The traditional method of learning this part is through “debit” and “credit.” We are not going to do that. That will take good amount of our time. Our objective is not to get into the preparation of accounting statement but to know how to get benefit from the financial statements. Still, if we understand how accounting system works, it will give some confidence in dealing with the subject. We will use our accounting equation to show how accounting transactions are recorded. Today, in this computer age, machine will not understand debit and credit. It can understand only plus and minus. We are going to learn accounting in this way. Let us start a company and run a business for few days, notionally. Let us create few accounting transactions and learn how to record the same. Once the transactions are recorded, we can prepare a financial statement. We will use our accounting equation, that is, assets is equal to liabilities, plus revenue, minus expense.

Let us set up the accounting equation in an Excel sheet. In the first column, let us provide the transaction details. Column 2 will show the name of the asset—we need to know the name of the asset when we prepare a financial statement. Column 3 shows asset value. Column 4 is a blank. Let us use this place to put “equal” sign. Column 5 and 6 shows the liability name and the liability value. Column 7 is for equity. Column 8 and 9 are revenue name and revenue value, and, finally, we have two columns 10 and 11. They are for expense account name and expense value. We need to have the name column because after few transactions, we will not be able to recollect the accounting head related to that value. You will now see how easy to record the accounting transaction.

Suppose, a few of us jointly promote a trading company on January 1 of this year to buy and sell few consumer durable items. We contribute Rs 1 lakh each, and we are thirty people. This is called share capital. Received equity capital is transaction details. Let us enter Rs 30 lakhs under the equity column. The equation now fails. We have thirty on the right hand side and zero on the left hand side. This is not allowed. We have Rs 30 lakhs cash with us. Let us enter Rs 30 lakhs under the asset column and write down the name as cash and bank. The equation now holds good.

We now approach a bank for a loan. The bank, based on our requirement, gives a loan of Rs 20 lakhs at 12% interest. We need to pay interest at the end of every month. Under the transaction column, we write “bank loan obtained”. Under the liability column, let us write “bank loan” and Rs 20 lakhs. Again, the equation fails. On the right hand side, we have Rs 50 lakhs total, on the left hand side, we have only Rs 30 lakhs, but the loan amount is given to us and it is in our bank account. Now, we enter Rs 20 lakhs under the asset column and write cash and bank under the asset name. The equation now holds good.

By now, you will realize we record every transaction in two places to ensure our equation holds good. That is the reason we call this as a double-entry book-keeping system. The two entries can be opposite side of each other or on the same side with a different sign.

Let’s move on further. Now, we find a place for our showroom and pay Rs 5 lakhs towards refundable advance. The rent for the showroom is Rs 1 lakh per month and payable by fifth of the following month. While we need to record the showroom rent advance, we don’t need to record the agreement to pay the rent of Rs 1 lakh at this point of time. Advance is treated as an asset because it is refundable. We first enter cash and bank minus Rs 5 lakh because we are making the payment and
our cash balance declines. We also get a new asset called advance or rent advance with a positive value of Rs 5 lakh. In this transaction, both entries are on the left hand side but with a different sign. The equations are preserved. Suppose we want to know how much cash we have. We add up all the cash values related to the cash column and show that our cash balance is Rs 45 lakhs. That is, we collected cash of Rs 30 lakhs through equity, Rs 20 lakhs through loan, but we spent Rs 5 lakhs towards the rent advance. We spent another Rs 5 lakhs towards furniture for our showroom. Furniture is an asset. We enter again cash minus Rs 5 lakhs and furniture plus Rs 5 lakh. Now, cash value comes down again as we spend money.

Let us do some business. We purchase consumer durables worth of Rs 60 lakhs. We pay Rs 30 lakhs in cash and agree to pay balance Rs 30 lakhs in 60 days’ time. Our accounting entries are cash minus 30, inventory plus 60. These two are on the asset side; the net balance on the asset side is +30, that is inventory plus 30 and cash minus 30. We enter payable plus 30 under the liability, which is on the other side of the equation. These entries result in increase of 30 on the asset side and also increase in 30 on the liability side. The equation is now maintained. We entered the data in three places. It is not triple-entry book-keeping system. Actually, we have two transactions. The first transaction is purchase of Rs 30 lakhs worth of inventory by paying cash. Our second transaction is another purchase of Rs 30 lakhs worth of inventory through credit. We can record these two transactions separately as inventory plus 30, cash minus 30 and again, inventory plus 30, payable plus 30. Since the inventory appears twice, we added them. This resulted in three entries.

Let us do some sales. During the month, we are able to sell Rs 40 lakhs worth of goods for Rs 50 lakhs. Of this, we collected Rs 30 lakhs in cash and remaining Rs 20 lakhs will be collected after 30 days. Our accounting equation is now bit lengthy. We need to understand these entries and break them into smaller components before we record them. First, let us record the transaction related to goods worth of Rs 40 lakhs going out of our shop. The entry is inventory minus 40, because inventory is going out and expenses minus 40. Both right hand side and left hand side have the same negative value of Rs 40 lakhs. Our second transaction is sales transaction. It again has two transactions, that is, cash sales worth of Rs 30 lakhs and another credit sales worth of Rs 20 lakhs. We can combine them and treat them as a single transaction or we can separately enter the two transactions. Let us enter them separately to have clarity. The entry for the first transaction is cash plus 30, sales plus 30, and for the second transaction, receivable, which is under asset column plus 20 and sales plus 20. We have a sales of Rs 50 lakhs and cost of sales is at Rs 40 lakhs, and, therefore, our gross profit margin is Rs 10 lakhs.

Our manager now informs that we have paid Rs 2 lakhs as salary, another Rs 2 lakhs for advertisement, and Rs 1 lakh towards rent. We record these transactions as cash minus 5 lakhs and under the expenses, salary minus 2 lakhs, advertisement another Rs 2 lakhs, and rent minus Rs 1 lakh. Though interest is not payable at the end of this one month, we realized that we need to make a provision for the same. The reason is we have used the loan funds to do our business. Computation of profit without considering the interest will not give a correct picture. We call this accrual concept. We are going to discuss many of these concepts later. We also call our accounting as an accrual method of accounting. The accounting entry for the interest is, that is the provision for interest is interest payable Rs 0.2 lakhs under the liability and interest expense as minus Rs 0.2 lakhs under the expenses. Both entries are on the right hand side, one with a positive sign, and the other one is a negative sign.
We also paid an interim dividend of Rs 1 lakh. Our entries are cash minus Rs 1 lakh and under the expenses minus Rs 1.0 lakh.