Rent Advance of Rs 5 lakhs, Receivables of Rs 20 Lakhs, Cash Balance of Rs 34 lakhs. The total is Rs 84 lakhs. This way, we achieved balancing both sides of the equation. Our liabilities and equity is now equal to asset.