LOVELY PROFESSIONAL UNIVERSITY

FINANCIAL ACCOUNTING-I

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SYLLABUS

Financial Accounting-I

Objectives: To develop conceptual knowledge about the preparation and use of financial statements.

Sr. No.	Topics
1.	**Introduction to Accounting:** Needs, objectives, branches, users and Difference between Book- Keeping and Accounting. Double entry system: Meaning, Importance & rules.
2.	**Generally Accepted Accounting Principles:** Accounting Concepts and conventions. Capital & revenue items.
3.	Accounting Equation and Accounting Cycle.
4.	Preparation of Journal, Posting to ledger and Balancing.
5.	**Subsidiary Books:** Purchases, Purchases Return, Sales, Sales Return book and Cash book: Single column, Double column & triple column cash book including petty cash book.
6.	**Trial Balance:** Different types of errors which are revealed and not revealed by the Trial Balance.
7.	**Depreciation Accounting:** Meaning and methods- Straight line and written down value method.
8.	Final Accounts, Adjustments, Final accounts with adjustments.
9.	Bank reconciliation statement.
10.	Rectification of Errors.

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Unit 1: Introduction to Accounting

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Objectives

After studying this unit, you will be able to:

- Explain the needs and objectives of accounting
- State the branches of accounting
- Identify the users and differences between book-keeping and accounting

Introduction

Accounting is a business language which elucidates the various kinds of transactions during the given period of time.

Accounting is broadly classified into three different functions viz

1. Recording
2. Classifying and
3. Summarizing

American Institute of Certified Public Accountants Association defines the term accounting as follows "Accounting is the process of recording, classifying, summarizing in a significant manner of transactions which are in financial character and finally results are interpreted."

Caution Accounting is not an equivalent function to book keeping. Accounting is broader in scope than the book keeping, the earlier cannot be equated to the latter.

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1.1 Need of Financial Accounting

A well known author of Accounting, [Prof. R.R. Gupta, Principal, Poddar College, Nawalgarh (Rajasthan)] wrote in …..”First write/record before one delivers goods or renders the services and if there is any disagreement in future, use the writing or record as an evidence to resolve the misunderstanding or rectifying the error.”

Recording of business transactions is necessary from owners’ point of view and other interested party as well. The persons included in the second category are the suppliers of the materials, products and services to the business, the government and the society at large. The creditors (suppliers who are willing to take their payment later) are interested to know whether the business will be able to pay them later (solvency of the business) whereas the government wants to know whether the business has paid whatever was due to them in terms of taxes, fees etc.

Did u know? **What are the purposes of preparing financial statements?**

1. Accounting provides necessary information for decisions to be taken initially and it facilitates the enterprise to pave way for the implementation of actions
2. It exhibits the financial track path and the position of the organization.
3. Being business in the dynamic environment, it is required to face the ever changing environment. In order to meet the needs of the ever changing environment, the policies are to be formulated for the smooth conduct of the business.
4. It equips the management to discharge the obligations at every moment.
5. Obligations to customers, investors, employees, to renovate/restructure and so on.

1.2 Objectives of Accounting

The main purpose of book-keeping and accounting is to furnish the necessary financial data to the persons interested in the business. In brief, following are the objectives of accounting:

1. ***To maintain the systematic records of the business:*** The primary objective of the accounting is to maintain the records of all transactions of the business. As the memory of human being is very limited and short, it would be very difficult to remember all the transactions especially if there is a huge amount of transaction. So it is very necessary to record all business transactions properly to determine the amount of profit or loss and the financial position of the business on a particular date.
2. ***To ascertain the profit or loss of the business:*** The main objective of the business is to earn a profit. The profits are calculated with the help of financial accounting. Financial accounting helps to determine the net profit or loss of the business over a period. To calculate the amount of profit or loss, a trading and profit and loss account is prepared at the end of a period. If the revenue for a period are more than the expenses incurred to earn that revenue then it is said to be a profit and on the other hand if the expenses are more than the revenues for a period then it is said to be a loss. In the case of profit, the management can take the relating to selling price and output etc.
3. ***To present the financial position of the business:*** The objective of the accounting is not only recording of the financial transactions of the business and determination of profit or loss but also to present the financial position of the business. To present the financial position, financial accounting helps in the preparation of balance sheet. Balance sheet is the statement of assets and liabilities of the business. It also gives the information about the borrowed capital as well as owned capital along with different assets such as fixed assets,

current assets and miscellaneous. Balance sheet is the reflector of the financial position of a business.

4. ***To provide the financial information to the various users:*** One more objective of the accounting is to provide the required financial information to the different users – internal as well as external users. Internal users of the financial statements are owners, shareholders, management and external users of the financial statements are debenture holders, creditors, investors, employees, government, etc.

1.3 Branches of Accounting

The main objectives of accounting are to record the business transactions and to provide the necessary information to the internal and external users of the financial statements. In order to achieve the above objectives, the accounting is classified into followings branches:

1. ***Financial Accounting:*** It is the original form of accounting. It refers to the recording of daily business financial transaction. Recording of the transaction is done in such a way that the profit of the business may be ascertained after a definite period and the picture of the financial position of the business may be presented.
2. ***Cost Accounting:*** As the name indicates, this accounting is related with the ascertainment of cost of the product in a period. Under this system, record of raw materials used in production, wages and labour paid and other expanses incurred on production are kept to control the costs.
3. ***Management Accounting:*** The accounting which provides the necessary information to the management is called management accounting. Under this, the analysis and interpretation of the accounts, prepared by financial accounting, are done in a manner so that the managers may forecast, plan for future and frame the policy.
4. ***Tax Accounting:*** Under tax accounting, the accountants prepare the accounts as per the provisions of taxation. The accounts prepared as per taxation provisions may differ from the accounts prepared as per financial accounting.
5. ***Inflation Accounting:*** The financial statements are prepared on the basis of historical cost which do not present the true picture of the financial position and correct profit or loss of the business due to inflation. Thus the fresh financial statements are prepared keeping in mind the price level changes under inflation accounting.
6. ***Human Resource Accounting:*** Human Resource Accounting means the accounting for human being as now in an organization human being is treated as an asset like other physical assets. It is recorded in the books like other assets. HRA deals with the measurement of costs on recruiting, selecting, hiring, training, placing and development of the employees in one side and on the other side it deals with the present economic value of the employees. For the determination of the value of human being different methods are used under HRA.
7. ***Responsibility Accounting:*** Responsibility accounting is a special technique of management under which accountability is established according to the responsibility delegated to the various levels of management. A management information and reporting system is instituted to give adequate feedback in terms of the delegated responsibility. Under this system, units of an organization, under a specified authority in a person, are developed as responsibility center and evaluated individually for their performance.

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1.4 Functions of Accounting

The main function of accounting is to record the business transactions scientifically and systematically. Apart from this, there are other functions of accounting which are as follows.

1. It depicts the true and fair picture of the financial position of the company.
2. It helps in ascertaining profit or loss of the business which is the only primary aim of the business.
3. It helps in future decision-making by different persons interested in such accounting information.
4. It depicts the earning capacity of the business.
5. It satisfies all Government rules and regulations connected with Accounting information such as all the companies are required to prepare their statements as per requirements of the Indian companies Act, 1956, amended upto date.

1.5 Users of Accounting Informations

There are two types of persons interested in financial statements: (1) Internal users, and (2) External users.

1. ***Internal Users:*** These are: (a) Shareholders, (b) Management, and (c) Trade unions employees etc.
   (a) *Shareholders* are interested to know the welfare of the business. They can know the operational results through such financial statements and the financial position of the business.
   (b) *Management* is interested to take important decisions relating to fixing up the selling prices and making future policies.
   (c) *Trade unions and employees* are interested to know the operational results because their bonus etc. is dependent on the profit earned by the business. Financial statements also help in their negotiations for wages/salaries.
2. ***External Users:*** The following are most important external users of financial statements:
   (a) *Investors:* They are interested to know the earning capacity of business which can be known through financial statements. They can also know the financial soundness of the business through financial statements.
   (b) *Creditors, Lenders of Money etc:* The creditors and lenders of money etc. can also know the financial soundness through financial statement. They have to see two things (i) Regularity of income and (ii) solvency of the business so that their investment is risk free.
   (c) *Government:* Government is interested to formulate laws to regulate business activities and also law relating to taxation etc. Financial statements help while computing National Income statistics etc.
   (d) *Taxation authorities:* Financial statements provide information relating to operational results as well as financial position of the business. Tax authorities decide the amount of tax as per financial statement. It is very useful to other taxation authorities such as sales tax etc.
   (e) *Stock Exchanges* are meant for dealing in share/securities. Purchase and sale of such shares and securities are possible through stock exchanges which provide financial information about each company which is listed with them.

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3. ***Consumers:*** These groups are interested in getting the goods at reduced price. Therefore, they wish to know the establishment of a proper accounting control, which in turn will reduce to cost of production, in turn less price to be paid by the consumers. Researchers are also interested in accounting for interpretation.

4. ***Research Scholars:*** Accounting information, being a mirror of the financial performance of a business organization, is of immense value to the research scholar who wants to make a study into the financial operations of a particular firm. To make a study into the financial operations of a particular firm, the research scholar needs detailed accounting information relating to purchases, sales, expenses, cost of materials used, current assets, current liabilities, fixed assets, long-term liabilities and share-holders funds which is available in the accounting record maintained by the firm.

1.6 Differences between Book-keeping and Accounting

As we discussed earlier that accounting is the process of identifying, measuring and communicating the economic information of an organization to its users who need the information for decision making. It identifies transactions and events of a specific entity. Before knowing the difference between the accounting and book-keeping we should know the meaning and concept of book-keeping.

Meaning and Definition of Book-keeping

Book- keeping includes recording of journal, posting in ledgers and balancing of accounts. All the records before the preparation of trail balance is the whole subject matter of book- keeping. Thus, book- keeping many be defined as the science and art of recording transactions in money or money's worth so accurately and systematically, in a certain set of books, regularly that the true state of businessman's affairs can be correctly ascertained. Here it is important to note that only those transactions related to business are recorded which can be expressed in terms of money.

"Book- keeping is the art of recording business transactions in a systematic manner".

– A.H.Rosenkamph

"Book- keeping is the science and art of correctly recording in books of account all those business transactions that result in the transfer of money or money's worth".

– R.N.Carter

Objectives of Book-keeping

1. Book- keeping provides a permanent record of each transaction
2. Soundness of a firm can be assessed from the records of assets and abilities on a particular date.
3. Entries related to incomes and expenditures of a concern facilitate to know the profit and loss for a given period.
4. It enables to prepare a list of customers and suppliers to ascertain the amount to be received or paid.
5. It is a method gives opportunities to review the business policies in the light of the past records.
6. Amendment of business laws, provision of licenses, assessment of taxes etc., are based on records.

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The following table explains the key differences between book-keeping and accounting:

Basis of difference	Book-keeping	Accounting
Transactions	Recording of transactions in books of original entry.	To examine these recorded transactions in order to find out their accuracy.
Posting	To make posting in ledger	To examine this posting in order to ascertain its accuracy.
Total and Balance	To make total of the amount in journal and accounts of ledger. To ascertain balance in all the accounts.	To prepare trial balance with the help of balances of ledger accounts.
Income Statement and Balance Sheet	Preparation of trading, Profit & loss account and balance sheet is not book keeping	Preparation of trading, profits and loss account and balance sheet is included in it.
Rectification of errors	These are not included in book-keeping	These are included in accounting.
Special skill and knowledge	It does not require any special skill and knowledge as in advanced countries this work is done by machines.	It requires special skill and knowledge.
Liability	A book-keeper is not liable for accountancy work.	An accountant is liable for the work of book-keeper.

1.7 Basic Accounting Terminology

The terms, which are generally used in the day-to-day business, are called accounting terminology. So it is very much necessary to know all the terms properly. Some of the terms which are frequently used are given below:

1. ***Capital:*** It is the money invested by the owner of the business. It is also known as owners' equity or as net worth. It is the total assets minus the liabilities. In other words, excess of assets over liabilities is termed as capital. As we know that business is considered as a separate entity, hence capital introduced by the owner is also considered as liability for the business. This can be shown in an algebraic way as follows:

   Capital = total assets – total liabilities

2. ***Assets***: Assets are the things/properties of value used by the business in its operations. In other words, anything by which the firm gets some benefit, is termed as asset. According to Finny & Miller, "Assets are future economic benefits, the rights which are owned or controlled by an organization or individual" whereas Kohler in Dictionary for Accountants says "Any owned physical object (tangible) or right (intangible) having economic value to the owner is an asset. The Institute of Chartered Accountants of India defines assets as, "tangible objects or Intangible rights owned by an enterprise and carrying probable future benefits". Thus, it is clear from the above definitions that an asset must have future economic benefit which must be controlled by an enterprise. The assets may be broadly classified as fixed assets and current assets:

   (i) *Fixed Assets* are the assets which are purchased for the purpose of operating the business and not for resale such as land and building, plant and machinery and furniture, etc.

   (ii) *Current Assets* are the assets which are kept for short-term for converting into cash or for resale such as unsold goods, debtors, bills receivable, bank balance, etc.

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3. ***Liability:*** It may be defined as currently existing obligations which a business enterprise requires to meet sometime in future. According to Finny and Miller, "Liabilities are debts, they are amounts owned to creditors." In other words, liabilities mean liabilities other than the capital (contributed by the owner of the business). F.A.S.B. Stanford, 1980 has defined liabilities as "liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events". Whereas according to Accounting Principles Board (APB), liabilities are defined as, "economic obligations of an enterprise that are recognized and measured in conformity with generally accepted accounting principles." Thus, it is clear from the above definitions that liability is a legal obligation to pay for the transaction that has already taken place. Liabilities may be classified into three types namely:

   (i) Short-term liabilities,

   (ii) Long-term liabilities, and

   (iii) Contingent liabilities.

   (i) *Short-term liabilities* are such obligations which are payable within one year. Examples are creditors, Bills payable, overdraft from a bank, etc.

   (ii) *Long-term liabilities* are such obligations which are payable after a period of one year such as debentures, bonds issued by the company, etc.

   (iii) *Contingent liability* is a liability which arises only on the happening of an uncertain event. If it happens, the contingent liability is there. If it does not happen, there is no liability. Such liabilities are not shown in the balance sheet, but are given as a foot note. Example of such liabilities are (i) Liability on account of bills discounted (ii) Claims against the firm not acknowledged as debts.

4. ***Debtors:*** The debtors are the persons who owe to an enterprise an amount for receiving goods or services on credit. The total balance outstanding at the end of a particular date is shown as an asset in the balance sheet of an enterprise. The debtors are also known as accounts receivables.

5. ***Creditors:*** The creditors are the persons to whom the firm owes for providing goods or services.

6. ***Revenue:*** The amounts which earned by a business by selling a product or rendering its services to the customers is called revenue. Such as sales, commission, interest, dividends, rent and royalties received. It is the amount which is added to the capital as a result of business operations.

7. ***Equity:*** Equity is, normally, ownership or percentage of ownership in a company or items of value

8. ***Bills of Exchange:*** A written order from one person (the payor) to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at some fixed future date, a certain sum of money, to either the person identified as payee or to any person presenting the bill of exchange.

9. ***Income:*** The financial gain (earned or unearned) accruing over a given period of time.

10. ***Expenditure:*** A payment or incurrence of an obligation to make a future payment for an asset or service rendered.

11. ***Profit and Loss A/c:*** Profit & Loss Account is the second part of Trading and Profit & Loss Account. Trading Account shows the gross profit which is the difference of sales and cost of sale. Thus the gross profit can not treated as net profit while the businessman wants to

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know how much net profit he has earned from the operating activities during a period. For this purpose Profit & Loss Account is prepared keeping in mind all the operating and non-operating incomes and losses of the business. In the debit (left hand side) side all the expenses and losses are disclosed and in the credit side (right hand side) all the incomes are disclosed. The excess of credit side over debit side is called net profit while the excess of debit side over credit side shows net loss.

12. ***Goods:*** It is a general term used for the articles in which the business deals; that is, only those articles which are bought for resale for profit are known as Goods.

13. ***Drawings:*** It is the amount of money or the value of goods which the proprietor takes for his domestic or personal use. It is usually subtracted from capital.

1.8 Summary

- Accounting is the medium of recording the business activities and considered as a language of business.
- Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money transactions and events which are, in part at least, of a financial character, and interpreting the results thereof.
- Identification of financial transactions, recording, classifying them into different groups, summarizing them into trial balance and preparation of financial statements and analyzing and interpreting them, are included in the accounting process.
- Financial accounting, cost accounting, management accounting, responsibility accounting, tax accounting, inflation accounting, etc. are the branches of accounting. Accounting is an art as well as a science.
- Accounting is done for the following objective:
  - For maintaining the systematic records
  - For ascertaining the profit/loss of the business
  - To present the financial position
  - To provide the financial information
- Accounting plays an important role in the determination of profit, financial position, tax liability, valuation of goodwill and shares and comparative study.

1.9 Keywords

Accounting Conventions: Customs and traditions which guide the accountants to record the financial transactions.

Accounting Process: It includes the recording of financial transactions, ledger posting, preparation of financial statements and analyzing and interpretation of them.

Cost Accounting: Accounting relating to the ascertainment of cost of the product.

Management Accounting: Presenting of accounting information in such a way as to assist the management in taking the important decisions and making the policies.

Notes

1.10 Self Assessment

Fill in the blanks:

1. The users of accounting are …… and external.
2. Accounting records all the transactions which can be expressed either in …… .
3. The creditors are interested to know the …… of the business.
4. The main purpose of …… and accounting is to furnish the necessary financial data to the persons interested in the business.
5. …… refers to the recording of daily business financial transaction.
6. The accounting which provides the necessary information to the management is called …… .
7. Accounting records all the transactions which can be expressed either in …… .
8. Every financial transaction of the business has …… and recorded at two places.
9. …… enables the comparison of the profit or performance of a business in a year with the performance of another year.

State whether the following statements are true or false:

10. Exact profit can be ascertained with the help of financial accounting.
11. Balance sheet is the reflector of the financial position of a business.
12. The objective of the accounting is to only recording of the financial transactions of the business and determination of profit or loss.
13. The profits are calculated with the help of management accounting.
14. Financial statements provide information relating to operational results as well as financial position of the business.

1.11 Review Questions

1. "Accounting is the process of recording, classifying and summarizing of accounting transactions." Explain.
2. What are the key internal and external users of accounting information?
3. State the key branches of accounting.
4. Is there any differences between book keeping and accounting?
5. Why creditors are interested in financial records of the business?
6. Discuss the scope of responsibility accounting.
7. State the differences between cost accounting and management accounting.

Answers: Self Assessment

1. internal
2. money or money's worth
3. solvency
4. book-keeping
5. Financial accounting
6. management accounting

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7.	money or money's worth	8.	dual effect
9.	Horizontal Consistency	10.	True
11.	True	12.	False
13.	False	14.	True

1.12 Further Readings

Books

Dr. S.N. Maheshwari, Sharad, K. Maheshwari, *Financial Accounting*, Vikas Publishing Co. Pvt. Ltd., New Delhi.

R.L. Gupta, M. Radhaswami, *Advanced Accountancy*, Sultan Chand, New Delhi.

T.S. Grewal, M.C. Shukla, *Advanced Accounts*, S. Chand, New Delhi.

Online links

http://www.globusz.com/

www.futureaccountant.com

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Unit 2: Double Entry System

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2.5 Summary

2.6 Keywords

2.7 Self Assessment

2.8 Review Questions

2.9 Further Readings

Objectives

After studying this unit, you will be able to:

- Explain the meaning of double entry accounting system
- State the importance and rules of double entry accounting system

Introduction

The modern system of book keeping is based on the double entry system. Therefore, we are discussing this system only. The father of this system is the Lucas Paciolo. He gave the details of this system in his book "*De Compute Set Scripturise*" in Italy in 1494 A.D. As per this system every transaction of the business has double aspects/double effect. Therefore, every transaction must be recorded at two places or accounts. If in a transaction someone is a giver, some other will be a receiver.

Did u know? This system of accounting is also called Mercantile System or Western System of Accounting.

This system is so organized, accurate, complete and scientific that it is now adopted universally. In the words of Keller, M.J. Keller in–*Intermediate Accountancy*, "The most common system of accounting data for an enterpriser is the double entry system. As the name implies, the entry made for each transaction is composed of two parts, a 'debit' and a 'credit'.

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2.1 Meaning of Double Entry Accounting System

Double entry system is a system in which every transaction affects at least two accounts. Under this system every debit has a credit. Every transaction, which is in money or measured in terms of moneys worth, is recorded. These transactions, as it is clear from its very name are recorded in two accounts. These accounts are of individuals or Institutions who either receive some benefit or sacrifice something. If they receive then debit the benefit if it is a sacrifice then credit the same.

Example: Ram receives ₹ 100 from Shyam. Under this contract, Ram is the receiver. Hence Ram a/c is to be debited and as Shyam pays, then his a/c is to be credited.

Cash and Mercantile System of Double Entry System

There are two systems of double entry book keeping namely cash system and mercantile system. In case of cash system, transactions are recorded only if cash is received or paid. Government accounting is done basing on this system. On the other hand, mercantile system is one where both cash and credit transactions are recorded. Besides, outstanding expenses or incomes also find place in the mercantile system. It is fair enough to adopt mercantile system because when an event takes place, it gets recorded irrespective of its immediate impact on the cash position. In case of credit transactions, cash does not flow immediately but it takes place at a future point of time. Transactions like sales or purchases on credit, salary payable, rent receivable, interest accrued but not received, depreciation provided etc., influence on the financial position of the business unit and therefore they should be recorded. Mercantile system facilitates this. Hence double entry recognizes the fact that every transaction, whether cash or credit, influences at least two accounts – one representing debit aspect and another credit aspect.

2.2 Importance of Double Entry System

As we know that double entry system of accounting is a systematic and scientific system of accounting, so it offers a number of advantages. The following are the most important advantages of the system:

1. ***Complete record of transactions:*** Under this system, recording of all transactions is done whether related to personal or impersonal accounts.
2. ***Ascertainment of profit or loss:*** Under this system of Accounting complete profit and loss account can be prepared by which profit or loss of a particular period can be ascertained.
3. ***Mathematical check on accuracy:*** Every debit has a credit, so it is an accurate system as far as mathematical accuracy is concerned which may be proved by preparing trial balance.
4. ***Check for fraud:*** Scope of fraud is limited as it minimizes the chances of fraud because of scientific system.
5. ***Ascertainment and knowledge of financial position of the business:*** Under this system, it is possible to know the financial position of the business at any time. For this purpose Balance Sheet can be prepared any time.
6. ***Possibility of full control over business:*** Under this system full information is available which enables the management to exercise full control over the business.
7. ***Easy accessibility of information:*** Under this system all information is easily available and accessible which is very helpful and useful for the management.

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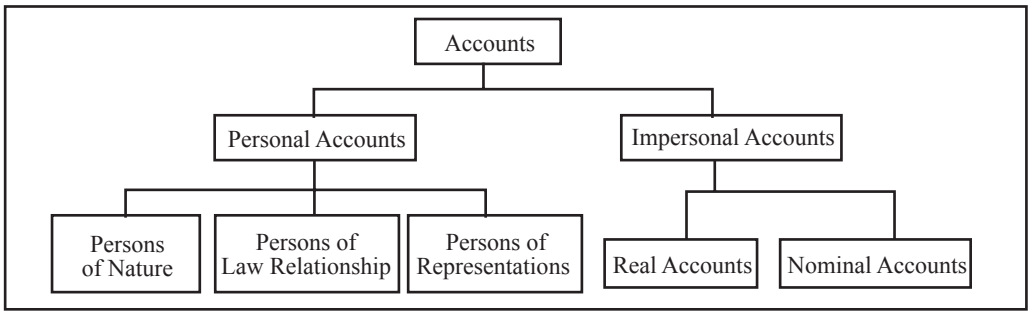
8. ***Possibility of comparative study:*** Under this system, it is possible to prepare comparative statement and also compare the previous year's results with the current year's result and take corrective steps as and when necessary to improve the operational results.

9. ***Reliable information:*** Under this system information received is reliable.

2.3 Classification of Accounts

Before knowing about the journal entries and ledger posting we should know about the different types of accounts and their accounting treatment. For classification, the entire process of accounting brought under three major segments; which are broadly grouped into two categories, *viz.* Personal accounts and Impersonal Accounts. The Impersonal accounts are further classified into two categories, *viz.* Real accounts and Nominal accounts.



2.3.1 Personal Account

It is an account which deals with a due balance either to or from these individuals on a particular period. It is an account that normally reveals the outstanding balance of the firm to individuals.

Examples: 1. Outstanding balance to suppliers

2. Outstanding balance from customers.

This is the only account which emphasizes the future relationship in between the business firm and the individuals. Personal accounts can be classified into three categories on the basis of individuals, *viz.*

1. Persons of nature
2. Persons of artificial relationship
3. Persons of representations

Let us understand each of them one by one.

1. ***Persons of Nature:*** Persons who are nothing but outcome of nature i.e. almighty

2. ***Persons of Artificial Relationship:*** Persons who are made out of artificial relationship through legal structure.

Example: Organizations, corporate, partnership firm, etc.

The companies and partnership firm are governed by the Companies Act, 1956 and the partnership act. The relationship among the owners of the company or partners of the firm is totally structured through respective laws.

Example: LIC and SBI

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These governed by the artificial relationship among the members through LIC Act, SBI Act and the Companies Act, 1956 and so on respectively.

3. ***Persons of Representations:*** This classification represents amount outstanding or prepaid in connection with the individual transactions.

The personal account is the account of future relationship; to maintain the relationship of future in two different angles, *viz.*

(a) Receiver of the benefits from the firm

Example: The credit sale of the goods worth of ₹ 1,500 to Mr X.

In this transaction Mr. X is the receiver of the benefits through the credit sale of the firm. Till the collection of the sale benefits, the firm should maintain the relationship of business with the Mr. X in the books of accounts.

(b) Giver of the benefits to the firm.

Example: The credit purchase of the goods worth of ₹ 3,000 from Mr. Y.

The giver of the goods nothing but the supplier of the goods Mr. Y should be recorded in the books of the firm till the payment of dues of the credit purchase. The future relationship is maintained in the books of the accounts till the payment process is over.

Debit the Receiver
Credit the Giver

2.3.2 Real Account

It is a major classification which highlights the real worth of the assets. This account deals with especially the movement of assets. It is an account reveals the asset value and movement (taking place in between the firm and also other parties due to any transactions).

The movement of the assets can be classified into two categories, *viz.*

1. assets which are coming into the firm
2. assets which are going out of the firm

Whenever any movement of the assets takes place with reference to any transaction either coming into the firm or going out of the firm, it should be recorded in accordance with the set golden rules of this account.

Debit what comes in
Credit what goes out

2.3.3 Nominal Accounts

This is an account deals with the amount of expenses incurred or incomes earned. It includes all expenses and losses as well as incomes and gains of the enterprise. This nominal account records the expenses and incomes which are not carried forwarded to near future.

Debit all the expenses and losses
Credit all incomes and gains

Notes

2.4 Rules of Double Entry Accounting System

In Double Entry accounting both the aspects of the transaction are recorded. Every transaction has two aspects and according to this system, both the aspects are recorded. If the business acquires something, it must have been acquired by giving something. While recording each transaction, the total amount debited must be equal to the total amount credited. The terms Debit' and 'Credit' indicate whether the transaction is to be recorded on he left hand side or right hand side of the account. In its simplest form, an account looks like the English Language Letter 'T'. Because of its shape, his simple form of account is called T-account.

In a T' account, the left side is called debit (usually abbreviated as Dr.) and the right side is known as credit (as usually abbreviated Cr.).

The following are the key rules of debiting and crediting under double entry system of accounting:

1. ***In case of traditional type of accounts***

   (a) *Personal Account:* If in a transaction, a person receives something in cash or goods, it is debited and if that person gives, that is credited. Debit account is denoted by 'Dr.' while credit account is denoted by 'Cr.' In brief, the rule of personal account is

   Debit the Receiver (Dr.)

   Credit the Giver (Cr.)

   (b) *Real Account:* If in a transaction, the assets are coming into business, they are debited and if those are going outside from business, they are credited. Thus these rules are as below:

   Debit what comes in (Dr.)

   Credit what goes out. (Cr.)

   (c) *Nominal Account:* The rules of debiting and crediting of nominal account are–the expenses and losses of the business are debited and the gains and profit of the business are credited. In brief the rules are:

   Debit all expenses and losses (Dr.)

   Credit all gains profits or incomes (Cr.)

2. In case of modern classification of account also known as classification based on accounting equation

   Capital (Owned and Borrowed) = Assets

   Thus, Total Assets – Borrowed = Capital

   We also know that if there is a change on one side. The other side is bound to be affected. This change occurs because of the concept of dual aspect.

   Technically, when some transaction is entered/recorded on the left hand side of an account it is termed as debit whereas when some transaction is recorded/entered on the right hand side of an account, it is termed as credit. Both debit and credit result, either an increase or decrease depending upon the nature of an account.

Notes

Following are the rules for debit and credit

(a)	Assets	Increase in Assets	Debit
		Decrease is Assets	Credit
(b)	Capital	Increase in Capital	Credit
		Decrease in Capital	Debit
(c)	Liabilities	Decrease in Liability	Debit
		Increase in Liability	Credit
(d)	Revenue Income	Decrease in Revenue	Debit
		Increase in Revenue	Credit
(e)	Expenses	Increase in Expenses	Debit
		Decrease in Expenses	Credit

Thus, it is clear from the above rules of debit and credit that,

1. An increase in assets is recorded on the left hand side of account and decrease in assets on the right hand side.
2. In case of Capital and liabilities: Increase is recorded on the right hand side of an account whereas decrease is recorded on the left hand side of an account.

Task What will be the impact of following transactions on balance sheet?

1. R started business with cash of ₹ 500000
2. Machinery purchased for ₹ 100000.
3. Payment made to creditors of ₹ 20000
4. Goods sold for ₹ 15000

Caselet

ICAI told to Hasten Process for Double-entry Accounting System

"There is a need to set up a separate committee for converting the single entry accounting system to double entry. The process is rather slow. It should be hastened," Mr K. Rahman Khan, Honorary Deputy Chairman, Rajya Sabha, and member of the Institute of Chartered Accountants of India (ICAI), said.

While stating that the accounting system has already been converted to double entry in local bodies, Mr Khan added that the institute should play a vital role in monitoring governmental expenditure.

'A chartered accountant's responsibility should not be limited to his clients alone. He owes it to the society. The institute and the custodian of government expenditure - Comptroller and Auditor General of India have already resolved to effect the conversion. Various

Contd...

Notes

governments across the globe now follow the double entry accounting system. We need to switch to double entry quickly," he added.

He clarified his statement by stating: "I am not saying that the Government accounts are not perfect. We need to ensure better transparency. The double entry accounting system would help measure cost escalation, go into the details of total public expenditure and so on."

The Vice-President of ICAI, Mr G. Ramasamy, said that the Governmental outgo towards the Mahatma Gandhi National Rural Employment Guarantee Act Scheme totalled over ₹ 42,000 crore and there were over 6 lakh panchayats in the country preparing their expenditure statement. "The institute is supporting the panchayats prepare the statement," he said.

On implementation of International Financial Reporting Standards (IFRS), he said by July 31, all approvals would be in place. The institute has started programmes to enlighten professionals and jumpstart the process in India, launched certification course on IFRS. "In the first phase, we have started with Nifty companies with a turnover of over ₹ 1,000 crore."

The institute, he said has inked MoUs with its various international counterparts to augment bilateral relationships. "We recently interacted with professional bodies in West Asia, discussed the need for improving networking ties between members and professionals of the two countries. We are looking to enter into mutual recognition agreements with the professional bodies in Canada, Singapore and New Zealand among others," he said.

Source: http://www.thehindubusinessline.in/2010/07/05/stories/2010070551931300.htm

2.5 Summary

- Double Entry Mechanism entails recording of transactions keeping in mind the debit and credit aspect of the transaction.
- To record every transaction, one account is debited and the other is credited. This is based on the principle 'every debit has a credit'.
- The Double entry Book-keeping seeks to record every transaction in money or money's worth in its dual aspect.
- Rules of debiting and crediting are:
  - Personal A/c – Receiver – Debit and Giver-Credit
  - Real A/c – What comes in – Debit, What goes out – Credit
  - Nominal Account – Expenses and Losses are Debited and Income and Gains are credited

2.6 Keywords

Cash System: In case of cash system, transactions are recorded only if cash is received or paid.

Mercantile System: Mercantile system is one where both cash and credit transactions are recorded.

Nominal A/c: Accounts which are relating to the revenues, incomes, expenses and losses of the business are called nominal accounts.

Notes

Personal A/c: Accounts which are related to person, firms, companies and representatives.

Real A/c: Accounts which are related to all the assets accounts are included into it.

2.7 Self Assessment

Fill in the blanks:

1. Double entry system is a system in which every transaction affects at least .....
2. There are two systems of double entry book keeping namely cash system and .... system.
3. An increase in assets is recorded on the ..... side of account.
4. When some transaction is entered/recorded on the left hand side of an account it is termed as .....
5. The system of double entry can be understood easily by an equation which is called ....

State whether the following statements are true or false:

6. Every transaction must be recorded at two places or accounts.
7. The most common system of accounting data for an enterpriser is the double entry system.
8. Increase in capital is recorded on the right hand side of an account.
9. Modern classification of account is also known as classification based on accounting equation.
10. The rules of debiting and crediting of nominal account are–the expenses and losses of the business are credited and the gains and profit of the business are debited.

2.8 Review Questions

1. Which A/c is to be debited:
   - A. If furniture is purchased for cash
     - (a) Furniture A/c (b) Cash A/c
   - B. If goods are sold for cash.
     - (a) Goods A/c (b) Cash A/c
   - C. If expenses are paid in cash
     - (a) Expenses A/c (b) Cash A/c
   - D. If commission is accrued but not received
     - (a) Income (Commission) (b) Commission accrued
2. Explain, in brief, cash basis of accounting and differentiate it with accrual basis of accounting.
3. State the fundamental rules followed to record the changes in various accounts.
4. What are the rules of double entry system of accounting? Explain with suitable examples.
5. Illustrate the key points which make double entry accounting system more significant than the other traditional accounting systems.

Notes

6. As per the double entry system of accounting what will be the impact of following transactions on balance sheet:
   (a) Mr. Rakesh started business with cash of ₹1,00,000
   (b) Gods sold on credit for ₹ 10000
   (c) Furniture purchased for ₹ 5000
7. Explain the meaning and importance of double entry system of accounting.

Answers: Self Assessment

1.	two accounts	2.	mercantile
3.	left hand	4.	debit
5.	accounting	6.	true
7.	true	8.	false
9.	true	10.	false

2.9 Further Readings

Books

Dr. S.N. Maheshwari, Sharad, K. Maheshwari, *Financial Accounting*, Vikas Publishing Co. Pvt. Ltd., New Delhi.

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T.S. Grewal, M.C. Shukla, *Advanced Accounts*, S. Chand, New Delhi.

Online links

http://www.globusz.com/

www.futureaccountant.com

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Unit 3: Principles of Accounting

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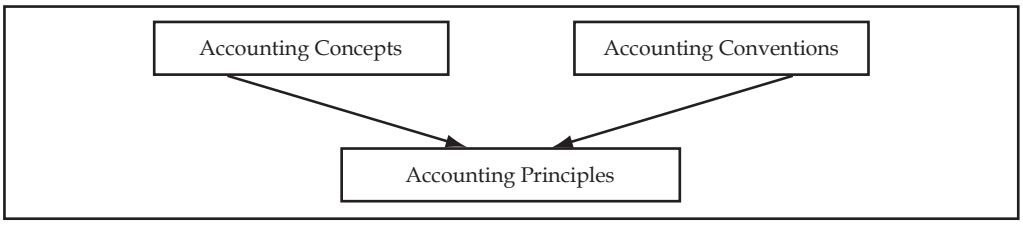
Objectives

After studying this unit, you will be able to:

- Explain Generally Accepted Accounting Principles
- Illustrate Accounting concepts and conventions

Introduction

The transactions of the business enterprise are recorded in the business language, which routed through accounting. The entire accounting system is governed by the practice of accountancy. The accountancy is being practiced through the universal principles which are wholly led by the concepts and conventions.



3.1 Generally Accepted Accounting Principles (GAAP)

In course of time business enterprises would like to know how they are performing in comparison to each other. Similarly there would be common owners of several enterprises.

Accounting principles are those rules of actions on the basis of which the transactions of the business are recorded, classified and summarized. If the financial statements are not prepared on the basis of these principles, there will be low acceptability and difficulty to understand them, and the comparison will be impossible and unreliable. Therefore, the accountants recommend that there should be common concepts and conventions of accounting so that the above difficulties

and problems may not occur, they are termed as Generally Accepted Accounting Principles (GAAP).

Notes

Caution There are various bodies, national and international, who from time to time frame guidelines, define terms, formulate principles and standards to be used in the field of Accounting and finance, The industry, firms, business groups have to follow these, both as legal provisions and as convenience.

Case Study

Enron & Accounting Issues: Yawning GAAP

The Enron Corp imbroglio holds many lessons for Indian accounting professionals most of whom are working in a country which fancies itself as a software sweatshop and, therefore, have to deal frequently with tricky revenue recognition issues.

In fact, revenue recognition is so tricky that the Financial Accounting Standards Board (FASB), which sets the global benchmark for private sector accounting, has tagged it "the largest single category of fraudulent financial reporting and financial statement restatements".

But what do revenue recognition issues have to do with Enron? The answer is... just about everything.

Consider these facts: Between 1996 and 2000, the energy trading outfit reported an increase in its sales from $13.3 billion to $100.8 billion. In one single accounting year, 1999-2000, it doubled its reported sales. And said that it was set to double its sales again the following year.

How was Enron able to claim this phenomenal increase in sales revenue? Very simple — it exploited a loophole in accounting rules that allowed it to book revenue from energy-derivative contracts at their gross — as against net — value.

The basic incongruity of this practice becomes apparent if you examine the way a Wall Street firm — which is also in trading, although not energy trading — books its revenue. Let's say Wall Street Company X handles, on behalf of a client, the sale of 10,000 shares worth $500,000 of Company Y. It would record as revenue its commission on the sale or the spread between the bid price and the ask price — a few hundred dollars. But Enron (or any other energy trader in the US, for that matter) handling an energy trade would book the full $500,000.

According to Enron's 2000 annual report, it was in the business of building "wholesale businesses through the creation of networks involving selective asset ownership, contractual access to third-party assets and market-making activities". It seems to have used the term "wholesale businesses'' to mean trading, plain and simple. From which it made more than 90 per cent of its revenue....

To make matters worse, Enron bought and sold the same goods over and over again. And all this trading — a good amount of which was being carried on with purportedly independent partnerships which do not look very independent on examination — was being booked as revenue at full value.

It got away with this fancy book-keeping because the FASB just could not make up its mind about how energy contracts should be accounted for and, at some point or the other, decided that each company had a "free option'' to do what it wanted.

Contd....

Notes

However, looking on the positive side of things, all this number-pumping without any basis in good accounting ensured that the Enron bankruptcy, in the words of the US Treasury Secretary, Mr Paul O'Neill, had no "spill-over effect.''

The downside, of course was that it did not do anything for its profits because of the steady erosion in its trading margins (caused, ironically enough, by the entry of many players into a market created by Enron) from 5.3 per cent in 1998 to less than 1.7 per cent in the third quarter of the current year.

In retrospect, it would seem that the company made frantic attempts to keep up its profits in spite of diminishing margins through various methods, including the setting up of several off-the-balance sheet entities represented as independent of Enron to which it sold assets or portfolios of assets.

It created so-called special purpose entities (SPEs) like the Chewco and JEDI partnerships to get assets like power plants off its books. Enron was able to do this because, under standard accounting, a company is allowed to spin off its assets — and related debts — to an SPE if an outside investor has put up capital worth at least three per cent of the SPE's total value.

These methods also stretched across the lumping of assets into its trading business and the booking as operating revenues the proceeds of the sale of fixed assets.

Gaps, it would seem, abound in GAAP....

Source: http://www.thehindubusinessline.in/2002/01/20/stories/2002012001470100.htm

3.2 Accounting Concepts and Conventions

Accounting principles are broadly classified into three categories, these are:

1. Accounting Concepts
2. Accounting Conventions

3.2.1 Accounting Concepts

The following are the most important concepts of accounting:

1. Money measurement concept
2. Business entity concept
3. Going concern concept
4. Matching concept
5. Accounting period concept
6. Duality or double entry concept
7. Cost concept
8. Revenue Recognition Concept
9. Full Disclosure Concept
10. Objectivity Concept

Let us understand each them one by one.

Notes

Money Measurement Concept

This is the concept tunes the system of accounting as fruitful in recording the transactions and events of the enterprise only in terms of money. The money is used as well as expressed as a denominator of the business events and transactions. The transactions which are not in the expression of monetary terms cannot be registered in the book of accounts as transactions.

