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DIRECTORATE OF DISTANCE

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CONTINUING EDUCATION

INTRODUCTION TO **ACCOUNTANCY**



Prepared by

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Introduction to Accountancy

II Year – III Semester

Objectives:

1. To enable the students to prepare and provide accounting information to the interested parties.
2. To enhance their knowledge of the fundamental and technical concepts of accounting.

Unit I: Accounting – Definition – Functions – Advantages – Limitations – Book Keeping – Difference between Accounting and Book- Keeping – Users of Accounting Information - Accounting Principles – Concepts and Conventions – classification of Accounts – Double entry system – Merits – Rules of Debit and Credit – Accounting Equation.

Unit II: Journal – Procedure of journalizing - Compound Journal Entry - Subsidiary books – Purchase book – Sales book – Purchase Return book – Sales return book – Single Column Cash book.

Unit III: Ledger – Features of Ledger Accounts – Difference between Journal and Ledger – Ledger Posting – Balancing of Ledger Accounts- Preparation of Ledger Accounts

Unit IV: Trial Balance – Features– objectives – Preparation of Trial Balance

Unit V: Final Accounts – Simple problems with Closing Stock, Outstanding and Prepaid adjustments only

Text Books

1. T.S.Reddy&A.Murthy, Advanced Accountancy, Margham Publications, Chennai.
2. S.P.Jain&K.L.Narang, Advanced Accountancy, Kalyani Publishers, New Delhi.

Reference Books

1. M.C.Shukla and T.S.Grewal, Advanced Accountancy, Sultan Chand &Co, New Delhi.
2. Dr.M.A.Arulanandam&K.S.Raman, Advanced Accountancy, Himalaya Publishing House,

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Introduction to Accountancy

Unit – I

INTRODUCTION

Accounting is a system meant for measuring business activities, processing of information into reports and making the findings available to decision-makers. The documents, which communicate these findings about the performance of an organisation in monetary terms, are called financial statements.

Usually, accounting is understood as the Language of Business. However, a business may have a lot of aspects which may not be of financial nature. As such, a better way to understand accounting could be to call it The Language of Financial Decisions. The better the understanding of the language, the better is the management of financial aspects of living. Many aspects of our lives are based on accounting, personal financial planning, investments, income-tax, loans, etc. We have different roles to perform in life-the role of a student, of a family head, of a manager, of an investor, etc. The knowledge of accounting is an added advantage in performing different roles. However, we shall limit our scope of discussion to a business organisation and the various financial aspects of such an organisation.

When we focus our thoughts on a business organisation, many questions (is our business profitable, should a new product line be introduced, are the sales sufficient, etc.) strike our mind. To answer questions of such nature, we need to have information generated through the accounting process. The people who take policy decisions and frame business plans use such information.

All business organisations work in an ever-changing dynamic environment. Any new programme of the organisation or of its competitor will affect the business. Accounting serves as an effective tool for measuring the financial pulse rate of the company. It is a continuous cycle of measurement of results and reporting of results to decision makers.

Just like arithmetic is a procedural element of mathematics, book keeping is the procedural element of accounting.



DEVELOPMENT OF ACCOUNTING DISCIPLINE

The history of accounting can be traced back to ancient times. According to some beliefs, the very art of writing originated in order to record accounting information. Though this may seem to be an exaggeration, but there is no denying the fact that accounting has a long history. Accounting records can be traced back to the ancient civilizations of China, Babylonia, Greece and Egypt. Accounting was used to keep records regarding the cost of labour and materials used in building great structures like the Pyramids.

During 1400s, accounting grew further because the needs for information of merchants in the Venis City of Italy increased. The first known description of double entry book keeping was first published in 1494 by Lucas Pacioli. He was a mathematician and a friend of Leonardo Ileda Vinci.

The onset of the industrial revolution necessitated the development of more sophisticated accounting system, rather than pricing the goods based on guesses about the costs. The increase in competition and mass production of goods led to the rise of accounting as a formal branch of study.

With the passage of time, the corporate world grew. In the nineteenth century, companies came up in many areas of infrastructure like the railways, steel, communication, etc. It led to a rapid growth in accounting. As the complexities of business grew, ownership and management of business was divorced. As such, managers had to come up with well-defined, structured systems of accounting to report the performance of the business to its owners.

Government also has had a lot to do with more accounting developments. The Income Tax brought about the concept of 'income'. Government takes a host of other decisions, relating to education, health, economic planning, for which it needs accurate and reliable information. As such, the government demands stringent accountability in the corporate sector, which forces the accounting process to be as objective and formal as possible.