Example:

1. 5 machines, 1 ton of raw material, 6 fork-lift trucks, 10 lorries and so on. The early mentioned items are not expressed in terms of money instead they are illustrated only in numbers. The worth of the items is getting differed from one to the other. To record the above enlisted items in the book of accounts, all the assets should be converted into money.
2. 5 lathe machines worth ₹ 1,00,000; 1 ton of raw materials worth amounted ₹ 15,00,000 and so on.

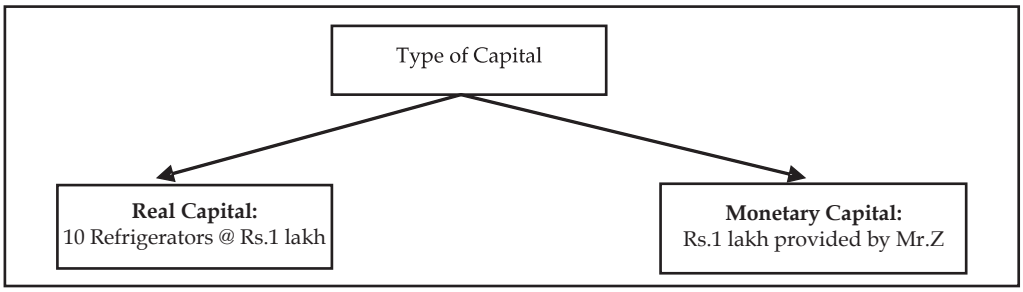
The transactions which are not in financial in character cannot be entered in the book of accounts.

Recording of transactions are only in terms of money in the process of accounting

Business Entity Concept

This concept treats the owner as totally a different entity from the business. To put in to nutshell "Owner is different and Business is different". The capital which is brought inside the firm by the owner, at the commencement of the firm is known as capital. The amount of the capital, which was initially invested, should be returned to the owner considered as due to the owner; who was nothing but the contributory of the capital.

Example: Mr. Z has brought a capital of ₹ 1 lakh for the commencement of retailing business of refrigerators. The brought capital of ₹ 1 lakh is utilized for the purchase of refrigerators from the Godrej Ltd. He finally bought 10 different sized refrigerators. Out of 10 refrigerators, one was taken away by himself as the owner.



In the Angle of the Firm

The amount of the capital ₹ 1 lakh has to be returned to the owner Mr. Z, which considered being as due. Among the 10 newly bought refrigerators for trading, one was taken away by the owner for his personal usage. The one refrigerator drawn by the owner for his personal usage led the firm to sell only 9 refrigerators. It means that ₹ 90,000 out of ₹ 1 Lakh is the volume of real capital and the ₹ 10,000 worth of the refrigerator considered to be as drawings; which illustrates the capital owed by the firm is only ₹ 90,000 not ₹ 1 lakh.

Notes

In the Angle of the Owner

The refrigerator drawn worth of ₹ 10,000 nothing but ₹ 10,000 worth of real capital of the firm was taken for personal use as drawings reduced the total volume of the capital of the firm from ₹ 1 lakh to ₹ 90,000, which expected the firm to return the capital due amounted ₹ 90,000.

Owner and business organizations are two separate entities

Going Concern Concept

The concept deals with the quality of long lasting status of the business enterprise irrespective of the owners' status, whether he is alive or not. This concept is known as concept of long term assets. The fixed assets are bought in the intention to earn profits during the season of the business. The assets which are idle during the slack season of the business retained for future usage, in spite of that those assets are frequently sold out by the firm immediately after the utility leads to mean that those assets are not fixed assets but tradable assets. The fixed assets are retained by the firm even after the usage is only due to the principle of long lastingness of the business enterprise. If the business disposes the assets immediately after the current usage by not considering the future utility of the assets in the firm which will not distinguish in between the long term assets and short term assets known as tradable in categories.

Accounting concept for long lastingness of the business enterprise

Matching Concept

This concept only makes the entire accounting system as meaningful to determine the volume of earnings or losses of the firm at every level of transaction; which is an outcome of matching in between the revenues and expenses.

The worth of the transaction is identified through matching of revenues which are mainly generated from the sales volume and the expenses of the firm at every level.

Example: The cost of goods sold and selling price of the pen of ABC Ltd. are ₹ 5 and ₹ 10 respectively. The firm produced 100 ball pens during the first shift and out of 100 pens manufactured 20 pens are considered to be damage which cannot be supplied to the customers, rejected by the quality circle department. There was an order from the firm XYZ Ltd. which amounted to 80 pens to be supplied immediately.

The worth of the transaction of the firm at every level of the transaction is being studied only through the matching of revenues with the expenses.

At first instance, the firm produced 100 pens which incurred the total cost of ₹ 500 required to match with the expected revenues of ₹ 1,000; illustrated the level of profit how much would it accrue if the entire level of production is sold out?

If the entire production capacity is sold out in the market the profit level would be ₹ 500. Out of the 100 pens manufactured 20 were identified not ideal for supply as damages, the remaining 80 pens were supplied to the individual retailer. The retailer has been dispatched 80 pens amounted ₹ 400 which equated to ₹ 800 of the expected sales. At the moment of dispatching, the firm expected to earn a profit of ₹ 400 at the level of 80 pens supplied. After the dispatch, the retailer found that 50 pens are in accordance with the order placement but the remaining are to the tune of the retailers' specifications. Finally, the retailer has agreed to make the payment of the bill only in accordance with the order placed which amounted ₹ 500 out of the expenses of the manufacturer ₹ 250.

This concept facilitates to identify the worth of the transaction at every moment.

Notes

Concept of fusion in between the expenses and revenues

Accounting Period Concept

The life period of the business is of a long span which is classified into the operating periods which are smaller in duration. The accounting period may be either calendar year of Jan.-Dec. or fiscal year of April-Mar. The operating periods are not equivalent among the trading firms. This means that the operating period of one firm may be shorter than the other one. The ultimate aim of the concept is to nullify the deviations of the operating periods of various traders in the trading practice.

According to the Companies Act, 1956, the accounting period should not exceed more than 15 months.

Concept of uniform accounting horizon among the firms to evade deviations

Duality or Double Entry Accounting Concept

It is the only concept which portrays the two sides of a single transaction. The law of entire business revolves around only on mutual agreement sharing policy among the players. How mutual agreement is taking place?

The entire principle of business is mainly conducted on mutual agreement among the parties from one occasion to another. The payment of wages is only made by the firm out of the services of labourers. What kind of mutual agreement in sharing the benefits is taking place? The services of the labourers are availed by the firm through the payment of wages. Likewise, the labourers are regularly getting wages for their services in the firm.

Payment of Wages = Labourers' service

In the angle of accounting aspects of a firm, the labourer services are availed through the payment of wages nothing but the mutual sharing of benefits. This is denominated into two different facets of accounting, viz. Debit and Credit. Every debit transaction is appropriately equated with the transaction of credit.

All the above samples of transactions are being carried out by the firm through the raising of financial resources. The resources raised are finally deployed in terms of assets. It means that the total funds raised by the firm are equated to the total investments.

From the below Table 3.1, it is clearly evidenced that the entire raised financial resources are applied in the form of asset applications. It means that the total liabilities are equivalent to the total assets of the firm.

Total Financial Resources → Total Assets

Notes

Table 3.1: for Duality Concept

Liabilities	Assets
Share capital	Plant and Machinery
Preference Share Capital	Land and Buildings
Debentures/Long-term Borrowing	Fixtures and tools
Retained Earnings	Delivery vehicles
Commercial Paper	Furniture – Industry and office
Public Deposits	Office administrative devices
Bank Loan	Marketable securities
Overdraft	Short term investments
Pre-received income	Closing stock
Outstanding expenses	Prepaid expenses
Sundry Creditors	Outstanding Income
Bills Payable	Sundry debtors
Provision for taxation	Bill Receivable
	Cash at Bank
	Cash in Hand

Concept of mutual agreement and sharing of benefits

Cost Concept

It is the concept closely relevant with the going concern concept. Under this concept, the transactions are recorded only in terms of cost rather than in market value. Fixed assets are only entered in terms of the purchase price which is an original cost of the asset at the moment of purchase. The depreciation is deducted from the original value which is the initial purchase price of the asset will highlight the book value of the asset at the end of the accounting period. The marketing value of the asset should not be taken into consideration, why? The main reason is that the market value of the asset is subject to fluctuations due to demand and supply forces. The entry of market value of the asset will require the frequent update of information to the tune of changes in the market. Will it be possible to record the changes taken place in the market then and there? This is not only impossible for regular updating of information but also leads to lot of consequences. Though the firm is ready to register the market value, which market value has to be taken into consideration? The market value can be bifurcated into two categories, viz.

1. Realizable value and
2. Replacement value

Realizable value is the value of the asset at the moment of sale or realization. Replacement value is another value which considered at the moment of replacing the old asset with the new one. These two cannot be the same at single point of time and the wear and tear of the asset will play pivotal role in fixing the realization value which has the demarcation over the later.

Notes

Revenue Reorganization Concept

It is also called revenue realization principle. As per this principle the revenue is recorded in accounting when the sales have taken place. If there is expectation that there will be a particular transaction in future, that is not recorded in accounting. Revenue/sales is considered to be made when title of ownership of goods passes from the seller to buyer and the buyer become legally liable to pay.

Example: If R Enterprise is expecting that S ltd will purchase some goods from their company in future than it can not record it as a sales transaction in the books of accounts. The transaction will be recorded only when there is actual transfer of goods by R Enterprise to S ltd.

However, this principle has some exemptions which are as follows:

1. In the case of sales made on the basis of hire purchase system where ownership is not transferred at the time of sales but transferred at the time of final payment. Herewith, sales are presumed to the extent of installments received.
2. In the case of contract accounts, if the contract is for a long period revenue cannot be realized until the contract is not completed. Here, only a part of total revenue is treated as realized.

Full Disclosure Concept

As per this principal, the financial statements should disclose true and fair view so that these may provide accurate and sufficient information to the users of financial statements (the statements which includes the financial data for a particular time period). Disclosure principle means to give all the information relating to the economic activities of the business to the owner, creditors and investors. Now-a-days this principle is getting more importance as big business organisations are being run in the form of limited companies. As per Companies Act, 1956, the profit and loss account and the balance sheet of the company must show true and fair view of the company. Therefore, companies are showing foot notes for some items as investments, contingent liabilities etc. along with the balance sheet.

Objectivity Concept

It is also known as objective evidence concept. As per this principle the transactions which are recorded in accounting must be on the objective and factual basis. There should be a voucher or documentary evidence behind each entry in the accounting. The entry must be free from personal bias and based on the rational approach. If the entries are made without evidence, it will lose the confidence of the several users of the financial statements about their reliability. For the auditing of the financial statements, there is also a need of objective evidence.

3.2.2 Accounting Conventions

Accounting conventions are bearing the practical considerations in recording the transactions of the business enterprise in systematic manner.

1. Convention of consistency
2. Convention of conservatism
3. Convention of disclosure
4. Convention of materiality

Let us understand each of them one by one.

Notes

1. ***Convention of Consistency:*** The nature of recording the transactions should not be changed at any cause or moment. It should be maintained throughout the life period of the firm. If a firm follows the straight line method of charging the depreciation since its inception should be followed without any change. The firm should not alter the method of charging the depreciation from one method to another. The change cannot be entertained. If any change has to be incorporated, the valid reason for change should be emphasized.

2. ***Convention of Conservatism:*** The conservatism wont give any emphasis on the anticipation of the firm, instead it gives paramount importance to all possible uneventualities of the firm without considering the future profits.

   The most important of the rule of guidance at the moment of valuing the stock is as follows:

Stock of the goods should be valued either market price or cost whichever is lower to anticipate the future losses due to default in the payments of the customers

   This provision is created for bad and doubtful debts of the firm in order to meet the losses expected out of the defaulters.

   According to this convention, the entire status of the firm should be highlighted/presented in detail without hiding anything; which has to furnish the required information to various parties involved in the process of the firm.

3. ***Convention of Disclosure:*** Convention of disclosure requires that all material and relevant facts concerning financial statements should be fully disclosed. Full disclosure means that there should be full, fair and adequate disclosure of accounting information. Adequate means sufficient set of information to be disclosed. Fair indicates an equitable treatment of users. Full refers to complete and detailed presentation of information. Thus, the convention of disclosure suggests that every financial statement should fully disclose all relevant information.

   Example: Let us take the example of business.

   The business provides financial information to all interested parties like investors, lenders, creditors, shareholders etc. The shareholder would like to know profitability of the firm while the creditor would like to know the solvency of the business. In the same way, other parties would be interested in the financial information according to their objectives. This is possible if financial statement discloses all relevant information in full, fair and adequate manner.

   If the financial information is complete, then only it is possible for different parties to use that information in the required manner.

   Similarly, if there is a change in accounting methods of providing depreciation on fixed assets, or in the methods of valuation of stock or in making provision for doubtful debts, these should be clearly shown in the Balance Sheet by way of notes. In short, we can say that all important facts are to be fully disclosed, otherwise financial statements would be incomplete, unreliable and misleading.

4. ***Convention of Materiality:*** The convention of materiality states that, to make financial statements meaningful, only material fact i.e. important and relevant information should be supplied to the users of accounting information. The question that arises here is what a material fact is. Information is material if its omission or misstatement could influence the economic decision of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather

than being a primary qualitative characteristic which information must have if it is to be useful.

Example: A businessman starts a textile mill. Take only two items weaving machine and bulbs for light in the office. He will purchase these items for his business. From the accounting point of view, weaving machine is more important than bulbs. Therefore, distributing the cost of machine over various years is important. But, it is not so important to distribute the cost of bulbs. If an accountant starts keeping the details of each bulb, then his work would be unduly burdened with every small detail. It is also not useful for the businessman to know every small details since it does not affect the financial position in any significant manner.

Caselet

Rule versus Principle

Students of accounting would be well aware of the long discussed differences between rule-based accounting and principle-based accounting. Both have their protagonists. While the US GAAP is rule-based, the International Accounting Standards (IAS), both as IAS and IFRS, are principle-based.

The debate on which is better will be put to rest when the US GAAP converges with IFRS eventually and becomes principle-based. Being principle-based means that broad principles are laid out by the standard-fixing body and the interpretation is left to the users of these standards.

The problem (and also the benefit) with principle-based accounting is that most of the times, in a situation which requires a finding, one would have to exercise a great deal of judgment based on substance as opposed to a readymade solution being available for a particular issue prescribed in the rule-based accounting.

While the US accounting is considered to be rule-based, one can find echoes of principle-based accounting also in it. In the widely publicised 1969 case of Continental Vending where the auditors were questioned for lack of professional standards, the court gave a direction to the jury to look at the facts and the substance of the case rather than rules of accountancy and mere adherence to GAAP.

The court held that in the audit report the statement "fairly presented … in accordance with generally accepted accounting principles" is two statements rather than one, i.e., "fairly presented" is principle-based and the other "in accordance with generally accepted accounting principles" is rule-based.

Problems for Auditors

The preparation of financial statements in accordance with the GAAP in a rule-based environment, however, presents problems to the auditors. If an auditor were to confront the management over a certain treatment of a transaction, the management is likely to ask the auditor "show me where it says I can't do that".

In other words, in a rule-based environment, the onus is on the auditor to demonstrate clearly that the particular treatment is not permitted and hence closes the avenues for the auditor to develop further arguments that would be available in a principle-based accounting environment (Principles-based Accounting, by Ronald M. Mano, Matthew Mouritsen and Ryan Pace, published in the CPA Journal, February 2006).

Since accounting standards followed in India have their origin in the IAS, the Indian accounting standards are principle-based. However, there are exceptions to the rule. One

Contd....

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prime example is the Income Recognition and Asset Classification (IRAC) norms prescribed by the Reserve Bank of India for provisioning for non-performing assets applicable to banks.

Thus, if any asset is non-performing, based on certain prescribed criteria, a provision is created for the potential loan loss irrespective of the security available with the bank.

Subjectivity Issue

Principle-based accounting has its own issues too. Ian Wright, Director of Corporate Reporting at the Financial Reporting Council of UK, writing in accountancy magazine (October 2008), talks about the subjectivity that is present in the IFRS.

The IFRS is full of words and phrases that are open to interpretation. The accompanying table has a selection of the probabilities in IFRS literature that a user is expected to interpret in the context of understanding what an accounting standard requires.

Ian Wright also identifies other issues that are potentially problematic.

The IFRS literature contains an increasing range of technical terms which don't translate well into languages other than English. Also, the standards were written in different eras and sometimes by individual national standard-setters due to which the usage of the English language differs resulting in them being structured in disparate ways.

One can therefore see the potential hazards in interpreting a principle-based accounting standard that contains highly subjective phraseology.

In this context, one can expect problems of interpretation in India also. For instance, the word "shall" (a key word in accounting standards) is used in a manner that is completely different from its usage in countries where English is the mother tongue. Any user of IFRS would therefore need to be alive to these issues when interpreting IFRS.

Hint: The preparation of financial statements in accordance with the GAAP in a rule-based environment.

Source: www.thehindubusinessline.com

3.3 Summary

- Accounting is the process of recording, classifying, summarizing in a significant manner of transactions which are in financial character and finally results are interpreted.
- The revenues are recognized only at the moment of realization but the expenses are recognized at the moment of payment.
- The charges which were paid only are taken into consideration but the outstanding, not yet paid is not considered.
- The revenues are recognized only at the time of occurrence and expenses are recognized only at the moment of incurring.
- The financial statements are found to be more useful to many people immediately after presentation only in order to study the financial status of the enterprise in the angle of their own objectives.
- The entire accounting system is governed by the practice of accountancy.
- The accountancy is being practiced through the universal principles which are wholly led by the concepts and conventions.

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- Money measurement concept tunes the system of accounting as fruitful in recording the transactions and events of the enterprise only in terms of money.
- Business entity concept treats the owner as totally a different entity from the business.
- Going concern concept deals with the quality of long lasting status of the business enterprise irrespective of the owners' status, whether he is alive or not.
- Matching concept only makes the entire accounting system as meaningful to determine the volume of earnings or losses of the firm at every level of transaction.
- Duality or Double entry accounting concept is the only concept which portrays the two sides of a single transaction.

3.4 Keywords

Accrual System: The revenues are recognized only at the time of occurrence and expenses are recognized only at the moment of incurring.

Assets: The economic resources of an entity. They include such items as cash, accounts receivable (amounts owed to a firm by its customers), inventories, land, buildings, equipment, and even intangible assets like patents and other legal rights and claims. Assets are presumed to entail probable future economic benefits to the owner.

Book Value: It is the value of the asset maintained in the books of the account. The book value of the asset could be computed as follows:

Book Value = Gross (Original) value of the asset – Accumulated depreciation

Liabilities: Amounts owed to others relating to loans, extensions of credit, and other obligations arising in the course of business.

3.5 Self Assessment

Fill in the blanks:

1. Accounting records all the transactions which can be expressed either in …… .
2. Every financial transaction of the business has …… and recorded at two places.
3. …… enables the comparison of the profit or performance of a business in a year with the performance of another year.
4. The revenues are recognized only at the moment of …… .
5. Book Value = Gross (Original) value of the asset – …… .
6. The …… are the persons who owe to an enterprise an amount for receiving goods or services on credit.
7. …… is a liability which arises only on the happening of an uncertain event.
8. …… = total assets – total liabilities

Choose the appropriate answers:

9. Three key activities of the accounting function are identifying transactions, recording transactions, and communicating transactions. The proper order for these activities is considered to be which of the following?
   (a) Communicating, recording, and identifying.

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(b) Recording, communicating, and identifying.

(c) Identifying, communicating, and recording.

(d) Identifying, recording, and communicating.

(e) None of the above

10. Which one of the following users of accounting information is considered to be an external user of accounting information rather than an internal user of accounting information?

    (a) Sales staff

    (b) Company managers

    (c) Company customers

    (d) Officers and directors

    (e) Budget officers

11. All of the following people can properly be called managers. Which one of the following individuals is not considered an internal user of accounting information?

    (a) Service manager

    (b) Research and development manager

    (c) Production manager

    (d) Partner in CA firm charged with conducting the company's external audit

    (e) Human resources manager

12. A college student pays ₹ 150 cash for her textbook. In the student's opinion, the textbook is worth ₹ 50. In accounting, however, the value of the textbook is assumed to be and is recorded at the ₹ 150 amount. The accounting principle that is most demonstrated by this example is:

    (a) The cost principle

    (b) The going-concern principle

    (c) The business entity principle

    (d) The monetary unit principle

    (e) The conservatism principle

3.6 Review Questions

1. "Accounting is the process of recording, classifying and summarizing of accounting transactions." Explain.
2. The entire accounting system is governed by the practice of accountancy. What are the key principles used in accounting?
3. Discuss dual entry concept.
4. What are the key assumptions of going concern concept?
5. "Every debit transaction is appropriately equated with the transaction of credit." Define.
6. Classify the various kinds of values in accounting process.

Notes

7. Distinguish between material and immaterial transactions of business.

8. Singania Chartered Accountants Firm established in the year 1956, having very good number of corporate clients. It continuously maintains the quality in audit administration with the clients since its early inception. The firm is eagerly looking for promising students who are having greater aspirations to become auditors. The firm is having an objective to recruit freshers to conduct preliminary auditing process with their corporate clients.

   For which the firm would like to select the right person who is having conceptual knowledge as well as application on the subjects. It has given the following Balance sheet to the participants to study the conceptual applications. The participants are required to enlist the various concepts and conventions of accounting.

   (a) List out the various accounting concepts dealt in the above balance sheet.

   (b) Explain the treatment of accounting concepts.

9. "Liability is defined as currently existing obligations which a business enterprise requires to meet sometime in future." Explain.

10. What are the key accounting conventions?

Answers: Self Assessment

1.	money or money's worth	2.	dual effect
3.	Horizontal Consistency	4.	realization
5.	Accumulated depreciation	6.	debtors
7.	Contingent liability	8.	Capital
9.	(d)	10.	(c)
11.	(d)	12.	(a)

3.7 Further Readings

Books

Khan and Jain, "*Management Accounting*".

M.P. Pandikumar, "*Accounting & Finance for Managers*", Excel Books, New Delhi.

R. L. Gupta and Radhaswamy, "*Advanced Accountancy*".

S. N. Maheswari, "*Management Accounting*".

V. K. Goyal, "*Financial Accounting*", Excel Books, New Delhi.

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Unit 4: Capital and Revenue Items

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4.1.1 Capital Expenditure

4.1.2 Capital and Revenue Receipts

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Objectives

After studying this unit, you will be able to:

- Define capital and revenue expenditure
- Identify capital and revenue receipts

Introduction

A businessman is interested to know the net result of his business operations after a certain period. But neither the trial balance nor the books of accounts reveal the net results of the business. For this, the financial statements are prepared. But before you learn how to prepare these statements, it is all the more necessary to know about the nature of expenditure and receipts i.e. capital and revenue. This will help in recording correctly the items in these statements.

4.1 Capital and Revenue Expenditures

In business, there are thousands of items of expenditure. The following are some of these expenditures which are generally incurred in all types of business:

1. Purchase of goods
2. Purchase of fixed assets such as Building, Furniture, Machine, etc.
3. 'Carriage inwards'
4. Octroi
5. Purchase of Raw Material
6. Import duty
7. Coal, gas, water, oil, grease, fuel, heating and lighting
8. Wages paid to workers for installation of machinery
9. Salaries

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10. Rent, rates and taxes
11. Stationery and printing
12. Postage and Telegrams
13. Entertainment
14. Repairs and renewals
15. Depreciation on fixed assets
16. Office expenses
17. Bank charges
18. General expenses
19. Travelling expenses
20. Overhauling of second hand machinery purchased
21. Major repairs affected for reconditioning a machinery/the old assets
22. Increasing the seating capacity of a cinema hall
23. Constructing an additional room
24. Carriage for bringing a fixed asset to place of business
25. Shifting business to convenient premises
26. Advertisement on introducing a new product in market
27. Replacement of hand driven machine by automatic machine
28. Research and development

On the basis of items of expenditure, the expenditure can be classified into three categories:

1. Capital Expenditure,
2. Revenue Expenditure, and
3. Deferred Revenue Expenditure.

4.1.1 Capital Expenditure

The expenditure incurred for acquiring a fixed asset or which results in increasing the earning capacity of the business is known as Capital Expenditure.

The benefits of capital expenditures are generally availed in several accounting years. Following are some of the examples of Capital Expenditure.

1. Expenditure incurred for the acquisition of a fixed asset

   Example: Building, furniture, machinery etc.

2. Expenditure incurred for the inward carriage or erection of a fixed asset

   Example: (a) Carriage paid in connection with the purchase of fixed asset;

   (b) Wages paid to labourers in connection with the installation of machinery.

   These expenses form part of the cost of the fixed asset.

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3. Expenditure incurred for extension or improvement of an existing fixed asset

Example: Money spent in connection with increasing the seating capacity of a cinema hall or constructing an additional room.

4. Expenditure incurred for the major repairs of an old asset

Example: Repairs for reconditioning a machinery.

5. Expenditure incurred for the replacement of an old asset with a new asset.

Example: Replacing a hand-driven machine by automatic machine.

Revenue Expenditure

An expenditure incurred in the course of regular business transactions of a concern is availed during the same accounting year is known as Revenue Expenditure. Following are some of the examples, of Revenue Expenditure.

1. Expenditure incurred on the purchase of raw materials.
2. Expenditure incurred in the day-do-day running of business,

Example: Wages, salaries, rent, rates and taxes, office expenses, interest, discount, etc.

3. Expenditure incurred for the upkeep of an asset

Example: Repairs, maintenance charges, etc.

4. Expenditure incurred for the purchase of goods meant for sale

Example: Purchases, carriage inwards, import duty, octroi, etc.

5. Depreciation of fixed assets.

The above examples are not exhaustive and are not universally accepted. Whether an expenditure is capital expenditure or revenue expenditure depends upon its purpose and nature of the business.

Example:

1. Amount spent on the purchase of furniture is a capital expenditure but it is revenue expenditure for a business dealing in furniture.
2. Amount spent on Plant and Machinery is a capital expenditure but it is revenue expenditure for a business dealing in engineering goods.
3. Amount spent on wages or carriage are revenue expenditure, but when wages are paid for the installation of a new machinery or carriage paid to bring the machine to the place of business, they are capital expenditure as they increase the value of fixed asset i.e. machinery here.

Deferred Revenue Expenditure

There are certain revenue expenditures that are incurred during one accounting year but are applicable wholly or in part in future periods such as heavy expenditure on advertisement for introducing a new product in the market or for exploring new markets for the product. These expenditures appear to be revenue expenditure. But it is not so because the benefit from this is

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likely to the enjoyed over a number of years. Such expenditure whose benefit is enjoyed not in one year but over a number of years is known as deferred revenue expenditure.

Example: 1. Heavy initial expenditure incurred on Advertisement for introducing a product in the market.

2. Expenditure incurred in shifting business to more convenient premises

3. Expenditure incurred on research and development

Task Choose the right kind of expenditure by putting a Tick Mark in correct column:

Expenditure	Capital Revenue	Deferred Revenue
Salaries		
Legal Charges		
Wages for installing a machinery		
Depreciation		
Repairs of furniture purchased second hand		
Advertisement for introducing a new product		
Carriage paid on goods purchased		
Research & Development expenditure		
Expenditure on dismantling and reinstallation of Plant		
Office expenses		
Expenditure on the construction of an additional room		
Maintenance charges of building		

Distinction between Capital and Revenue Expenditure

Following are the main points of difference between capital and revenue expenditures.

Basis of Difference	Capital Expenditure	Revenue Expenditure
Purpose	It is incurred for the purchase of fixed assets.	It is incurred for the maintenance of fixed assets.
Earning capacity	It increases the earning capacity of the business.	It does not increase the earning capacity of the business.
Periodicity of benefit	Its benefits are spread over a number of years.	Its benefit is only for one accounting year.
Placement in financial statements	It is an item of Balance Sheet and is shown as an asset.	It is an item of Trading and Profit and Loss Account and is shown on the debit side of either of the two.
Occurrence	It is non-recurring expenditure in nature.	It is usually a recurring expenditure.

4.1.2 Capital and Revenue Receipts

Just as expenditures are classified into Capital or Revenue Expenditure, in the same way receipts are classified into:

1. Capital Receipts, and
2. Revenue Receipts.

Notes

Capital Receipts

The receipts which do not arise out of normal course of business are known as Capital Receipts.

Example: 1. Receipts from sale of fixed assets.
2. Additional capital introduced by the Proprietor
3. Loans raised

Revenue Receipts

The receipts which arise out of normal course of a business are known as Revenue Receipts.

Example: 1. Income from sale of goods
2. Rent received form letting out the business property
3. Dividend received from shares
4. Interest received from investment

4.2 Summary

- The expenditure incurred for acquiring a fixed asset or which results in increasing the earning capacity of the business is known as Capital Expenditure.
- An expenditure incurred in the course of regular business transactions of a concern is availed during the same accounting year is known as Revenue Expenditure.
- The receipts which do not arise out of normal course of business are known as Capital Receipts.
- The receipts which arise out of normal course of a business are known as Revenue Receipts.

4.3 Keywords

Capital Expenditure: The expenditure incurred for acquiring a fixed asset or which results in increasing the earning capacity of the business is known as Capital Expenditure.

Capital Receipts: The receipts which do not arise out of normal course of business are known as Capital Receipts

Deferred Revenue Expenditure: Such expenditure whose benefit is enjoyed not in one year but over a number of years is known as deferred revenue expenditure.

Revenue Expenditure: An expenditure incurred in the course of regular business transactions of a concern is availed during the same accounting year is known as Revenue Expenditure.

Revenue Receipts: The receipts which arise out of normal course of a business are known as Revenue Receipts.

Notes

4.4 Self Assessment

Fill in the blanks:

1. Purchase of furniture is a ..... expenditure.
2. The benefits of ..... expenditures are generally availed in several accounting years.
3. An expenditure incurred in the course of regular business transactions of a concern is availed during the same accounting year is known as ..... Expenditure.
4. Expenditure incurred on research and development are .....
5. The receipts which do not arise out of normal course of business are known as ....
6. The receipts which arise out of normal course of a business are known as ....

State whether the following statements are true or false:

7. Dividend received from shares is capital receipt.
8. Loans are the part of capital receipt
9. Revenue expenditure benefit is only for one accounting year.
10. Depreciation on fixed assets is capital expenditure.

4.5 Review Questions

1. Define capital and revenue expenditure with some suitable examples.
2. State the difference between capital and revenue receipts. Give some examples.
3. Categorise the following items in capital and revenue items:
   (a) Rent, rates and taxes
   (b) Stationery and printing
   (c) Postage and Telegrams
   (d) Entertainment
   (e) Repairs and renewals
   (f) Depreciation on fixed assets
   (g) Office expenses
   (h) Bank charges
   (i) General expenses
   (j) Travelling expenses
4. "There are certain revenue expenditures that are incurred during one accounting year but are applicable wholly or in part in future periods." Discuss.
5. State the difference between capital and revenue expenditures.
6. Why furniture expenses are termed as capital expenditure? Give some examples to support the above statement.

Notes

Answers: Self Assessment

1.	capital	2.	capital
3.	Revenue	4.	deferred revenue expenditure
5.	Capital Receipts	6.	Revenue Receipts
7.	False	8.	True
9.	True	10.	False

4.6 Further Readings

Books

Khan and Jain, "*Management Accounting*".

M.P. Pandikumar, "*Accounting & Finance for Managers*", Excel Books, New Delhi.

R. L. Gupta and Radhaswamy, "*Advanced Accountancy*".

S. N. Maheswari, "*Management Accounting*".

V. K. Goyal, "*Financial Accounting*", Excel Books, New Delhi.

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Unit 5: Accounting Equation and Accounting Cycle

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5.1 Effect of Transactions on the Accounting Equation

5.2 Accounting Cycle

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5.5 Self Assessment

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5.7 Further Readings

Objectives

After studying this unit, you will be able to:

- Explain the concept of accounting equation
- Describe accounting cycle

Introduction

The basic accounting equation is the foundation for the double-entry bookkeeping system. It shows how assets were financed: either by borrowing money from someone (liability) or by paying your own money (shareholders' equity).

Assets = Liabilities + (Shareholders or Owners equity)

The accounting equation is also the basis for the most basic of accounting reports, the aptly named Balance Sheet. A balance sheet reports what a business owns (assets), what it owes (liabilities) and what remains for the owners (equity) as of a certain date. This equation should remain in balance at all times because of double-entry accounting or bookkeeping. This can be further understood by the following illustrations.

An owner's investment into the company will increase the company's assets and will also increase owner's equity. When the company borrows money from its bank, the company's assets increase and the company's liabilities increase. When the company repays the loan, the company's assets decrease and the company's liabilities decrease. If the company pays cash for a new delivery van, one asset (cash) will decrease and another asset (vehicles) will increase. If a company provides a service to a client and immediately receives cash, the company's assets increase and the company's owner's equity will increase because it has earned revenue. If the company provides a service and allows the client to pay in 30 days, the company has increased its assets (Accounts Receivable) and has also increased its owner's equity because it has earned service revenue. If the company runs a radio advertisement and agrees to pay later, the company will incur an expense that will reduce owner's equity and has increased its liabilities.

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Example: If a business has ₹ 1,000 of assets at a particular time those assets must be matched by the total of the claims of creditors and owners. Here is one example of an infinite number of acceptable balance sheets:

Fazal-ur-Rehman and Sons.
Balance Sheet

	₹
Assets	1000
Liabilities	500
Equity	500
Total Liabilities and Equity	**1000**

Equity as Residual Claims

Equity is simply the difference between assets and liabilities. The owner has positive equity only to the extent that assets exceed liabilities.

Example: If a business has ₹ 1,000 of assets and ₹ 600 of liabilities the ₹ 600 of liabilities are, in effect, a claim on the assets. Equity is the difference between the assets and liabilities, or ₹ 400.

Equity = Assets – Liabilities

Equity is simply the difference between assets and liabilities. The owner has positive equity only to the extent that assets exceed liabilities.

Example: If a business has ₹ 1,000 of assets and ₹ 500 of liabilities the ₹ 500 of liabilities are, in effect, a claim on the assets. Equity is the difference between the assets and liabilities, or ₹ 500.

If a business ceases operations remaining assets first go to outside creditors. The claims of owners can be realized only after outside creditors' claims are satisfied. So equity represents the owners' residual claim on business assets.

Notes **Rules for Accounting Equation**

Following rules help in making the accounting equation:

1. ***Assets:*** If there is increase in assets, this increase is debited in assets account. If there is decrease in assets, this decrease credited in assets account.
2. ***Liabilities:*** When liabilities are increase, outsider's equities are credited and when liabilities are decreased, outsider's equities are debited.
3. ***Capital:*** When capital is increased, it is credited and when capital is withdrawn, it is debited.
4. ***Expenses:*** Owner's equity is decreased by the amount of revenue expenses.
5. ***Income or profits:*** Owner's equity is increased by the amount of revenue income.

Notes

5.1 Effect of Transactions on the Accounting Equation

You have learnt that assets, liabilities and capital are the three basic elements of every business transaction, and their relationship is expressed in the form of accounting equation which always remains equal. At any point of time, there can be a change in the individual asset, liability or capital, but the two side of the accounting equation always remain equal. Let us verify this fact by taking up some transactions and see how these transactions affect the accounting equation:

Example:

1. Mr. Kamlesh started business with cash of ₹2,00,000.

   In this transaction, one side cash is coming into business and in the other side capital is being brought by Mr. Kamlesh. Thus:

   Capital = Assets (Cash)

   ₹ 2,00,000 = ₹ 2,00,000

2. In the next transaction, if a plant of ₹50,000 is purchased in cash, this transaction will also leave two sides. In one side cash is going and in other side plant is coming. In this situation, the accounting equation will be as follows:

   Capital = Plant + Cash (Assets)

   ₹ 2,00,000 = ₹ 50,000 + (₹ 2,00,000 – 50,000)

3. If a loan of ₹1,50,000 is taken from the SBI, it will also affect the accounting equation by two sides. On one side, cash will increase and on the other side. liabilities of the business will increase. This may be depicted as follows:

   Capital + Liability (Loan) = Plant + Cash

   ₹ 2,00,000 + 1,50,000 = ₹ 50,000 + (1,50,000 + 1,50,000)

   ₹ 3,50,000 = ₹ 3,50,000

4. If some goods of ₹ 20,000 are purchased on credit, it will also affect the accounting equation in two ways. On one side it increases the goods and on the other side it increases the liability (creditors). Now the changed form of the above accounting equation will be as follows:

   Capital + Liabilities = Assets

   Capital + Loan + Creditors = Plant + Cash + Goods

   ₹ 2,00,000 + 1,50,000 + 20,000 = ₹ 50,000 + 3,00,000 + 20,000

   ₹ 3,70,000 = ₹ 3,70,000

5.2 Accounting Cycle

Accounting is described as origin for the creation of information and the continuous utility of information. Now the question is how is this information created? For this, there is a step by step process, as shown below. The major steps involved in the accounting cycle are:

1. ***Analyse Transactions:*** The first step of a accounting cycle is to know what type of transaction we are dealing with; we also need to verify that the information is correct and that transactions have taken place only with proper **a**uthorization. Most accounting transactions originate with what are called source documents**,** which are the invoices, invoices, orders, time cards, checks, and other "paperwork" (or now, commonly digital

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files) which provide the first indication that a transaction has taken place (or will be taking place in the future.)

2. ***Preparing Journals:*** The journal is the "book of original entry," the place where the transactions first become part of the official financial records of the organization. We make ***journal entries*** which specify the accounts which are affected by a transaction, and the amount of money involved.

3. ***Post to Ledger A/c:*** The ledger is the entire group of accounts maintained by an organization. Posting refers to the transfer of the journal entries to the ledger. In a manual system, posting was a separate process. In computerized systems, posting is typically accomplished contemporaneously with recording the transaction in the journal.

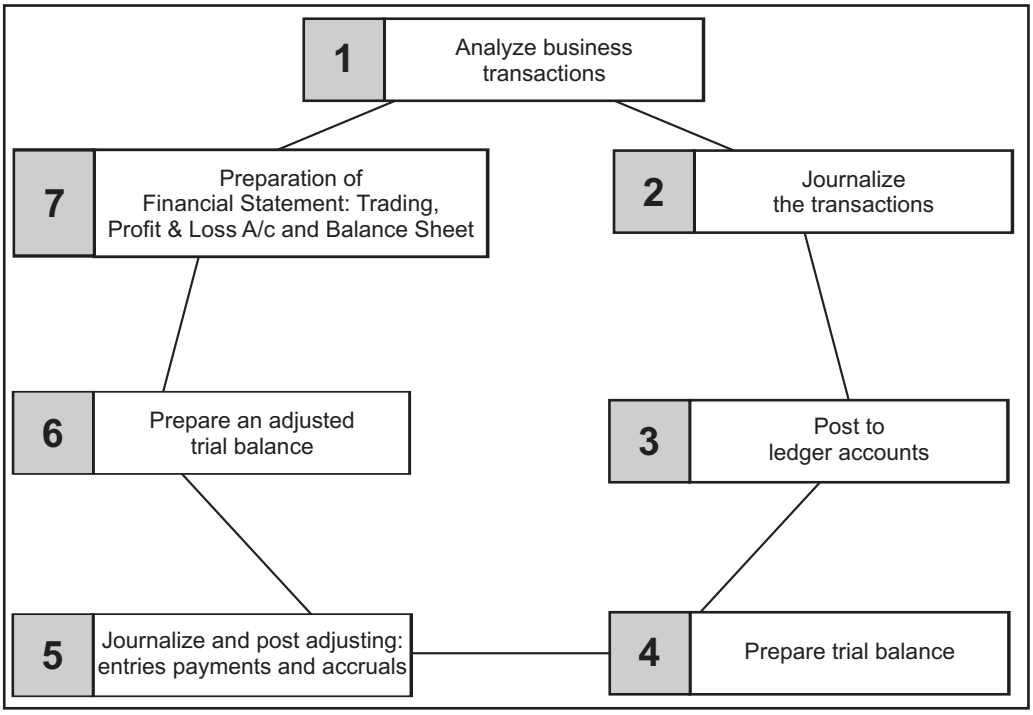
4. ***Preparation of Trial Balance:*** A trial balance is nothing more than a summation of the account balances to be sure that the books do, in fact, balance.

5. ***Prepare financial statements:*** After preparing the trial balance the next step is to prepare the financial statements like income statement, balance sheet and cash flow statement.

6. ***Post Closing Entries:*** Closing entries are the entries that we make to close the temporary accounts (the expense and revenue accounts). In manual systems, each closing entry had to be made individually. In computerized systems, a single command closes the books.

7. ***Preparation of Financial Statement:*** Last step includes the preparation of Trading and Profit & Loss A/c and opening and closing balance sheet.

The following figure explain the key steps of accounting cycle:



Notes

Notes ***Classifying:*** It is one of the most important processes of the accounting. Under this, grouping of transactions is carried out on the basis of certain segments or divisions. It can be described as a method of rational segregation of the transactions. The segregation is generally done into two categories, viz.