AN ACCOUNTANT'S JOB PROFILE: FUNCTIONS OF ACCOUNTING

A man who is involved in the process of book keeping and accounting is called an accountant. With the coming up accounting as a specialised field of knowledge, an accountant has a special place in the structure of an organisation, because he performs certain vital functions.



The following paragraphs examine the functions of accounting and what role does an accountant play in discharging these functions.

An accountant is a person who does the basic job of maintaining accounts as he is the man who is engaged in book keeping. Since the managers would always want to know the financial performance of the business. An accountant prepares profit and loss account which reports the profits/losses of the business during the accounting period, Balance Sheet, which is a statement of assets and liabilities of the business at a point of time, is also proposed by all accountants. Since both statements are called financial statements, the person who prepares them is called a financial accountant.

Accounting information serves many purposes. Apart from revealing the level of performance, it throws light on the causes of weakness and deviation from plans (in any). In this way an accountant becomes an important functionary who plays a vital role in the process of management control, which is a process of diagnosing and solving a problem. Seen from this point of view, an accountant can be referred to as a management accountant.

Tax planning is an important area as far as the fiscal management of a company is concerned. An accountant has a suggestive but very specific job to do in this regard by indicating ways to minimise the tax liability through his knowledge of concessions and incentives available under the existing taxation framework of the country.

An accountant can influence a company even by not being an employee. He can act as a man who verifies and certifies the authenticity of accounts of a company by auditing the accounts. It is a strictly professional job and is done by persons who are formally trained and qualified for the purpose. They have an educational status and a prescribed code of conduct like the Chartered Accountants in India and Certified Public Accountants in USA.

Information management is another area which keeps an accountant busy. He is the one who classifies the financial information into information for internal use (management accounting function); and information for external use (financial accounting function). Irrespective of the size and degree of automation of a business, information management is a key area and many organisations are known to have perished because they failed to recognise this as an important



function of an accountant because information system is imperative for effective cost control, to forecast cash needs and to plan for future growth of the organisation.

UTILITY OF ACCOUNTING

The preceding section has just brought out the importance of information. Effective decisions require accurate, reliable and timely information. The need for quantity and quality of information varies with the importance of the decision that has to be taken on the basis of that information. The following paragraphs throw light on the various users of accounting information and what do they do with that information.

Individuals may use accounting information to manage their routine affairs like operating and managing their bank accounts, to evaluate the worthwhileness of a job in an organization, to invest money, to rent a house, etc.

Business Managers have to set goals, evaluate progress and initiate corrective action in case of unfavourable deviation from the planned course of action. Accounting information is required for many such decisions—purchasing equipment, maintenance of inventory, borrowing and lending, etc.

Investors and creditors are keen to evaluate the profitability and solvency of a company before they decide to provide money to the organisation. Therefore, they are interested to obtain financial information about the company in which they are contemplating an investment. Financial statements are the principal source of information to them which are published in annual reports of a company and various financial dailies and periodicals.

Government and Regulatory agencies are charged with the responsibility of guiding the socio-economic system of a country in such a way that it promotes common good. For example, the Securities and Exchange Board of India (SEBI) makes it mandatory for a company to disclose certain financial information to the investing public. The government's task of managing the industrial economy becomes simplify if the accounting information such as profits, costs, taxes, etc. is presented in a uniform manner without any manipulation or 'window-dressing'.

Central and State governments levy various taxes. The taxation authorities, therefore, need to know the income of a company to calculate the amount of tax that the company would have to pay.



The information generated by accounting helps them in such computations and also to detect any attempts of tax evasion.

Employees and trade unions use the accounting information to settle various issues related to wages, bonus, profit sharing, etc. Consumers and general public are also interested in knowing the amount of income earned by various business houses. Accounting information helps in finding whether or not a company is over charging or exploiting the customers, whether or not companies are showing improved business performance, whether or not the country is emerging from the economic recession, etc. All such aspects draw heavily on accounting information and are closely related to our standard of living.

Definition of Accounting

Definition by the American Institute of Certified Public Accountants (Year 1961): “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 result thereof”.

Definition by the American Accounting Association (Year 1966):

“The process of identifying, measuring and communicating economic information to permit informed judgments and decisions by the users of accounting”.

(a) Objectives of Accounting

(i) Providing Information to the Users for Rational Decision-making

The primary objective of accounting is to provide useful information for decision-making to stakeholders such as owners, management, creditors, investors, etc. Various outcomes of business activities such as costs, prices, sales volume, value under ownership, return of investment, etc. are measured in the accounting process. All these accounting measurements are used by stakeholders (owners, investors, creditors/bankers, etc.) in course of business operation. Hence, accounting is identified as ‘language of business’.