1. Cash transactions and
2. Non-cash transactions.

The preparation of the ledger A/cs and Subsidiary books are prepared on the basis of rational segregation of accounting transactions. For eg, the preparation of cash book is involved in the unification of cash transactions.

Summarizing: The ledger books are appropriately balanced and listed one after another. The list of the name of the various ledger book A/cs and their accounting balances is known as Trial Balance. The trial balance is summary of all unadjusted name of the accounts and their balances.

Preparation: After preparing, the summary of various unadjusted A/cs are required to adjust to the tune of adjustment entries which were not taken into consideration at the time of preparing the trial balance. Immediately after the incorporation of adjustments, the final statement is readily available for interpretations.

Did u know? **What are the purposes of preparing financial statements?**

1. Accounting provides necessary information for decisions to be taken initially and it facilitates the enterprise to pave way for the implementation of actions
2. It exhibits the financial track path and the position of the organization.
3. Being business in the dynamic environment, it is required to face the ever changing environment. In order to meet the needs of the ever changing environment, the policies are to be formulated for the smooth conduct of the business.
4. It equips the management to discharge the obligations at every moment.
5. Obligations to customers, investors, employees, to renovate/restructure and so on.

5.3 Summary

- The recording of business transactions in the books of account is based on a fundamental equation called Accounting Equation.
- This equation expresses the equality of assets on the one side and other side equity
- Expenses and Revenue also affect the accounting equation. Their effect is always on the capital account.
- The accounting equation is also the basis for the most basic of accounting reports, the aptly named Balance Sheet.
- A balance sheet reports what a business owns (assets), what it owes (liabilities) and what remains for the owners (equity) as of a certain date.
- Accounting is described as origin for the creation of information and the continuous utility of information.

Notes

5.4 Keywords

Accounting Equation: The recording of business transactions in the books of account is based on a fundamental equation called Accounting Equation.

Asset: Any physical thing or right owned that has money value is an asset.

Liability: It means the amount which the firm owes to outsiders that is, accepting the proprietors.

Stock: The goods purchased are for selling, if the goods are not sold out fully, a part of the total goods purchased is kept with the trader unlit it is sold out, it is said to be a stock.

5.5 Self Assessment

Fill in the blanks:

1. The basic accounting equation is the foundation for the ..... system.
2. A ..... reports what a business owns (assets), what it owes (liabilities) and what remains for the owners (equity) as of a certain date.
3. An owner's investment into the company will increase the company's assets and will also increase .....
4. Accounting Equation serves as a basis for preparing .....
5. Liabilities = ... – Capital

Choose the appropriate answers:

6. The basic accounting equation is Assets = Liabilities + Equity. The Equity term of the equation can be further broken down into several other terms. Assume that the entity is a sole proprietorship. Which of the following statements is correct?
   - (a) Additional investments by the business owner will increase equity; and revenues will decrease equity.
   - (b) Additional investments by the business owner will decrease equity; and revenues will increase equity.
   - (c) Increases in expenses will decrease equity; and owner withdrawals will decrease equity.
   - (d) Revenues will increase equity; and owner withdrawals will increase equity.
   - (e) Revenues will decrease equity; and owner withdrawals will increase equity.
7. If at the end of the accounting period the company's liabilities total ₹ 19,000 and its equity totals ₹ 40,000, then what must be the total of assets?
   - (a) ₹ 14,000
   - (b) ₹ 40,000
   - (c) ₹ 21,000
   - (d) ₹ 59,000
   - (e) None of the above
8. If during the current accounting period the company's assets increased by ₹ 24,000 and equity increased by ₹ 5,000, then how did liabilities change?
   - (a) Increased by ₹ 29,000
   - (b) Increased by ₹ 24,000
   - (c) Decreased by ₹ 5,000
   - (d) Decreased by ₹ 19,000
   - (e) Increased by ₹ 19,000

Notes

5.6 Review Questions

1. Prepare accounting equation from the following Transactions:

	₹
Hemant started business with cash	3,00,000
Purchased goods for cash	80,000
Sold goods[costing ₹30,000] for cash	45,000
Purchased goods from Monika	70,000
Salary paid	7,000
Commission received	5,000
Paid Cash to Monika in full settlement	69,000
Goods sold to Rahul {Costing ₹20,000} for cash	25,000

2. "Accounting equation remains intact under all circumstances" Justify the statement with the help of example.

3. Prepare accounting equation on the basis of the following:
   (i) Anup started business with cash ₹250,000
   (ii) Purchased goods for cash ₹35000
   (iii) Purchased office furniture for cash ₹12000
   (iv) Paid rent ₹7000
   (v) Sold goods (costing ₹30000) for ₹50000 for cash

4. Show the accounting equation on the basis of the following transactions

(i)	Manu started business	
	Cash	600000
	Goods	100000
(ii)	Purchased office machine for cash	90000
(iii)	Sold goods (costing ₹ 60000) for credit to Asha	
(iv)	Purchased building for cash	130000
(v)	Cash received from Ashu	80000
(vi)	Purchased goods on credit to M/S Ashok Trader for cash	70000
(vii)	Salaries paid	6000
(viii)	Insurance prepaid	10000
(ix)	Cash paid to M/s Ashok traders in full settlement	68000

5. "Accounting is described as origin for the creation of information and the continuous utility of information." Discuss.

6. Why does accounting equation remains in balance?

7. "Accounting is the process of recording, classifying and summarizing of accounting transactions." Discuss.

Notes

Answers: Self Assessment

1.	double-entry bookkeeping	2.	balance sheet
3.	owner's equity	4.	Balance Sheet
5.	Assets	6.	(c)
7	(d)	8	(e)

5.7 Further Readings

Books

Khan and Jain, "*Management Accounting*".

M.P. Pandikumar, "*Accounting & Finance for Managers*", Excel Books, New Delhi.

R. L. Gupta and Radhaswamy, "*Advanced Accountancy*".

S. N. Maheswari, "*Management Accounting*".

V. K. Goyal, "*Financial Accounting*", Excel Books, New Delhi.

Online link www.futureaccountant.com

Notes

Unit 6: Preparation of Journal

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Objectives

After studying this unit, you will be able to:

- Prepare journal
- Construct journal entries between the accounts of two different categories
- Illustrate opening and compound journal entries

Introduction

Journal is a book of accounts in which all day to day business transactions are recorded in a chronological order i.e. in the order of their occurrence. Transactions when recorded in a Journal are known as entries. It is the book in which transactions are recorded for the first time. Journal is also known as 'Book of Original Record' or 'Book of Primary Entry'.

6.1 Journal: Meaning and Format

The practice starts with the journalizing of entries. After journalisation, the entries passed in the journal will be passed into the ledger A/c. The immediate next stage is to prepare the trial balance.

Did u know? **What is meant by the journal entry?**

It is an entry systematically recorded to the tune of golden rules of accounting in the journal book is known as journal entries.

The journal entries are recorded in the sequential order. The order of recording is conventionally done on the basis of date. The journal entry usually contains two different parts, which are nothing but two different accounts affecting the transactions.

Notes

Date	Particulars	Ledger Folio	Debit (₹)	Credit (₹)
Number of the day in the month, Name of the month and Year in full	To debit the name of the account	Page number in the respective ledger		
	To credit the name of the account			

The given below is the explanation of journal:

1. ***Date:*** In this column, we record the date of the transactions with its month and accounting year. We write year only once at the top and need not repeat it with every date.

   Example: Date
   2006
   April 15

2. ***Particulars:*** The accounts affected by a transaction i.e the accounts which have to be debited or credited are recorded in this column. It is recorded in the following way:

   In the first line, the account which has to be debited is written and then the short form of Debit i.e., Dr., is written against that account's name in the extreme right of the same column. In the second line after leaving some space from the left of the entry in the first line, the account which has to be credited is written starting with preposition 'To' Then in the third line, Narration for that entry which explains the transaction, the affected accounts of which are entered, is written within Brackets. Narration should be short, complete and clear. After every journal entry, horizontal line is drawn in the particulars column to separate one entry from the other.

   Example: Rent paid in cash on 1st April, 2006

Date	Particulars
2006	Rent A/c..... Dr
April 1	To Cash A/c .....

   (Rent paid in cash)

   _____

3. ***Ledger Folio:*** The transaction entered in a Journal is posted to the various related accounts in the 'ledger' (which is explained in another unit). In ledger-folio column we enter the page-number where the account pertaining to the entry is opened and posting from the Journal is made.

4. ***Dr. Amount:*** In this column, the amount to be debited is written against the same line in which the debited account is written.

5. ***Cr. Amount:*** In this column, the amount to be credited. is written against the same line in which the credited account is written.

Journalising the entries is different from one transaction to another. The difference is only due to nature and characteristics of the transactions. To journalise as easy as possible, the systematic approach to be adopted to post the transactions without any ambiguity.

Notes Journalising can be generally categorized into following various categories:

1. Taking place within the same natured accounts
2. Taking part in between accounts of two different in categories.

Notes

First, we will discuss the journalizing of entries of the same natured accounts. This can be classified into various segments:

1. Transactions only in between the personal accounts
2. Transactions only in between the real accounts

Under the category of transactions which affect only the personal accounts are as follows:

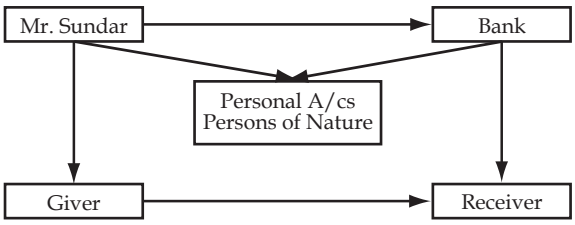
1. Between the persons of the nature
2. Between the persons of the artificial relationship
3. Between the persons of representations

Caution The points to be observed at the moment of journalizing:

1. The nature of the accounts to be identified
2. The accounts to be correlated to the golden rules
3. The entry to be passed through proper debiting and crediting of the accounts respectively.

The meaning of the transaction should be made explicit for easier understanding through brief and catchy narration to follow as well as evade the ambiguity in near future.

Example: Mr. Sundar is a debtor who has paid ₹ 1,500 in the bank A/c



1. Transaction is identified which is in between two different persons under the personal A/c, they are nothing but persons of nature
2. The benefits are shared in between two persons, *viz.* Mr. Sundar and Banker who are nothing but giver and receiver of the benefits respectively.
3. It means that Sundar is the giver of ₹ 1,500 to Banker who is the receiver of the same ₹ 1,500.

Debit the Receiver	Banks	Debit the Melvin A/c
Credit the Giver	Sundar	Credit the Sundar A/c

Final step is to pass the journal entry

Bank A/c	Dr	₹1,500	
To Sundar A/c			₹1,500

(Being cash is paid by Sundar to Bank A/c)

Notes

6.2 Transactions in between the Real A/c

Real A/c is an account to highlight the movement of the assets. There are two different type of assets *viz.* Cash and Plant & Machinery. Among the two assets, cash is one of the current assets and the Plant & Machinery is one of the fixed assets. In general, these two are brought under the category of assets or applications of the firm.

If the assets are involved in the transaction, Real account should only be referred.

The movement of the assets can be classified into two segments *viz.* movement in and movement out.

movement-in: The movement-in is the movement of the assets to the business enterprise.

movement-out: The movement-out is the movement of the assets from the business enterprise. Next stage is to highlight the movement of the assets during the purchase

Movement-In	Plant and Machinery	Debit what comes in
Movement-out	Cash resources	Credit what goes out

Any simultaneous movement is taking place in between two different assets of the enterprise can be explained with the following example:

Example: Purchase of a Plant and Machinery of ₹ 15,000/–.

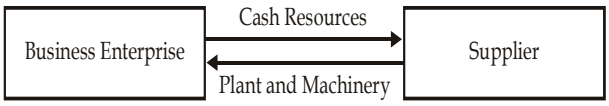
The purchase of a plant and machinery is only through cash payment to the vendor.

There are two different type of assets viz. Cash and Plant & Machinery. Among the two assets, cash is one of the current assets and the Plant & Machinery is one of the fixed assets. In general, these two are brought under the category of assets or applications of the firm. If the assets are involved in the transaction, Real account should only be referred.

How the movement of assets is taking place at the moment of purchase?

The movement of the assets classified into two segments *viz.* movement in and movement out. The movement-in is the movement of the assets to the business enterprise. With reference to above cited example which asset is coming into the business enterprise? Plant & Machinery are the assets which comes into the business enterprise only at the moment of purchase.

The movement out is the movement of the assets from the business enterprise. From the above illustrated example, which asset is going out of the firm during the purchase? Cash resources are going out of the firm in order to make the payment of the purchase to the supplier of the assets.



Next stage is to highlight the movement of the assets during the purchase

Movement-In	Plant and Machinery	Debit what comes in
Movement-out	Cash resources	Credit what goes out

What is coming in?—Plant and Machinery

What is going out?—Cash Resources

Plant and Machinery A/c Dr. ₹15,000

To Cash resources A/c ₹15,000

(Being Plant & Machinery is purchased)

Notes

During the purchase, the plant & machinery worth of ₹ 15,000/- is coming into the firm, in turn ₹ 15,000/- worth of cash resources are going out of the firm. During the cash purchase, the assets are moving from one entity to another *viz.* from business enterprise to supplier and vice versa.

6.3 Journal Entries in between the Accounts of two different Categories

Transactions are in between the Real A/c and Personal A/c

This type of the transaction is mainly governed by one important principle that future relationship. It major focuses on the maintenance of future relationship among the parities involved, till the realization of the transaction is over.

Example: Goods sold to Gopal ₹ 15,000/-

Meaning: The goods were sold on credit to Gopal amounted ₹ 15,000.

In the given transaction, there are two different A/cs, *viz.* Real A/c and Personal A/c

During the sales, irrespective of nature, goods are moving out of the firm, which finally will reach the individual Gopal. The goods, which are sold out to Gopal led to movement of goods out of the firm. Any movement of asset should be referred only to the tune of Real A/c. The goods which are going out of the firm could be recorded as transaction under the Real A/c, i.e. "Credit what goes out".

While recording the transaction, it should not be entered as Goods A/c. The reason for goods going out of the firm is only due to sales which have to be registered in the books of accounts at the time of entering the journal entries.

The second account which gets affected is the personal A/c of representations. The goods sold out on credit led to register the receiver of goods who has not paid at the moment of sale. Gopal is the individual received the goods on credit during the sales expected to make the payment as per the terms of credit period. Till the maturity of the credit period agreed, the firm should wait and collect the amount from the individual who is nothing but the receiver of goods.

Movement-out – Real A/c	Goods are moving out of the firm	Credit what goes out Sales A/c
Receiver of benefits- Personal A/c	Receiver of the goods on credit with future relationship	Debit the receiver Gopal A/c

Next step is to record the journal entry

Gopal A/c Dr ₹ 15,000

To Sales A/c ₹ 15,000

(Being goods sold on credit to Gopal)

Transaction in between the Real A/c and Nominal A/c

Example: Office Rent paid ₹ 10,000

The two different accounts involved in the above illustrated transaction are the Rent A/c and Cash A/c. It is because of the cash payment at the moment of making the payment of rent.

Notes

The Rent which is paid to the owner is an expense out of the benefits derived out of the asset during the previous month. In accordance with the Nominal A/c all the expenses are to be recorded, i.e. "Debit all the expenses and losses".

The second is in relevance with the cash payment which finally led to the movement of cash resources from the firm to the owner of the Asset. This mobility of the assets leads to movement-out which in connection with the Real A/c is the account for the assets.

Rent paid	Expense- Office Rent paid	Nominal A/c- Debit All expenses and losses
Movement -out	Cash – moving out of the firm	Real A/c- Credit what goes out

Illustration 1: Pass the following various journal entries.

1. Jan 1,2006 Mr. Sundar has started business with a capital of ₹ 50,000
2. Jan 2, 2006 Goods purchased ₹ 10,000
3. Jan 5, 2006 Goods sold ₹ 5,000
4. Jan, 10, 2006 Goods purchased from Mittal & co ₹ 10,000
5. Jan, 11, 2006 Goods sold to Ganesh & co ₹ 10,000
6. Jan, 12, 2006 Goods returned to Mittal & co ₹ 1,500
7. Jan 20, 2006 Goods returned from Ganesh ₹ 2,000
8. Jan 31, 2006 Office Rent paid ₹ 500
9. Feb 2, 2006 Interim Dividend paid ₹ 3000
10. Feb 8, 2006 Cash withdrawn from bank ₹ 2,000

Solution:

1. Jan 1, 2006 Mr. Sundar has started business with a capital of ₹ 50,000

Date	Divisions of Transactions	A/cs involved	Golden Rule Registration
Jan 1,2006	Capital brought-Cash Resources in the form of capital	Real A/c-Movement of Assets-Cash Resources are coming in, in the form of capital	Debit what comes in
	Sudar-Introducer of the capital as owner- Due to return the amount at later point of time	Personal A/c-Individual-Sundar-Giver/contributor of the capital-which should be returned later –involves with Relationship	Credit the giver

This transaction involves with two different accounts viz.Real A/c and Personal A/c:

		L.F.	₹	₹
Jan 1, 2006	Cash A/c Dr		50,000	
	To Sundar's Capital A/c			50,000
	Being capital brought by sundar as cash			

2. Jan 2, 2006 Goods purchased ₹ 10,000:

Date	Divisions of Transactions	A/cs involved	Golden Rule Registration
Jan 2,2006	Goods purchased-Goods movement in- for trading	Real A/c-Purchase of the goods –stock of Goods- Assets- Movement in-coming in-Reason of coming in-Purchase	Debit what comes in
	Cash resources –movement out-payment of the bill out of the purchase	Real A/c-Cash resources-is paid at the point of purchase- Movement out-cash is going out of the firm	Credit what goes out

Notes

This transaction consists of two accounts only from the Real A/c:

		L.F.	₹	₹
Jan 2, 2006	Purchase A/c Dr		10,000	
	To Cash A/c			10,000
Being cash purchase is made				

3. Jan 5, 2006 Goods sold ₹ 5,000:

Date	Divisions of Transactions	A/cs involved	Golden Rule Registration
Jan 5,2006	Good sold-Movement of the goods- Movement out-Sale	Real A/c- goods are moving out of the firm-Reason for moving out of goods with routine trading purpose –Sale	Credit what goes out
	Collection of Sales bill-Movement of cash resources-Movement in- Cash	Real A/c-Cash resources are coming in-sale through cash	Debit what comes in

This transaction includes two different Real A/cs:

		L.F.	₹	₹
Jan 5, 2006	CashA/c Dr		5,000	
	To Sale A/c			5,000
Being cash sale is made				

4. Jan, 10, 2006 Goods purchased from Mittal & Co ₹ 10,000:

Date	Divisions of Transactions	A/cs involved	Golden Rule Registration
Jan 10,2006	Goods purchased-Movement of the goods –Movement in –Purchase	Real A/c- goods are moving in – coming into the firm-reason for moving in-Purchase	Debit What comes in
	Mittal &co- Supplier of the goods-Person of legal relationship-on credit- leads to Person of representations	Personal A/c- Supplier of the goods on credit-involves future relationship –till the payment of purchase dues is over -Giver of the goods (benefits)	Credit the giver

This transaction has got two different accounts, viz Real A/c and Personal A/c:

		L.F.	₹	₹
Jan 10,2006	Purchase A/c Dr		10,000	
	To Mittal A/c			10,000
Being credit purchase from Mittal				

5. Jan, 11,2006 Goods sold to Ganesh & co ₹ 10,000

Date	Divisions of Transactions	A/cs involved	Golden Rule Registration
Jan 11,2006	Good Sold-Movement of the goods-Movement out-Sale	Real A/c-Movement of the goods i.e. out of the firm-Reason for moving out-sale	Credit what goes out
	Mr. Ganesh- Buyer of the goods of the enterprise on credit-Receiver of the goods- Person of legal relationship-Person of representation as well as future relationship	Personal A/c-Mr.Ganesh is the receiver of the goods on credit-to be maintained till the bill payments are over	Debit the receiver

Notes

This transaction has got two different accounts viz Real A/c and Personal A/c:

		L.F.	₹	₹
Jan 11, 2006	Ganesh A/c Dr		10,000	
	To SaleA/c			10,000
Being credit sale made to Ganesh				

6. Jan, 12, 2006 Goods returned to Mittal & Co ₹ 1,500.

Date	Divisions of Transactions	A/cs involved	Golden Rule Registration
Jan 12,2006	Goods return- Movement out- goods moving out of the firm – Returned-Purchase Return	Real A/c-Movement of the goods-out of the firm – to the suppliers-due to improper supply-Purchase Returns	Credit what goes out
	Mittal &Co – Receiver of the goods returned i.e., original supplier-Person of legal relationship as well as future relationship	Personal A/c-Mittal & Co is the receiver of the returned goods –out of purchase- to reduce the overall purchase amount from Mittal & Co	Debit the receiver

This transaction has got two different accounts viz Personal A/c and Real A/c:

		L.F.	₹	₹
Jan 12, 2006	Mittal & Co A/c Dr		1,500	
	To Purchase Return A/c Cr			1,500
(Being the goods returned to supplier Mittal &Co)				

7. Jan 20,2006 Goods returned from Ganesh ₹ 2,000

Date	Divisions of Transactions	A/cs involved	Golden Rule Registration
Jan 20,2006	Goods Return from- Movement In-Goods Return-Sales Return	Real A/c- Movement In – Goods are received –Goods Return – One of the assets- by the customer-Sales return	Debit what comes in
	Ganesh&Co – Giver of the goods returned to the firm-person of legal relationship	Personal A/c-Giver of the goods – Sales return by Ganesh &Co-to account the goods as well as reduce the balance of early purchase from our firm-Name of the entity is earmarked –person of representation as well as future relationship	Credit the giver

This transaction has got two different accounts viz Real A/c and Personal A/c

		L.F.	₹	₹
Jan 20,2006	Sales Return A/c Dr		2,000	
	To Ganesh & Co			2,000
Being sales return made by Ganesh &Co				

Notes

8. Jan 31, 2006 Office Rent paid ₹ 500

Date	Divisions of Transactions	A/cs involved	Golden Rule Registration
Jan 31,2006	Office Rent-Expenses-Revenue Expense-Paid out of the usage of the asset-to the owner	Nominal A/c- Expenses- Revenue expenses-incurred by the firm-out of the usage of the asset for the specified period	Debit all expenses and losses
	Cash resources paid-movement of assets-movement out of the firm-cash resources moving from the firm to the owner of the asset	RealA/c-Movement of Assets-moving out of the firm-Cash resources paid	Credit what goes out

This transaction has got two different accounts, viz Nominal A/c and Real A/c:

		L.F.	₹	₹
Jan 31, 2006	Office Rent A/c Dr		500	
	To Cash A/c			500
Being office rent paid				

9. Feb 2, 2006 Interim Cash Dividend received ₹ 3000

Date	Divisions of Transactions	A/cs involved	Golden Rule Registration
Feb 2, 2006	Cash resource in-movement in – movement of cash resource into the firm	Real A/c- Movement of assets-movement of cash resources from another company to the business enterprise-while collecting the payment of dividend	Debit what comes in
	Interim Cash Dividend-source of income for the generation/circulation of additional source of cash resources.	Nominal A/c –source of the income- receipt of Interim cash dividend-Revenue income	Credit all incomes and gains

This transaction has got two different accounts, viz Real A/c and Nominal A/c:

		L.F.	₹	₹
Feb 2, 2006	Cash A/c Dr		3,000	
	To Interim Dividend			3,000
Being cash interim dividend received				

10. Feb 8,2006 Cash withdrawn from bank ₹ 2,000:

Date	Divisions of Transactions	A/cs involved	Golden Rule Registration
Feb 8,2006	Cash Resource- withdrawal from the account-movement of the cash resources in-from the banker to the firm	Real A/c-movement of assets-movement of cash resources-withdrawal of cash from the bank	Debit what comes in
	Bank-Institution-Person of legal relationship-giver of the cash resources from the account	Personal A/c-Giver of the cash resources – from the bank account-person of legal relationship	Credit the giver

This transaction has got two different accounts, viz Real A/c and Personal A/c:

		L.F.	₹	₹
Feb 8,2006	Cash A/c Dr		2,000	
	To Bank			2,000
Being cash withdrawn from the bank				

Classification of transactions is being done only on the basis of preparing the ledger accounts. The accounts are classified on the basis of nature and characteristics.

Notes

How are the account transactions classified?

The accounts are classified through the preparation of ledger.

Illustration 2: Journalize the following transactions with narration:

Date	Particulars	₹
2006		
June 1	Receive cash from Ramu	2,500
June 4	Purchase goods for cash	1,000
June 5	Sold goods to Hari	4,000
June 8	Bought furniture from Raju	500
June 10	Paid for office stationery	150

Solution:

Journal Entries

Date	Particulars	L.F.	₹	₹
2006				
June 1	Cash a/c Dr. To Ramu Cash received from Ramu		2,500	2,500
June 4	Purchases a/c Dr. To cash a/c Goods purchased for cash		1,000	1,000
June 5	Hari Dr. To Goods a/c (Sales A/c) Goods sold to Hari		4,000	4,000
June 8	Furniture a/c Dr. To Raju Furniture bought from Raju		500	500
June 10	Office Stationery a/c Dr. To cash a/c Paid for office stationery		150	150

Task Identify nature of the transactions:

Ramchander has purchased goods on credit from M/s Royals Aventis for ₹ 15,000. The portions of the goods were found to be damaged which worth of ₹ 5,000. Ramchander immediately returned the damaged goods to Royals.

1. Identify the various types of accounts involved in the above illustrated transactions.
2. Pass the journal entries with regards to the nature of accounts involved.

6.4 Compound Entries

When two or more transactions take place in the business relating to a same account on the same date, then in the place of passing many entries for the same account a single journal entry is passed which is called a compound journal entry.

Notes

Example: If a debtor is allowed cash discount and he makes the payment, then the accounts involved are three, i.e., (1) Cash A/c, (2) Discount A/c, and (3) Debtors A/c.

The following compound entry is to be passed:

Cash A/c	Dr.
Discount A/c	Dr.
To Debtors A/c	
Debtor paid & was allowed discount.	

Thus, we see that all the transactions are recorded in the journal and that too in a chronological (date wise) order. That is why the journal is known as the book of original entry. All such transactions which take place in the business are recorded which have documentary proof. Such documents are known as vouchers, cash memos or debit or credit-note or pay-in-slip etc.

6.5 Opening Entry

The closing balance of account of one year is transferred to the next year. In the next year this balance becomes the opening balance. After recording the opening balance, the transaction of the year is recorded. To record the opening balance a Journal entry is passed which is called opening entry.

Example: Suppose in a business there are closing balances of cash of ₹10,000, plant ₹90,000 and capital of ₹1,00,000, then opening Journal entry will be as follows:

Assets Account	Dr.	90,000	
Cash Account	Dr.	10,000	
To Capital Account			1,00,000

If all assets are more than all liabilities, its excess will be the value of capital which is showed credit side in the opening journal entry. If liabilities are more than the value of all assets, then this excess will be goodwill and it will be debited in opening journal entry. Typically, different of assets and liability will be positive and excess value of assets are showed as capital in the credit of journal entry.

Illustration 3: Pass the necessary opening entry on 1st January, 2006 in the books of Gopinath.

	₹
Cash in hand	3,000
Cash at Bank	16,000
Stock in trade	30,000
Furniture & Fittings	5,000
Sundry Debtors	21,000
Sundry Creditors	18,000
Loan from Ganesh & Co.	9,000

Notes

Solution

Opening Journal Entries

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
1.1.2006	Cash in hand a/c	Dr.		3,000	
	Cash at Bank a/c	Dr.		16,000	
	Stock in trade a/c	Dr.		30,000	
	Furniture's Fittings a/c	Dr.		5,000	
	Sundry debtors a/c	Dr.		21,000	
	To Sundry creditors a/c				18,000
	To Ganesh & Co. a/c				9,000
	To Capital a/c				48,000
	Opening entry in respect of assets and liabilities. (Difference between Assets and liabilities is equal to capital)				

6.6 Summary

- Journal is the first book of the original entries in which all the business transactions of the financial nature are recorded, then posted to ledger accounts.
- Accounts are of three types – Personal, Real and Nominal Account.
- The law of entire business revolves around only on mutual agreement sharing policy among the players.
- A personal account is an account which deals with a due balance either to or from these individuals on a particular period.
- Real Accounts is the account especially deals with the movement of assets.
- Nominal Account is an account deals with the amount of expenses incurred or incomes earned.
- It includes all expenses and losses as well as incomes and gains of the enterprise.

6.7 Keywords

Journal: The primary book in which the business transactions are recorded at first time.

Nominal A/c: Accounts which are relating to the revenues, incomes, expenses and losses of the business are called nominal accounts.

Personal A/c: Accounts which are related to person, firms, companies and representatives.

Process of Accounting: It includes the recording of transactions into Journal, classifying into Ledger and summarizing into Trial Balance and Final Accounts.

Real A/c: Accounts which are related to all the assets accounts are included into it.

6.8 Self Assessment

Fill in the blanks:

1. Journalising is the process of entering transactions in .....
2. Another name for Journal is .....
3. Transactions, when recorded in Journal, are known as .....

Notes

4. The explanation of a Journal entry is known as .....
5. In a Journal entry preposition ..... is used before the name of the account to be credited.
6. Journal is a …… of original entries for accounting data.
7. The journal is known as the …… .
8. The process of transferring the entries from Journal to Ledger accounts is called ……

State whether the following statements are true or false:

9. Real account deals with especially the movement of assets.
10. Rent is a personal A/c.

6.9 Review Questions

1. Pass the following various journal entries:
   (a) Jan. 1, 2006 Mr. Sundar has started business with a capital of ₹ 50,000
   (b) Jan. 2, 2006 Goods purchased ₹ 10,000
   (c) Jan. 5, 2006 Goods sold ₹ 5,000
   (d) Jan. 10, 2006 Goods purchased from Mittal & Co. ₹ 10,000
   (e) Jan. 11, 2006 Goods sold to Ganesh & Co. ₹ 10,000
   (f) Jan. 12, 2006 Goods returned to Mittal & Co ₹ 1,500
   (g) Jan. 20, 2006 Goods returned from Ganesh ₹ 2,000
   (h) Jan. 31, 2006 Office Rent paid ₹ 500
   (i) Feb. 2, 2006 Interim Dividend paid ₹ 3000
   (j) Feb. 8, 2006 Cash withdrawn from bank ₹ 2,000
2. Your purchases 10 Furniture from other company, your starting own furniture business. Each furniture value is ₹ 1000/-, your business purpose use two furniture and other furniture are sales purpose. What will be the Purchases Entry?
3. Distinguish between material and immaterial transactions of business.
4. The ledger of Salizar Company at the end of the current year shows Accounts Receivable $110,000, Sales $840,000, and Sales Returns and Allowances $40,000. If Allowance for Doubtful Accounts has a credit balance of $2,500 in the trial balance, journalize the adjusting entry at December 31, assuming bad debts are expected to be
   (a) 1% of net sales, and
   (b) 10% of accounts receivable.
5. Which A/c will you put goodwill in, what about commission received and why?
6. Journalise the following transactions:
   (a) Started business with cash ₹3,00,000.
   (b) Bought Goods on credit for ₹5,000.
   (c) Sold Goods for cash ₹12,000 and on credit ₹ 8,000.

Notes

7. Explain the process of journalising the transactions with suitable examples.
8. What are compound entries? Explain with suitable examples.
9. The following are the transactions of Kumar Swami for the month of January. Journalise these transactions.

2006

January 1	Capital paid into Bank	3,00,000
″ 1	Bought Stationery for cash	400
″ 2	Bought Goods for cash	25,000
″ 3	Bought Postage Stamps	
″ 5	Sold Goods for Cash	10,000
″ 6	Bought Office Furniture from Mahendra Bros.	40,000
″ 11	Sold goods to Jacob	12,000
″ 12	Received cheque from Jacob	12,000
″ 14	Paid Mahendra Bros. by cheque	40,000
″ 16	Sold goods to Ramesh & Co	5,000
″ 20	Bought from S. Seth & Bros	15,000
″ 23	Bought Goods for cash from S.Narain & Co	22,000
″ 24	Sold Good to P.Prakash	17,000
″ 26	Ramesh & Co. Paid on account	2,500
″ 28	Paid S.Seth & Bros. by cheque in full settlement	14,800
″ 31	Paid Salaries	2,800
″ 31	Rent is due to S. Sharma but not yet paid 2,000	

Answers: Self Assessment

1. the journal
2. original book of entries/Primary Book of entries
3. entires
4. narration
5. 'To'
6. primary book
7. book of original entry
8. posting
9. True
10. False

6.10 Further Readings

Books

Khan and Jain, "*Management Accounting*".

M.P. Pandikumar, "*Accounting & Finance for Managers*", Excel Books, New Delhi.

R. L. Gupta and Radhaswamy, "*Advanced Accountancy*".

S. N. Maheswari, "*Management Accounting*".

V. K. Goyal, "*Financial Accounting*", Excel Books, New Delhi.

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Unit 7: Posting to Ledger and Balancing

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Objectives

After studying this unit, you will be able to:

- Prepare ledger
- Make ledger posting
- Illustrate the balancing of accounts

Introduction

You have learnt that business transactions are recorded in various special purpose books and journal proper. The accounting process does not stop here. The transactions are recorded in number of books in chronological order. Such recording of business transactions serves little purpose of accounting. Items of same title in different books of accounts need to be brought at one place under one head called an account. There are numerous account titles of items/ persons or accounts. All the accounts, if brought in one account book, will be more informative and useful. The account book so maintained is called Ledger.

7.1 Preparation of Ledger

Classification of transactions is being done only on the basis of preparing the ledger accounts. The accounts are classified on the basis of nature and characteristics.

Did u know? **How are the account transactions classified?**

The accounts are classified through the preparation of ledger.

Ledger is nothing but preliminary book of accounting transactions at which, each account is separately maintained through the allotment of various pages for exclusive recording. The exclusive allotment of pages is made for every account to finalize their balances. Finally, ledger can be understood that is a document of grouping the transactions under one heading.

Notes

It is a fundamental book of accounts which mainly highlights the status of the accounts.

Example: Plant & Machineries' Ledger A/c should reveal the transactions of the sale and purchase of the plant & machinery.

The journal entries that are recorded nothing but posting of the entries in the ledger book of accounts. Posting/entering the journal entries are routinely carried out immediately after the transactions.

Prior to discussing the posting of journal entries into the ledger accounts, everybody should know the contents of the ledger. The ledger is segmented into two different categories.

The proforma of a Ledger account is given below:

Dr.	Name (Title)			Page No…….			Cr.
Date	**Particulars**	**L.F.**	**Amount (₹)**	**Date**	**Particulars**	**L.F.**	**Amount (₹)**

Journal entries are divided into two categories, viz:

1. Debit item of the transaction
2. Credit item of the transaction

Once the journal entries are identified for classification, the entries should be recorded in accordance with the date order of the transactions in the respective pages.

While recording a transaction, normally a journal entry has got an impact on two or even three different accounts.

7.2 Ledger Posting

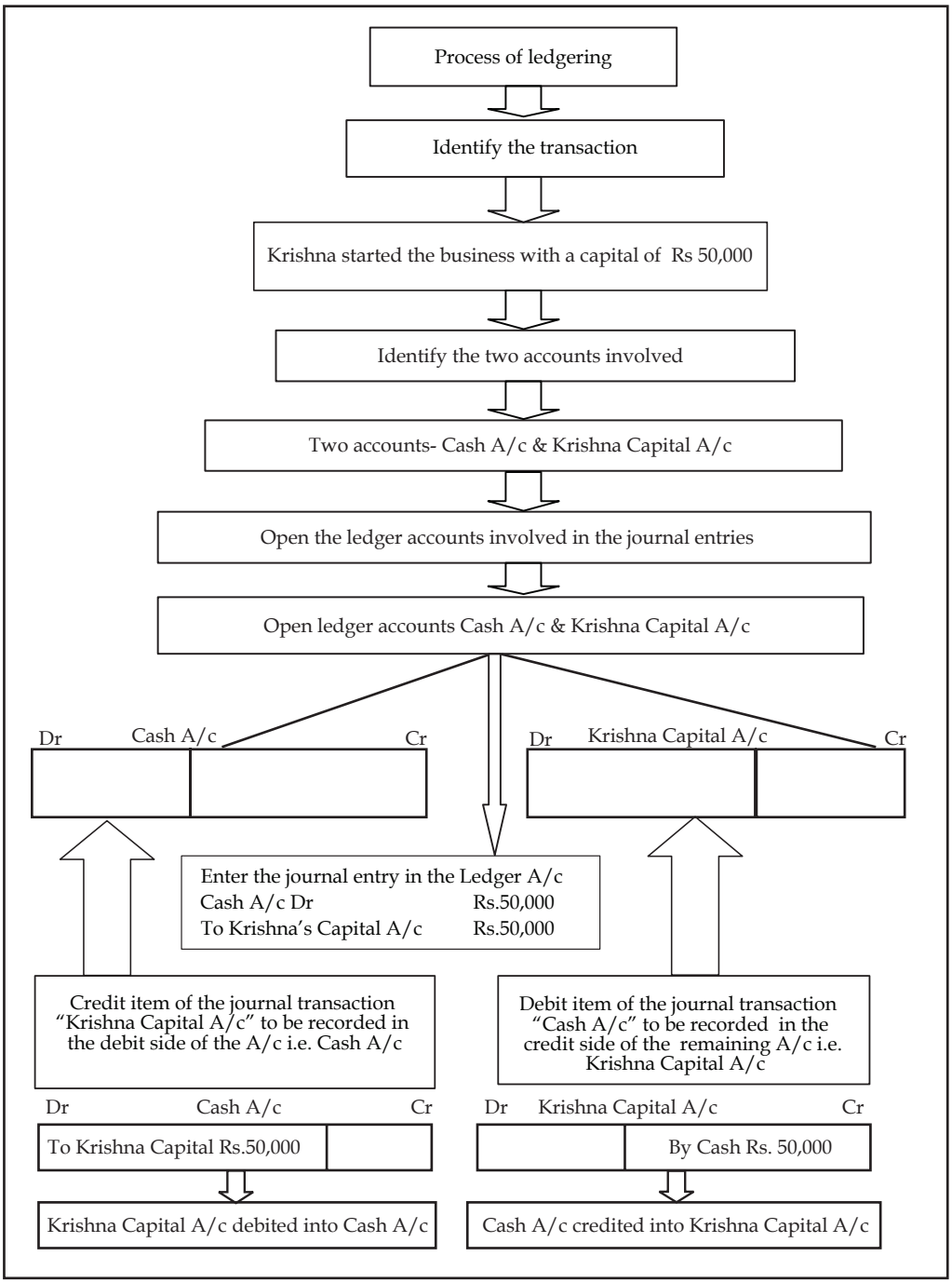
It is a process of recording the transactions under one group from the early process of journalizing. Without journalizing, ledgering is not meaningful. The process of ledgering involves various steps. The process begins only at the completion of journalizing and ends at the end of balancing of journal accounts.

Rules of Posting in Ledger Account

At the time of posting of transactions from Journal to ledger the following points/rules should be kept in mind:

1. In the debit side of a ledger account, the word 'To' is used while in the credit side word 'By' is used.
2. All those accounts are opened in the Ledger which are given in the Journal.
3. All the debit items of an account given in the Journal are posted in the debit side of the respective account. And all the credit items of an account given in the Journal are posted in the credit side of the respective account in ledger.
4. The name of the account, in which the posting is being made, is not written. But the posting is done by the name of the other account given in the opposite side of that entry in the Journal.
5. At the time of posting if the page is full and account is not complete, its total is carried to the next page and then remaining posting is done.

Notes



7.3 Balancing

The individual Ledger A/c may have more than two transactions during the specified period. The given below are the key steps included in a balancing process:

1. The first step is to find out the totals of debit and credit side of the Ledger account.
2. The second step is to compare the totals of the two different sides.

Notes

3. The third step is to find out the total of which side is greater over the other.
4. The fourth step is to identify the difference among the two side's balances i.e. debit and credit side totals.
5. The fifth step is the most important step which balances the difference on the total of the side which bears lesser total over the greater.
6. If the balance of the debit side of the ledger is more than the credit side it is called as Debit balance ledger and vice versa in the case of Credit balance ledger.
7. The closing balance of one ledger account will automatically become an opening balance of the same ledger account for the next accounting period.

Balancing of Different types of Accounts

Assets: All asset accounts are balanced. These accounts always have a debit balance.

Liabilities: All Liability accounts are balanced. All these accounts have a credit balance.

Capital: This account is always balanced and usually has a credit balance.

Expense and Revenues: These Accounts are not balanced but are simply totaled up. The debit total of Expense/Loss will show the expense/Loss. In the same manner, credit total of Revenue/ Income will show increase in income. At the time of preparing the Trial Balance, the totals of these are taken to the Trial Balance.

Illustration: Post the journal entries into respective ledger accounts and list out their accounting balances.

1. Jan 1,2006 Mr. Sundar has started business with a capital of ₹ 50,000.

		Dr	Cr
		₹	₹
Jan 1,2006	Cash A/c Dr	50,000	
	To Sundar Capital A/c		50,000
Being capital brought by Sundar as cash			

2. Jan 2,2006 Goods purchased ₹ 10,000

		Dr	Cr
		₹	₹
Jan 2,2006	Purchase A/c Dr	10,000	
	To Cash A/c		10,000
Being cash purchase is made			

3. Jan 5, 2006 Goods sold ₹ 5,000

		Dr	Cr
		₹	₹
Jan 5,2006	CashA/c Dr	5,000	
	To Sale A/c		5,000
Being cash sale is made			

Notes

4. Jan, 10, 2006 Goods purchased from Mittal & Co ₹ 10,000

		Dr	Cr
		₹	₹
Jan 10,2006	Purchase A/c Dr	10,000	
	To Mittal A/c		10,000
Being credit purchase from Mittal			

5. Jan,11, 2006 Goods sold to Ganesh & co ₹ 10,000

		Dr	Cr
		₹	₹
Jan 11,2006	Ganesh A/c Dr	10,000	
	To SaleA/c		10,000
Being credit sale made to Ganesh			

6. Jan,12, 2006 Goods returned to Mittal & Co ₹ 1,500

		Dr	Cr
		₹	₹
Jan 12, 2006	Mittal &Co A/c Dr	1,500	
	To Purchase Return A/c		1,500
(Being the goods returned to supplier Mittal &Co)			

7. Jan 20, 2006 Goods returned from Ganesh ₹2,000

		Dr	Cr
		₹	₹
Jan 20,2006	Sales Return A/c Dr	2,000	
	To Ganesh & Co		2,000
Being sales return made by Ganesh &Co			

8. Jan 31, 2006 Office Rent paid ₹ 500

		Dr	Cr
		₹	₹
Jan 31,2006	Office Rent A/c Dr	500	
	To Cash A/c		500
Being office rent paid			

9. Feb 2,2006 Interim Cash Dividend received

		Dr	Cr
		₹	₹
Feb 2, 2006	Cash A/c Dr	3,000	
	To Interim Dividend		3,000
Being cash interim dividend received			

10. Feb 8,2006 Cash withdrawn from bank ₹ 2,000

		₹	₹
Feb 8, 2006	Cash A/c Dr	2,000	
	To Bank		2,000
Being cash withdrawn from the bank			

Notes

List out the various accounts that are involved in the enterprise during the year.

(i) Cash Account (ii) Sundar Capital Account

(iii) Purchase Account (iv) Sales Account

(v) Mittal & Co. Account (vi) Ganesh & Co Account

(vii) Sales Return Account (viii) Purchase Return Account

(ix) Office Rent Account (x) Interim Dividend Account

(xi) Bank Account

Solution:

Dr **Cash Account** Cr

Date	Particulars	₹	Date	Particulars	₹
Jan 1	To Sundar Capital	50,000	Jan 2	By Purchase	10,000
Jan 5	To Sale	5,000	Jan 31	By Office Rent	500
Feb 2	To Interim Dividend	3,000		By Balance c/d	49,500
Feb 8	To Bank	2,000			
		60,000			60,000
	To balance b/d	49,500			

Note: Debit side total is greater than the credit side total of the cash account. After determining the difference, the cash account is nothing but Debit Balance Account.

Dr **Sundar Capital Account** Cr

Date	Particulars	₹	Date	Particulars	₹
	To Balance c/d	50,000	Jan 1	By Cash	50,000
		50,000			50,000
				By Balance b/d	50,000

Note: Sundar capital account is having the greater credit balance over the debit balance account which led to credit balance account.

Dr **Purchase Account** Cr

Date	Particulars	₹	Date	Particulars	₹
Jan 2 Jan 10	To Cash To Mittal & Co	10,000 10,000		By Balance c/d	20,000
		20,000			20,000
	To Balance b/d	20,000			

Note: Purchase account is bearing the debit balance account.

Dr **Sale Account** Cr

Date	Particulars	₹	Date	Particulars	₹
	To Balance c/d	15,000	Jan 5 Jan 11	By Cash By Ganesh	5,000 10,000
		15,000			15,000
				By Balance b/d	15,000

Note: Sale account is bearing the credit balance account.

Notes

Dr **Sales Return Account** Cr

Date	Particulars	₹	Date	Particulars	₹
Jan 20	To Ganesh	2,000		By Balance c/d	2,000
		2,000			2000
	To Balance b/d	2000			

Note: Sales return account is having the debit balance account.

Dr **Purchase Return Account** Cr

Date	Particular	₹	Date	Particulars	₹
	To Balance c/d	1,500	Jan 12	By Mittal &Co	1,500
		1,500			
				By Balance b/d	1,500

Note: Purchase return account is bearing credit balance account.

Dr **Mittal & Co. Account** Cr

Date	Particulars	₹	Date	Particulars	₹
Jan 12	To Purchase Return To Balance c/d	1,500 8,500	Jan 10	By Purchase	10,000
		10,000			10,000
				By Balance b/d	8,500

Note: Mittal & Co account is having the greater total in the credit side than the debit side led to credit balance at the closing.

Dr **Ganesh & Co. Account** Cr

Date	Particulars	₹	Date	Particulars	₹
Jan 11	To Sale	10,000	Jan 20	By Sale Return By Balance c/d	2,000 8,000
		10,000			10,000
	To Balance b/d	8,000			

Note: Ganesh & Co. account is bearing a greater debit side total than the credit side total which led to have debit balance account.

Dr **Office Rent Account** Cr

Date	Particulars	₹	Date	Particulars	₹
Jan 31	To Cash	500		By Balance c/d	500
		500			500
	To Balance b/d	500			

Note: Office rent account is bearing debit balance.

Dr **Interim Divided Account** Cr

Date	Particulars	₹	Date	Particulars	₹
	To Balance c/d	3,000	Feb 2	By Cash	3,000
		3,000			3,000
				By Balance b/d	3,000

Note: Interim dividend account is having the credit balance.

Notes

Dr **Bank Account** Cr

Date	Particulars	₹	Date	Particulars	₹
	To Balance c/d	2,000	Feb 2	By Cash	2,000
		2,000			2,000
				By Balance b/d	2,000

Note: Bank account is having the credit balance. Nothing but overdraft.

Case Study

Mr. Kamal Nath was doing a business as a cloth merchant. On 1st July, 2007 his assets were: Furniture and Office Equipment = ₹ 12,500, Stock ₹ 1,25,000 Cash in Hand ₹ 3,000, Bank Balance ₹ 42,500, Amounts due from Brijesh ₹ 6,000, Amount due from Girijesh ₹ 7,500. On the date he owed ₹ 10,000 to Manish and ₹ 7,250 to Naresh. His transactions during the month were as follows:

2008		₹
July 2	Sold cloth on credit to Xavier	2,500
July 3	Purchased cloth from Yogesh	10,000
July 4	Paid Rent by cheque	4,000
July 5	Purchase of cloth by cheque	10,000
July 7	Cash sales	2,250
July 8	Received cheque from Brijesh	5,900
	allowed him discount	100
July 9	Paid for stationery	250
July 10	Drawn cash for private use	1,250
July 11	Purchased cloth on credit from Manish	12,500
July 12	Sent cheque to Manish (in full settlement for July 1 transactions)	9,750
July 13	Sold cloth on credit to Girijesh	9,000
July 14	Paid telephone charges	400
July 15	Cash Sales	1,500
July 18	Paid for Advertisement	1,750
July 19	Cash Purchases	3,000
July 30	Paid Salaries for July	4,000

Question

You have to journalise these transactions and from that information prepare his Ledger.

Notes

7.4 Summary

- Ledger is nothing but preliminary book of accounting transactions at which, each account is separately maintained through the allotment of various pages for exclusive recording.
- Posting is the process of selecting of transactions from Journal on the basis of accounts and writing them into ledger accounts.

7.5 Keywords

Balancing: Balancing of an account is the difference between the total of debits and total of credits of an account.

Ledger Posting: It is a process of recording the transactions under one group from the early process of journalizing.

Ledger: It is the classification of accounts in which various accounts are maintained.

7.6 Self Assessment

Fill in the blanks:

1. Ledger contains various ..... in it.
2. The process of transfer of entries from Journal and special purpose books to ledger is called .....
3. Ledger is also called .....
4. Ledger is a ..... book of accounting system.
5. Classification of transactions is being done only on the basis of preparing the ....

State whether the following statements are true or false:

6. If the balance of the debit side of the ledger is more than the credit side it is called as Debit balance ledger
7. Without journalizing, ledgering is not meaningful.
8. Left hand side of ledger account is credit side.
9. Every transaction must be recorded at two places or accounts.
10. Outstanding rent is an example of nominal A/c.

7.7 Review Questions

1. Record the following transactions in the Journal and post them into Ledger of Mr. Aditya Raj:

2008		₹
March 1	Purchase of Goods from Ramautar	3,20,000
March 10	Paid Rent for the month	2,000
March 11	Purchase of Plant	1,00,000
March 12	Paid Salaries	12,000

Notes

March 15	Paid Ramautar	1,00,000
March 20	Sold Goods to Shyam	20,000
March 25	Received from Shyam	30,000
March 31	Reserved Cash from Cash Sales	2,50,000
March 31	Wages Paid	5,000

2. What are the key steps in balancing a ledger a/c?
3. State the relation between journalizing and ledger posting with suitable examples.
4. Why is ledger known as the primary book or the principal -book of accounts? Can profit of the business and its financial position be known without maintaining ledger?
5. What is the rule for posting the debit account from the journal into the ledger account?
6. How do we balance the following types of accounts?
   (a) Assets
   (b) Expense
   (c) Capital
   (d) Revenue
7. Following are the transactions of Dhani Ram and Sons for the month of July 2006. Make journal entries, post them into ledger and balance the account.

2006

July 1	Commenced business with cash	60,000
″ 2	Paid into bank	40,000
″ 5	Purchased furniture for cash	5000
″ 7	Purchased Goods and paid for them by cheque	20000
″ 10	Sold Goods to Lata Gupta for cash	12000
″ 12	Sold Goods to Mahavir on credit	24000
″ 18	Purchased Goods from Harish	30000
″ 19	Withdrew cash for domestic use	2500
″ 20	Received a cheque from Mahavir on account	18900
	Allowed him discount	100
″ 27	Paid to Harish cash on account	16800
	Discount allowed by him	200
″ 31	Paid salary by cheque 1800	
	Paid cash for telephone bill	600

8. Enumerate the various types of ledgers which may be maintained by a business.

Notes

9. Prepare the account of X & Co. from the following:

2006		₹
Feb 1	Balance due from X & Co.	1,000
Feb 3	Cash sales to X & Co.	700
Feb 4	Bought furniture from X & Co.	250
Feb 6	Murthy returned goods to us	200
Feb 9	X & Co. Purchased goods from us	1,200
Feb 10	Return of goods from X & Co.	150
Feb 20	X & Co. settled his account by cheque and received discount	20

10. Why is ledger prepared?

Answers: Self Assessment

1.	accounts	2.	posting
3.	Principal Book of Account	4.	reference book
5.	ledger accounts	6.	True
7.	True	8.	False
9.	True	10.	True

7.8 Further Readings

Books

Khan and Jain, "*Management Accounting*".

M.P. Pandikumar, "*Accounting & Finance for Managers*", Excel Books, New Delhi.

R. L. Gupta and Radhaswamy, "*Advanced Accountancy*".

S. N. Maheswari, "*Management Accounting*".

V. K. Goyal, "*Financial Accounting*", Excel Books, New Delhi.

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Unit 8: Subsidiary Books

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8.7 Journal Proper

8.8 Cash Book

8.9 Summary

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Objectives

After studying this unit, you will be able to:

- Prepare Subsidiary books
- Initiate Purchase and purchase return book
- Construct Sales and sales return book

Introduction

If the transactions of the enterprise are voluminous, to ease the process of posting the transactions, they should be classified into two categories. The transactions are segmented, one on the basis of regular and another on the basis of non-regular occurrence.

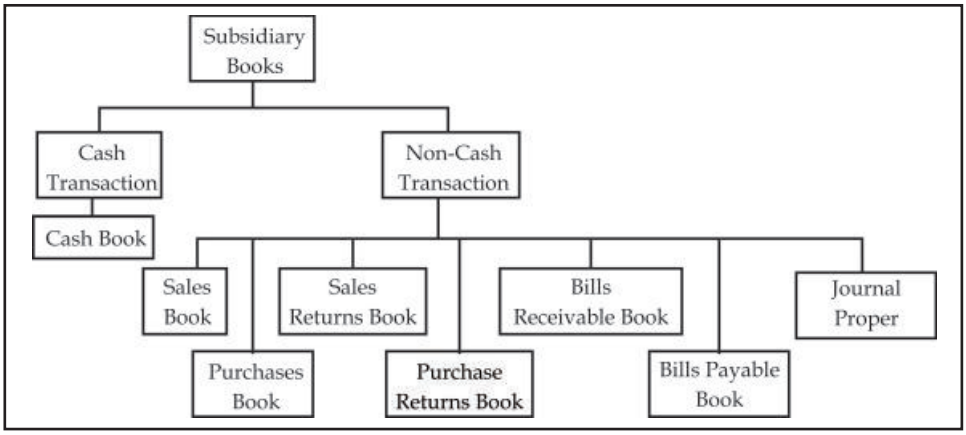
The regular/frequent occurrence of transactions are recorded only in the separate books which are known as subsidiary book of accounts or subsidiary journals, instead of being recorded in the regular journal. The infrequent transactions are recorded/posted in the original journal or journal proper which do not have any specific subsidiary journal or subsidiary books.

The subsidiary journals or books are developed by the firms based only on the occurrence of the transactions. Normally the frequent occurrence of the transactions of the firm is a major part of the subsidiary books of the accounting system.

Notes

8.1 Classification of Subsidiary Books

The following are the subsidiary books on the major frequent occurrence of transactions.



Subsidiary books are classified on the basis of transactions viz Cash transactions and Non cash-transactions.

Did u know? **What is meant by the non-cash transaction?**

A non-cash transaction is a transaction in terms of credit and conditions of the enterprise.

The non-cash transactions shall include the following transactions of the enterprise, which do not involve any cash; they are as follows

1. Credit Sales Book
2. Credit Purchases Book
3. Credit Sales Return Book
4. Credit Purchases Return Book
5. Bills Payable Book – Outcome of Credit Transaction
6. Bills Receivable Book – Outcome of Credit Transaction, and
7. Journal Proper

8.2 Purchase Book

The purchases book is known in other words as purchase journal. It is a book meant for credit purchases only for resale.

Pro forma of the Purchases Book

Date	Name of the Supplier	Ledger Folio	Inward Invoice No	Details	Amount ₹

The purchase book usually contains various components viz.

Name of the supplier: From whom the raw material was procured on credit.

Ledger folio: It is the number of the page where the journal entry is transacted.

Notes

Inward Invoice No: This book contains the invoice number of the credit purchase of the goods from the supplier.

Amount (₹): The book contains the value of credit purchase transactions from the supplier.

Steps involved in posting the entries:

1. Posting the entries pertaining to the individual accounts into the purchase journal.
2. The total of the purchase journal is determined monthly and finally should be posted into debit side of the purchase account - to satisfy the rule of Real Account; which not only contains the cash purchase but also the credit purchase of the firm during the year.

Illustration 1: From the following transactions of Ram for July,2003 prepare the Purchases Book and ledger accounts connected with this book.

2003

July 5 Purchased on credit from Kannan & Co.

50 Iron boxes@ ₹ 500

10 Grinders@ ₹ 3,000

6 Purchased for cash from Siva & Bros.

25 Fans@ ₹ 1,250

10 Purchased from Balan & Sons on credit

20 Grinders@ ₹ 2,500

10 Mixie@ ₹ 3,000

20 Purchased, on credit, one Computer from Kumar for ₹ 35,000.

Solution:

In the books of Ram

Purchases Book

Date	Particulars	Inward Invoice No.	L.F.	Detail ₹	Total ₹
2003 July 5	Kannan & Co. 50 Iron boxes @ ₹ 500 10 Grinders @ ₹ 3,000 Goods purchased vide their bill No..... Dated.....			25,000 30,000	55,000
July 10	Balan & Co. 20 Grinders @ ₹2,500 10 Mixie @ ₹ 3,000 Goods purchased vide their bill No..... Dated.....			50,000 30,000	80,000
	Total				1,35,000

Ledger Accounts
Purchases Account

Dr. Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2003 July 31	To Sundries as per Purchases Book		1,35,000				

Notes

Kannan & Co. Account

Dr. Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
				2003 July 5	By Purchases A/c		55,000

Balan & Co. Account

Dr. Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
				2003 July 10	By Purchases A/c		80,000

Note: July 6th transaction is a cash transaction and July 20th transaction ispurchase of an asset, so both will not be recorded in the purchases book.

Task Enter the following transactions in the Purchases Book and post the same in the relevant ledger accounts.

2001	₹
Aug. 1 Bought goods from S	1,500
Aug. 4 Bought goods from N	1,000
Aug. 8 Bought goods from A	500

8.3 Purchase Return Book

This is a book of goods returned to the supplier which are out of credit purchases.

The return of goods out of the credit purchase is due to non-confirmation with the specification mentioned in the order.

Pro forma of the Purchase Returns Book

Date	Name of the Supplier	Ledger Folio	Debit Note No	Details	Amount ₹

The purchase returns book consists of various components, viz:

Name of the supplier: To whom the goods/raw material purchased, were returned.

Ledger folio: It is the number of the page where the journal entry is posted.

Debit Note: Whenever goods are returned to the supplier, a letter which is known as the debit note is also sent along with returned goods. The purpose of this note is to inform the supplier about this deduction or debit given to his account. This note contains the following particulars such as:

1. Name and address of the supplier
2. Description of the goods returned
3. Rate and total value

Notes

4. Invoice No., along with date
5. Signature

Amount (₹): The book should illustrate the value of goods/raw materials returned out of credit purchase.

Steps involved in the Purchase Return Book:

1. Posting the entries of the purchase returns to the individual suppliers' account into the purchase return journal.
2. The monthly total of the purchase return journal is credited into the purchase return account.

8.4 Sales Book

It is a book maintained by the enterprise only during the moment of selling the goods on credit. It is known in other words as a sales journal.

Pro forma of the Sales Book

Date	Name of the Customer	Ledger Folio	Outward Invoice No.	Details	Amount ₹

The sales book normally contains the following components:

Name of the customer: The sales book usually records the name of the buyer who has been sold the goods or raw materials on credit.

Ledger Folio: The page number where the journal entry is posted/transacted.

Outward Invoice No: This book registers the invoice number of the goods/raw materials sold out to the buyers on credit.

Amount (₹): It is a fundamental document to earmark the value of the goods/raw materials sold out on credit to the various buyers. It aids the firm in identifying the amount of sales transacted on credit as well as in collecting the amount of dues from the buyers.

Steps involved in the Sales Book:

1. Sale of the goods/raw materials to the individual buyers are entered on a daily basis.
2. The monthly total of sales book is credited into the sales account of the firm which includes both the sale transactions of cash as well as credit.

Illustration 2: From the transactions given below prepare the Sales Book of Ram for July 2003.

2003			
July 5	Sold on credit to S.S. Traders		
	10 Chairs@	₹ 250	Less 10%
	10 Tables@	₹ 850	Discount
8	Sold to Raja for cash		
	15 Chairs@	₹ 250	

Notes

20	Sold to Mohan & Co.	
	5 Almirah@	₹ 2,200
	10 Tables@	₹ 850
23	Sold on credit to Narayanan old computer for ₹ 5,000	
28	Sold to Kumaran for cash	
	15 Chairs@	₹ 250

Solution:

In the books of Ram
Sales Book

Date	Particulars	Outward Invoice No.	L.F.	Detail ₹	Total ₹
2003 July 5	S.S. Traders & Co. 10 Chairs @ ₹ 250 10 Tables @ ₹ 850 Less : 10% Discount Sold to S.S. Traders, Invoice No..... dated			2,500 8,500 11,000 1,100	9,900
July 20	Mohan & Co. 5 Almirah @ ₹ 2,200 10 Tables @ ₹ 850 Sales as per Invoice No..... dated			11,000 8,500	19,500
	Total				29,400

Ledger Accounts
Sales Account

Dr. Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
				2003 July 31	By Sundries as per sales book		29,400

S.S. Trader's Account

Dr. Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2003 July 5	To Sales A/c		9,900				

Mohan & Co.'s Account

Dr. Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2003 July 20	To Sales A/c		19,500				

Note: July 8th and 28th transactions are cash transactions and July 23rd transaction is sale of an asset, so all these transactions will not be recorded in the sales book.

Notes

8.5 Sales Return Book

It is a book that registers the goods sold on credit and received from the buyers. The sales return from the buyers is due to not confirming to the specifications mentioned at the moment of placement of the order. It is known as sales return journal.

Pro forma of the Sales Return Book

Date	Name of the Customer	Ledger Folio	Credit Noted No	Details	Amount ₹

The following are the various components dealt in the design of the book:

Name of the customer: It includes the most important information about the buyer who returned the goods/raw materials, because of non-confirmation to specifications of the placed order.

Ledger folio: It contains the page number of the journal entry posted.

Credit Note No: It is nothing but a statement sent by one person to another person showing the amount credited to the account of the latter along with a brief explanation. The credit notes are used for sales return in order to intimate related abatement and are similar to invoice although they are usually printed in red ink.

Steps involved in the sales return book:

1. Sales return of the enterprise from the individual buyers are recorded immediately after the transactions.
2. The monthly total of the sales return is posted into the debit side of the sales return account in accordance with the rule of real account.

8.6 Trade Bills Book

The trade bills book can be classified into two categories, viz Bills receivable book and Bills payable book.

1. ***Bills Receivable Book:*** It is a book maintained especially for promissory notes and bill of exchanges accepted by the customers out of their dues, as an outcome of credit sale of the enterprise. The bills receivable and promissory notes are nothing but the resultant of the credit sale transactions of the enterprise not only to safeguard the interest of enterprise, but also to collect the dues from the customers as per the terms of the trade agreed earlier.

Proforma of the Bills Receivable Book

Sl. No	Date	From whom Received	Acceptor	Date of the bill	Term	Date of the Maturity	Where Payable	Amt. ₹	How Dis-posed

The various components of the bills payable book are as follows:

(a) *From whom received:* Either the bill or promissory received from whom? The name of the party should be entered at the moment of receiving the negotiable instruments of the trade.

(b) *Acceptor:* The person/institution who/which accepts the terms of the bill to make the payment.

Notes

(c) *Date of the bill:* When the bill is drafted/drawn for obtaining the acceptance of the buyer; who bought the goods on credit.

(d) *Term:* Modalities involved in the process of payment of the dues mentioned in the bill.

(e) *Date of Maturity:* Date at which the bill is to be presented for collection from the customer.

(f) *Where payable:* The place of amount payable by the customers or buyers who bought the goods on credit.

(g) *Amount (₹):* It reveals the amount how much to be collected from the customer through either bill receivable or promissory note.

(h) *How disposed:* The process of the collection done should be recorded for future verification in settling the dues of the customer.

2. ***Bills Payable Book:*** It is a book of bills payable or promissory notes accepted by the enterprise to the suppliers at the moment of carrying out the credit purchase.

Proforma of the Bills Payable Book

Sl. No	Date	Name of the Drawer	Payee	Date of the bill	Term	Date of the Maturity	Where Payable	Amt. ₹	Remarks

The following are the some of the important components normally included in the book:

(a) *Name of the drawer:* Name of the person or concern, who or which draws the bill. This is nothing but either the name of the seller or manufacturer or supplier of the goods or raw materials.

(b) *Payee:* To whom the payment has to be paid.

(c) *Date of the bill:* Normally included to know the date at which the bill was drafted which is under the possession of the seller or supplier.

(d) *Date of Maturity:* It is the date at which the payment has to be made as per the terms of trade.

(e) *Where payable:* The place where the amount of the bills is to be paid.

8.7 Journal Proper

This journal is meant for recording all such transactions for which no special journal has been maintained in the business. Therefore, in this journal, all such transactions are recorded which do not occur frequently and for these transactions no special journal is required. For example, if Machinery is purchased on credit, it will be recorded in the journal proper, because in the Cash Book, we will record only cash purchases of machinery. Similarly, many other transactions, which do not find their place in the special journals, will be recorded in the General Journal such as

1. Outstanding expenses – Salaries outstanding, Rent outstanding, etc.
2. Prepaid expenses – Prepaid Rent, Salaries paid in advance
3. Income received in advance – Rent received in advance, interest received in advance, etc.
4. Accrued Incomes – Commission yet to be received, interest yet to be received.
5. Interest on Capital

Notes

6. Depreciation
7. Credit Purchase and Credit Sale of fixed Assets – Machinery, Furniture.
8. Bad debts.
9. Goods taken by the proprietor for personal use.

Illustration 3: Enter the following transactions in the Purchases Book and post the same in the relevant ledger accounts.

2001		₹
Aug. 1	Bought goods from S	500
Aug. 4	Bought goods from N	1,000
Aug. 8	Bought goods from A	1,500

Solution:

Purchases Books

Date	Particulars	L.F.	Inward Invoice Number	Details	Amount ₹
2001					
Aug. 1	S				500
Aug. 4	N				1,000
Aug. 8	A				1,500
					3,000

Ledger

Purchases A/c

Dr. Cr.

Date	Particulars	₹	Date	Particulars	₹
2001			2001		
Aug. 12	To Sundries	3,000			

S's A/c

Dr. Cr.

Date	Particulars	₹	Date	Particulars	₹
2001			2001		
			Aug. 1	By Purchase A/c	500

N's A/c

Dr. Cr.

Date	Particulars	₹	Date	Particulars	₹
2001			2001		
			Aug. 4	By Purchase A/c	1,000

A's A/c

Dr. Cr.

Date	Particulars	₹	Date	Particulars	₹
2001			2001 Aug. 8	By Purchase A/c	1,500

Notes

Illustration 4: Enter the following transactions in sales Book and post the same in the relevant ledger accounts.

2002		₹
Aug. 15	Sold goods to Ajay	2,000
Aug. 18	Sold goods to Vijay	1,500
Aug. 22	Sold goods to Mohan	1,000

Solution:

Sales Book

Date	Particulars	L.F.	Inward Invoice Number	Details	Amount ₹
2002					
Aug. 15	Ajay				2,000
Aug. 18	Vijay				1,500
Aug. 22	Mohan				1,000
					4,500

Ledger
Sales A/c

Dr. Cr.

Date	Particulars	₹	Date	Particulars	₹
2002			2002		
			Aug. 31	By Sundries	4,500

Ajay's A/c

Dr. Cr.

Date	Particulars	₹	Date	Particulars	₹
2002 Aug. 15	To Sales A/c	2,000	2002		

Vijay's A/c

Dr. Cr.

Date	Particulars	₹	Date	Particulars	₹
2002 Aug. 18	To Sales A/c	1,500	2002		

Mohan's A/c

Dr. Cr.

Date	Particulars	₹	Date	Particulars	₹
2002 Aug. 22	To Sales A/c	1,000	2002		

Illustration 5: Enter the following transactions in proper Subsidiary Books and post the same in the relevant ledger accounts.

2003		₹
Aug. 1	Bought goods from Raj	2,500
Aug. 2	Sold goods to Ravi	1,500
Aug. 5	Rohit sold goods to us	1,500
Aug. 8	Rakesh purchased goods from us	1,200
Aug. 11	Received goods returned by Ravi	150

Notes

Aug. 13	Returned goods to Raj	100
Aug. 17	Sold goods to Amit	800
Aug. 22	Purchased goods from Sumit	900
Aug. 27	Returned goods to Rohit	150

Solution:

Purchase Book

Date	Particulars	L.F.	Inward Invoice Number	Details	₹
2003					2,500
Aug. 1	Raj				1,500
Aug. 5	Rohit				900
Aug. 22	Sumit				4,900

Sales Book

Date	Particulars	L.F.	Outward Invoice Number	Details	₹
2003					1,500
Aug. 2	Ravi				1,200
Aug. 8	Rakesh				800
Aug. 17	Amit				3,500

Purchase Return Book

Date	Name of Supplier	L.F.	Debit Note	Details	₹
2003					
Aug. 13	Raj				100
Aug. 27	Rohit				150
					250

Sales Return Book

Date	Particulars	L.F.	Credit Note	Details	₹
2003					
Aug. 11	Ravi				150
					150

Ledger

Purchases A/c

Dr. Cr.

Date	Particulars	₹	Date	Particulars	₹
2003			2003		
Aug. 31	To Sundries A/c	4,900			

Sales A/c

Dr. Cr.

Date	Particulars	₹	Date	Particulars	₹
2003			2003		
			Aug. 31	By Sundries A/c	3,500

Notes

Purchase Return A/c

Dr. Cr.

Date	Particulars	₹	Date	Particulars	₹
2003			2003		
			Aug. 31	By Sundries A/c	250

Sales Return A/c

Dr. Cr.

Date	Particulars	₹	Date	Particulars	₹
2003 Aug. 31	To Sundries	150			

Ravi' s A/c

Dr. Cr.

Date	Particulars	₹	Date	Particulars	₹
2003 Aug. 2	To Sales A/c	1,500	2003 Aug. 11	By Sales Returns A/c	150
				By Balance c/d	1350
		1,500			1,500
Sept. 1	To Balance b/d	1,350			

Rakesh' s A/c

Dr. Cr.

Date	Particulars	₹	Date	Particulars	₹
2003 Aug. 8	To Sales A/c	1,200	2003 Aug. 31	By Balance c/d	1,200
		1,200			1,200
Sept. 1	To Balance b/d	1,200			

Amit' s A/c

Dr. Cr.

Date	Particulars	₹	Date	Particulars	₹
2003 Aug. 17	To Sales A/c	800	2003 Aug. 31	By Balance c/d	800
		800			800
Sept. 1	To Balance b/d	800			

Raj' s A/c

Dr. Cr.

Date	Particulars	₹	Date	Particulars	₹
2003			2003		2,500
Aug. 13	To Purchases Returns A/c	100	Aug. 1	By Purchases A/c	
Aug. 31	To Balance c/d	2,400	Sept. 1		
		2,500			2,500
				By Balance b/d	2,400

Notes

Rohit A/c

Dr. Cr.

Date	Particulars	₹	Date	Particulars	₹
2003			2003		
Aug. 27	To Purchases Returns A/c	1,500	Aug. 5	By Purchases A/c	1,500
Aug. 31	To Balance c/d	1,350			
		1,500			1,500
			Sept. 1	To Balance b/d	1,350

Sumit A/c

Dr. Cr.

Date	Particulars	₹	Date	Particulars	₹
2003			2003		
Aug. 3 1	To Balance c/d	900	Aug. 22	By Purchases A/c	900
		900			900
			Sept. 1	To Balance b/d	900

Illustration 6: Enter the following transactions in the Bills Receivable Book and post the same in the relevant ledger accounts.

1998

Aug. 1 Received from Raj a bill duly accepted for ₹ 1,500 Payable 3 month after date.

Aug. 9 Drew a 2 months bills on Rakesh for ₹ 1,200 which was duly accepted and has been discounted.

Aug. 19 Ajay accepted a 3 month bill drawn by us for ₹1,100 payable at Canara Bank, Salem.

Solution:

Bills Receivable Book

SI. No.	Date of Receipt	L.F.	Drawer	Acceptor	Term	Due Date	₹	Remarks
1.	Aug. 1, 1998		Self	Raj	3 mths.	Nov. 4, '98	1,500	-
2.	Aug. 9,1998		Self	Rakesh	2 mths.	Oct.12,'98	1,200	Discounted
3.	Aug. 19,1998		Self	Ajay	3 mths.	Nov. 22,'98	1,100	-
							3,800	

Ledger

Bills Receivable A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
1998					
Aug. 3 1	To Sundries	3,800	Aug. 3 1	By Balance c/d	3,800
		3,800			3,800
Sept. 1	To Balance b/d	3,800			

Notes

Raj's A/c

Dr. Cr.

Date	Particulars	₹	Date	Particulars	₹
1998			1998 Aug. 1	By Bills Receivable A/c	1,500

Rakesh's A/c

Dr. Cr.

Date	Particulars	₹	Date	Particulars	₹
1998			1998 Aug. 9	By Bills Receivable A/c	1,200

Ajay's A/c

Dr. Cr.

Date	Particulars	₹	Date	Particulars	₹
1998			1998 Aug. 19	By Bills Receivable A/c	1,100

Illustration 7: Enter the following in the Bills Payable Book and post them in the ledger.

1998

Sept. 1 We accept Sundar & Go's, bill for ₹ 1,000,2 months duration payable at Bank of India.

Sept. 21 Maduri & Co. drew on us a 3 months bill for ₹2,050 which we accepted and returned.

Sept. 28 Swami's bill for ₹ 1,200 accepted by us, the bill being due after 3 months

Bill Payable Book

SI. No.	Date of Acceptance	Drawer	Payee	L.F.	Where Payable	Date of bill	Term	Due Date	₹	Remarks
1.	Sept. 1, 1998	Sundar &Co.	Sundar &Co.		Bank of India	Sept. 1, 1998	2 mth.	Nov. 4, 1998	1,000	-
2.	Sept. 21, 1998	Maduri &Co.	Maduri &Co.		Bank of India	Sept. 21, 1998	3 mth.	Dec. 24, 1998	2,050	Returned
3.	Sept. 28, 1998	Swami	Swami		Bank of India	Sept. 28, 1998	3 mth.	Dec. 31, 1998	1,200	-
									4,250	

Ledger
Bills Payable A/c

Dr. **Cr.**

Date		Particulars	₹	Date		Particulars	₹
1998 Sept.	30	To Balance c/d	4,250	Sept.	30	By Sundries By	4,250
			4,250				4,250
				Oct.	1	Balance b/d	4,250

Notes

Sundar & Co's A/c

Dr. **Cr.**

Date		Particulars	₹	Date		Particulars	₹
1998 Sept.	1	To Bills Payable A/c	1,000	1998			

Maduri & Co's A/c

Dr. **Cr.**

Date		Particulars	₹	Date		Particulars	₹
1998 Sept.	21	To Bills Payable A/c	2,050	1998			

Swami's A/c

Dr. **Cr.**

Date		Particulars	₹	Date		Particulars	₹
1998 Sept.	28	To Bills Payable A/c	1,200	1998			

Illustration 8 (Subsidiary Books): Record the following transactions into various Subsidiary Books and Journal Proper of Mr. Shiv Kumar:

2008

January 1 Cash in hand ₹31,400, Cash at Bank ₹50,800 and Capital Account ₹82,200.

January 2 Bought goods for cash ₹8,200.

January 5 Purchased goods from Lalit Mohan & Co. for ₹11,600 less 10% trade discount.

January 7 Sold goods to Shobhit & Co. for ₹17,800 less 20% trade discount.

January 9 Withdrew ₹1,000 from bank for private use.

January 12 Sold goods to Karim for ₹12,800.

January 15 ₹10,000 paid to Lalit Mohan in full settlement of their claim.

January 18 Goods worth ₹800 returned by Karim.

January 20 Received ₹8,000 from Karim

January 21 Purchased goods from Krishna & Co. for ₹17,400.

January 23 ₹12,000 paid to Krishna & Co. by cheque, discount allowed ₹600.

January 24 Purchased furniture for ₹1,600 from Sardar Furniture House on credit.

January 26 Paid into bank ₹4,400.

January 28 Karim declared insolvent, a first and final dividend of 50 paise in a rupee is received from him.

January 29 Goods worth ₹1,200 returned to Krishna & Co.

January 31 Interest on capital provided ₹ 822.

Notes

January 31 Goods worth ₹800 taken by Mr. Shiv Kumar for his personal use.

January 31 Paid salaries to staff ₹3,600.

January 31 Paid into bank ₹40,000.

January 31 Bought 200 shares in Dehradun Chemicals Ltd. at ₹11, per share Brokerage paid ₹50.

January 31 Received ₹11,800 from Shobhit & Co. discount allowed ₹200.

Solution:

Journal Proper

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
2008			₹	₹
January 01	Cash Account Dr.		31,400	
	Bank Account Dr.		50,800	
	To Capital Account			82,200
	(Entry made for opening balances)			
January 24	Furniture Account Dr.		1,600	
	To Sardar Furniture House			1,600
	(Being purchase of furniture on credit from Sardar Furniture House)			
January 28	Bad Debts Account Dr.		2,000	
	To Karim			2,000
	(On the insolvency of Karim 50 paise in a rupee received and balance treated as bad debts)			
January 31	Interest on Capital Account Dr.		822	
	To Capital Account			822
	(Interest on capital charged)			
January 31	Drawing Account Dr.		800	
	To purchase Account			800
	(Proprietor took goods for personal use)			
January 31	Capital Account Dr.		1,800	
	To Drawing Account			1,800
	(Balance of drawing account transferred to Capital account)			
	Total		89,222	89,222

Sales Book

Date	Particulars	L.F.	Details ₹	Amount ₹
2008				
Jan. 7	Shobhit & Co.: Sale of goods		17,800	
	(–) 20% discount		3,560	14,240
Jan. 12	Karim: Sale of goods			12,800
Jan. 31	Total: Sale – Credit balance			27,040

Notes

Purchase Book

Date	Particulars	L.F.	Details ₹	Amount ₹
2008				
Jan. 5	Lalit Mohan & Co.: Goods purchased		11,600	
	(-) 10% Discount		1,160	10,440
Jan. 21	Krishna & Co.			17,400
Jan. 31	Total: Purchases debited			27,840

Sales Book

Date	Particulars	L.F.	Details ₹	Amount ₹
2008				
Jan. 18	Karim: Sales return		800	
Jan. 31	Sales Return debited			800

Purchase Return Book

Date	Particulars	L.F.	Details ₹	Amount ₹
2008				
Jan. 29	Krishna & Co.: Returns		1,200	
Jan. 31	Purchase Returns Credited			1,200

Three Column Cash Book

Date	Particulars	L.F.	Discount ₹	Cash ₹	Bank ₹	Date	Particulars	L.F.	Discount ₹	Cash ₹	Bank ₹
2008						2008					
Jan 1	To balance b/d		-	31,400	50,800	Jan 2	By Purchases A/c		-	8,200	-
	To Karim				-	Jan 9	By Drawings A/c		-	-	1,000
Jan 20	To cash A/c		-	8,000		Jan 15	By Lalit Mohan		440	10,000	-
Jan 26	To Karim	c	-	-	4,400	Jan 23	By Krishna & Co.		600	-	12,000
Jan 28	To sales A/c		-	2,000	-	Jan 26	By Bank A/c	c		4,400	
Jan 31	To cash		-	43,600		Jan 31	By Advertisement A/c		-	-	1,000
Jan 31	To Shobhit & Co.	c	-	-	40,000	Jan 31	By Salaries A/c		-	3,600	-
Jan 31			200	11,800		Jan 31	By Bank A/c		-	40,000	
						Jan 31	By Investment A/c	c	-	2,250	-
						Jan 31	By Balance C/d		-	28,350	81,200
			200	96,800	95,200				1,040	96,800	95,200
Feb 1	To balance b/d			28,350	81,200						

8.8 Cash Book

Cash transaction is a transaction carried out only in terms of cash. The cash transactions are recorded in the subsidiary book known as the cash book. The cash book can be classified into four categories:

1. Single columnar cash book
2. Double columnar cash book and
3. Three columnar cash book
4. Petty cash book

Note: Different type of cash books are discussed in next unit.

Notes

8.9 Summary

- Subsidiary books are classified on the basis of transactions viz Cash transactions and Non cash-transactions.
- The purchases book is known in other words as purchase journal. It is a book meant for credit purchases only for resale.
- Purchase return book is a book of goods returned to the supplier which are out of credit purchases.
- Sales book is a book maintained by the enterprise only during the moment of selling the goods on credit. It is known in other words as a sales journal.
- Sales return is a book that registers the goods sold on credit and received from the buyers.

8.10 Keywords

Non-cash transactions: A Non-cash transaction is a transaction in terms of credit and conditions of the enterprise.

Purchase book: It is known in other words as purchase journal. It is a book meant for credit purchases only for resale.

Sales book: It is a book maintained by the enterprise only during the moment of selling the goods on credit. It is known in other words as a sales journal.

Sales return book: Sales return is a book that registers the goods sold on credit and received from the buyers.

Subsidiary book: It is a book maintained for routine transactions of the enterprise.

8.11 Self Assessment

State whether the following statements are true or false:

1. Cash sales are recorded in Sales Day Book.
2. Credit sales are recorded in Sales Day Book.
3. Cash and credit sales are recorded in Sales Day Book.
4. Purchase of fixed asset is recorded in the Purchases Day Book.
5. Credit purchase of raw material is recorded in the Purchases day Book.
6. Whenever goods are returned to the supplier, a letter which is known as the credit note.
7. Journal proper is meant for recording all such transactions for which no special journal has been maintained in the business.