(ii) Systematic Recording of Transactions



To ensure reliability and precision for the accounting measurements, it is necessary to keep a systematic record of all financial transactions of a business enterprise which is ensured by bookkeeping. These financial records are classified, summarized and reposted in the form of accounting measurements to the users of accounting information i.e., stakeholder.

(iii) Ascertainment of Results of above Transactions

‘Profit/loss’ is a core accounting measurement. It is measured by preparing profit and loss account for a particular period. Various other accounting measurements such as different types of revenue expenses and revenue incomes are considered for preparing this profit and loss account. Difference between these revenue incomes and revenue expenses is known as result of business transactions identified as profit/loss. As this measure is used very frequently by stockholders for rational decision making, it has become the objective of accounting.

or example, Income Tax Act requires that every business should have an accounting system that can measure taxable income of business and also explain nature and source of every item reported in Income Tax Return.

(iv) Ascertain the Financial Position of Business

‘Financial position’ is another core accounting measurement. Financial position is identified by preparing a statement of ownership i.e., Assets and Owings i.e., liabilities of the business as on a certain date. This statement is popularly known as balance sheet. Various other accounting measurements such as different types of assets and different types of liabilities as existed at a particular date are considered for preparing the balance sheet. This statement may be used by various stakeholders for financing and investment decision.

(v) To Know the Solvency Position

Balance sheet and profit and loss account prepared as above give useful information to stockholders regarding concerns potential to meet its obligations in the short run as well as in the long run.

Scope of accounting

1. Accounting is concerned with financial transactions and events which bring' about a change in the resources (or wealth) position of the business firm. Such transactions have to be identified first, as



and when they occur. It is not difficult because there will be proof in the form of a bill or receipt (called vouchers). With the help of these bills and receipts identification of a transaction is easy. For example, when you purchase something you get a bill, when you make payment you get a receipt.

2. These transactions are to be measured or expressed in terms of money, if not done already. Generally, this problem will not arise, because the statement of proof expresses the transaction in terms of money. For example, if ten books are purchased at the rate of Rs. 20 each, then the bill is prepared for Rs. 200. But, if an event cannot be expressed in monetary terms, it will not come under the scope of accounting.

3. The transactions which are identified and measured are to be recorded in a book called journal or in one of its sub-divisions.

4. The recorded transactions are to be classified with a view to group transactions of similar nature at one place. The work of classification is done in a separate book called ledger. In the ledger, a separate account is opened for each item so that all transactions relating to it can be brought to one place. For example, all payments of salaries are brought to salaries account.

5. The recording and classification of many transactions will result in a mass of financial data. It is, therefore, necessary to summarise such data periodically (at least once a year), in a significant and meaningful form. The summarisation is done in the form of profit and loss account which reveals the profit made or loss incurred, and the balance sheet which reveals the financial position.

6. The summary results will have to be analysed, interpreted (critically explained) and communicated to interested parties. Accounting information is generally communicated in the form of a 'report'. Big organisations generally present printed reports, called published account.

Advantages of Accounting

- Maintenance of business records
- Preparation of financial statements
- Comparison of results
- Decision making
- Evidence in legal matters



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- Provides information to related parties
 - Helps in taxation matters
 - Valuation of business
 - Replacement of memory

Maintenance of business records

It records all the financial transaction pertaining to the respective year systematically in the books of accounts. It is not possible for management to remember each and every transaction for a long time due to their size and complexities.

Preparation of financial statements

Financial statements like Trading and profit and loss account, Balance Sheet can be prepared easily if there is a proper recording of transactions. Proper recording of all the financial transactions is very important for the preparation of financial statements of the entity.

Comparison of results

It facilitates the comparison of the financial results of one year with another year easily. Also, the management can analyze the systematic recording of all the financial transactions according to the policies of the entity.

Decision making

Decision making becomes easier for management if there is a proper recording of financial transactions. Accounting information enables management to plan its future activities, make budgets and coordination of various activities in various departments.

Evidence in legal matters

The proper and systematic records of the financial transactions act as evidence in the court of law.



Provides information to related parties

It makes the financial information of the organization available to stakeholders like owners, creditors, employees, customers, government etc. easily.

Helps in taxation matters

Various tax authorities like income tax, indirect taxes depends on the accounts maintained by the management for settlement of taxation matters.

Valuation of business

For proper valuation of an entity's business accounting information can be utilized. Thus, it helps in measuring the value of the entity by using the accounting information in the case of sale of the entity.

Replacement of memory

Proper recording of accounting transactions replaces the need to remember transactions.

Disadvantages of Accounting

- Expresses Accounting information in terms of money
- Accounting information is based on estimates
- Accounting information may be biased
- Recording of Fixed assets at the original cost
- Manipulation of Accounts
- Money as a measurement unit changes in value



Expresses Accounting information in terms of money

Non-financial transactions cannot be given effect to in books of accounts. Only transactions of financial nature are measurable by the accountant. In fact, financial transactions are expressed in terms of money.

Accounting information is based on estimates

There are some accounting data which are based on estimates. Thus, inaccuracy in estimates is possible.

Accounting information may be biased

Accountant's personal influence affects the accounting information of the entity. Different methods of inventory valuation, depreciation methods, treatment of revenue and capital expenses etc can be adopted by the accountant for measurement of income of the entity.

Hence, the income arrived in certain cases might be incorrect due to the lack of objectivity.

Recording of Fixed assets at the original cost

There can be a difference between the original cost and current replacement cost of a fixed asset due to efflux of time, change in technology etc. Thus, the balance sheet may not show the true financial status of an entity.

Manipulation of Accounts

The accountant or management can manipulate or misrepresent the profits of an entity.



Money as a measurement unit changes in value

Stability in the value of money is not possible. Accounting information will not show the true financial position if changes in the price level are not considered.

Book Keeping

Bookkeeping means recording the financial transactions and information concerning the business of a company regularly. It is a systematic recording of financial transactions in a company. It ensures that the records of each financial transaction are up-to-date, correct and comprehensive.

The bookkeepers are individuals or entities who maintain the books of account of a company. They manage all the financial data of a company. The companies can track all their financial transactions on their books with accurate bookkeeping. Bookkeeping helps companies to make important investing, operating and financing decisions.

Difference between Bookkeeping and Accounting

Bookkeeping is a separate process from accounting, which occurs within the broader scope of accounting. The accounts are prepared from the information provided by bookkeeping. A strong relationship between these two functions is necessary to take the business to the next level.

Bookkeeping is a segment of the whole accounting system. Bookkeeping is the basis for accounting as it contains the proper records of all financial transactions whereas, accounting involves organising, summarising, classification and reporting financial transactions.

If the bookkeeping is correct, the accounting of a company will be proper. Thus, accounting is broader than bookkeeping and accounting of a company relies on a proper and accurate bookkeeping system.



Bookkeeping helps to interpret the accounting information for decision making by both the internal and external users. Bookkeeping is a subset of accounting and clerical in nature which involves the following:

- Recording financial transactions
- Posting credits and debits
- Producing invoices
- Maintaining and balancing current account and general ledgers
- Completing payroll

Objectives of Bookkeeping

The objectives of bookkeeping are as follows:

To record the transactions

The first objective of bookkeeping is to maintain accurate and complete records of all financial transactions in an orderly manner. It systematically records all transactions and ensures that all financial transactions recorded are reflected in the books of accounts. These transactions can be used for future references.

To show the correct position

Bookkeeping helps to ascertain the overall impact of all financial transactions of a company. It reflects the financial effect of all business transactions that have taken place in a financial year. It provides financial information to the shareholders and management of the company, thus helping them formulate future policies and plans.



To detect errors and frauds

Bookkeeping helps to identify the transactions and summarise them chronologically in a systematic manner. It ensures that the books of accounts are correct, up-to-date, chronological and complete. Thus, it helps to detect any errors or frauds in the business.

Types of Bookkeeping System

There are two types of bookkeeping systems. The business entities can choose any one of the types of bookkeeping system. Some entities use a combination of both types. The following are the two types of bookkeeping system:

Single-entry system of bookkeeping

The single-entry system of bookkeeping is a basic system to record daily receipts or generate a weekly or daily report of a company's cash flow. In the single-entry system of bookkeeping, the bookkeeper records one entry for each financial transaction or activity.

The single-entry system of bookkeeping involves recording only one side of the transaction or activity. It maintains only the purchases, cash receipts and payments and sales. It is used mainly by small businesses, which have minimal transactions.

Double-entry system of bookkeeping

The double-entry system of bookkeeping records a double entry for each financial activity or transaction. The double entry system provides balances and checks as it records the corresponding



credit entry for every debit entry. It is not cash-based, and the transactions are entered when revenue is earned, or debt is incurred.