Choose the appropriate answers:

8. The Sales Day Book records ……
   (a) all sales.
   (b) credit sales
   (c) cash sales

Notes

9. The Sales Return Book records ……
   (a) the return of goods by the firm.
   (b) the return of goods by the customers.
   (c) the return of assets by the customers.
10. The total of the Purchases Day Book is posted to the …….
   (a) debit of the purchases account.
   (b) credit of the sales account.
   (c) debit of the sales account.

8.12 Review Questions

1. Illustrate the preparation of records for non cash transactions with suitable examples.
2. What are the different types of trade bills books?
3. Write a short note on the following:
   (a) Debit Note
   (b) Credit Note
4. Make the proforma of purchase return book and sales return book and explain it.
5. Explain the significance of preparing subsidiary books of accounts.
6. Journalise the following in Journal Proper.
   (a) Electricity bill for the month of March 2004 of ₹20,000 was received on 15 April 2004.
   (b) Obsolete stock of ₹ 30,000 written off.
   (c) Mr. A, who owed ₹ 20,000, was absconding and there is a definite possibility that the amount will not be realised.
   (d) Machinery worth ₹ 50,00,000 was bought from M/s MNC payable in five equal annual installments starting from end of the current year
   (e) Five computers were bought for ₹ 1,60,000 from M/s XYZ who accepted three old computers (worth ₹ 50,000 in total) in exchange. The balance was payable after six months.
   (f) Advertising expenses paid for ₹ 100,000 was entirely shown as current year's expenses. Actually 25% of such expense relate to the following year.
7. Name the journal in which the following items will be recorded:

(a)	Cash purchase of goods	₹ 25,000
(b)	Cash purchase of furniture	₹ 30,000
(c)	Credit sale of goods	₹ 56,000
(d)	Credit sale of furniture	₹ 27,000
(e)	Interest accrued on investment	₹ 5,000
(f)	Bill accepted by a customer	₹ 7,500

Notes

(g) Goods returned by a customer ₹ 3,500

(h) Cheque dishonoured by bank ₹ 2,000

8. Record the following transactions for the Month of August 2006 in the Purchases Book of M/s Harsha Electronics:

Date	Details
2006 August 5	Purchased from M/s.Naresh Electronics (Invoice No. 250) 5 Colour T.V @ 12500 per piece. Trade Discount on all items @20%.
August 10	Bought from M/s Capital Electronics: (Invoice No. 826) 20 Tape Recorders @ ₹1650 per piece Trade Discount 10% on purchases.
August 17	Purchased from M/s. East Electronics: (Invoice No. 456) 15 Stereos @ ₹4000 per piece 2 Color T.V. 14"@ ₹ 10500 per piece Trade Discount @5%.
August 25	Purchased form M/s. Naresh Electronics: (Invoice No. 294) 10 Small T.V. @ ₹1,200 per piece 3 Colour T.V. 17"@ ₹12000 per piece Trade Discount 10%.
August 30	Bought from M/s Pavitra Electronics: (Invoice No. 82) 20 Video cassettes @ ₹150 per piece Net.

9. The Details submitted by M/s. Harsha Electronics for the month of August 2006 are as under:

Date	Details
2006 August 17	Goods returned to M/s. Capital Electronics vide Debit note No.016/2006. 5 Tape Recorders @ ₹1650 per piece Trade Discount @ 10% on purchases.

10. M/s Furniture Mart wants you to prepare Sales journal for the month ended March 2006, from the following details of sale of goods:

Date	Details
2006	
March 4	Sold on Credit to M/s Mena Traders : Vide Invoice No.213
	(a) Two Double Beds @ ₹7100 each.
	(b) Five Chairs @ ₹260 each
March 9	Sold on Credit to M/s Kohli Furniture : Vide Invoice No. 278
	5 Tables @ ₹1400 Each
March 24	Sold on Credit to M/s Handa Furniture Mart : Vide Invoice No. 302
	4 Sofa Sets @ ₹18000 each
March 30	Sold on Credit to M/s Furniture Traders : Vide Invoice No. 327,
	6 Single Beds @ ₹6,000 each

Notes

Answers: Self Assessment

1.	False	2.	True
3.	False	4.	False
5.	True	6.	False
7.	True	8.	(b)
9.	(b)	10.	(a)

8.13 Further Readings

Books

Khan and Jain, "*Management Accounting*".

M.P. Pandikumar, "*Accounting & Finance for Managers*", Excel Books, New Delhi.

R. L. Gupta and Radhaswamy, "*Advanced Accountancy*".

S. N. Maheswari, "*Management Accounting*".

V. K. Goyal, "*Financial Accounting*", Excel Books, New Delhi.

Online links

http://www.globusz.com/

www.futureaccountant.com

www.scribd.com

Notes

Unit 9: Cash Book

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Objectives

After studying this unit, you will be able to:

- Prepare single column cash book
- Construct double and triple column cash books
- Prepare petty cash book

Introduction

Cash book is the book of accounts where most of the transactions are generally related with the receipts and payment of cash. It may be either purchase of goods for cash or sale of goods for cash or it may be either payment of expenses or receipts of income. All such transactions are recorded separately in a book, which is known as the cash book. This book is helpful in telling the accurate balance of cash in hand or at bank. All cash transactions are directly entered into the cash book and on the basis of cash book, ledger accounts are prepared.

Generally, four types of cash book are prepared. These are:

1. Single column cash book
2. Double columns cash book
3. Three columns cash book
4. Petty Cash Book

9.1 Single Column Cash Book

It is a book that generally records the transactions into two classification, viz Payments and Receipts. The receipts and payments are recorded in the debit and credit side of the cash book respectively. The debit and credit side transactions of the cash book are prefixed with "To" and "By" respectively.

Notes

Dr **Pro forma of the Single Columnar Cash Book** Cr

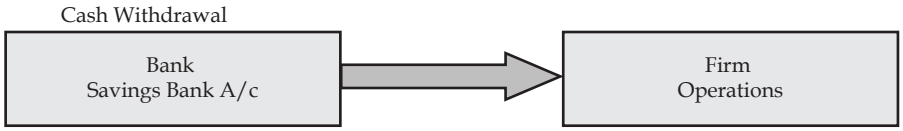
Date	Receipts	L.F.	Amount ₹	Date	Payments	L.F.	Amount ₹
	To Opening Balance B/d				By Closing Balance B/d		

9.2 Double Column Cash Book

It is another kind of cash book which is nothing but an extension of the single columnar cash book. The double columnar cash book includes the operations of the enterprise into two different categories viz transactions through Cash and Bank. It means that the entire receipts and payments of the business routed through cash and bank. The transaction of the business with the bank either at the moment of cash withdrawal or cash deposit leads to registering the movement of cash from one entity to another through the contra entries©.

The contra entries are posted in two different occasions viz cash withdrawal and cash deposit.

During the cash withdrawal, the movement of cash is depicted below for easier understanding, which is nothing but the movement of the asset from bank to firm.



Transaction No 1: Jan 5,2006, Cash withdrawal ₹10,000 from the bank is having the following journal entry:

Cash A/c Dr ₹10,000

To Bank A/c ₹10,000

(Being cash withdrawn from the bank A/c)

From the above entry, it is obviously understood that the bank is the giver of the cash resources from the savings bank a/c and cash receipts are made only due to withdrawal of cash from the bank.

There are two different angles of cash withdrawal; one is in the dimension of firm and another is bank.

Transaction No 2: Jan 20, 2006: Cash deposit has a similar kind of process to post a contra entry, just opposite to the entry of cash withdrawal. Cash deposit of ₹ 5,000. in the bank account. The following is the journal entry for the cash deposit:

Bank A/c Dr ₹5,000

To Cash A/c ₹5,000

(Being cash deposited into the bank account)

Notes

Dr **Pro forma of Double columnar Cash Book** Cr

Date	Receipts	L.F.	Bank	Cash	Date	Payments	L.F.	Bank	Cash
	To Balance B/d					By Balance c/d*			
Jan 5	To Bank C1			10,000	Jan 5	By cash C1		10,000	
Jan20	To Cash C2		5,000		Jan20	By Bank C2			5,000
						By Balance B/d			

* Bank overdraft

The above table of double columnar cash book clearly elucidates the contra entry process taking place between the two entities, viz firm and bank.

9.3 Three Column Cash Book

It is another dimension of cash book which has three components of operations of the enterprise viz cash, bank and discount. This cash book is an extension of the early one, not only allows and incorporates the receipts and payments of the firm through cash and bank, but also discount allowed and received.

Proforma of Three Columnar Cash Book

Date	Receipts	L.F.	Bank	Cash	Discount Allowed	Date	Payments	L.F.	Bank	Cash	Discount Received
	To Balance B/d						By Balance c/d*				
							By Balance B/d				

Did u know? **Why is discount allowed brought under the debit side?**

The discount is allowed at the time of receipts out of sale. The discounts are categorized into two categories, viz cash discount and trade discount.

Cash discount is the discount allowed by the firm, only at the moment of making the payment within the stipulated time frame. 7% @ 10 days means that 7% discount will be given to the parties who are able to make the payment of dues within 10 days of the stipulated time period.

Example: Roop owes ₹ 1000 to M/s. Goyal Traders of Muzaffar Nagar. The firm offers a discount of 1% if payment is made within one month. Roop makes the payment within stipulated time. So he is offered ₹ 10 as discount and he makes the payment of ₹ 990 to the firm. The following entry is required to be passed in the Journal if no Cash Book is used in the books of M/s. Goyal Traders.

Date	Particulars		L.F.	₹	₹
	Cash A/c	Dr.		990	
	Discount A/c	Dr.		10	
	To Roop				1000
	Cash received and discount allowed.				

If Cash Book is used, then both the accounts namely cash and discount are to be recorded on the debit side of the Cash Book. Similarly, if discount is received for making prompt payment then

such items are to be recorded on the credit side of the Cash Book, i.e., amount received or paid in the Amount/Cash column and discount allowed/received in the discount column.

Trade discount is the discount allowed by the firm to encourage the regular customers to buy more and more. This type of discount is allowed by the firm only on the total value of the invoice. The discount is granted on the gross value of the goods purchased by the regular customer from the enterprise.

Why is discount received brought under the credit side?

The reason for showing the discount received under the credit side of the cash book is that the amount of discount received is availed only during the moment of payment of overdues only due to credit purchase.

Note **Multi-columnar Cash Book**

The regular receipts and payments on various heads require the firm to design not only a most suited cash book which is in a position to incorporate all the entries in nature of cash, but also to reduce the excessive labour involved in the process of sorting them out. To replace the bottlenecks of the three columnar cash book, multi columnar cash book is developed, which is in a position to highlight the receipts and payments of a firm under various accounting heads within a specified period. Under this system of cash book, the firm is required to register the payments and receipts of the respective heads only in the columns especially provided for determining the balance under each head at the end of the specified month.

9.4 Petty Cash Book

It is a book maintained by the petty cashier who is especially appointed for the purpose of assisting the cashier of the business enterprise in order to meet the day to day expenses that are meager in volume. The cashier normally hands over a certain sum of money to the petty cashier to meet tiny expenses of the enterprise based on the early estimation on the daily requirement e.g. postage, refreshment charges. The meagre amount that is given by the cashier is known in other words as petty cash or float. The vouchers and receipts are finally examined by the cashier based on the presentation of petty cash book balance.

The given below is the proforma of petty cash book:

Analytical Petty Cash Book

Receipts (₹)	Date	Particulars	Voucher No.	Total Amount (₹)	Printing & Stationery	Cartage	Postage

Illustration 1: Prepare a cash book from the following:

2006			₹
June	1	Cash in hand	7,850
June	2	Cash Purchases	2300
June	3	Cash Sales	6,250
June	4	Wages paid in cash	25

Notes

June	6	Cash paid to Ram	1,220
June	7	Cash Received from Mohan	2260
June	8	Paid to a creditor in full Settlement of his account Amounting to ₹ 4500	4,410
June	9	Paid cartage	15
June	10	Issued a cheque to a creditor	11,500
June	11	Goods purchased from Arun on credit	2,750
June	14	Cash Sales	2,670
June	15	Goods sold to Amit on credit	6,500
June	17	Cash Sales of ₹ 7500 of which ₹ 5700 were deposited In bank	
June	18	Received a cheque from Amit and deposited in a bank	2,500
June	24	Rent paid	500
June	29	Electricity paid	1,210
June	30	Cash purchases	2,450

Solution:

Cash Book

Dr. **Cr.**

Date	Particulars	L.F.	₹	Date	Particulars	L.F.	₹
2005				2005			
June 1	To Balance b/d		7,850	June 2	By Purchases a/c		2,300
June 3	To Sales a/c		6,250	June 4	By Wages a/c		25
June 7	To Mohan's a/c		2,260	June 6	By Ram's a/c		1,220
June 14	To Sales a/c		2,670	June 8	By Creditor's a/c		4,410
June 17	To Sales a/c		7,500	June 9	By Cartage		15
June 18	To Amit a/c		2,500	June 17	By Bank a/c		5,700
				June 18	By Bank a/c		2,500
				June 24	By Rent a/c		500
				June 29	By Electricity a/c		1,210
				June 30	By Purchases a/c		2,450
				June 30	By Balance a/c		8,700
July 1	To Balance b/d		29,030				29,030

Notes

1. Cheque issued on June 10 to a creditor is not recorded in the Cash Book.
2. Goods purchased from Arun on June 11 is also not recorded as per rule no credit transaction is recorded.
3. Similarly goods sold to Amit on credit is also not recorded.
4. Cheque received from a debtor is recorded treating it as cash received as it is banked immediately.

Illustration 2: From the following particulars, write up the Cash Book of M/s. K.K. of Chennai with Cash and Bank columns and bring down the final balance:

2006			₹
Oct.	1	Cash in hand	100
Oct.	1	Cash at bank	3,500
Oct.	5	Paid salary by cheque	250

Notes

Oct.	7	Paid to K.K. & Co. by cheque	260
Oct.	9	Received a cheque from B & Co.	2,500
Oct.	12	Bought goods for cash paid by cheque	750
Oct.	15	Received cash from M/s. S. Chand	1,500
Oct.	17	Deposited cash into bank	1,450
Oct.	18	Sundry creditors were paid by cheque	1,250
Oct.	19	Received from debtors by cheque which could not be sent to bank	1,780
Oct.	20	B & Co. cheque dishonoured	2,500
Oct.	22	B & Co. paid cash	2,500
Oct.	24	R & Co. issued a cheque for ₹ 470 in full satisfaction of his account for	500
Oct.	27	Shyam lal was paid ₹ 395 in full settlement of his A/c amounting to	400
Oct.	31	Deposited into the Bank	2,200

Solution:

Three Columns Cash Book

Date	Particulars	L.F.	Dis-count (₹)	Cash (₹)	Bank (₹)	Date	Particulars	L.F.	Dis-count (₹)	Cash (₹)	Bank (₹)
2006						2006					
Oct. 1	To Balance b/d			100	3,500	Oct. 5	By Salaries A/c			–	250
Oct. 9	To B & Co.			–	2,500	Oct. 7	By K & Co.			–	260
Oct. 15	To S. Chand			1,500		Oct. 12	By Purchase A/c			–	750
Oct. 17	To Cash A/c	(C)		–	1450	Oct. 17	By Bank A/c	(C)		1450	–
Oct. 19	To Debitors A/c			1,780	–	Oct. 18	By S. Creditors			–	1250
Oct. 22	To B & Co.			2,500	–	Oct. 20	By B & Co.			–	2,500
Oct. 24	To R & Co.		30		470	Oct. 27	By Shyam Lal		5	395	
Oct. 31	To Cash A/c	(C)			2,200	Oct. 31	By Bank A/c	(C)		2,200	
							By Balance c/d			4,885	5,110
			30	5,880	10,120				5	5,880	10,120

Illustration 3: Enter the following transactions in Analytical petty Cash Book:

2006		₹
Jan. 1	Received cheque from head cashier	100.00
Jan. 2	Paid for postage and telegram	15.00
Jan. 3	Stationery purchased	5.00
Jan. 14	Paid for cartage	8.00
Jan. 18	Paid for travelling	7.00
Jan. 27	Tea for guests	6.00
Jan. 29	Office cleaning charges	12.00
Jan. 30	Paid for carriage	4.00
Jan. 31	Telegram charges	8.00

Solution:

Analytical Petty Cash Book

Re-ceipts	Date	Particulars	Voucher No.	Total Amount	Postage telegram	Stationary	Cartage Travelling	Tea & office expenses
₹	2006			₹	₹	₹	₹	₹
100.00	Jan. 1	To cash a/c		–				
	Jan. 2	By Postage & telegram		15.00	15.00	–	–	–
	Jan. 3	By Stationery		5.00	–	5.00	–	–

Contd....

Notes

	Jan. 14	By Cartage		8.00	–	–	8.00	–
	Jan. 18	By Travelling		7.00	–	–	7.00	6.00
	Jan. 27	By Tea for guest		6.00	–	–	–	12.00
	Jan. 29	By office cleaning charges		12.00	–	–	–	–
	Jan. 30	By Carriage		4.00	–	–	–	–
	Jan. 31	By Telegram		8.00	8.00	–	4.00	
		By Balance c/d		65.00 35.00	23.00	5.00	19.00	18.00
		Total		100.00				
100.00	Feb. 1							
35.00	Feb. 1							
65.00		To Balance b/d						
100.00		To Cash						

Case Study

Record the following transactions into various Subsidiary Books and Journal Proper of Mr. Shiv Kumar:

2008

January 1	Cash in hand ₹31,400, Cash at Bank ₹50,800 and Capital Account ₹82,200.
January 2	Bought goods for cash ₹8,200.
January 5	Purchased goods from Lalit Mohan & Co. for ₹11,600 less 10% trade discount.
January 7	Sold goods to Shobhit & Co. for ₹17,800 less 20% trade discount.
January 9	Withdrew ₹1,000 from bank for private use.
January 12	Sold goods to Karim for ₹12,800.
January 15	₹10,000 paid to Lalit Mohan in full settlement of their claim.
January 18	Goods worth ₹800 returned by Karim.
January 20	Received ₹8,000 from Karim
January 21	Purchased goods from Krishna & Co. for ₹17,400.
January 23	₹12,000 paid to Krishna & Co. by cheque, discount allowed ₹600.
January 24	Purchased furniture for ₹1,600 from Sardar Furniture House on credit.
January 26	Paid into bank ₹4,400.
January 28	Karim declared insolvent, a first and final dividend of 50 paise in a rupee is received from him.
January 29	Goods worth ₹1,200 returned to Krishna & Co.
January 31	Interest on capital provided ₹ 822.
January 31	Goods worth ₹800 taken by Mr. Shiv Kumar for his personal use.
January 31	Paid salaries to staff ₹3,600.
January 31	Paid into bank ₹40,000.
January 31	Bought 200 shares in Dehradun Chemicals Ltd. at ₹11, per share Brokerage paid ₹50.
January 31	Received ₹11,800 from Shobhit & Co. discount allowed ₹200.

Notes

9.5 Summary

- The cash transactions are recorded in the subsidiary book known as the cash book. The cash book can be classified into four categories:
  - Single columnar cash book,
  - Double columnar cash book,
  - Three columnar cash book, and
  - Petty cash book.

9.6 Keywords

Cash Discount: It is given for prompt payment, hence, it is recorded in the Cash Book.

Contra Entries: Transactions that relate to both cash and bank and is entered on cash column of one side and bank column of other side of Bank Column Cash Book. Recording of such transactions is known as 'Contra entries'.

Petty Cash Book: It is a book maintained by the petty cashier who is especially appointed for the purpose of assisting the cashier of the business enterprise in order to meet the day to day expenses that are meager in volume.

Simple Cash Book: A Simple Cash Book records only cash receipts and cash payments. It has two sides, namely debit and credit.

Trade Discount: It is given for increasing the volume of sales and it is adjusted in the invoice, hence no entry is passed in the books of the business, as it is always deducted from the catalogue price. It is usually allowed by a whole seller to a retailer.

9.7 Self Assessment

State whether the following statements are true or false:

1. Petty Cash Book is handled by the Head Cashier.
2. Petty Cash Book is maintained by a person known as Petty Cashier.
3. The Cash Book records all cash payments only.
4. The Cash Book records all cash payments and all receipts only.
5. Cash discount is the discount allowed by the firm to encourage the regular customers to buy more and more.
6. The receipts and payments are recorded in the debit and credit side of the cash book respectively.
7. The contra entries are posted in two different occasions viz cash withdrawal and cash deposit.

Choose the appropriate answers:

8. The balance of cash account is generally …….
   (a) credit
   (b) debit
   (c) None of these

Notes

9. Cash discount is offered as an incentive ……..
   (a) for increase in volume of sales.
   (b) For prompt payment.
   (c) One of the above.
10. ……. Discount is recorded in the books of the business.
   (a) Cash
   (b) Trade
   (c) Both

9.8 Review Questions

1. Explain the nature of petty cash book.
2. What is the difference between a petty cash book and a simple cash book?
3. Prepare a Cash Book form the transactions given below:

2006		₹
July 1	Balance at bank	10,000
July 4	Received a cheque from Pankaj	5,000
July 7	Issued a cheque to Rakesh	6,000
July 10	Received dividend by bank draft	2,000
July 15	Mukesh was paid by issuing a cheque	1,500
July 20	Deposited into bank	7,000
July 24	Interest collected by bank	200
July 28	Dividend collected by bank	500
July 31	Bank charges debited	800

4. Compose three columns Cash Book from the following transactions:

2006		₹
Jan. 1	Cash in hand	567
Jan. 1	Cash at bank	12,675
Jan. 2	Received from Ashish and	7,900
	Allowed him a discount	100
Jan. 4	Deposited into the bank	5,000
Jan. 6	Furniture purchased for cash	2,500
Jan. 7	Paid to Vikas by cheque	7,800
	And received discount	200
Jan. 14	Received from Manish by cheque and Deposited into bank	5,000
Jan.16	Cash Sales	8,000
Jan. 20	Deposited into bank	6,000
Jan. 25	Purchased a Machine and paid by a cheque	12,000
Jan. 26	Paid by cheque to Kishore	1,370
	and received discount	30
Jan. 27	Withdrew from bank for office use	2,500
Jan. 28	Purchased goods for cash	5,000
Jan. 29	Paid wages by cheque	4,500
Jan. 31	Paid Rent	500

Notes

5. Enter the following transactions in Analytical petty Cash Book:

2006		₹
Jan. 1	Received cheque from head cashier	100.00
Jan. 2	Paid for postage and telegram	15.00
Jan. 3	Stationery purchased	5.00
Jan. 14	Paid for cartage	8.00
Jan. 18	Paid for travelling	7.00
Jan. 27	Tea for guests	6.00
Jan. 29	Office cleaning charges	12.00
Jan. 30	Paid for carriage	4.00
Jan. 31	Telegram charges	8.00

6. Record the following transactions in the Bank column Cash Book of M/s Time Zone for the month of January 2006.

Date	Details	Amount (₹)
2006		
January 01	Bank Balance	32,500
01	Cash Balance	12,300
03	Purchased Goods by cheque	5,300
08	Goods Sold for cash	9,500
10	Purchased Typewriter by Cheque	5,400
15	Sold Goods and received Cheque	7,900
	(deposited on the same day)	
17	Purchased Stationery by Cheque	1,000
20	Cash deposited into bank	10,000
22	Paid Cartage	500
24	Cheque given to Mudit	7,000
28	Rent paid by Cheque	3,000
30	Paid Salary	3,500

7. Prepare a triple column cash book from the following transactions:

2003

July 1 Opening balance—cash ₹ 26,000; Bank ₹ 57,200.

July 2 Cash purchases ₹ 15,000

July 4 Purchase of goods by cheque—gross value ₹ 46,000 less trade discount 2%.

July 5 Cash sales ₹ 36,000.

July 7 Cheque received from customers of ₹ 76,500 in full settlement of dues of ₹ 77,000.

July 10 Cash withdrawn ₹ 10,000.

July 15 Payment made to supplier by cheque ₹ 54,500, got 1% cash discount.

July 20 Cheque received from a customer in June 2003 of ₹ 75,000 was dishonoured.

July 25 Cash deposited ₹ 5,600.

July 31 Salary paid ₹ 10,000 by cash.

Notes

8. What is Contra entry? How will you deal with this entry while preparing Bank Column Cash Book?

9. From the following transactions prepare Simple Cash Book:

July 31 2006		₹
March 01	Cash in hand	32,500
″ 08	Cash paid to Rohan	8,000
″ 12	Goods Purchased	3,000
″ 15	Cash received from Tanaya	2,000
″ 18	Cash Sales	4,000
″ 22	Paid wages	4,000
″ 25	Salary paid	3,000
″ 28	Cash paid to Manish	3,500
″ 31	Rent paid	2,500

10. What do you mean by Petty Cash Book? Explain the imprest system of Petty Cash Book.

Answers: Self Assessment

1.	False	2.	True
3.	False	4.	True
5.	False	6.	True
7.	True	8.	(b)
9.	(b)	10.	(a)

9.9 Further Readings

Books

Khan and Jain, "*Management Accounting*".

M.P. Pandikumar, "*Accounting & Finance for Managers*", Excel Books, New Delhi.

R. L. Gupta and Radhaswamy, "*Advanced Accountancy*".

S. N. Maheswari, "*Management Accounting*".

V. K. Goyal, "*Financial Accounting*", Excel Books, New Delhi.

Online links

http://www.globusz.com/

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Unit 10: Trial Balance

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Objectives

After studying this unit, you will be able to:

- Understand the preparation of trial balance
- Identify the types of errors
- Distinguish the errors which are revealed and not revealed by the trial balance

Introduction

According to the dual aspect concept, the total of debit balance must be equal to the credit balance. It is a must that the correctness of posting to the ledger accounts and their balances be verified. This is done by preparing a trail balance.

Trial Balance is a statement which shows balances of all accounts on a particular date. In other words, trial balance is a schedule or list of balances whether debit or credit, extracted from the accounts in the ledger including cash and bank balances from the Cash Book. As the name indicates it is prepared to check the ledger balances. If the total of the debit and credit amount columns of the trail balance are equal, it is assumed that the posting to the ledger in terms of debit and credit amounts is accurate. The agreement of a trail balance ensure arithmetical accuracy only, A concern can prepare trail balance at any time, but its preparation as on the closing date of an accounting year is compulsory.

10.1 Purposes of the Preparing the Trial Balance

The following are the key objectives of preparing trial balance:

1. To prepare a statement of disclosure of final accounting balances of various ledger accounts on a particular date.

Notes

2. To prepare a statement of cross checking device of accounting, while in the process of posting of entries which mainly on the basis of Double entry accounting principle. It helps the accountant to have systematic posting of entries.
3. It assists the enterprise for the preparation of Trading & Profit and Loss Accounts for the year ended…….. and the Balance sheet as on dated ……..
4. It provides a birds' eye view of accounting balances of various ledger accounts during the specified period.

10.2 Preparation of Trial Balance

The preparation of the trial balance is classified on the basis of three different accounts, viz:

1. Real Account (R)
2. Nominal Account (N)
3. Personal Account (P)

The classification of the transactions is done not only on the basis of accounts but also on the basis of payments and receipts. These payments and receipts are further classified into following categories:

Payments Category – Debit Balance

Debit Balance is the source of following golden rules of the three different accounts:

Personal Account: Debit the Receiver

Nominal Account: Debit all the expenses and losses

Real Account: Debit what comes in and Debit all assets

1. Trading Expense Category (TE)
2. Profit and Loss Category (PE)
3. Assets - Balance Sheet (BA)

Receipts Category – Credit Balance

Credit Balance is the major source of the other half of the golden rules of accounting

Personal Account: Credit the Giver

Nominal Account: Credit all income and gains

Real Account: Credit what goes out and Credit all liabilities

1. Trading Income Category (TI)
2. Profit and Loss Category (PI)
3. Liabilities - Balance Sheet (BL)

The given below is the proforma of trial balance:

Trial Balance
as on ……

S.No.	Particulars	L.F.	Debit Balance (₹)	Credit Balance (₹)

Notes

10.3 Methods of Preparing Trial Balance

Generally speaking there is one method of preparing Trial Balance i.e., by balance method. But as per Accountants, the following are the methods of preparing Trial balance:

1. By Balance Method
2. By Total Method
3. By Combined Method i.e., Balance and Total Method

The given below is the explanation of methods:

1. ***Balance Method:*** Under this method, as the name of method suggests, the balance of each account is taken. This method is very simple, easy to calculate, saves both time and labour. That is why it is in vogue.
2. ***Total Method:*** Under this method, instead of taking balance of each account, the total of both the sides of each account is taken.
3. ***Combined Method:*** Under this method, as it is clear from the name of the method, both the above explained methods i.e., balance as well as total method are used. This method is not in use because of wastage of time and labour.

Preparation of Trial Balance with the Help of Balances

In the examination problems, the Ledger accounts are not given but a list of balances of accounts is given. With the help of these balances the students are asked to prepare the Trial Balance. Students should kept in mind the following rules to prepare a Trial Balance:

1. The balances of all the assets accounts and drawing accounts are recorded in the debit side of the Trial Balance.
2. The balances of all the liabilities and capital accounts are recorded in the credit side of the Trial Balance.
3. The balances of all expenses and losses of the business are showed in the debit side of the Trial Balance.
4. The balances of all incomes and gains are disclosed in the credit side of the Trial Balance.
5. The balances of sales and sale returns are disclosed in the credit side and debit side of Trial Balance respectively.
6. The balances of purchases and purchase returns are disclosed in the debit side and credit side of the Trial Balance respectively.

Illustration 1: Mr. Akshey Kumar furnishes the following balances as on 31st March, 2008. You have to prepare a Trial Balance with the following information:

Particulars	₹	Particulars	₹
Interest on Capital	24,000	Salaries	1,28,000
Creditors	6,00,000	Capital	8,00,000
Discount Received	23,000	Drawings	2,46,000
Loan	1,74,000	Machinery	3,00,000
Purchase Returns	40,000	Bills Payable	20,000
Sales Return	6,000	Furniture	6,00,000
Advertisement	1,63,000	Debtors	5,00,000
Commission Received	20,000	Bank Loan	2,00,000
Rent	10,000	Patents	60,000
Purchases	19,00,000		
Sales	32,60,000		
Opening Stock	12,00,000		

Notes

Solution:

Trial Balance
(as on 31st March, 2008)

Particulars	L.F.	Dr. (₹)	Cr. (₹)
Interest on Capital		24,000	–
Creditors		–	6,00,000
Discount Received		–	23,000
Loan		–	1,74,000
Purchase Returns		–	40,000
Sale Returns		6,000	–
Advertisement		1,63,000	–
Commission Received		–	20,000
Rent		10,000	–
Purchases		19,00,000	–
Sales		–	32,60,000
Opening Stock		12,00,000	–
Salaries		1,28,000	–
Capital		–	8,00,000
Drawings		2,46,000	–
Machinery		3,00,000	–
Bills Payable		–	20,000
Furniture		6,00,000	–
Debtors		5,00,000	–
Bank Loan		–	2 00 000
Patents		60,000	–
Total		**51,37,000**	**51,37,000**

From the above trial balances, it is clear that the total of debit side will agree with the total of credit side if Ledger accounts are arithmetically correct. If these totals does not tally with each other, there will be some error in the ledger accounts.

Illustration 2: From the following transactions, pass journal entries, prepare ledger accounts and also prepare Trial Balance under (i) Balance method (ii) Total method.

		₹
1.	Anil started business with	8,000
2.	Purchased furniture	1,000
3.	Purchased goods	6,000
4.	Sold goods	7,000
5.	Purchased from Raja	4,000
6.	Sold to Somu	5,000
7.	Paid to Raja	2,500
8.	Received from Somu	3,000
9.	Paid rent	200
10.	Received commission	100

Solution:

Notes

Journal Entries

Particulars		L.F	Dr.	Cr.
Cash A/c	Dr.		8,000	
To Capital A/c				8,000
[Started business]				
Furniture A/c	Dr.		1,000	
To Cash A/c				1,000
[Purchased furniture]				
Purchases A/c	Dr.		6,000	
To Cash A/c				6,000
[Purchased goods]				
Cash A/c	Dr.		7,000	
To Sales A/c				7,000
[Sold goods for cash]				
Purchases A/c	Dr.		4,000	
To Raj a A/c				4,000
[Purchased goods]				
Somu A/c	Dr.		5,000	
To Sales A/c				5,000
[Sold goods on credit]				
RajaA/c	Dr.		2,500	
To Cash A/c				2,500
[Paid cash]				
Cash A/c	Dr.		3,000	
To Somu A/c				3,000
[Received from Somu]				
Rent A/c	Dr.		200	
To Cash A/c				200
[Paid rent]				
Cash A/c	Dr.		100	
To Commission received A/c				100
[Received commission]				

Cash Account

	₹		₹
To Capital	8,000	By Furniture	1,000
To Sales	7,000	By Purchases	6,000
To Somu	3,000	By Raja	2,500
To Commission	100	By Rent	200
		By Balance c/d	8,400
	18,100		18,100
To Balance b/d	8,400		

Capital Account

	₹		₹
To Balance c/d	8,000	By Cash	8,000
	8,000		8,000
		By Balance b/d	8,000

Notes

Furniture Account

	₹		₹
To Cash	1,000	By Balance c/d	1,000
	1,000		1,000
By Balance b/d	1,000		

Purchase Account

	₹		₹
To Cash	6,000	By Balance c/d	10,000
To Raja	4,000		
	10,000		10,000
To Balance b/d	10,000		

Sales Account

	₹		₹
To Balance c/d	12,000	To Cash	7,000
		To Somu	5,000
	12,000		12,000
		By Balance b/d	12,000

Raja Account

	₹		₹
To Cash	2,500	By Purchase	4,000
To Balance c/d	1,500		
	4,000	By Balance b/d	4,000
			1,500

Somu Account

	₹		₹
To Sales	5,000	To Cash	3,000
		To Balance c/d	2,000
	5,000		5,000
To Balance c/d	2,000		

Rent Account

	₹		₹
To Cash	200	By Balance c/d	200
	200		200
To Balance b/d	200		

Commission received Account

	₹		₹
To Balance c/d	100	By Cash	100
	100		100
		By Balance b/d	100

I. ***Balance Method*** **Notes**

Trail balance as on…..

	Dr.	Cr.
Cash	8,400	
Capital	–	8,000
Furniture	1,000	–
Purchases Sales	10,000	–
Raja	–	12,000
	–	1,500
Somu	2,000	–
Rent	200	–
Commission received		100
	21,600	21,600

II. ***Total Method***

Trial balance as on…..

	Dr. (₹)	**Cr. (₹)**
Cash	18,100	9,700
Capital	–	8,000
Furniture	1,000	–
Purchases	10,000	–
Sales	–	12,000
Raja	2,500	4,000
Somu	5,000	3,000
Rent	200	–
Commission received	–	100
	36,800	36,800

Task From the following transactions, pass journal entries, prepare ledger accounts and also prepare Trial Balance under:

		₹
1.	Anil started business with	8,000
2.	Purchased furniture	1,000
3.	Purchased goods	6,000
4.	Sold goods	7,000
5.	Purchased from Raja	4,000
6.	Sold to Somu	5,000
7.	Paid to Raja	2,500
8.	Received from Somu	3,000
9.	Paid rent	200
10.	Received commission	100

Notes

10.4 Errors

There can be certain errors in recording the accounting transactions in primary and secondary books of accounts. When there are some errors in the accounting then the balance of both the sides of trail balance will not tally. Some of the errors are easy to detect but there are certain errors which are not detected through the trial balance. In other words, a trial balance would agree in spite of these errors. These errors are very difficult to detect because you will not be aware of such errors. The examples of such errors are errors of principle, errors of omission, errors of commission, compensating errors, etc.

There are two types of errors:

10.4.1 Errors which cannot be Located by Trial Balance

The following errors cannot be detected by the trial balance means inspite of agreeing the totals of debit side and credit side, these errors occur in the accounts.

1. ***Error of Omission:*** These errors occur when any business transaction is completely or partially omitted from the recording in the books of original records.

Example: Goods, sold of ₹10,000 to Mr. Ram, is not entered anywhere in the original books so its effect will not appear on the ledger and trial balance.

Thus, such type of errors can not be located by trial balance.

2. ***Error of Commission:*** Such type of errors are found when one account is debited or credited in the place of another account.

Example: Cash received from Shyam ₹1,000 has been credited in the name of Ram.

Such type of errors do not affect the agreement of the totals of the debit and credit side of the trial balance but they affect the result of the business.

3. ***Error of Principle:*** These errors occur when there is wrong classification between the capital and revenue nature incomes or expenditures.

Example: The purchases of furniture of ₹20,000, are entered in the book of purchases while it should be in furniture account.

Such errors can not be located by trial balance.

4. ***Compensating Error:*** When two errors of the same account occur and the effect of one error is compensated by the effect of other error it is called compensating error.

Example: If purchase of ₹10,000 from Ajay is credited only by ₹1,000 while the purchases from Vijay for ₹1,000 is credited by ₹10,000. Thus, such type of errors do not affect on the agreement of the Trial Balance.

10.4.2 Errors which can be Located by Trial Balance

The errors which affects the agreement of the totals of the Trial balance, can be located easily. These errors may be relating to:

1. Totals of the subsidiary books or ledger accounts.

Example: The total of Purchases Book is written as ₹44800 while actual total is ₹ 44300, the total of Sales Day Book is written as ₹52500 while it is ₹52900.

Notes

2. Balancing of an account of the ledger.

Example: The total of the debit column of Mohan's A/c is ₹8600 and that of credit column is ₹6800. The balance calculated is as ₹1600 while the actual balance is ₹1800.

3. Wrong posting of any amount in any account.

Example: Goods purchased of ₹5400 from Rajesh Mohanti was posted to the debit of Rajesh Mohanti or posted twice to his account or posted to the credit of Rakesh Mohanti.

4. Posting of any account may be in the wrong side of the account.

Example: Sales made to Krishna ₹ 5000 is transferred to credit side of Krishna's account in the ledger.

5. Balance of any account may be omitted in writing in the Trial Balance.

Example: Advertisement account which shows a debit balance is completely omitted from trial balance.

6. Wrong total of the Trial Balance.

Did u know? **What is suspense account?**

Sometimes, it is not possible to point out errors easily, then the difference is put to an account, known as suspense account. Suspense A/c is shown in the trial balance. As and when errors are located, the same is debited or credited for rectifying the error and the other account which is credited or debited is the suspense account. Thus, the suspense account is automatically closed.

Case Study

The following balances are extracted from the books of Mr. Rakesh as on 31.12.2005.

	₹		₹
Capital	15,000	Purchases	7 ,200
Land & Building	15,600	Provision for bad debts	370
Bank overdraft	2,500	Sales	17,000
Cash in hand	680	Wages	1250
Stock in Trade as on 1.1.04	6,000	Salaries	700
Advertisement	210	Insurance	40
Rent & Taxes	160	Discount allowed	300
Interest & Discount received	300	Repairs to building	210
Debtors	6420	Creditors	4,100
		General Expenses	500

Prepare a trial balance.

Hint: Total of Trial Balance ₹ 39,270.

Notes

10.5 Summary

- Trial Balance is a list of accounting balances and their names; of the enterprise during the specified period which includes debit and credit balances of the various balanced ledger accounts out of the journal entries.
- Purposes of preparing the Trial Balance is to prepare a statement of disclosure of final accounting balances of various ledger accounts on a particular date.
- There can be certain errors in recording the accounting transactions in primary and secondary books of accounts.
- The following errors cannot be detected by the trial balance means inspite of agreeing the totals of debit side and credit side
  - Error of omission
  - Error of commission
  - Error of principle
  - Compensating error
- The errors which can be located in the trial balance are wrong total, balancing error, positioning error etc.
- Sometimes, it is not possible to point out errors easily, then the difference is put to an account, known as suspense account.

10.6 Keywords

Bill of exchange: A bill of exchange is an unconditional order signed by the maker which directs the recipient to pay a fixed sum of money to a third party at a future date.

Suspense account: Sometimes, it is not possible to point out errors easily, then the difference is put to an account, known as suspense account.

Trial balance: It is the list of accounts taken from the ledger.

10.7 Self Assessment

Fill in the blanks:

1. …… is a statement which shows balances of all accounts on a particular date.
2. The balances of all the liabilities and capital accounts are recorded in the …… of the Trial Balance.
3. The balances of all incomes and gains are disclosed in the …… of the Trial Balance.
4. …… is found when one account is debited or credited in the place of another account.
5. ……. occur when any business transaction is completely or partially omitted from the recording in the books of original records.
6. ……. occur when there is wrong classification between the capital and revenue nature incomes or expenditures.
7. Suspense A/c is shown in the …….

Notes

8. The balances of all the assets accounts and drawing accounts are recorded in the ……. of the Trial Balance.

9. The balances of all incomes and gains are disclosed in the ……. of the Trial Balance.

Choose the appropriate answers:

10. Purchases Day Book under cast by ₹ 200.
    (a) Error of Principle
    (b) Compensating Error
    (c) Error of Omission
    (d) Error of Commission.

11. Amount spent on the repair of a plant is wrongly debited to repairs a/c:
    (a) Error of Omission
    (b) Error of Commission
    (c) Error of Principle
    (d) Compensating Error.

12. Mr. Ram's account is debited in place of Shyam's a/c for ₹ 500.
    (a) Error of Omission
    (b) Error of Principle
    (c) Error of Commission
    (d) Compensating Error.

13. Sales day book overcast by ₹ 150.
    (a) Error of Omission
    (b) Error of Commission
    (c) Compensation Error
    (d) Error of principle.

14. Purchase of Furniture is debited to Purchases a/c.
    (a) Error of Omission
    (b) Error of Principle
    (c) Error of Commission
    (d) None of the above.

15. Bad debts recovered from a debtor is credited to his account.
    (a) Error of Omission
    (b) Error of Commission
    (c) Error of Principle
    (d) Compensating Error.

Notes

10.8 Review Questions

1. From the following ledger accounts of Mr. S, draw Trail Balance as on 31st December 2004.

	₹
House Property	45,000
Repairs	1,200
Furniture	5,000
Rent Received	4,800
Utensils	6,000
Medical Expenses	1,200
Ornaments	25,000
School Free	1,800
Cash	630
Conveyance	1,350
Cosmetics	1,150
Interest Received	3,000
Bank Balance:	
Fixed Deposits	20,000
Savings Bank	3,500
House Building Loan from Govt.	20,000
Shares & Govt. Securities	12,000
Interest paid	1,870
Claims against persons	1,500
Municipal Taxes	3,000
Salary (Income)	24,000
Income-tax	2,500
Servants wages	1,200
Accumulated Fund	88,300
Food and Drink	3,750
Dress and Clothing's	2,450

2. The following Trail Balance was extracted from the books of a Merchant, although the columns are agreed, yet they are incorrect. You are required to correct and redraft it.

	Dr.		Cr.
Premises	30,000	Capital	36,800
Machinery	8,500	Fixture	2,800
Bad Debts	1,400	Sales	52,000

Contd....

Notes

Returns Outwards	1,300	Debtors	30,000
Cash	200	Interest	1,300
Discount Received	1,500	Received	
Bank Overdraft	5,000		
Creditors	25,000		
Purchases	50,000		
	1,22,900		1,22,900

3. Prepare Trial Balance of M/s Multiplying enterprise as on 31st December, 2006.

Accounts	Balances (Rs.)	Accounts (Rs.)	Balances
Cash in hand	2500	Debtors	18200
Cash at Bank	14500	Creditors	16600
Capital	70000	Opening stock	8700
Drawing	9000	Wages	6700
Purchases	60000	Rent	5000
Sales	82000	Salary	8400
Machine	35000	Bills Payable	11400
Furniture	12000		

4. Prepare Trial Balance as on 31st March, 2006 from the following balances of Sabana:

	Dr.	Cr.
Accounts	Balances (Rs.)	Balances (Rs.)
Cash in hand	3100	
Bank overdraft		18250
Opening stock	24600	
Purchases	59800	
Sales		72350
Sabana's Capital		50000
Drawings	12000	
Carriage Inward	1600	
Rent	2400	
Commission		2100
Interest	780	
Furniture	5220	
Creditors		13600
Debtors	27800	
Building	20000	1000
Suspense	157300	157300

Notes

5. From the following ledger accounts of Sathiya, draw Trail Balance as on 31st December 2004.

	Rs.		Rs.
House Property	45,000	Repairs	1,200
Furniture	5,000	Rent Received	4,800
Utensils	6,000	Medical Expenses	1,200
Ornaments	25,000	School Free	1,800
Cash	630	Conveyance	1,350
Bank Balance:		Cosmetics	1,150
Fixed Deposits	20,000	Interest Received	3,000
Savings Bank	3,500	House Building Loan from Govt.	20,000
Shares & Govt. Securities	12,000	Interest paid	1,870
Claims against persons	1,500	Municipal Taxes	3,000
Salary (Income)	24,000	Income-tax	2,500
Servants wages	1,200	Accumulated Fund	88,300
Food and Drink	3,750		
Dress and Clothing's	2,450		

6. List the various reasons because of which the totals of two columns of Trial Balance do not tally.
7. What are the key methods of preparing the trial balance? Give suitable examples.
8. Illustrate the different types of errors which are not revealed by the trial balance.
9. Explain why?
   (a) Discount allowed is brought under the debit side
   (b) Discount received is brought under the credit side
10. Make the proforma s trial balance.

Answers: Self Assessment

1. Trial Balance
2. credit side
3. credit side
4. Error of commission
5. Error of omission
6. Error of principle
7. Trial balance
8. Debit side
9. Credit side
10. (d)
11. (c)
12. (d)
13. (b)
14. (b)
15. (b)

10.9 Further Readings

Notes

Books

Khan and Jain, "*Management Accounting*".

M.P. Pandikumar, "*Accounting & Finance for Managers*", Excel Books, New Delhi.

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Online link www.futureaccountant.com

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Unit 11: Depreciation Accounting

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Objectives

After studying this unit, you will be able to:

- Describe the meaning of depreciation
- State the methods of depreciation
- Compare straight line and written down value method

Introduction

Depreciation accounting is mainly based on the concept of income. The concept of income is matching of revenues with expenses. The goods purchased are frequently matched through immediate sale or within a year. The crux of the concept of income is that the expenses are to be matched against the revenues. The ultimate aim of matching is done in order to determine the volume of profit or loss of the transaction. If the assets are nothing but long term assets procured by the enterprise, they should be matched against the revenues of them. The matching of expenditure of the assets incurred by the firm at the time of purchase against the revenues is the core task of the firm.

Did u know? **Why is it being considered as a cumbersome task in matching?**

The benefits/revenues of the fixed assets are expected to accrue for many numbers of years but not within a year. The initial investment on the assets at the time of purchase should be matched against the revenue pattern of the same year after year in order to find out the profitability of the long term investment.

To have an effective matching against the revenues on every year, the amount of purchase has to be stretched. The stretching of expenses into many years is known as depreciation.

Notes

11.1 Meaning of Depreciation

According to Dickens, Depreciation is the permanent and continuous diminution in the quality/quantity/value of the asset.

In simple words, depreciation is the permanent decrease in the value of the fixed assets. It is a matching in between the fixed charge expense against the current year's revenue.

The remaining/left which is the un-recovered portion should be carried forward to forthcoming years in order to match against the respective revenues. The ultimate purpose of the depreciation is to replace the fixed assets only at the moment of becoming useless through the current revenues.

Did u know? **What are the items which are not covered under fixed assets?**

Under the fixed assets the following items are not considered on which special considerations apply:

1. Forests, plantations and similar regenerative natural resources,
2. Wasting assets including mineral rights, expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non-generative resources,
3. Expenditure on real estate development, and
4. Livestock.

Notes **Reasons for Depreciation**

1. ***Wear and Tear of the Asset:*** The long term assets are becoming less efficient and poor quality in operations due to the continuous usage of the asset.
2. ***Exhaustion:*** Nothing will be left due to the continuous extraction of resources. The resources in the oil wells, mine fields will be completely exhausted due to incessant extraction. This has to be replaced by a new method of exploration. Investment in new exploration methods requires depreciation as a charge against the revenues of the wells/fields.

   Example: Oil & Natural Gas Corporation Ltd. (ONGC) indulges in the process of new oil exploration projects through research projects. The new projects should then be identified and invested by huge initial investment outlay through the current revenues out of the existing projects on account of replacement due to depletion of resources.
3. ***To face technological obsolescence:*** To replace the old machinery with new machinery, before the expiry of the economic life period of the asset in order to maintain the efficiency and economy of the asset. The typewriter was replaced by the electronic typewriter during the yester periods of office automation. To replace the old typewriter which is neither efficient nor economical, it should be replaced by the new electronic typewriter through the depreciation charge on the old one.
4. ***Accident:*** The value of the asset mainly depends upon the efficiency and economy; which gets affected due to accident.

Notes

11.2 Journal Entries and Ledger Accounts

There are two methods to record the depreciation on fixed assets in the books of the owner:

1. ***When provision for depreciation account is maintained:*** Under this method, the amount of depreciation each year is transferred to the provision for depreciation account and the assets are shown in the books at their original cost. And when an asset is sold on the expiry of its useful life, sales proceeds of the assets and the amount of provision for depreciation is transferred to the assets account. Profit or loss arises from the sale of the assets is carried to profit and loss account. Under this method the following journal entries are passed in the books of owner:

   (a) *When depreciation is charged on Assets:*

   Depreciation Account Dr.

   To Provision for Depreciation Account

   (b) *When depreciation is transferred to P & L Account:*

   P. & L. Account Dr.

   To Depreciation Account

   (c) *When assets are sold on the expiry of useful life of the assets:*

   Provision for Depreciation Account Dr.

   To Assets Account

   (d) *If there is any profit on the sale of Assets:*

   Assets account Dr.

   To P & L Account

   (e) *If there is any loss on the sale of assets:*

   P & L Account Dr.

   To Assets Account

2. ***When Provision for Depreciation Account is not Maintained:*** In this case the depreciation on the assets is not transferred to the provision for depreciation account, but that is transferred to assets account and the assets are shown at the written down value (cost of assets minus depreciation) in the balance sheet. Depreciation is treated as an expense and is transferred to the profit and loss account. Under this method the following journal entries are passed in the books of the owner:

   (a) *When depreciation is charged on Assets:*

   Depreciation Account Dr.

   To Assets Account

   (b) *When depreciation is transferred to the P & L Account:*

   P & L Account Dr.

   To Depreciation Account

   (c) *If the assets are sold at profit on the expiry of the useful life of Assets:*

   Cash Account Dr.

   To Assets Account

   To P. & L. Account

Notes

(d) *In the case of loss the following entry is passed:*

Cash Account	Dr.
P. & L. Account	Dr.
To Assets Account	

11.3 Methods of Charging Depreciation

There are various methods of depreciation:

1. Straight line method
2. Depletion or Output method
3. Machine hour rate method
4. Diminishing Balance or Written down method
5. Sum of digits method
6. Annuity method
7. Sinking fund method and
8. Insurance policy method

In this unit we will discuss only about the straight line method and diminishing balance method.

11.4 Straight Line Method

Under this method, depreciation is calculated as a fixed proportion on the original value of the asset. The depreciation is charged as fixed in volume on the original value of the asset at which it was purchased. The original value of the asset is nothing but the purchase value of the asset.

Illustration 1:

. Cost of Machine - ₹1,00,000

Estimated life of the machine - 5 years

Scrap value-Nil

$$\text{Depreciation} = \frac{\text{Cost of the machine - Scrap value}}{\text{Economic Life period of the asset in years}}$$

According to the concept of depreciation, the value of the asset is dispersed throughout the life of the period in order to match the respective earnings of the year after year. The purchase value of the asset is an expenditure to be stretched to many number of years in order to equate with the revenues. To equate the revenues, the scrap value of the asset at the end of the life period is realized should be deducted and apportioned to the total number of the economic life period of the asset. The aim of deducting the scrap value of the asset is reducing the original value of the investment.

$$\text{Depreciation} = \frac{₹1,00,000 - 0}{5} = ₹\ 20,000$$

Notes

To understand the above calculation, the following table is most valuable:

Value of the asset (Begin) ₹ Col. 1	Depreciation ₹ Col. 2	Value of the asset End ₹ Col 3=Col.1-Col.2
1st year – 1,00,000	20,000	80,000
2nd year – 80,000	20,000	60,000
3rd year – 60,000	20,000	40,000
4th year – 40,000	20,000	20,000
5th year – 20,000	20,000	"0"

From the above table, ₹20,000 is charged on every year to recover ₹1,00,000 during its life period i.e. 5 years.

Illustration 2: Original value of the investment- ₹1,00,000

Scrap value - ₹10,000

Life of the asset -5 years

$$\text{Depreciation} = \frac{₹1,00,000 - ₹1\ 0,000}{5\ \text{years}} = \frac{₹90,000}{5\ \text{years}} = ₹18,000$$

To understand the methodology of straight line depreciation, the following table will illustrate the process.

Value of the asset (Begin) ₹	Depreciation ₹	Value of the asset (End) ₹
1st year – 1,00,000	18,0000	82,000
2nd year – 82,000	18,0000	64,000
3rd year – 64,000	18,0000	46,000
4th year – 46,000	18,0000	28000
5th year – 28,000	18,0000	10,000(Scrap value)*

The scrap value of the asset is expected to realize only at the end of the life period of the asset i.e. 5 years.

Illustration 3: Mr. Shankar purchased a machine for ₹90,000 on 1st April 1999. Its probable working life was estimated at 5 years and its probable scrap value at the end of that time is ₹10,000. You are required to prepare the necessary account based on straight line method of depreciation for five years.

To prepare the various accounts of the enterprise connected to depreciation is as follows:

The depreciation charge process is carried out in three stages:

- ***The asset to be initially purchased:*** Purchase entry has to be carried out. How is the purchase made? While making the purchase there are two different accounts that are affected which are normally known as real accounts. At the moment of purchase on one side the asset is coming into the firm; on the other side the cash resources are depleted due to the payment of purchase bill of the asset.

		₹	₹
1 April,1999	Plant & Machinery A/c Dr	90,000	
	To Cash A/c		90,000
Being plant & machinery purchased			

- The next account involved in the process of accounting is depreciation account. Before transacting the depreciation entry in the books of accounts, we must find the amount of depreciation to be charged against every year's revenue.

Notes

- The amount of depreciation is to be calculated as follows:

$$\text{Depreciation} = \frac{\text{Original value of the asset- Scrap value}}{\text{Estimated life of the asset in years}}$$

$$= \frac{₹90,000 - 10,000}{5 \text{ years}} = ₹16,000$$

- Depreciation is a fixed charge to be calculated on the value of the asset on every year and deducted from the original value. Depreciation is nothing but charge as an expenditure against the revenues in accordance with the matching concept. Hence the depreciation non-recurring expenditure account and the plant & machinery account should be debited and credited respectively.
- For the accounting entry I year depreciation

			₹	₹
31st March, 2000	Depreciation A/c	Dr	16,000	
	To Plant Machinery A/c			16,000
Being the first year depreciation is charged				

- For the accounting entry II year depreciation

			₹	₹
31st March, 2001	Depreciation A/c	Dr	16,000	
	To Plant Machinery A/c			16,000
Being the second year depreciation is charged				

- For the accounting entry III year depreciation

			₹	₹
31st March, 2002	Depreciation A/c	Dr	16,000	
	To Plant Machinery A/c			16,000
Being the Third year depreciation is charged				

- For the accounting entry IV year depreciation

			₹	₹
31st March, 2003	Depreciation A/c	Dr	16,000	
	To Plant Machinery A/c			16,000
Being the fourth year depreciation is charged				

- For the accounting entry V year depreciation

			₹	₹
31st March, 2004	Depreciation A/c	Dr	16,000	
	To Plant Machinery A/c			16,000
Being the fifth year depreciation is charged				

- The next account involved is the scrap value account which amounted ₹ 10,000

  While selling the residual portion of the asset, the firm is able to receive ₹ 10,000 as receipt as cash. The sale of residual part of the machinery leads to bring cash resources into the firm and in turn, the plant and machinery is going out of the firm.

- For the accounting entry of scrap value:

31st March, 2004	Cash A/c	Dr	10,000	
	To Plant Machinery A/c			10,000
Being the residual part of the machinery is sold				

Notes

- The next transaction is the final transaction pertaining to the posting of depreciation accounting balance under the P & L account.
- It is nothing but the transfer of Depreciation accounting balance into P&L account. At the end of every year, immediately after finalizing the accounting, balance of depreciation is regularly posted under the P&L account.
- The journal entry transfer is carried out as follows:
- For the I year depreciation transfer to P&L A/c

		₹	₹
31st March, 2000	P&L A/c Dr	16,000	
	To Depreciation A/c		16,000
Being the first year depreciation is transferred to P&L A/c			

- For the II year depreciation transfer to P&L A/c

		₹	₹
31st March, 2001	P&L A/c Dr	16,000	
	To Depreciation A/c		16,000
Being the second year depreciation is transferred to P&L A/c			

- For the III year depreciation transfer to P&L A/c

		₹	₹
31st March, 2002	P&L A/c Dr	16,000	
	To Depreciation A/c		16,000
Being the third year depreciation is transferred to P&L A/c			

- For the IV year depreciation transfer to P&L A/c

		₹	₹
31st March, 2003	P&L A/c Dr	16,000	
	To Depreciation A/c		16,000
Being the fourth year depreciation is transferred to P&L A/c			

- For the V year depreciation transfer to P&L A/c

		₹	₹
31st March, 2004	P&L A/c Dr	16,000	
	To Depreciation A/c		16,000
Being the fifth year depreciation is transferred to P&L A/c			

The preparation of Plant & Machinery account: It is very easy to prepare the machinery Ledger account.

Dr **Plant & Machinery A/c I Yr** Cr

Date	Particular	₹	Date	Particulars	₹
1 April, 1999	To Cash A/c	90,000	31st March, 2000	By Depreciation	16,000
				By Balance c/d transferred to Second year Plant & Machinery A/C	74,000
		90,000			90,000
	To Balance B/d	74,000			

Notes

Dr **Plant & Machinery A/c II Yr** Cr

Date	Particular	₹	Date	Particulars	₹
1 April, 2000	To Balance B/d (transferred from I Yr Plant & Machinery)	74,000	31st March, 2001	By Depreciation	16,000
				By Balance c/d transferred to III Yr Plant & Machinery A/C	58,000
		74,000			74,000
	To Balance B/d	58,000			

Dr **Plant & Machinery A/c III Yr** Cr

Date	Particular	₹	Date	Particulars	₹
1 April, 2001	To Balance B/d (transferred from II Yr Plant & Machinery)	58,000	31st March, 2002	By Depreciation	16,000
				By Balance c/d (transferred to IV Yr Plant & Machinery A/C)	42,000
		58,000			58,000
	To Balance B/d	42,000			

Dr **Plant & Machinery A/c IV Yr** Cr

Date	Particular	₹	Date	Particulars	₹
1 April, 2002	To Balance B/d (transferred from III Yr Plant & Machinery)	42,000	31st Mar,2003	By Depreciation	16,000
				By Balance c/d (transferred to V Yr Plant & Machinery A/C)	26,000
		42,000			42,000
	To Balance B/d	26,000			

Dr **Plant & Machinery A/c V Yr** Cr

Date	Particular	₹	Date	Particulars	₹
1st April, 2003	To Balance B/d (transferred from IV Yr Plant & Machinery)	26,000	31st Mar, 2004	By Depreciation	16,000
				By Cash	10,000
		26,000			26,000

The next ledger account to be prepared is the Depreciation A/c.

Depreciation A/c

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
31st Mar, 2000	To Plant & Machinery	16,000	31st Mar, 2000	By P & L A/c	16,000
31St Mar, 2001	To Plant & Machinery	16,000	31St Mar, 2001	By P & L A/c	16,000
31St Mar, 2002	To Plant & Machinery	16,000	31St Mar, 2002	By P & L A/c	16,000
31St Mar, 2003	To Plant & Machinery	16,000	31St Mar, 2003	By P & L A/c	16,000
31St Mar, 2004	To Plant & Machinery	16,000	31St Mar, 2004	By P & L A/c	16,000

Notes

Illustration 4: M/s Muruganand &Co is a trader bought furniture costing ₹ 2,20,000 for his new branch on 1st April, 2000. As the furniture bought was superior quality material. The auditors estimated its residual value at ₹20,000 after a working life of ten years. Further additions were made into the same category on 1st Oct, 2001 and 1st April, 2002 costing ₹ 16,800 and ₹19,000 (with a scrap value of ₹ 800 and ₹1000 respectively). The trader closed his accounts on 31st March every year and wanted to apply straight line method of depreciation. Show the furniture a/c for four years.

First step is to find out the depreciation of the furniture for various number of years i.e. 4 years. The depreciation is to be calculated on every year.

The most important point to be borne in our mind while calculating depreciation, the following points to be taken into consideration:

First, is there any % of depreciation charge given? If given, the depreciation has to be calculated on the volume of available balance at the end.

Secondly, if the % of depreciation charge is not given in our problem, how can the volume of depreciation be calculated?

The depreciation can be calculated as follows

$$\text{Depreciation} = \frac{\text{Original value of the asset} - \text{Scrap value}}{\text{Life period of the asset}}$$

In this problem, due to absence of depreciation %, the above illustrated formula should have to be applied throughout the problem.

Date of Purchase Particulars	**First Furniture 2000 ₹**	**Second furniture 2001 ₹**	**Third Furniture 2002 ₹**	**Total Depreciation cost ₹**
Cost of the furniture R1	2,20,000	16,800	19,000	
Scrap value at the end (–) R2	20,000	800	1000	
Depreciable value of the furniture R3	2,00,000	16,000	18,000	
Life of the furniture R4	10 years	10 years	10 years	
Depreciation R5=R3/R4	20,000	1,600	1,800	
Depreciation for 2000-01	20,000	------	-------	20,000
Depreciation for 2001-02	20,000	For 6 months 800	-------	20,800
Depreciation for 2002-03	20,000	1,600	1,800	23,400
Depreciation for 2003-04	20,000	1,600	1,800	23,400

Accounting entries are as follows:

Accounting entries for the accounting year 2000-2001

During the year 1st April 2,000 – 2,20,000 worth of furniture was bought

		₹	₹
1 April, 2000	Furniture A/c Dr	2,20,000	
	To Bank A/c		2,20,000
Being the furniture is purchased			

Depreciation for the year 2000 for the first furniture

		₹	₹
31st Mar,2001	Depreciation A/c Dr	20,000	
	To Furniture A/c		20,000
Being depreciation charged			

Notes

Accounting entries for the accounting year for 2001-02

Second new furniture bought during the month 1st Oct, 2001

		₹	₹
1 April, 2001	Furniture A/c Dr	16,800	
	To Bank A/c		16,800
Being new furniture procured			

Depreciation for the first furniture

31st Mar, 2002	Depreciation A/c Dr	20,000	
	To Furniture A/c		20,000
Being the depreciation charged			

Depreciation for the second furniture

31st Mar,2002	Depreciation A/c Dr	800	
	To Furniture A/c		800
Being the depreciation charged for the second furniture for 6 months			

Accounting entries for the accounting year for 2002-03

Third new furniture bought during the month of 1st April, 2002.

1st April,2002	Furniture A/c	19,000	
	To Bank A/c		19,000
Being the furniture purchased during the year			

Depreciation charged for the first furniture

31st March, 2003	Depreciation A/c Dr	20,000	
	To Furniture A/c		20,000
Being the depreciation charged for the first furniture			

Depreciation charged for the second furniture

31st March, 2003	Depreciation A/c Dr	1,600	
	To Furniture A/c		1,600
Being the depreciation charged for the second furniture			

Depreciation for the third furniture

31st March, 2003	Depreciation A/c Dr	1,800	
	To Furniture A/c		1,800
Being the depreciation charged for the third furniture			

Accounting entries for the fourth year 2003-04

Depreciation charged for the first furniture

31st March, 2004	Depreciation A/c Dr	20,000	
	To Furniture A/c		20,000
Being the depreciation charged for the first furniture			

Depreciation charged for the second furniture

31st March, 2004	Depreciation A/c Dr	1,600	
	To Furniture A/c		1,600
Being the depreciation charged for the second furniture			

Notes

Depreciation for the third furniture

31st March, 2004	Depreciation A/c Dr	1,800	
	To Furniture A/c		1,800
Being the depreciation charged for the third furniture			

In the next step, the furniture account to be prepared for every year is given.

Furniture A/c (2000-01)

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
1 April, 2000	To Bank	2,20,000	31 Mar, 2001	By Depreciation	20,000
				By Balance c/d	2,00,000
		2,20,000			2,20,000
31st Mar,2001	To Balance B/d	2,00,000			2,20,000

Furniture A/c(2001-02)

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
1 April, 2001	To Balance B/d	2,00,000	31 Mar, 2002	By Depreciation	20,000
1st Oct, 2001	To Bank	16,800		By Depreciation	800
				By Balance c/d	1,96,000
		2,16,800			2,16,800
31st Mar, 2002	To Balance B/d	1,96,000			

Furniture (2002-03)

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
1st April, 2002	To Balance B/d	1,96,000	31st Mar, 2003	By Depreciation	20,000
1St April, 2002	To Bank	19,000		By Depreciation	1,600
				By Depreciation	1,800
				By Balance c/d	1,91,600
		2,15,000			2,15,000
31st Mar, 2003	To Balance B/d	1,91,600			

Furniture (2003-04)

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
1st April, 2003	To Balance B/d	1,91,600	31st Mar, 2004	By Depreciation	20,000
				By Depreciation	1,600
				By Depreciation	1,800
				By Balance c/d	1,68,200
		1,91,600			1,91,600
31 Mar, 2004	To Balance B/d	1,68,200			

Task Mr. Ramesh purchased a second hand machine for ₹24,000 on 1st April, 2006. He spend ₹10,000 on its overhaul and installation. Depreciation is written off 10% p.a. on the original cost. On 30th June, 2008 machine was found to be unsuitable and sold for ₹19,000. Prepare the machine account from 2006 to 2008 assuming that accounts are closed on 31st December, every year.

Notes

11.5 Written Down Value Method

This method also has the same methodology in charging depreciation on the fixed assets like fixed percentage. Though it bears similar approach in charging depreciation, it is different in application from the straight line method. Under this method, the depreciation is charged on the value of the asset available at the beginning of the year.

The following formula highlights the application of this method in charging depreciation:

$$= 1 - (S/C)^{1/n}$$

The meaning of the above illustrated formulae is discussed through the explanation of two different components.

The first one is $(S/C)^{1/n}$ the ratio of the scrap value of the asset on the original value is appropriately apportioned throughout the life period. It is nothing but the percentage of scrap value widened across the life period of the asset. Once the scrap value percentage is known, the next important step is to determine the depreciable value of the asset. The depreciable value of the asset can be derived by deducting the percentage from 1.

Example: Life of the asset (n) = 3 years

Expected scrap value at the end of 3 years = ₹12,800

Original Investment = ₹2,00,000

Find out the percentage of depreciation to be charged.

Under this method, to charge depreciation as well as to find out the value of the asset as on a particular date, the depreciation percentage must be given. In this problem, depreciation % is not given, in order to determine the above illustrated formulae should be applied:

$$= 1 - (S/C)^{1/n}$$

$$= 1 - (₹12,800/₹2,00,000)^{1/3}$$

$$= 1 - 4/10 = 6/10 = 60\%$$

The following workings will obviously facilitate the understanding of the charge of depreciation:

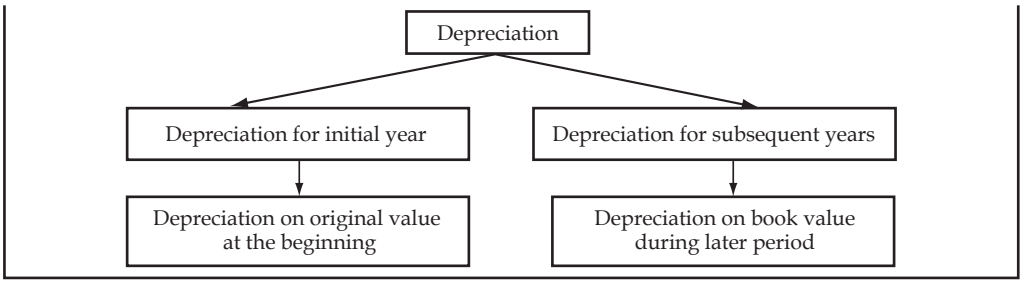
The value of the Asset at the beginning of 1st Year	= ₹2,00,000
(–) Depreciation 60% on ₹2,00,000 (Original value)	= ₹1,20,000
Value of the asset at the beginning of 2nd Year	= ₹ 80,000
(–) Depreciation 60% on ₹ 1,20,000.(Book Value)	= ₹ 48,000
Value of the asset at the beginning of 3rd Year	= ₹ 32,000
(–) Depreciation 60% on ₹ 32,000 (Book Value)	= ₹ 19,200
Value of the asset at the end of the year	= ₹ 12,800

Notes **Straight Line Method vs. Written Down Value Method**

Under this method of charging depreciation, unlike the straight line method, the percentage is usually given for calculation. While calculating this method, the depreciation is calculated on two different values.

Contd....

Notes



Example: Calculate the depreciation using straight line method and WDV method of depreciation from the information given below:

Cost of equipment = ₹ 8,000

Estimated useful life = 4 years

Scrap value at the end of useful life = ₹ 500

Depreciation rate for reducing balance method = 50%

Solution:

(i) Computation of Depreciation under SLM:

Dep. = ₹ 8000 – ₹ 500/4 years

= ₹ 1875

(ii) Rate of depreciation for reducing balance method is 50%.

Dep. = Net Book Value * 50%

The following table shows a comparison between the two methods of depreciation:

	Straight-line ₹	**Reducing Balance** ₹
Cost	8,000	8,000
Depreciation - year 1	1,875	4,000
Net book value	6,125	4,000
Depreciation - year 2	1,875	2,000
Net book value	4,250	2,000
Depreciation - year 3	1,875	1,000
Net book value	2,375	1,000
Depreciation - year 4	1,875	500
Net book value (diposal value)	500	500

Illustration 5: On 1st April, 2000, a firm purchases machinery worth ₹3,00,000. On 1st October, 2002 it buys additional machinery worth ₹60,000 and spends ₹6,000 on its erection. The accounts are closed normally on 31 March. Assuming the annual depreciation to be 10%, show the machinery account for 3 years under the written down value method.

Notes

Accounting Journal entries for the year 2000-01:

During the year 1st April 2,000 - ₹ 3,00,000 worth of machinery was bought:

			₹	₹
1 April, 2000	Machinery A/c	Dr	3,00,000	
	To Bank A/c			3,00,000
Being the machinery is purchased				

Depreciation for the year 2000 for the first machinery:

			₹	₹
31st Mar, 2001	Depreciation A/c	Dr	30,000	
	To Machinery A/c			30,000
Being depreciation charged				

Accounting Journal entries for the year 2001-02:

Depreciation for the year 2001 for the first machinery

			₹	₹
31st Mar, 2001	Depreciation A/c	Dr	27,000	
	To Machinery A/c			27,000
Being depreciation charged				

Accounting Journal entries for the year 2002-03

During the year 2002 new machinery worth of ₹ 60,000 was purchased. Before determining the volume of depreciation, the amount of original value of the machinery should be found out.

Original value of the asset = The purchase price of the asset + Erection charges incurred

= ₹ 60,000 + ₹ 6,000 = ₹ 66,000

			₹	₹
1 April, 2002	Machinery A/c	Dr	66,000	
	To Bank A/c			66,000
Being the machinery is purchased				

Depreciation for the year 2002 for the first machinery:

			₹	₹
31st March, 2003	Depreciation A/c	Dr	24,300	
	To Machinery A/c			24,300
Being depreciation charged				

Depreciation for the year 2002 for the second machinery:

			₹	₹
31st Mar,2003	Depreciation A/c	Dr	3,300	
	To Machinery A/c			3,300
Being depreciation charged				

Notes

After passing the journal entries, the next step is to prepare ledger account of machinery.

Dr **Machinery A/c (2000-01)** Cr

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
1st April, 2000	To Bank	3,00,000	31st Mar, 2001	By Depreciation	30,000
				By Balance c/d	2,70,000
		3,00,000			3,00,000
31st March, 2001	To Balance B/d Transfer to Machinery A/c (20001-02)	2,70,000			

Dr **Machinery A/c (2001-02)** Cr

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
1st April, 2000	To Balance B/d	2,70,000	31st Mar, 2001	By Depreciation	27,000
				By Balance c/d	2,43,000
		2,70,000			2,70,000
31st Mar, 2001	To Balance B/d Transfer to Machinery A/c (2002-03)	2,43,000			

Dr **Machinery A/c (2002-03)** Cr

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
1st April, 2000	To Balance B/d	2,43,000	31st Mar, 2001	By Depreciation First machinery	24,300
1st Oct, 2002	To Bank	66,000		By Depreciation Second machinery	3,300
				By Balance c/d	2,81,400
		3,09,000			3,09,000
31st Mar, 2003	To Balance B/d	2,81,400			

Caselet

Tata Steel Ltd. wants to establish its EOU in the state of Orissa through exploration of iron ore. It identified that the state of Orissa is one of the ideal states having greater potential of iron ore than any other state in India. The firm has reached lease contract with the Government of Orissa for the amount of ₹200 Cr towards the extraction of 40,00,000 tonnes iron ore from the field for 10 years.

The firm would like to establish a processing plant which amounts to ₹50 Cr to produce the quality carbon steel for the foreign industrial buyers. The life period of the machine is denominated in terms of 2,50,000 working hours. The firm is required to extract the iron ore.

Year	1	2	3	4	5	6	7	8	9	10
Expected Extraction Per Year In Lakh	8	7	6	5	4	3	3	2	1	1
Hrs. Working	1,00,000	75,000	25,000	12,500	6,250	6,250	6,250	6,250	6,250	6,250

Contd...

Notes

To meet out the cost of escalation, the firm should invest the amount of depreciation in the interest bearing securities. The rate of interest is 8%.

Questions

1. To go for further replacement after 10 years, how much should the firm charge depreciation in the case of iron ore field ? Which method should be applied ? Reason out the suitability of the method opted.
2. To replace the machinery recently bought after 10 years how much should be charged as depreciation in accordance with the working hours given ? Which method is considered to be most suitable to replace ? Why ?
3. To replace the both investments viz on the iron ore field and processing unit, how much the firm should invest during the 10 years time span?

11.6 Summary

- Depreciation is the decrease in the value of assets at the given date due to wear and tear, obsolescence, efflux of time, accident and exhaustion.
- Cost of assets, residual value of assets, and useful life of assets are the important factors of depreciation.
- There are several methods for providing depreciation on fixed assets. The method of the depreciation is selected on the basis of various factors as – types of assets, nature of business and circumstances prevailing in the business etc.
- Under straight line method, depreciation is calculated as a fixed proportion on the original value of the asset.
- Under written down value method, the depreciation is charged on the value of the asset available at the beginning of the year.

11.7 Keywords

Book Value of the Asset: The value of the asset after deducting the depreciation from the value of the asset at the beginning.

Depreciation: Continuous reduction/ decrease /diminution in the value of the asset.

Depreciation Accounting: Recording the entries of depreciation through journal, ledger accounts of Depreciation, Fixed Asset and Profit & Loss account.

Original Value of the Asset: The value of the asset at the time of purchase or acquisition.

Scrap Value of the Asset: It is the value at the end of the life period of the asset; when the asset cannot be put for further usage.

11.8 Self Assessment

Fill in the blanks:

1. Depreciation accounting is mainly based on the ……. .
2. Depreciation is the permanent decrease in the value of the ……... .
3. Depreciation is calculated on the basis of ……. .
4. …… can be created for replacement of fixed assets.

Notes

5. Amount of depreciation if charged on the basis of ……. remains constant for every year.
6. The original value of the asset is the ……. of the asset.
7. Reserve is created to strengthen the ……. of the business.
8. The profits can be distributed without providing for depreciation with the prior permission of the ……. .

State whether the following statements are true or false:

9. Amount of depreciation, if charged on the basis of written down value method, increases every year.
10. Depreciation is charged to find out the correct P&L accounting balance.
11. The depreciation charge is a mean to recover the cost of operations of the enterprise.
12. Under written down value method depreciation is charged on the original value of the asset.
13. The following formula to highlights the application of Diminishing Balance method in charging depreciation is = $(S/C)^{1/n} - 1$.
14. Profit or loss arises from the sale of the assets is carried to profit and loss appropriation account.
15. When provision for depreciation account is maintained the assets are shown in the books at their original cost.

11.9 Review Questions

1. Rakesh purchased a Machine for ₹ 12,000. The expected life of machine is 4 years. If its scrap realizes Rs 1,200, calculate the amount of depreciation to be charged from profit and loss a/c for 4 years. Prepare machine account of all the 4 years under straight line method of charging depreciation.
2. On 1st October 2002 M/s Goyal Traders, installed one machine in their shop at a total cost of ₹ 1,50,000. On 1st April, 2004 another machine of the cost of ₹ 50,000 was installed. Depreciation is charged at 10% p.a. on the reduced balances every year. Accounts are closed on every 31st March.

   Prepare Machine Account for first three years.
3. On 1.2003 M/s K.K. traders of Rajasthan purchased plants amounted to ₹ 2,00,000 and decided to write off depreciation @ 25% on written down value method. Show the plants a/c for first three years.
4. Thaper oil and fats limited purchased furniture for the office amounting to ₹ 12,500. The company wanted to charge depreciation @ 10% p.a.

   Prepare Furniture a/c for three years when

   (a) Depreciation is charged on original cost method and

   (b) When it is charged on reducing balance method.
5. Elucidate the process of depreciation accounting.
6. Explain the key methods of charging depreciation.

Notes

7. State the difference between the straight line method and written down value method with suitable examples.
8. What are the key reasons for charging depreciation?
9. Construct the key depreciation entries for charging and recording depreciation.
10. Golden Transport Company, New Delhi purchased 3 Trucks at ₹ 4,00,000 each on 1st Jan 2003 from the dealer. The company decided to charge 20% deprecation on the basis of original cost of trucks.

    Prepare Trucks A/c for 3 years and find out its w.d.v. at the end of 3rd year.

Answers: Self Assessment

1.	concept of income	2.	fixed assets
3.	cost price	4.	Depreciation funds
5.	straight line method	6.	purchase value
7.	financial position	8.	central Government
9.	False	10.	True
11.	True	12.	False
13.	False	14.	False
15.	True		

11.10 Further Readings

Books

Khan and Jain, "*Management Accounting*".

M.P. Pandikumar, "*Accounting & Finance for Managers*", Excel Books, New Delhi.

R. L. Gupta and Radhaswamy, "*Advanced Accountancy*".

S. N. Maheswari, "*Management Accounting*".

V. K. Goyal, "*Financial Accounting*", Excel Books, New Delhi.

Online links

http://www.globusz.com/

www.futureaccountant.com

Notes

Unit 12: Final Accounts

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Objectives

After studying this unit, you will be able to:

- Prepare Trading and Profit & Loss a/c
- Prepare Balance sheet
- Construct Adjustments Entries
- Prepare Final accounts with adjustments

Introduction

In the present unit, you will study about the final accounts with adjustments. After studying this unit, you will be able to understand the trading and profit and loss account, balance sheet and key adjustments related to them. Every organisation prepares its final accounts after a particular period to know its financial results and financial position. Final accounts mean profit and loss account and the balance sheet. Profit and loss account also contains one more account, known as trading account, and if the business is manufacturing any item or article, then Manufacturing account is also there. All these accounts are prepared only after preparing trial balance.

12.1 Objectives of Preparing Final Accounts

You already know that final accounts are prepared at the end of a particular time period. The final accounts plays an important role for every kind of organisation. There are two main objectives of preparing final accounts: (1) to know the operational results i.e. final accounts are prepared to know the profit or loss during a particular period through the profit and loss account which is also known as income statement, and (2) to ascertain the financial position of the business on a particular date through the balance sheet, also known as position statement.

Notes

Did u know? There are two types of persons interested in financial statements: (1) Internal users, and (2) External users.

1. ***Internal Users:*** These are: (a) Shareholders, (b) Management, and (c) Trade unions employees etc.

   (a) *Shareholders* are interested to know the welfare of the business. They can know the operational results through such financial statements and the financial position of the business.

   (b) *Management* is interested to take important decisions relating to fixing up the selling prices and making future policies.

   (c) *Trade unions and employees* are interested to know the operational results because their bonus etc. is dependent on the profit earned by the business. Financial statements also help in their negotiations for wages/salaries.

2. ***External Users:*** The following are most important external users of financial statements:

   (a) *Investors:* They are interested to know the earning capacity of business which can be known through financial statements. They can also know the financial soundness of the business through financial statements.

   (b) *Creditors, Lenders of Money etc:* The creditors and lenders of money etc. can also know the financial soundness through financial statement. They have to see two things (i) Regularity of income and (ii) solvency of the business so that their investment is risk free.

   (c) *Government:* Government is interested to formulate laws to regulate business activities and also law relating to taxation etc. Financial statements help while computing National Income statistics etc.

   (d) *Taxation authorities:* Financial statements provide information relating to operational results as well as financial position of the business. Tax authorities decide the amount of tax as per financial statement. It is very useful to other taxation authorities such as sales tax etc.

   (e) *Stock Exchanges* are meant for dealing in share/securities. Purchase and sale of such shares and securities are possible through stock exchanges which provide financial information about each company which is listed with them.

12.2 Preparation of Final Accounts

The profit and loss account and the balance sheet are, together popularly known as the final accounts. The profit and loss account is prepared to show the financial results of a business and the balance sheet is prepared to show the financial position. To calculate the accurate amount of profit or loss, it is a must that there should be a recognisation of the revenues and expenditures. If there is a wrong recognisation of expenses or revenues, results of the business will also be wrong. Thus the distinction between the capital and revenue items is very important.

There are two types of expenses and two types of incomes which are classified as:

1. Revenue expenditure/Revenue receipts
2. Capital expenditure/Capital receipts

Notes

12.3 Trading and Profit & Loss Account

In the Trading and Profit & Loss Account all those accounts are disclosed which affect the profit or loss of the business. In other words, all the nominal accounts of the Trial Balance are used to prepare the Trading and Profit & Loss Account. In the left hand side, all the expenses incurred during a period and in the right hand side all the incomes earned during a period are disclosed. This account contains two parts:

1. Trading Account
2. Profit & Loss Account

Trading Account

Trading account is the comparison of sales and purchase. This account is prepared to determine the amount of gross profit or gross loss on sales. The proforma of Trading Account is given below:

Proforma of Trading Account
In the Books of …….
Trading Account
(for the year ending …….)

Particulars		Dr. Amount (₹)	Particulars		Cr. Amount (₹)
To Opening Stock		–	By Sales	–	
To Purchases	–		Less: Returns	–	–
Less: Returns	–	–	By Closing stock		–
To Wages & Salaries		–	By Gross Loss (if any)		
To Carriage Inwards		–	Transferred to P/L A/c		–
To Cartage		–			
To Freight		–			
To Light Power & Heating in factory					
To Factory Insurance		–			
To Works Manager's Salary		–			
To Foreman's Salary		–			
To Factory Rent & Taxes		–			
To Motive Power		–			
To Factory Repairs		–			
To Factory Expenses		–			
To Octroi duty		–			
To Custom Duty		–			
To Manufacturing Exps.		–			
To Consumable Stores		–			
To Gross Profit		–			
Transferred to P/L A/c.		–			
		–			–

Notes

Notes

1. There is no particular proforma of the Trading Account. The above proforma given is traditional one. That is not as per law. Here the students are advised to follow this proforma.
2. If the total of credit side is more than the total of debit side, difference is called gross profit or vice versa gross loss.

Illustration with no Opening Stock and Closing Stock

Illustration 1: Prepare the trading account for M/s Shan & Co Ltd. for the year ended 31st Mar, 2006

Total Purchases during the year ₹10,000

Total Sales during the year ₹ 15,000

In this problem, the gross profit is simply found by deducting the sales volume from the purchases.

Gross profit = Sales – Purchases

The first step is to open the trading account for the year ended 31st March 2006

Solution:

Trading account for the ended 31st March 2006

Dr	₹		₹ Cr
To Purchases	**10,000**	**To Sales**	**15,000**
To Gross profit c/d	5,000*		
Balancing figure(₹15,000-₹10,000)			

*Gross profit ₹5,000 is the resultant of excess income over the expenses.

The total of the credit side is more than the debit side total of the trading account.

Illustration with Opening stock, various kinds of purchases and sales, Closing stock

Illustration 2: From the following information, prepare the trading account for the year ended 31st March 2006.

Stock on 1st April 2005 (Opening stock)		₹ 4,000
Purchases		
i.	Cash purchases	20,000
ii.	Credit purchases	50,000
Sales		
i.	Cash sales	20,000
ii.	Credit sales	60,000
Stock on 31st March 2006 (Closing Stock)		₹ 6,000

Notes

In this problem, the sales and purchases are given in two different categories viz. cash and credit. The credit and cash purchases and sales of a firm should be added to determine the total volume of purchases and sales made during the year.

The purpose of crediting the closing stock in the trading account is to find out the materials or goods consumed for trading purposes. In order to find out the total amount of goods or materials consumed during a year, three different components are to be separately considered.

1. Opening stock
2. Purchases and
3. Closing Stock

Opening Stock: It is a stock of goods or raw materials available at the opening of the accounting period, which is nothing but a closing stock of the yester accounting period utilized for trading during the current year.

Purchases: Purchase of goods or raw materials is either for resale or manufacturing.

Closing Stock: It is a stock nothing but an outcome of lesser volume of sales than the aggregate of opening stock and purchases.

Material consumed could be calculated as:

Material consumption = Opening stock + Purchases-Closing stock

The closing stock is credited in the trading account instead of deducting it directly from the aggregate of opening stock and purchases during the year. The posting of the closing stock under the credit side of the trading account not only helps the firm to find out the consumption during the year but also reduces the cost of goods sold incurred during the year.

Solution:

Dr **Trading Account** Cr
for the year ended 31st March 2006

	₹		₹
To Opening stock	4,000	By Credit sales 20,000	
To Credit purchases 20,000		By Cash sales 60,000	
To Cash purchases 50,000		By Total sales	80,000
To Total purchases	70,000	By Closing stock	6,000
To Gross profit c/d	12,000		
	86,000		86,000
		By Gross profit B/d	12,000

Illustration with Opening stock, Closing stock, cash, credit and returns of sales and purchases and other major expenses of trading/manufacturing.

Illustration 3: Prepare trading account of M/s Sundar and sons as on 31st March 2005

	₹
Opening stock on 1st April 2004	50,000
Purchases	
Cash	1,20,000
Credit	1,00,000
Sales	
Cash	40,000
Credit	1,00,000
Purchase Returns	20,000

Notes

Carriage Inwards	10,000
Marine insurance on purchase	6,000
Other direct expenses	4,000
Sales Returns	30,000
Stock as on 31st March 2005	10,000

In this problem, return outwards and inwards are given in addition to cash and credit purchases and sales of a firm to find out the net purchases and the net sales of the firm.

Net Sales = Cash Sales+ Credit Sales- Sales Returns

Net Purchases = Cash Purchases + Credit Purchases-Purchase Returns

Solution:

Trading account
for the year ended 31st March 2005

Dr		₹		₹ Cr
To Opening Stock		50,000	By Cash Sales 40,000	
To Cash Purchase	1,20,000		Add: Credit Sales 1,00,000	
Add: Credit Purchase	1,00,000		By Total Sales 1,40,000	
To Total Purchase	2,20,000		Less: Sales Return 30,000	
Less: Purchase Return	20,000		By Net Sales	1,10,000
To Net Purchase		2,00,000	By Closing Stock	10,000
To Carriage Inwards		10,000	By Gross Loss c/d	1,50,000
To Marine Insurance		6,000		
To Other Direct Expenses		4,000		
		2,70,000		2,70,000
To Gross Loss B/d		1,50,000		

Gross Loss is due to an excess of the debit side total over the credit side total.

Task Calculate the Gross Profit from the following:

	₹
Opening stock	11,500
Purchases	1,05,000
Wages	3,500
Sales	1,40,000

Hint: ₹ 20,000

Profit & Loss Account

Profit & Loss Account is the second part of Trading and Profit & Loss Account. Trading Account shows the gross profit which is the difference of sales and cost of sale. Thus the gross profit can not treated as net profit while the businessman wants to know how much net profit he has earned from the operating activities during a period. For this purpose Profit & Loss Account is prepared keeping in mind all the operating and non-operating incomes and losses of the business. In the debit (left hand side) side all the expenses and losses are disclosed and in the credit side (right hand side) all the incomes are disclosed. The excess of credit side over debit side is called net

Notes

profit while the excess of debit side over credit side shows net loss. Net profit increases the net worth of the business, therefore, it is added to the capital of owner. Net loss decreases the net worth of business so it is subtracted from capital. The proforma of Profit & Loss Account is given below:

Proforma of Profit & Loss Account

Particulars	₹	Particulars	₹
To Gross Loss (if any) transferred from Trading Account	–	By Gross Profit (transferred from Trading Account)	–
To Staff Salaries	–	By Discount Received	–
To Office Rent	–	By Commission Received	–
To Rates & Taxes	–	By Dividend	–
To Office Lighting and Heating	–	By Interest Received	–
To Printing & Stationary	–	By Rent from Tenant	–
To Bank Charges	–	By Interest from Bank	–
To Insurance	–	By Interest on Drawings	–
To Telephone Charges	–	By Profit on Sale of Investment	–
To Legal Expenses	–	By Provision for Discount on Creditors	–
To Repairs	–	By Bad Debts recovered	–
To Postage & Stamps	–	By Profit on Sale of Assets	–
To Trade Expenses	–	By Other Incomes	–
To Establishment Exps.	–	By Net Loss (if any) transferred to Capital A/c	–
To Audit Fees	–		
To Charity & Donations	–		
To Management Exps.	–		
To Depreciation on	–		
Land & Buildings	–		
Plant and Machinery	–		
Furniture	–		
To Stable Expenses	–		
To Directors Fee	–		
To Bank Charges	–		
To Interest on Loan	–		
To Interest on Capital	–		
To Discount on B/R	–		
To Sales Tax	–		
To Advertisement	–		
To Bad Debts	–		
To Agents' Commission	–		
To Travelling Expenses	–		
To Free Samples distributed	–		
To Warehouse Expenses	–		
To Packing Expenses	–		
To Brokerage	–		

Notes

To Distribution Expenses	–		
To Delivery Van Expenses	–		
To Provision for Bad and Doubtful Debts	–		
To Entertainment Expenses	–		
To Carriage Cutward	–		
To Loss on Sale of Assets	–		
To Licence Fees	–		
To Repairs of Assets & Motor Car			
To Loss by Fire			
To Conveyance Expenses			
To Net Profit (Transferred to Capital A/c.)			
	–		–

Illustration 4: From the following information, prepare the Profit & Loss account.

	Debit	**Credit**
	₹	₹
Gross profit from the trading account	1,00,000	
Manager Salary	30,000	
Office lighting	5,000	
Office Rent	15,000	
Local Taxes	1,000	
Salary paid to salesmen	20,000	
Commission charges paid	10,000	
Legal charges paid	3,000	
Bad debts	1,500	
Advertising charges	25,000	
Package charges	7,500	
Discount allowed	3,000	
Discount received		4,000
Dividend received		2,000
Rent received		1,000
Depreciation charges	10,000	
Repairs and Maintenance	2,500	
Interest on loans	1,500	500

Notes

Dr **Profit and loss account for the year ended.....** Cr

	₹		₹
To Manager Salary	30,000	By Gross profit B/d	1,00,000
To Office lighting	5,000	By Discount received	4,000
To Office Rent	15,000	By Dividend received	2,000
To Salary paid salesman	20,000	By Rent received	1,000
To Commission charges	10,000	By Interest received	500
To Legal charges	3,000	By Net Loss c/d*	24,500
To Bad debts	1,500		
To Advertising charges	25,000		
To Package charges	7,500		
To Depreciation charges	10,000		
To Repairs and maintenance	2,500		
To Interest on loan	1,500		
To Local taxes	1000		
	1,32,000		1,32,000

*Net loss is the excess of the expenses total in the debit side ₹24,500 over the incomes total in the credit side of the profit and loss account.

Task Calculate the cost of materials consumed from the following:

Opening Stock	₹
Raw materials	4,500
Work in Progress	12,000
Finished Goods	14,800
Sales	50,000
Purchases during the year	24,500
Carriage inwards	500
Closing stock—raw materials	1,500
Work in Progress	4,800
Finished Goods	2,700

Hint: ₹ 28000

Manufacturing Account

If in the business some goods are being manufactured along with the trading activities, a manufacturing account is also prepared. In the case of trading activities (selling and purchasing of goods) only, the Trading and Profit and Loss Account is prepared to compute the net profit which is discussed in the preceding pages. In case there is a manufacturing unit in the business with the trading, such a businessman's income statement will include:

1. Manufacturing Account
2. Trading Account
3. Profit and Loss Account

The proforma of Manufacturing Account is given here under:

Notes

Pro forma of Manufacturing Account
Manufacturing Account
(for the year ending ……)

Particulars	₹	Particulars	₹
To Opening Stock		By Closing Stock	
Raw Materials --------		Raw Materials ------	
Work-in-progress --------	–	Work-in-progress ------	–
		By Sale of Scrape	–
		By Cost of Production (Transferred to Trading A/c)	–
To Purchase of materials -----			
Less returns -----	–		
To Manufacturing Wages	–		
To Carriage Inwards	–		
To Factory Expenses	–		
To Stores Consumed	–		
To Factory Rent	–		
To Electricity	–		
To Depreciation on Plant	–		
To Repairs of Plant	–		
To Works Manager's Salary	–		
To Coal and Fuel	–		
To Other Factory exps.	–		
	–		–

Illustration 5: (Manufacturing, Trading and Profit & Loss A/c)

From the following particulars of Mr. Amit Agrawal, prepare a Manufacturing Account, Trading and Profit and Loss Account for the year ended 31st March, 2008.

	₹
Purchase of Raw Material	39,58,500
Return Inwards	21,000
Stock on 31st March, 2008:	
Raw Materials	3,63,000
Work-in-Progress	3,00,000
Finished Goods	4,11,000
Productive Wages	6,00,000
Factory Expenses	5,52,000
General Office Expenses	90,000
Salaries	1,80,000
Distribution Expenses	30,000
Selling Expenses	2,10,000
Purchase Expenses	1,80,000
Export Duty	90,000
Import Duty	60,000

Notes

Interest on Bank Loan	1,80,000
Stock on 1st April, 2007:	
Raw Material	1,20,000
Work-in-Progress	90,000
Finished Goods	1,23,000
Sales	58,50,000
Return Outwards	25,500
Carriage Inwards	31,500
Discount allowed	3,000
Sale of Scrap	6,000
Depreciation on Plant	1,50,000
Depreciation on Furniture	12,000

Solution:

Manufacturing Account
(for the year ending 31st March, 2008)

Particulars	₹	Particulars	₹
To Opening Stock			
Materials	1,20,000	By Sale of Scrap	6,000
Work-in-Progress	90,000	By Closing Stock:	
To Purchase less Returns		Materials	3,63,000
(39,58,500- 25,500)	39,33,000	Work-in-Progress	3,00,000
To Productive Wages	6,00,000	By Cost of Production	
To Factory Exps	5,52,000	(Transferred to Trading A/c)	50,76,000
To Purchase Exps.	1,80,000		
To Import Duty	60,000		
To Carriage Inwards	30,000		
To Depreciation on Plant	1,50,000		
To Repairs to Machines	30,000		
	57,45,000		57,45,000

Trading and Profit & Loss Account
(for the year ending 31st March, 2008)

Particulars	₹	Particulars	₹
To Opening Stock of Finished Goods		By Sales less Returns	
To Cost of Production	1,23,000	(58,50,000 – 21,000)	58,29,000
(Transfer from Manufacturing A/c)	50,76,000	By Closing Stock	4,11,000
To Gross Profit c/d	10,41,000		
	62,40,000		62,40,000

Contd..

Notes

To General Office Exps.	90,000	By Gross Profit b/d	10,41,000
To Salaries	1,80,000		
To Depreciation on Furniture	12,000		
To Discount Allowed	9,000		
To Carriage Outwards	25,500		
To Interest on Bank Loan	1,80,000		
To Export Duty	90,000		
To Selling Expenses	2,10,000		
To Distribution Expenses	30,000		
To Net Profit (Transferred to Capital A/c.)	2,14,500		
	10,41,000		10,41,000

12.4 Balance Sheet

After the determination of the net profit of the business through the Trading and Profit and Loss Account, the businessman wants to know the financial position of the business. For this purpose he prepares a statement which is called the Balance Sheet. The Balance Sheet depicts the financial position of the business on a fixed date. A Balance Sheet is prepared with those balances of Trial Balance which are left out (personal and real accounts) after taking out the nominal accounts' balances to prepare the Trading and Profit and Loss Account. A Balance Sheet has two sides – assets side and liabilities side. The assets and liabilities are shown in a particular order.

Marshalling of Assets and Liabilities

Order of presenting the assets and liabilities in the balance sheet is called marshalling of assets and liabilities. A balance sheet may be prepared by marshalling the assets and liabilities in the following orders:

Balance Sheet prepared in Liquidity Order

Here liquidity means conversion of assets into cash. When a Balance Sheet is prepared on the basis of liquidity order, more easily convertible assets into cash are shown first and those assets which can not be easily converted into cash are shown later and so on. In the case of liabilities, first those liabilities are shown which are payable earlier and then those liabilities are shown which are payable later. The proforma of such a Balance Sheet is given below:

Proforma of Balance Sheet in Order of Liquidity
(as on ……..)

Liabilities	₹	Assets	₹
Current Liabilities		**Current Assets**	–
Sundry Creditors	–	Cash in Hand	
Bank Overdraft	–	Cash at Bank	–
Short-term Loan	–	Short-term Investment	–
Outstanding Expenses	–	Prepaid Expenses	–
Unaccrued Income	–	Bills Receivable	–
Bills Payable	–	Accrued Incomes	–

Contd...

Notes

Long-term Liabilities			Debtors	–
Capital	–		Closing Stock	–
(+) Net Profit	–		**Fixed Assets**	
	–		Land & Building	–
(–) Drawings	–	–	Plant & Machinery	–
Long-term Loans		–	Furniture	–
Contingent Liabilities			Investments (Long-term)	–
	–		Goodwill	–
	–		Patents & Trademarks	–
			Livestock	–
		–		–

Balance Sheet prepared in Permanency Order

Balance Sheet prepared under this order is the reverse of the Balance Sheet prepared in liquidity order. In this case first those assets are shown which are more permanent means fixed assets and then less permanent assets (Current Assets) are shown. Similarly, first long-term liabilities (more permanent) are shown then less permanent (short-term on current) liabilities are shown. The proforma of such type of Balance Sheet is given below:

Proforma of Balance Sheet in Permanency Order
(as on …….)

Liabilities		₹	Assets	₹
Long-term Liabilities			**Fixed Assets**	
Capital	–		Land & Building	–
(+) Net Profit	–		Plant & Machinery	–
	–		Furniture	–
(–) Drawings	–	–	Long-term Investment	–
Long-term Loans		–	Goodwill	–
Current Liabilities			Patents & Trademarks	–
Sundry Creditors		–	Livestock etc.	–
Bank Overdraft		–	**Current Assets**	
Bill Payable		–	Cash in Hand	–
Short-term Loan		–	Cash in Bank	–
Outstanding Expenses		–	Short-term Investments	–
Un-accrued Incomes		–	Bill Receivable	–
			Prepaid Expenses	–
			Accrued Incomes	–
			Debtors	–
			Closing Stock	–
		–		–

12.5 Adjustment Entries

If the accountant finds that some transactions are not incorporated (making proper accounting) in the books or wrongly incorporated in books, to complete the records and rectifying the errors

Notes

done, some adjustments are made. They are called adjustment entries. Usually adjustment entries are made in the books before preparing the final accounts for the following items:

1. ***For Outstanding Expenses of the Business***

   Outstanding Expenses: All those expenses which are not paid in the related accounting period are termed as outstanding expenses.

   Example: If a company has to pay ₹4000 as rent for the accounting period 31.03.2009 - 31.03.2010 but the company had paid ₹3000 only then the balance ₹ 1000 will be treated as outstanding expense. The following general entries will be passed:

   Relating Expenses Account Dr.

   To Outstanding Expenses Account

   The outstanding expenses at the time of preparation of final account are shown in the liability side of the balance sheet and on the other hand, it is added in the relating expenses in the Trading and Profit & Loss Account.

2. ***For Prepaid Expenses of the Business***

   Prepaid expenses: The benefit of some expenses already spent will be available in the next accounting year, Such a portion of the expense is called pre-paid expense.

   Example: Rent paid in advance for the next accounting year.

   Prepaid Expenses Account Dr.

   To Relating Expenses Account

   The prepaid expenses are disclosed in the assets side of the Balance Sheet and on the other hand it will be subtracted from the relating expenses in the debit side of Trading and Profit & Loss Account.

3. ***For Accrued Incomes of the Business***

   Accrued Income: There may be certain incomes which have been earned during the year but not yet received till the end of the year.

   Example: A company has earned interest on income for the year 2009 but has not received it during that particular period.

   Accrued Income Account Dr.

   To Relating Income Account

   The accrued incomes are disclosed in the assets side of the Balance Sheet and showed in the credit side of the Trading and Profit & Loss Account.

4. ***For Unaccrued Incomes or income received in advance of the Business***

   Income received in advance: Sometimes, traders receive certain amounts during a particular trading period which are to be earned by them in future periods.

   Relating Income Account Dr.

   To Unaccrued Income Account

   Unaccrued incomes are disclosed in the liability side of the Balance Sheet and subtracted from the relating incomes in the credit side of the Trading and Profit & Loss Account.

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5. ***For the Depreciation on Assets***

Depreciation: The value of fixed assets diminishes gradually with their use for business purposes. The following general entries will be passed:

Depreciation Account Dr.

To Relating Assets Account

Depreciation is subtracted from the relating assets in the assets side of the Balance Sheet and disclosed in the debit side of Trading and Profit & Loss Account.

6. ***Interest on Capital and Drawings***

Interest on Capital: The proprietor wants to calculate his profit after considering the interest which he loses by investing his money in the firm.

Interest on Drawings: As business allows interest on capital it also charges interest on drawings made by the proprietor. Interest so charged is an income for the business on one hand and expense for the proprietor on the other hand.

The following general entries will be passed in the final accounts:

(a) *For Interest on Capital*

Interest on Capital Account Dr.

To Capital Account

Interest on Capital is added to the capital of owner in the liabilities side of the Balance Sheet and disclosed in the debit side of the Trading and Profit & Loss Account.

(b) *For Interest on Drawings*

Drawings Account Dr.

To Interest on Drawings Account

Interest on Drawings is subtracted from the amount of capital along with the drawings and also shown in the credit side of Trading and Profit & Loss Account.

7. ***Interest on Loan and Investments***

(a) *For Interest on Loan Payable*

Profit & Loss Account Dr.

To Interest on Loan Account

Interest on Loan payable is added to the amount of Loan in the liability side of the Balance Sheet and also shown in the debit side of Profit & Loss Account.

(b) *For Interest on Investment Receivable*

Interest on Investment Account Dr.

To Profit & Loss Account

Interest on Investment Receivable is added to investment in the assets side of the Balance Sheet and also shown in the credit side of Profit & Loss account.

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8. ***For Bad Debts***

Bad debts are irrecoverable debts from customers, during the course of the financial year.

Bad Debts Accounts Dr.

To Sundry Debtors Account

Bad Debts are deducted from the sundry debtors in the assets side of the Balance Sheet and shown in the debt side of Profit and Loss Account.

9. ***For Provision for Bad and Doubtful Debts***

Provision for Bad and Doubtful assets: At the end of the year, after writing off the bad debts there maybe some customers from whom it is doubtful to recover the entire amount. However, it cant be written off as bad because non-recovery of such amount is not certain. But at the same time the balance in sundry debtors account should be brought down to its net realizable figure so that balance sheet may not exhibit the debtors at more than their actual realizable value. Therefore, to show the approximately correct value of the sundry debtors in the balance sheet a provision or reserve is created for possible bad debts.

(a) *When the provision is created:*

Profit & Loss Account Dr.

To Provision for Bad and Doubtful Debts Account

Such a provision is subtracted from the debtors in the assets side of Balance Sheet and also shown in the debt side of Profit and Loss Account.

(b) *When Bad Debts are written off against the Provision for Bad and Doubtful Debts:*

Provision for Bad and Doubtful Debts Account Dr.

To Bad Debts Account

(c) *When excess amount of the provision is transferred:*

Provision for Bad and Doubtful Debts Account Dr.

To Profit & Loss Account

10. ***For Discount Provision on Debtors***

It is a normal practice in trade to allow discount to customers for prompt payment and it constitutes a substantial sum. The following general entries will be passed in the final accounts:

(a) *When the provision for discount on debtors is created:*

Profit & Loss Account Dr.

To Provision for Discount on Debtors Account

Provision for discount on Debtors is subtracted from Sundry Debtors in the assets side of Balance Sheet and shown in the debit side of Profit and Loss Account.

(b) *When the amount of discount is written off against the Provision for Discount Account:*

Provision for Discount on Debtors Account Dr.

To Discount on Debtors Account

(c) *When excess amount of provision is transferred:*

Provision for Discount on Debtors Account Dr.

To Profit and Loss Account

Notes

11. ***For Discount Provision on Creditors***

If a businessman receive some discounts from its customers then the following entries will be passed:

(a) *When provision for discount on creditors is created:*

Provision for Discount on Creditors Account Dr.

To Profit and Loss Account

Provision for discount on creditors is deducted from Creditors in the liability side of Balance Sheet and shown in the Credit side of Profit and Loss Account.

(b) *When discount on creditors is written off against the provision:*

Discount on Creditors Account Dr.

To Provision for Discount on Creditors Account

12. ***Goods drawn for personal use:*** If goods are drawn by the proprietor for the personal use or domestic purpose, the cost of such goods drawn is deducted from purchase account and the same is added to his drawings.

The following journal entry will be passed:

Drawing A/c Dr

To Purchase A/c

The amount of such drawings can not be treated as sales, as the goods are not drawn at selling price.

13. ***Loss of goods by fire or accidents***

(a) Such losses are abnormal losses. Stock destroyed by fire or accidents is credited to the Trading Account. The following journal entry will be passed:

Loss of stock A/c Dr

To Trading A/c

The loss of stock is closed by transferring the amount to Profit and Loss Account.

(b) If the loss is fully covered by insurance, no portion of the loss is debiting to the Profit and Loss Account. The amount due by Insurance Company is shown as an asset in the Balance Sheet. The following journal entry will be passed:

Insurance Company A/c Dr

To Loss of Stock A/c

(c) If the Insurance Company agrees to pay only a part of the loss, the position of loss not covered by insurance is debited to Profit and Loss Account and the amount due by the Insurance Company is shown as an asset in the Balance Sheet. The following journal entry will be passed:

Insurance Company A/c Dr

Profit and Loss A/c Dr

To Loss of stock A/c

Notes

14. ***Goods distributed as free samples/charity:*** It may be debited in the goods sent as free samples or Advertisement account and credited to Purchases Account. The following journal entry will be passed:

    Goods sent as free sample A/c Dr

    To Purchases A/c

15. ***Provision for Income Tax/advance tax:*** Provision for Income-tax is made based on estimation and accordingly Advance Tax would have been paid. `Provision for Income-Tax` would appear in Current liabilities and `Advance Tax` will appear under Advances in Current Assets. Both the accounts can be adjusted once the tax is assessed and the return is filed. If the provision made in the books is lesser, additional tax liability will be booked as expenditure and if the Advance Tax paid is more than the provision, the excess paid will continue to be shown under current Assets till the receipt of refund. So once the final tax is ascertained, both the accounts will be given effect and adjusted.

12.6 Final Accounts with Adjustments

The given below are the examples explaining the preparation of final accounts with adjustments:

Illustration 6: Prepare final accounts from the following balances of Mr. Ankit as on 31st December, 2007.

Extracts of Balances
as on 31st December, 2007

Debit Balances	₹	Credit Balances	₹
Drawings	45,000	Capital Account	6,09,000
Goodwill	90,000	Bills Payable	41,400
Land and Building	1,80,000	Sundry Creditors	91,500
Plant and Machinery	1,20,000	Purchase Returns	7,950
Loose tools	9,000	Sales	3,45,000
Bills Receivable	6,000		
Stock 1.1.2007	1,20,000		
Purchase	1,53,000		
Wages	60,000		
Carriage Inwards	3,600		
Carriage Outwards	4,500		
Coal and Gas	16,800		
Salaries	12,000		
Rent, Rates and Taxes	8,400		
Discount allowed	4,500		
Cash at Bank	75,000		
Cash in Hand	4,200		
Sundry Debtors	1,35,000		
Repairs	5,400		
Printing and Stationery	1,500		
Bad Debts	3,600		
Advertisements	10,500		
Sales Returns	6,000		
Furniture and Fittings	3,600		
General Expenses	15,750		

Notes

Additional Information:

1. Closing stock on 31st December, 2007 was ₹1,80,000.
2. Depreciate Plant and Machinery at 5%, Loose Tools at 15% and Furniture and Fittings at 5%.
3. Provide 2½% for Discount on Sundry Debtors and Creditors and 5% for Bad and Doubtful Debts.
4. Outstanding Wages ₹ 4,500 and Rent and Taxes ₹ 2,550.

Solution:

In the Book of Mr. Ankit
Trading and Profit & Loss Account
for the year ending on 31st December, 2007

Particulars		₹	Particulars	₹
To Opening Stock		1,20,000		
To Purchases Less Returns			By Sales Less Returns	
(₹1,53,000 – 7,950)		1,45,050	(₹ 3,45,000 – 6,000)	3,39,000
To Wages	60,000		By Closing Stock	1,80,000
(+) O/s Wages	4,500	64,500		
To Carriage Inwards		3,600		
To Coal and Gas		16,800		
To Gross Profit C/d		1,69,050		
		5,19,000		5,19,000
To Carriage Outwards		4,500		
To Salaries		12,000	By Gross Profit b/d	1,69,050
To Rent, Rates & Taxes	8,400		By Reserve for Discount on Creditors @2½%	2,250
(+) Outstanding	2,550	10,950		
To Discount Allowed		4,500		
To Repairs		5,400		
To Printing & Stationary		1,500		
To Bad Debts	3,600			
(+) New Provision (D/D)	6,750			
	10,350			
(+) Provision for Discount	3,206	13,556		
To Advertisement		10,500		
To General Expenses		15,750		
To Depreciation on:				
Plant & Machinery	6,000			
Loose tools	1,350			
Furniture & Fittings	180	7,530		
To Net Profit (transferred to Capital A/c)		85,114		
		1,71,300		1,71,300

Notes

Balance Sheet
as on 31st December, 2007

Liabilities		₹	Assets		₹
Capital	6,09,000		Goodwill		90,000
(+) Net Profit	85,114		Land & Buildings		1,80,000
	6,94,114		Plant & Machinery	1,20,000	
(–) Drawings	45,000	6,49,114	(–) Depreciation	6,000	1,14,000
Bills Payable		41,400	Furniture & Fittings	3,600	
Creditors	90,000		(–) Depreciation	180	3,420
(–) Provision for			Loose Tools	9,000	
Discount	2,250	87,750	(–) Depreciation	1,350	7,650
Outstanding Wages		4,500	Sundry Debtors	1,35,000	
Outstanding Rent		2,550	(–) Prov. for D/D	6,750	
				1,28,250	
			(–) Prov. For Discount	3,206	1,25,044
			Bills Receivable		6,000
			Closing Stock		1,80,000
			Cash in Hand		4,200
			Cash at Bank		75,000
		7,85,314			7,85,314

Illustration 7: From the following trial Balance of Mr. Das prepare Trading and Profit and Loss account for the year ended 31st December, 2006 and the Balance Sheet as on that date after taking in to account adjustments given below:

Trial Balance
as on 31st December 2006

	Dr.	Cr.
Particulars	₹	₹
Capital	–	86,140
Drawings	3,400	–
Purchases and sales	32,400	88,200
Returns	2,300	2,150
Carriage inwards	1,500	–
Lighting and heating	800	–
Water and gas	3,400	–
Stock as on 1.1.2006	7,300	–
Rent (office)	900	–
Wages and salaries	2,500	–
Electricity	1,300	–
Postage	200	–
Printing charges	700	–
Legal charges	480	–
Interest earned	–	390
Furniture	19,100	–
Machinery	60,000	–
Buildings	35,000	–
Cash in hand	5,600	–
	1,76,880	1,76,880

Notes

Additional Information

1. Closing stock amounted to ₹ 5,100
2. Outstanding expenses wages ₹ 700, Rent- ₹ 300
3. Prepaid Printing charges ₹ 200.
4. Interest earned but not received ₹ 100
5. Depreciate buildings @ 2% Machineries 5% and furniture 10%

Solution:

Trading and Profit and Loss Account
for the year ended 31st December 2006

Particulars		₹	**Particulars**		₹
To opening stock		7,300	By Sales	88,200	
To Purchases	32,400		(–) Returns	2,300	85,900
(–) Returns	2,150	30,250	By Closing stock		5,100
To Carriage inwards		1,500			
To Water & gas		3,400			
To Wages & salaries	2,500				
(+) Outstanding	700	3,200			
To Lighting & heating		800			
To Gross profit c/d		44,550			
		91,000			91,000
			By Gross Profit b/d		44,550
			By Interest earned	390	
To Rent	900		(+) Interest earned but not received		
(+) Outstanding	300	1,200		100	490
To Electricity		1,300			
To Postage		200			
To Printing charges	700				
(–) Prepaid	200	500			
To Legal charges		480			
To Depreciation on					
Buildings	700				
Machinery	3,000				
Furniture	1,910	5,610			
To Net Profit (Transferred to capital a/c)		35,750			
		45,040			45,040

Notes

Balance Sheet of Mr. Das
as on 31.12.2006

Liabilities		₹	Assets		₹
Capital	86,140		Cash in hand		5,600
(+) Net Profit	35,750		Furniture	19,100	
	121,890		(–) Depreciation	1,910	17,190
(–) Drawings	3,400	1,18,490			
			Machinery	60,000	
Wages outstanding		700	(–) Depreciation	3,000	57,000
Rent outstanding		300	Buildings	35,000	
			(–) Depreciation	700	34,300
			Closing stock		5,100
			Prepaid printing		200
			Interest earned		100
		1,19,490			1,19,490

Caselet

From the following balances draw up a Trading and Profit and Loss Account and Balance Sheet:

	₹
Amit Joseph's Capital	30,000
Bank Overdraft	7,500
Machinery	20,100
Cash in hand	1,500
Fixture & Fitting	8,250
Opening stock	67,500
Bills Payable	10,500
Creditors	60,000
Debtors	94,500
Bill receivable	7,500
Purchases	75,000
Sales	1,93,500
Returns from customers	1,500
Returns to Creditors	1,650
Salaries	13,500
Manufacturing Wages	6,000
Commission	8,250
Trade Expenses	2,250
Discount (Cr.)	6,000
Rent	3,300

The Closing Stock amounted to ₹ 78,000.

Hint: Gross Profit ₹ 1,23,150; Net Profit ₹ 1,01,850 and Balance Sheet Total ₹ 2,09,850.

Notes

12.7 Summary

- Final accounts include the Trading and Profit & Loss Account and Balance Sheet. Trading and Profit and Loss Account is prepared to calculate the net profit earned by business during a period.
- Balance Sheet of a business is prepared to disclose the financial picture of the business. The Trading Account shows the gross profit which is the difference of sales and cost of sales.
- Profit & Loss Account shows the net profit which is computed by matching the total revenues and expenses of the business.
- Balance Sheet is a statement which has two sides – Liability side and Assets side. Before preparing the final accounts of the business some adjustments are also done (if required).

12.8 Keywords

Balance Sheet: It is nothing but a positional statement of assets and liabilities of the firm on a particular date

Gross Loss: It is the excess of cost of sales over sales.

Gross Profit: It is calculated by comparing the sales and cost of sales. It is the excess of sales over cost of sales.

Net Loss: Excess of expenditures over revenues is called net loss.

Net Profit: It is the excess of revenues over expenses. It is depicted by P & L A/c.

Trading account: It is the accounting statement of revenues and expenses

12.9 Self Assessment

Fill in the blanks:

1. Trade unions are the part of …… of financial statement.
2. The creditors want to see two things (i) Regularity of income and (ii) …… .
3. …… help while computing National Income statistics etc.
4. …… are meant for dealing in share/securities.
5. Discount on the issue of shares/debentures is …… .
6. Preliminary expenses are shown in the balance sheet as …… .
7. All the nominal accounts of the …… are used to prepare the Trading and Profit & Loss Account.
8. Trading Account shows the …… which is the difference of sales and cost of sale.
9. The excess of credit side over debit side is called …… .
10. The Balance Sheet depicts the …… of the business on a fixed date.

State whether the following statements are true or false:

11. Rent outstanding is a nominal account.
12. Insurance prepared is a personal account.

Notes

13. Interest received is an asset.
14. Interest accrued is an asset.
15. Bad debts are personal account.

12.10 Review Questions

1. What do you mean by Trading Account? Give the proforma of Trading Account and explain why it is prepared.
2. What is the importance of Balance Sheet? Give a form of Balance Sheet in Liquidity order with imaginary examples.
3. What do you mean by adjustment? Explain the different adjustment entries.
4. Write short notes on the following:
   (a) Net Profit
   (b) Capital and Revenue Expenditures
   (c) Capital and Revenue Receipts
5. Illustrate the interrelationship between the accounting statements and statement of position.
6. Highlight the effect of the following entries in the:
   (a) Closing stock
   (b) Interest received in advance
   (c) Rent outstanding
7. From the following information extracted from the books of Jain & Co, prepare Trading, Profit & Loss A/c for the year ended and Balance sheet as on dated.

Particulars	Debit ₹	Credit ₹
Purchase	90,300	
Sales		1,37,200
Return inward	2,200	
Stock 1.1.96	40,000	
Drawing	5,000	
Building	30,000	
Machinery	20,000	
Furniture	8,000	
Debtors	25,000	
Wages	3,000	
Carriage inwards	2,000	
Rent and Rates	1,500	
Bad debts	1,000	
Cash	3,500	
Investment	10,000	
Postages	2,500	
Insurance	2,000	
Return outwards		1,300
Capital		50,000
Creditors		24,000

Contd...

Notes

Interest		500
Commission		3,250
Provision Bad debts		750
Bank O/d		40,000
Salaries	11,000	
Total	2,57,000	2,57,000

Additional Information

(a) Value of the stock on 31.12.96 ₹65,000

(b) Goods worth ₹ 800 for his personal use of the proprietor

(c) ₹ 400 of insurance paid is nothing but advance payment

(d) Salary ₹ 1,000 for the month of December 1996 not paid i.e. outstanding

(e) Charge depreciation:

(i) Building 2% per annum

(ii) Machinery 10% per annum

(iii) Furniture 15% per annum

(f) Maintain provision for doubtful debts 5% on sundry debtors

8. From the following information drawn from the books of M/s Sundaram & Co prepare Trading, Profit & Loss account for the year ended 31st March, 2004 and Balance sheet as on date.

Particulars	**Debit (₹)**	**Credit (₹)**
Sundaram's Capital		1,81,000
Sundaram's Drawings	36,000	
Plant and Machinery Balance on 1st April 2003	1,20,000	
Plant and machinery additions on 1st October, 2003	25,000	
Stock opening	95,000	
Purchases	7,82,000	
Return Inwards	12,000	
Sundry debtors	20,600	
Furniture & Fixture	15,000	
Freight duty	2,000	
Rent Rate and Taxes	24,600	
Printing stationery	3,800	
Trade expenses	5,400	
Sundry creditors		40,000
Sales		9,80,000
Return outwards		3,000
Postage & telegram	800	
Provision for bad debts		400
Discounts		1,800
Rent of the premises sub let for the year upto 30th September 2004		7,200
Insurance charge	2,700	
Salaries & wages	31,300	
Cash in hand	6,200	
Cash at bank	30,500	
Carriage outwards	500	
Total	12,13,400	12,13,400

Additional Information **Notes**

(a) Stock on 31st March, 2004 ₹ 94,600

(b) Write off ₹600 as bad debts

(c) Provision for doubtful debts 5% on debtors

(d) Create a provision for discount on debtors & reserve for creditors 2%

(e) Provide a depreciation on furniture and fixture at 5% per @

(f) Plant machinery depreciation 20%

(g) Insurance unexpired ₹ 100

(h) A fire occurred on 25th March 2004 in the godown and stock of the value of ₹ 5,000 was destroyed, which was the insurance company admitted the claim fully which is yet to be paid.

9. From the following figures extracted from the books of M/s Amal &Vimal 31st March, 02

Particulars		Debit(₹)	Credit (₹)
Opening stock		30,000	
Purchases		1,10,000	
Sales			2,50,000
Building		55,000	
Wages		23,000	
Carriage inwards		3,000	
Bills payable			10,000
Furniture		9000	
Salaries		42,000	
Advertisement		24,000	
Coal and coke		2,000	
Cash at bank		14,000	
Pre-paid wages		1,000	
Depreciation fund investment		25,000	
Machinery at cost (₹10,000 New)		60,000	
Sundry debtors		20,000	
Bad debts		3,000	
Depreciation fund			25,000
Sundry creditors			24,000
Rent rate and taxes		4,000	
Trade expense		4000	
Capital	Amal		50,000
	Vimal		40,000
Petty expenses		4,000	
Provision for doubtful debts		1,000	
Gas and water		1,200	
Cash in hand		800	
Outstanding rent			400
Bank loan			34,600
		4,35,000	4,35,000

Adjustment entries

(a) The partners share profit and losses Amal 2/5 and Vimal 3/5.

(b) Closing stock ₹15,000

Notes

(c) Stock valued at ₹10,000 was destroyed by fire but insurance company admitted a claim of 8,500 only and the claim is not yet paid.

(d) Wages include ₹2,000 for installation of a new machinery on 1st Dec, 2005

(e) Depreciate the machinery at 10% per annum

10. **SS Jain Bros for the year ended 31st December, 2003.**

Particulars	Debit ₹	Credit ₹
Capital		6,00,000
Drawings	12,000	
Buildings	2,00,000	
Furniture and fittings	30,000	
Depreciation on Reserve		
Buildings		10,000
Furniture		3,000
Depreciation for the year	13,000	
Purchases	4,00,000	
Sundry creditors		40,000
Sales		5,00,000
Debtors	1,20,000	
Establishment charges	20,000	
Electricity charges	6,575	
Postage and telegram	1,284	
Travelling and conveyance	3,816	
Advance for sales commission	1,000	
Insurance	2,500	
Rent received		12,000
Motor van (purchased 1.1.03)	80,000	
Motor van maintenance	23,425	
Fixed deposit (1.9.2003)	1,00,000	
Cash in hand	1,823	
Cash at bank	1,47,977	

Due to the difference in the trial balance, an examination of the goods was conducted which reveals following errors.

(a) ₹ 25 paid to the conveyance was debited to motor van maintenance account.

(b) ₹ 2,000 drawn from bank towards for establishment charges was omitted to be posted into ledger.

(c) Cash column in the cash book on the receipt side stands excess total by ₹400

Adjustment entries:

(a) Establishment of charges have been paid only up to November and provision of ₹ 2,000 has to be made for December.

(b) Electricity charges are O/s ₹25

(c) (½) commission on total sales is payable to salesmen, towards which ₹1000 as paid in advance.

(d) Fixed deposit earns interest at 9% per annum.

(e) Provide depreciation 20% per annum on motor car.

(f) Closing stock 31st December, 2003 ₹ 1,00,000

Notes

Answers: Self Assessment

1. internal users
2. Solvency of the business
3. Financial statements
4. Stock Exchanges
5. Capital expenditure
6. Intangible assets
7. Trial Balance
8. gross profit
9. net profit
10. financial position
11. False
12. True
13. False
14. True
15. False

12.11 Further Readings

Books

Khan and Jain, "*Management Accounting*".

M.P. Pandikumar, "*Accounting & Finance for Managers*", Excel Books, New Delhi.

R. L. Gupta and Radhaswamy, "*Advanced Accountancy*".

S. N. Maheswari, "*Management Accounting*".

V. K. Goyal, "*Financial Accounting*", Excel Books, New Delhi.

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Unit 13: Bank Reconciliation Statement

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Objectives

After studying this unit, you will be able to:

- Describe the purpose of bank reconciliation statement
- Identify the causes of difference in cash book and pass book
- Realise rectification of errors

Introduction

Business organisations record all the cash and bank transactions in cash book of the company. The Bank also maintains an account for each customer in its book. A copy of this account is regularly sent to the customer by the bank which is called 'Pass Book' or 'Bank statement'. It is usually to tally the firm's bank transactions as recorded by the bank with the cash book but sometimes the bank balances as shown by the cash book and that shown by the bank statement do not match. If the balance shown by the pass book is different from the balance shown by bank column of cash book, the business firm will identify the causes for such difference. It becomes necessary to reconcile them. To reconcile the balances of Cash Book and Pass Book a statement is prepared. This statement is called the 'Bank Reconciliation Statement'.

Caution Bank Reconciliation Statement is a statement prepared to reconcile the difference between the balances as per the bank column of the cash book and pass book on any given date.

13.1 Purpose of Bank Reconciliation Statement

The reconciliation statement is the most common tool used by organizations for reconciling the balance as per books of company with the bank statement and is made at the end of every month.

The main objective of reconciliation is to ascertain if the discrepancy is due to error rather than timing.

It is prepared from time to time to check that all transactions relating to the bank are properly recorded by the businessman in the bank column of the cash book and by the bank in its ledger account. Thus, it is prepared to reconcile the bank balances shown by the cash book and by the bank statement. It helps in detecting, if there is any error in recording the transactions and ascertaining the correct bank balance on a particular date.

The need and importance of the bank reconciliation statement may be given as follows:

1. The reconciliation process helps in bringing out the errors committed either in Cash Book or Pass Book.
2. Bank reconciliation statement may also show any undue delay in the clearance of cheques.
3. Sometimes the cashier may have the tendency of cheating, like he makes entries in the Cash Book, but does not deposit the cash into bank. These types of frauds by the entrepreneur's staff or bank staff may be detected only through bank reconciliation statement. So this way bank reconciliation statement acts as a control technique too.

13.2 Causes of Difference

A transaction relating to bank has to be recorded in both the books i.e. Cash Book and Pass Book but sometimes it happens that a bank transaction is recorded only in one book and not recorded simultaneously in other book this causes difference in the two balances. The causes for difference may be illustrated in detail as follows:

1. ***Cheques issued by the firm but not yet presented for payment:*** When cheques are issued by the firm, these are immediately entered on the credit side of the bank column of the cash book. Sometimes, the receiving person may present these cheques to the bank for payment on some later date. The bank will debit the firm's account when these cheques are presented for payment. There is a time period between the issue of cheque and being presented in the bank for payment. This may cause difference to the balance of cash book and pass book.
2. ***Cheques deposited into bank but not yet collected:*** When cheques are deposited into bank, the firm immediately enters it on the debit side of the bank column of cash book. It increases the bank balance as per the cash book. But, the bank credits the firm's account after these cheques are actually realised. A few days are taken in clearing of local cheques and in case of outstation cheques few more days are taken. This may cause the difference between cash book and pass book balance.
3. ***Amount directly deposited in the bank account:*** Sometimes, the debtors or the customers deposit the money directly into firm's bank account, but the firm gets the information only when it receives the bank statement. In this case, the bank credits the firm's account with the amount received but the same amount is not recorded in the cash book. As a result the balance in the cash book will be less than the balance shown in the Pass Book.
4. ***Bank charges:*** The bank charge in the form of fees or commission is charged from time to time for various services provided from the customers' account without the intimation to the firm. The firm records these charges after receiving the bank intimation or statement.

   Example: Interest on overdraft balance, credit cards' fees, outstation cheques, collection charges, etc.

   As a result, the balance of the cash book will be more than the balance of the pass book.

Notes

5. ***Direct receipts by the bank:*** Sometimes, the interest on debentures or dividends on shares held by the account holder is directly deposited by the company through Electronic Clearing System (ECS). But the firm does not get the information till it receives the bank statement. As a consequence, the firm enters it in its cash book on a date later than the date it is recorded by the bank. As a result, the balance as per cash book and pass book will differ.

6. ***Direct payments made by the bank:*** Sometimes, bank makes certain payments on behalf of the customer as per standing instructions. Telephone bills, rent, insurance premium, taxes, etc are some of the expenses. These expenses are directly paid by the bank and debited to the firm's account immediately after their payment but the firm will record the same on receiving information from the bank in the form of Pass Book or bank statement. As a result, the balance of the pass book is less than that of the balance shown in the bank column of the cash book.

7. ***Dishonour of cheques/bill discounted:*** If a cheque deposited by the firm or bill receivable discounted with the bank is dishonoured, the same is debited to firm's account by the bank. But the firm records the same when it receives the information from the bank. As a result, the balance as per cash book and that of pass book will differ.

8. ***Errors committed in recording transactions by the firm:*** There may be certain errors from the firm's side, e.g., omission or wrong recording of transactions relating to cheques deposited, cheques issued and wrong balancing etc. In this case, there would be a difference between the balances as per Cash Book and as per Pass Book.

9. ***Errors committed in recording transactions by the Bank:*** Sometimes, bank may also commit errors, e.g., omission or wrong recording of transactions relating to cheques deposited etc. As a result, the balance of the bank pass book and cash book will not agree.

Notes

Causes of Difference and their Impact on Balance

S. No.	Cause	Cash Book	Pass Book
1.	Cheques issued but not yet presented for payment	Entry is made Balance = Decreased	No entry is made till the cheques are presented for payment. Balance = Same as before
2.	Cheques paid into the bank but not yet cleared.	Entry is made Balance = Increased	No entry is made till the cheques are cleared Balance = Same
3.	Interest allowed by the bank	No entry is made till the pass Book is checked Balance = Same	Entry is made Balance = Increased
4.	Interest and expenses charged by the bank	No entry is made till the pass Book is checked Balance = Same	Entry is made Balance = Decreased
5.	Interest and dividends collected by bank	No entry is made till the pass book is checked Balanced = Same	Entry is made Balance = Increased
6.	Direct payments by the bank	No entry is made till the pass book is checked Balance = Same	Entry is made Balance = Decreased

Contd...

Notes

7.	Direct payments into the bank by a customer	No entry is made till the pass book is checked Balance = Same	Entry is made Balance = Increased
8.	Dishonor of a bill discounted with the bank	No entry is made till the pass book is checked Balance = Same	Entry is made Balance = Decreased
9.	Bills collected by the bank on behalf of the customer	No entry is made till the pass book is checked Balance = Same	Entry is made Balance = Increased
10.	Errors committed either in cash book or pass book.		

13.3 Rectification of Errors by Preparing Bank Reconciliation Statement

To reconcile the bank balance as shown in the pass book with the balance shown by the cash book, Bank Reconciliation Statement is prepared. After identifying the reasons of difference, the Bank Reconciliation statement is prepared without making change in the cash book balance. We may have the following different situations with regard to balances while preparing the Bank Reconciliation Statement. These are:

1. ***Favourable balances:***
   (a) Debit balance as per cash book is given and the balance as per pass book is to be ascertained.
   (b) Credit balance as per pass book is given and the balance as per cash book is to be ascertained.
2. ***Unfavourable balance/overdraft balance:***
   (a) Credit balance as per cash book (i.e. overdraft) is given and the balance as per pass book is to be ascertained.
   (b) Debit balance as per pass book (i.e. overdraft) is given and the balance as per cash book is to be ascertained.

The given below is the proforma of preparing the bank reconciliation statement:

	Particulars		**Amount**
			₹
Balance at Bank as Per Cash Book			Xxx
Add			
1.	Cheques issued but not yet presented for payment	Xx	
2.	Interest allowed by the bank	Xx	
3.	Interest and dividend collected by the bank	Xx	
4.	Direct payments into the bank by a customer	Xx	
5.	Bills collected by the bank on behalf of the customer	Xx	(+) xx

Notes

Less:

1.	Cheques paid into the bank but not yet cleared	Xx	
2.	Interest and expenses charged by the bank	Xx	
3.	Direct payment by the Bank	Xx	
4.	Dishonor of a bill discounted with the bank	Xx	(–) xx

Note: If you start the question with balance as per pass book all the adjustments will be reversed.

13.3.1 Reconcile Pass Book through Check Book

The following examples will help to understand that how to reconcile the pass book while the balance of cash book is given:

Illustration 1: From the following prepare a bank reconciliation statement on 31st March 2005.

1.	Balance as per Cash Book	1,80,000
2.	Cheques paid into the Bank March 2005 but credited by the bank in April 2005	7,900
3.	Cheques issued in March 2005 but cashed in April 2005	11,000
4.	Cheques entered in the Cash Book in March 2005 but paid into bank in April 2005	1,000
5.	Interest allowed by the bank	2500
6.	Interest charged by the bank	500

Solution:

Bank Reconciliation Statement
as on March 31, 2005

	Particulars		Amount
	Balance as per Cash Book		1,80,000
Add:	1. Cheques issued but not cashed	11,000	
	2. Int. allowed by bank	2,500	13,500
			1,93,500
Less:	1. Cheques paid into bank but not yet cleared	7,900	
	2. Cheques entered into cash book	1,000	
	3. Interest charged by bank	500	9,400
	Balance as per pass book		1,84,100

Illustration 2: From the following particulars of M/s. Ananaya Industries, prepare bank reconciliation statement as on December 31, 2006.

1. Bank balance as per cash book ₹32,500.
2. Cheques deposited into bank but not credited upto December 31, 2006 ₹ 8,900.
3. Cheques issued but not presented for payment ₹ 12,500.
4. Bank credited ₹5,000 for receiving dividend through Electronic Clearing System.
5. Bank charges debited by Bank ₹ 400.

Solution:

Notes

Bank Reconciliation Statement of M/s. Ananaya Industries as on December 31, 2006

	Particulars	(Plus) Amount (₹)	(Minus) Amount (₹)
1.	Balance as per cash book	32,500	
2.	Cheque deposited but not credited by the bank		8,900
3.	Cheques issued but not presented for payment	12,500	
4.	Dividend received through ECS	5,000	
5.	Bank charges debited by bank		400
	Balance as per pass book		40,700
		50,000	**50,000**

Illustration 3: From the following particulars of M/s. Reema Traders, prepare a bank reconciliation statement on June 30, 2006.

1. Balance as per the cash book ₹ 35,750
2. ₹ 250 charges for credit card fee is debited by bank, which is not recorded in cash book.
3. Cheques for ₹ 7,550 are deposited in the bank but not yet collected by the Bank.
4. There was also a debit in the pass book of ₹ 3,500 in respect of a discounted bill dishonoured.

Solution:

Bank Reconciliation Statement of M/s. Reema Traders as on June 30, 2006

	Particulars	(Plus) Amount (₹)	(Minus) Amount (₹)
1.	Balance as per cash book	35,750	
2.	Cheque deposited but not credited by the bank		7,550
3.	Credit card fee charges debited by the bank		250
4.	Discounted bill dishonoured recorded only in pass book		3,500
	Balance as per pass book		24,450
		35,750	**35,750**

Illustration 4: (Unfavourable balance of cash book)

On December 31, 2006, the cash book of the M/s. Mona Plastics shows the credit balance ₹6,500. Cheques amounting to ₹3,500 deposited into bank but were not collected by the bank. Firm issued cheques of ₹ 1,000 which were not presented for payment. There was a debit in the pass book of ₹200 for interest and ₹400 for bank charges. Prepare Bank Reconciliation Statement.

Solution:

Bank Reconciliation statement of M/s Mona Plastics as on December 31,2006

Particulars	(Plus) Amount (Rs.)	(Minus) Amount (Rs.)
1. Overdraft as per cash book		6,500
2. Cheques issued but not presented for payment	1,000	
3. Cheques deposited but not credited by the bank		3,500
4. Bank charges and interest charged		600
Overdraft balance as per Bank Pass book	9,600	
	10,600	**10,600**

Notes

Task ABC Ltd. maintains a current account with the State Bank of India. As on 31st March, 2004, the bank column of its cash book showed a debit balance of ₹ 1,54,300. However, the bank statement showed a different balance as on that date. The following are the reasons for such a difference:

		₹
1.	Cheques deposited but not yet credited by the bank	75,450
2.	Cheques issued but not yet presented	80,760
3.	Bank charges not yet recorded in the cash book	1,135
4.	Cheques received by the bank directly	1,35,200
5.	Insurance premium paid by the bank as per standing instructions not yet intimated	15,400

Find out the balance as per the bank statement.

Hint: Balance as per bank statement: 278275.

13.3.2 Reconcile Check Book through Pass Book

The following examples will help to understand that how to reconcile the check book while the balance of pass book is given:

Illustration 5: Bank Pass book of M/s. Brahm Industries showed a credit balance of ₹ 27,350 on July 31,2006. The following differences were found on that date between the cash book and the pass book:

1. Cheques issued before July 31,2006, amounting to ₹ 19,000 had not been presented for payment.
2. Two cheques of ₹ 5,000 and ₹ 3,500 were deposited into bank on July 31, but the bank gives credit for the same in August.
3. Insurance premium directly paid by the bank ₹ 5,000.
4. ₹ 2,000 wrongly debited to the firm's account by the bank.

Prepare Bank Reconciliation Statement as on July 31, 2006.

Solution:

Bank Reconciliation Statement of M/s. Brahm Industries as on July 31, 2006

	Particulars	(Plus) Amount (₹)	(Minus) Amount (₹)
1.	Balance as per pass book	27,350	
2.	Cheques issued but not presented for payment		19,000
3.	Cheques deposited but credited for payment	8,500	
4.	Insurance premium directly paid by the bank	5,000	
5.	Wrongly debited by the bank.	2,000	
	Balance as per cash book		23,850
		42,850	**42,850**

Notes

Illustration 6: (Unfavourable balance of pass book)

From the following particulars of Neha and Co. prepare Bank Reconciliation Statement on March 31,2006

	₹
Overdraft as per pass book	16,500
Interest on overdraft	1,600
Insurance premium paid by the bank	800
Cheques deposited but not yet credited	5,500
Cheques issued but not present for payment	6,000
Wrongly credit to firm account by the bank	1,000

Solution:

Bank Reconciliation Statement of M/s Neha & Co as on March 31, 2006

Particulars	(Plus) Amount (Rs.)	(Minus) Amount (Rs.)
1. Overdraft as per pass book		16,500
2. Interest on overdraft	1,600	
3. Insurance premium paid by bank	800	
4. Cheques deposited but not credited by the bank	5,500	
5. Cheques issued but not presented for payment		6,000
6. Wrongly credited by the bank		1,000
Overdraft balance as per cash book	15,600	
	23,500	**23,500**

Caselet

Probe Blames Lack of Internal Controls

An independent legal counsel appointed by IT major Wipro has found that lack of internal controls led to the embezzlement committed by one of the former junior employees between November 2006 and December 2009.

The legal counsel submitted the probe report last week to the audit committee set up to investigate the fraud early.

Based on the findings of the legal counsel, Wipro said that if corrections were to be carried out to the annual financial results of the company in view of the "mis-statements identified during the probe together with other "uncorrected audit adjustments'', profit-after-tax for 2009-10 would have been higher by 2.1 per cent (approximately ₹ 92 crore). Wipro's Chief Financial Officer, Mr Suresh C. Senapaty, told Business Line that the external legal counsel was appointed on the advice of the SEC. "He formally submitted the report this month and measures have already been taken to tighten the system," he said.

Contd....

Notes

Stating that it has been able to recover most of the embezzled amounts, Wipro, which is listed on the New York Stock Exchange, in its latest disclosure to the US Securities and Exchange Commission, said its audit panel has concluded that mistakes were committed in certain accounting entries and that they were also not supported by any documents. "We and our independent registered public accounting firm also identified the lack of internal controls that gave rise to the embezzlement and financial statement misstatements as material weaknesses in internal control over financial reporting," Wipro said in its disclosure to SEC. The material weaknesses related to sharing of online banking access passwords and Wipro's internal accounting system passwords by certain employees within the finance and accounting departments including those responsible for external financial reporting.

There was lack of effective controls over recording of journal entries, including inadequate documentation which resulted in ineffective controls over bank reconciliation statements, exchange rate fluctuation accounts and outstanding liabilities accounts and also there was lack of timely and adequate reconciliation and review of period and end reinstatement of foreign currency inter-company and unit balances, including recording of appropriate adjustments. Also, segregation of duties with respect to recording and initiating banking payments was found insufficient.

Source: http://www.thehindubusinessline.in/2010/11/17/stories/2010111753810100.htm

13.4 Summary

- The bank reconciliation statement is prepared as on a particular date to reconcile the differences between the check book and pass book by identifying the causes of difference and showing their impact.
- There are a lot of reasons due to which the balances of a cash book and pass book do not match, then the bank reconciliation statement is prepared to reconcile both the balances.
- The bank reconciliation statement facilitates checking of errors and frauds in the books of accounts.

13.5 Keywords

Bank Overdraft: If the bank statement shows the debit balance at a particular point of time it is known as overdraft.

Bills Receivable: An instrument in writing containing an unconditional order, signed by the maker directing a certain person to pay a certain sum of money to certain person or the bearer of the instrument.

Bank Statement: It gives the details of transactions between the bank and customer.]

Clearing of cheque: Collection of the amount of cheque by the bank.

Dishonor of Bill: A situation when the acceptor of the bill refuse to pay the amount or otherwise unable to do so.

Pay in Slip: Documents supporting the cheque deposited in bank.

Presentation of cheque: Depositing the cheque into bank for receiving payment.

Notes

13.6 Self Assessment

Fill in the blanks:

1. The main objective of reconciliation is to ascertain if the discrepancy is due to error rather than …… .
2. Direct payments made by banks will …… the balances in the pass book.
3. The bank reconciliation statement is prepared without making change in the …….. balance.
4. While reconciling the pass book through the check book the interest allowed by banks will be …….. .
5. While reconciling the check book through pass book the interest and expenses will be …….. from the balance as per pass book.
6. Overdraft means ..... balance.
7. The balance of cash book is ..... in case of overdraft
8. Bank charges will ..... in case of overdraft as per Cash Book.
9. Cheques issued but not encashed will ..... in case of the overdraft as per Pass Book.
10. Interest allowed by bank ..... in case of the favourable balance of cash book.

State whether the following statements are true or false:

11. Bank reconciliation statement may also show any undue delay in the clearance of cheques.
12. The balance of cash book will decrease when cheques paid into the bank account but not yet cleared.
13. Dishonour of bill discounted with the bank will decrease the balance in the pass book.
14. The main objective of reconciliation is to ascertain if the discrepancy is due to timing rather than error.
15. ECS means Electronic Clearance System.

13.7 Review Questions

1. What is a Bank Reconciliation statement?
2. Enumerate the causes of difference in the balance of cash book and pass book
3. From the following particulars, prepare Bank Reconciliation statement as on December 31, 2006.
   (a) Balance as per Cash Book ₹4,200
   (b) Cheques issued but not presented for payment ₹2,000
   (c) Cheques deposited but not collected ₹3,000
   (d) Bank charges debited by the bank ₹250

4 Prepare Bank Reconciliation statement as on March 31, 2006. On this date the passbook of M/s Noopur Industries showed a balance of ₹27,500.
   (a) Cheques of ₹14,000 directly deposited by a customer.

Notes

(b) Cheques for ₹13,500 were issued during the month of March but of these cheques for ₹1,500 were not presented by the end of March.

(c) The bank collected ₹2,500 as dividend on shares.

(d) Cheques of ₹17500 were paid into bank but of ₹ 8500 were realised in the month of April.

5. On April 1, 2006, Rohan had an overdraft of ₹16,000 as shown by the cash book. Cheques amounting to ₹6,000 had been paid by him but not collected by the bank till date. He issued cheques of ₹8,000 which were not presented to the bank for payment. There was a debit in his passbook of ₹500 for interest and ₹200 for bank charges and a cheque of ₹5000 was paid into bank but the same was debited twice in the cash book. Prepare Bank Reconciliation Statement.

6. Overdraft shown by the passbook of M/s. Mohit trader is ₹40,000. Prepare Bank Reconciliation statement on December 31,2006.

   (a) Bank charges debited as per pass book ₹1,000

   (b) Received a payment directly from customer ₹7,000

   (c) Cheques wrongly recorded in debit side of cash book ₹4,000

   (d) Cheques issued but not presented for payment ₹9,800

   (e) Cheques deposited with the bank but not collected ₹ 12,500

   (f) Insurance premium paid by the bank ₹3,500

7. Explain the reasons on account of which the balance as shown by the pass book does not agree with the balance as shown by the bank column of the cash book.

8. State the differences between cash book and pass book.

9. Make the proforma of bank reconciliation statement and also explains the rectification entries.

10. Explain the impact of following errors on pass book:

    (a) Cheques issued but not yet presented for payment

    (b) Interest allowed by the bank

    (c) Interest and expenses charged by the bank

    (d) Direct payments into the bank by a customer

    (e) Errors committed either in cash book or pass book.

11. The cash book showing a favourable balance and the bank statement showing an overdraft.

    The bank statement of Arthur & Co. showed an overdraft of ₹ 56,740 as on 30th September, 2004. The cash book, however, showed a positive balance of ₹ 45,520 as on the same date. The accountant of Arthur & Co. found that the difference in the balance was due to the following:

		₹
1.	Cheques issued to supplier not yet presented	1,54,320
2.	Cheques deposited in the bank not yet credited by the latter	2,06,200
3.	A cheque received by the bank from a customer has been wrongly credited by the bank in Andersen & Co. account	64,720

4.	Dividend received by the bank not yet intimated	15,740	**Notes**
5.	Bank charges not yet recorded in the cash book	1,400	

Answers: Self Assessment

1.	Timing	2.	Decrease	3.	Cash book
4.	Added	5.	Deducted	6.	Unfavourable
7.	Credit	8.	Increase	9.	Decrease
10.	Adds	11.	True	12.	False
13.	True	14.	False	15.	False

13.8 Further Readings

Books

Khan and Jain, "*Management Accounting*".

M.P. Pandikumar, "*Accounting & Finance for Managers*", Excel Books, New Delhi.

R. L. Gupta and Radhaswamy, "*Advanced Accountancy*".

S. N. Maheswari, "*Management Accounting*".

V. K. Goyal, "*Financial Accounting*", Excel Books, New Delhi.

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Unit 14: Rectification of Errors

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14.2 Rectification of Errors when it Affects both the Accounts

14.3 Rectification of Errors through Suspense A/C

14.4 Summary

14.5 Keywords

14.6 Self Assessment

14.7 Review Questions

14.8 Further Readings

Objectives

After studying this unit, you will be able to:

- Make rectification of errors affecting one account and more than one account
- List the steps to make rectification of errors
- Prepare suspense a/c

Introduction

In unit 10 we discussed about the different types of errors which are disclosed and not disclosed by trial balance. In this unit you will study about the rectification of errors and their accounting treatment. The process of rectification starts with understanding the mistakes and their ramifications. Once the nature of the mistake is comprehended, half the job is done. Having perceived the nature of the mistake, the accountant has to analyse the implications of the mistake on the balances of affected accounts as well as on trial balance. An error would have conferred benefits or imposed detriments to one or more accounts.

Example: Crediting Anand's account instead of Ahmad's account bestows an unwarranted benefit to Anand, but deprives Ahmad of the rightful benefit. In rectification, removing the incorrect credit given to Anand, by debiting his account with the amount and extending to Ahmad his due benefit by crediting him with a similar sum meets out justice. In other words, rectification entries would bring back normalcy in the accounting system by removing wrong credits or debits and restoring the affected accounts to their legitimate real positions.

Notes

14.1 Rectification of Errors when Error Affects only one Account

If it is so, no journal entry is required to pass, it is corrected by debiting or crediting the concerned account.

Example: Sales book was overcasted by ₹ 250 (As the sales book was overcasted by ₹ 250), hence sale account is to be debited by ₹ 250 in order to rectify the error. This error affects only one account. Similarly, if the Purchases Day Book is undercasted by ₹ 100 then the error also affects only one account and this can be corrected by debiting purchases account by ₹ 100. Likewise paid ₹ 20 as repairs were recorded ₹ 25 in Repairs account again the error is in one account i.e., repair account. It may be corrected by crediting repair a/c by ₹ 5 i.e. the difference (₹ 25 - ₹ 20).

Notes

Steps to Locate Error

The following steps help to locate the errors. In spite of the efforts, if the difference in the trial balance persists, a suspense account may be created and subsequently the suspense account can be eliminated as and when the errors are located and rectification is made.

1. To see whether the total of both the columns agree or does not agree. In order to see it, it must be again totaled.
2. It is also necessary to see whether the balances of all the accounts including cash and bank have been properly recorded or not.
3. Difference of both the sides must be checked carefully and if possible see whether any such item is there which is exactly of the same amount being omitted/left out. If it is not then have half of the difference and again compare it with the amount of any item of the same amount which is being left out or wrongly put.
4. Subsidiary books must also be checked again, so that if any error has taken place could be rectified.
5. Divide the amount of difference in the trial balance by 2 and see if any item of the debit or credit side, equal to that amount has been posted to the opposite side.
6. Where the difference in the trial balance is divisible by 9 then the difference is likely to be due to misplacement of figures like 12 for 21; 24 for 42;36 for 63 and so on.
7. Still, if there is any error, thorough and complete checking of all ledger accounts is required.

14.2 Rectification of Errors when it Affects both the Accounts

If it is so, it is rectified by passing a journal entry. For example, received ₹ 150 from Shri Bhagwan was credited to sales account. This error affects both the accounts i.e., (i) Shri Bhagwan A/c and (ii) Sales a/c. Journal entry for correction would be:

S.No.	Particulars	L.F.	₹	₹
1.	Sales a/c Dr. To Shri Bhagwan a/c Error in Sales a/c and Shri Bhagwan a/c rectified		150	150

Notes

Similarly, if Building is purchased for ₹ 2 lacs is recorded in the Purchases Book, again the error affects both the accounts i.e. (1) Building a/c (2) Purchases a/c.

Though the error is of principle, in the above case Purchases a/c is unnecessarily debited and Building a/c is wrongly left out. In order to rectify the error the following entry (correcting the error) is to be passed:

Journal Entry for Correction (Rectification)

S.No.	Particulars	L.F.	₹	₹
1.	Building a/c Dr. To Purchases a/c Error in Building a/c and Purchases a/c rectified		2,00,000	2,00,000

Journal Entry already passed which was a wrong entry

S.No.	Particulars	L.F.	₹	₹
1.	Purchase a/c Dr. To Cash/Creditor a/c Buildings purchased		2,00,000	2,00,000

Correct entry required to pass

S.No.	Particulars	L.F.	₹	₹
1.	Building a/c Dr. To Cash/Creditor a/c Buildings purchased		2,00,000	2,00,000

Thus, we see that if the error affects both the accounts, then it can be rectified by passing a journal entry as explained above.

Illustration 1: Rectify the following errors:

1. A sale of goods to Raja Ram for ₹ 2500 was passed through the Purchases Book.
2. Salary ₹ 800 paid to Hari Babu was wrongly debited to his Personal Account.
3. Furniture purchased on credit from Mohan Singh for ₹ 1000 was entered in the Purchases Book.
4. ₹ 5000 spent on the extension of building was debited to the buildings repairs account.
5. Goods returned by Mani Ram ₹ 1200 were entered in Returns Outward Book.

Solution:

Journal Entries to rectify the errors

S. No.	Particulars	L.F.	Dr. (₹)	Cr. (₹)
1.	Raja Ram Dr. To Purchases a/c To Sales a/c A sale of goods to Raja Ram through the Purchases book is rectified		5,000	 2500 2500
2.	Salary a/c Dr. To Hari Babu Salary wrongly debited in his personal a/c is rectified.		800	 800

Contd....

Notes

3.	Furniture a/c Dr. To Purchases a/c Furniture purchased was wrongly entered in the Purchases book is rectified.		1,000	1000
4.	Buildings a/c Dr. To Buildings Repairs a/c Spent on extension of building was wrongly debited to Building repairs a/c is rectified.		5,000	5000
5.	Returns Inward a/c (Sales Returns) Dr. Returns Outward a/c (Purchases Returns a/c) Dr. To Mani Ram Goods returned by Mani Ram were entered in returns outward book.		1,200 1,200	2400

Illustration 2: Following are some accounting errors. Rectify them by making journal entries:

(i) Sales for ₹20000 made to Malvika was not entered in the Sales Book.

(ii) Salary of ₹7500 paid to Accountant Raman was debited to his personal account

(iii) Old furniture sold for ₹2800 was entered in the Sales Book.

(iv) Carriage paid ₹500 on purchase of a Machine was debited to Carriage A/c

(v) Cash ₹50000 paid to the creditor Atulya Ghosh was debited to Praful Ghosh's A/c

Solution:

Journal

Date	Particulars	Amount (₹)	Amount (₹)
(i)	Malvika Dr. To Sales a/c (Sale to Malvika omitted to be entered in Sales Book is corrected)	20,000	20,000
(ii)	Salary A/c Dr. To Raman (Salary paid to Raman was debited to his personal account is now corrected)	7,500	7,500
(iii)	Sales A/c Dr. To Furniture A/c (Old furniture sold was entered in the Sales Book is now corrected)	2,800	2,800
(iv)	Machine A/c Dr. To Carriage A/c (Amount paid for carriage on purchase of machine is debited to carriage A/c is now corrected)	500	500
(v)	Atulya Ghosh Dr. To Praful Ghosh (Amount paid to Atulya Ghosh was debited to Praful Ghosh is corrected)	50,000	50,000

Notes

Task

Cash received from Ashok ₹ 2500 were posted to his account as ₹ 5200. Accountant erased amount of ₹ 5200 and wrote ₹ 2500 in its place. Is he justified in doing so?

14.3 Rectification of Errors through Suspense A/C

You have learnt that the Trial Balance prepared at the end of a period by the business concern must agree. It means the sum of its debit column and sum of credit column should agree. But if the totals do not agree the difference amount is written in a new account. This account is called Suspense Account. If the total of the debit side of the Trial Balance is more than the total of its credit side, the difference amount will be written in Suspense A/c on its credit side i.e. Suspense A/c is credited and vice-versa. You have also learnt that the two sides of the Trial Balance do not agree because there is some error or errors in the accounts, which is reflected in the Suspense Account. Thus, Suspense A/c is a summarised account of errors.

Opening of a Suspense Account is a temporary arrangement. As soon as the error that has led to Suspense Account is rectified, this account will disappear. One point needs to be noted that Suspense A/c is the result of one sided errors. So one sided errors are corrected through Suspense A/c. completing the double entry when an error is corrected by placing the correct amount on the debit of the proper account, the credit is placed in Suspense Account or vice-a-versa.

Example: Gopal's Account was debited short by ₹100. The error will be rectified through Suspense A/c by debiting Gopal A/c and crediting Suspense A/c by ₹100.

Journal entry for the same is as follows:

Gopal	Dr.	100	
To Suspense A/c			100

(Gopal's A/c debited short is now corrected)

Similarly, while correcting as one sided error the proper account is credited with the correct amount, the debit is placed in the Suspense A/c. For example, Sales Book for December, 2006 is undercast by ₹ 500. The error will be rectified by debiting Suspense A/c and crediting Sales A/c.

Journal Entry for the same will be as follows:

Suspense A/c	Dr	500	
To Sales A/c			500

(Sales Book undercast is rectified)

Illustration 3: On 31st Dec, 2006 the Trial balance of Sunil & Co balanced after inserting a suspense account in the nominal ledger. In the course of audit, the following facts were discovered:

(a) ₹ 120 received from A had been posted to B's account in the sales ledger.

(b) ₹ 50 paid for postage stamps had been entered correctly in the cash book, but not posted.

(c) In casting the Sales Day Book ₹ 878 were carried forward as ₹ 787.

(d) An Invoice of ₹ 960 in respect of Motor Car debited to Motor Car a/c included the cost of licence ₹ 60.

(e) ₹ 540 credited to Partners' current Account for interest on capital had been debited to Bank Interest account.

Notes

(f) Discount received from Mittal & Co. ₹ 200 had not been posted to Discount a/c. Pass entries necessary to correct the errors and prepare the suspense account. Also find out what effect these errors would have on the profit for the year ending 31st Dec, 2006.

Solution.

Journal Entries to rectify the errors

S.No.	Particulars	L.F.	Dr. Amount (₹)	Cr. Amount (₹)
(a)	B Dr. To A Error in B's a/c Corrected.		120	120
(b)	Postage a/c Dr. To Suspense a/c Postage a/c Omission corrected.		50	50
(c)	Suspense a/c Dr. To Sales a/c Sales Day Book balance Wrongly carried forward Hence corrected 878 - 787		91	91
(d)	Motor licence a/c Dr. To Motor Car a/c Error in Motor Car a/c corrected.		60	60
(e)	Suspense a/c Dr. To Partner's Current a/c To Bank Interest a/c Error in Bank Interest a/c corrected and partners' a/c credited.		1080	540 540
(f)	Suspense a/c Dr. To Discount a/c Omission in Discount a/c corrected.		200	200

Suspense A/c

S.No.	Particulars	J.F.	Dr. Amount ₹	S.No.	Particulars	J.F.	Cr. Amount ₹
(c)	To Sales a/c		91	(b)	By Postage a/c		50
(e)	To Partners' current a/c		540		By Balance		1321
	To Bank Int. a/c		540				
(f)	To Discount a/c		200				
			1371				1371

Effects on the profit for the year 2006:

(a) No effect.

(b) Net profit is higher by ₹ 50.

(c) Gross profit and Net profit is reduced by ₹ 91.

(d) Net profit is higher by ₹ 60.

(e) Net Profit is reduced by ₹ 540.

(f) Net profit is lower by ₹ 200.

The total effect of all errors on profit is ₹ 721.00 i.e. profit is lower to the extent of ₹ 721 and if corrected, Net profit increase by ₹ 721.

Notes

14.4 Summary

- Accounting errors are the errors committed by persons responsible for recording and maintaining accounts of a business firm in the course of accounting process.
- Errors can be in the form of omission of recording of transaction in various books or posting in ledger or mistake in totalling or recording wrong amount or in wrong account.
- There can be accounting errors which affect the agreement of trial balance and errors which do not affect the agreement of Trial Balance.

14.5 Keywords

Journal: The primary book in which the business transactions are recorded at first time.

Ledger: It is the classification of accounts in which various accounts are maintained.

Subsidiary book: It is a book maintained for routine transactions of the enterprise.

Suspense account: Sometimes, it is not possible to point out errors easily, then the difference is put to an account, known as suspense account.

14.6 Self Assessment

Fill in the blanks:

1. If the total of the debit side of the Trial Balance is more than the total of its credit side, the difference amount will be written in ..... on its credit side.
2. Opening of a Suspense Account is a .....
3. One sided errors are corrected through .....
4. The process of ..... starts with understanding the mistakes and their ramifications.
5. Error which affects two different accounts on the same sides or different sides is called ....
6. Suspense A/c is shown in the.....
7. The balances of all the assets accounts and drawing accounts are recorded in the …….of the Trial Balance.

State whether the following statements are true or false:

8. If the Purchases Day Book is undercasted by ₹ 100 then the error will affects only one account.
9. Suspense A/c is a summarised account of errors.
10. So one sided errors can not be corrected through Suspense A/c.

14.7 Review Questions

1. Give the journal entries necessary to rectify the following errors:
   (i) A payment of ₹ 450 for purchase of a Typewriter for office use has been debited to Purchases a/c.

Notes

(ii) A credit sale of ₹ 137 to Mr. Chandra has been posted to the debit of Mr. Kuchhal's account from the Sales Day book.

(iii) A payment of ₹ 196 for white washing the office has been charged to Buildings accounts.

2. Rectify the following Errors:

   (i) Sales to Vinod ₹ 163 posted to his account as ₹ 136.

   (ii) Sales to Vinod ₹ 153 debited to his account as ₹ 135.

   (iii) Sales to Vinod ₹ 143 credited to his account as ₹ 134.

3. Rectify the following Errors:

   (i) Wages paid for the construction of office debited to wages account ₹ 1,500.

   (ii) Cartage paid for the newly purchased furniture ₹ 10 posted to cartage account.

   (iii) Furniture purchased on credit from Ram for ₹ 300 posted as ₹ 30.

   (iv) Sales to X ₹ 400 posted to Y's account.

   (v) Wages paid ₹ 2,550 were recorded in the cash book as ₹ 2,505.

   (vi) Purchases from Y ₹ 1,002 were omitted from the books.

4. There was difference in the trial balance of Sri Arihant which was put to a newly opened suspense account. Subsequently the following mistakes were discovered. Pass journal entries to rectify them and ascertain the difference in the trial balance.

   (i) Materials Costing ₹ 1700 in the erection of the machinery and the wages for it amounting to ₹ 1,400 were included in the purchases account and the wage account respectively.

   (ii) Goods sold under credit terms ₹ 16,900 to music were recorded properly in the sales book but were debited to his account as ₹ 19600 and carriage outward and freight paid ₹ 700 chargeable from him were posted to sales expenses account.

   (iii) Sales return by Yogeshwar ₹ 2300 were correctly recorded in the sales return book from where they were debited to Yogeshwar's account by ₹ 32.

   (iv) Old furniture originally purchased for ₹ 1800 written down to ₹ 1100 was sold for ₹ 1700 and was credited to furniture account.

   (v) Machinery purchased on credit ₹ 17000 was recorded in purchases book and transport charges for the machine ₹ 1200 were debited to trade expenses account.

5. A businessman has prepared trial balance of his business firm that has agreed? He is satisfied that now there are no accounting errors. Do you agree with him? If not list the errors that do not affect the agreement of the trial balance.

6. When is a suspense Account opened? How are errors rectified through Suspense A/c?

7. Rectify the following errors:

   Goods purchased on credit for ₹8200 not recorded in the Purchases Book.

   Purchase Returns Book is overcast by ₹1000.

   Salary of ₹3200 paid to Gopal the accountant was debited to his personal account

   Sales to Shakila of ₹2400 was posted to her account

   Cash received from Suresh ₹2000 was not entered in the books.

Notes

8. Pass necessary journal entries to rectify the following errors:

   Sale of an old machine for ₹4500 was posted to Sales account

   Rent of proprietors residence of ₹12000 was posted to Rent Account.

   A credit to Brij Mohan of ₹6750 was posted to his account as ₹4750

   Furniture purchased from M/s Decorates for ₹22500 was entered in the Purchases Book

   Salary paid to the accountant Sushil Gupta of ₹6500 was debited to his personal Account.

9. Give two examples each of the one sided and doubles sided errors. How are they corrected?

10. Is the agreement of a Trial Balance a conclusive proof of accuracy of ledger accounts? If not, what are the errors which remain undetected by the Trial balance?

Answers: Self Assessment

1.	Suspense A/c	2.	temporary arrangement
3.	Suspense A/c	4.	rectification
5.	two sided error	6.	Trial balance
7.	Debit side	8.	True
9.	True	10.	False

14.8 Further Readings

Books

Khan and Jain, "*Management Accounting*".

M. P. Pandikumar, "*Accounting & Finance for Managers*", Excel Books, New Delhi.

R. L. Gupta and Radhaswamy, "*Advanced Accountancy*".

S. N. Maheswari, "*Management Accounting*".

V. K. Goyal, "*Financial Accounting*", Excel Books, New Delhi.

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