The double-entry system of bookkeeping is based on the duality concept, i.e. every financial transaction affects two accounts. It means that every debit entry to an account has a corresponding credit entry in another account and vice versa. This system is universally adopted and is considered accurate for recording business/financial transactions.

Importance of Bookkeeping

Bookkeeping is necessary for all businesses, irrespective of the size, nature, business transactions, or any specific industry. Upon the commencement of a business, maintaining proper records is essential. The following points state the importance of bookkeeping:

Records the source of transactions

Bookkeeping acts as a source of all the financial transactions of a business since it records all the financial transactions from the source of the transaction, like receipts, invoices, payment notes, etc.

Bookkeeping keeps track of payments, receipts, purchases, sales and records every transaction made from and by the business. The financial statements or other accounting reports of a business are summarised from their books of accounts. Thus, all businesses irrespective of their size, need to have proper bookkeeping in place.



Helps in decision making

A correct and proper bookkeeping process provides companies with an accurate measure of their performance. It also provides information for making general strategic decisions and a benchmark for its income and revenue goals. Bookkeeping is a reliable source for companies to measure their financial performance.

One of the main reasons for bookkeeping is maintaining all financial records of a business that shows the financial position of every head or account of income and expenditure. The companies can obtain detailed information about each income or expense instantaneously through bookkeeping.

Gives information to prepare financial statements

Bookkeeping summarises the expenditures, income and other ledger records periodically. Since bookkeeping records and tracks all financial transactions, it becomes the starting point of accounting. If the bookkeeping of a company is not proper, the accounting of the company will not be accurate.

Bookkeeping provides information to prepare financial reports, which states the specific information about the business on how much profits it has made or the worth of the business at a specific point in time.

Legal requirement

The maintenance of financial statements and books of accounts is a legal requirement under many acts. In the case of banks or companies or insurance companies, the acts that regulate them require such firms to maintain and keep financial records. Thus, bookkeeping becomes necessary for such companies.



The purpose of accounting information

The product of Accounting is accounting information. Accounting information is used in deciding between different courses of action and results in informed decision making. It serves to reduce the uncertainty inherent in the business environment where decisions are made about the future. It further reduces entropy based on the assumption that chaos exists where there is no information.

The role of the accountant in producing accounting information is to observe, screen and recognise events and transactions, to measure and process them and to compile corporate reports with accounting information that are communicated to users. These are then interpreted, decoded and used by management and other user groups. The main requirement for such corporate reports is that they should be useful to users. The provision of information that is useful to the decision-making process is currently recognised as the main purpose of accounting information. This holds for theoretical frameworks on financial reporting as well as accounting literature.

A number of international reports have been published since the early 1970s to determine, amongst others, the purpose of accounting information and the content of financial statements. These reports focused on the needs of external users, and identified decision usefulness as the main aim of accounting information.

In the Trueblood Report (AICPA, 1971), one of the definitive reports on corporate reporting which was published in the United States of America, 12 objectives of financial statements were identified including the following:

- To provide information for making economic decisions;
- To serve users who rely on financial statements as their principal source of information;
- To provide information useful for predicting and evaluating the amount, timing and uncertainty of potential cash flows;



- To supply information for judging management's ability to utilise resources effectively in meeting goals;
- To provide factual and interpretative information by disclosing underlying assumptions on matters subject to interpretation, evaluation, prediction or estimation; and
- To provide information on activities affecting society.

Whereas all these reports concentrated on the objectives of financial reporting to external users, the Institute of Chartered Accountants of Scotland (1988) considered the information needs of both management and external users. The conclusions made in the report are that an efficient market requires the communication of useful information from management to investors, that financial reports should reflect economic reality and that the information needed by investors is the same in kind as that needed by management. The finding is that one accounting system can serve the needs of both external and internal users but warns that the "patching up" of the present reporting regime would not be the ideal solution. An entirely new corporate reporting system that is useful to both management and, in an abbreviated form, to external users, is required. This report confirms that there should be only one accounting information system that is flexible enough to meet the needs of different types of users.

The needs of users

Before the needs of users can be considered, it is necessary to identify the users of business information, as different users utilise business information to satisfy different needs. There are two main user groups:

Internal users

- Management – decisions concerning the running of the business and strategic planning for the future.



- Employees – decisions on personal matters, e.g. promotion, appointments, security and training.

External users

- Investors and potential investors – information on the risks and returns on investments.
- Unions and employee groups – information on the stability, profitability and distribution of wealth within the business.
- Lenders and financial institutions – information on the creditworthiness of the company and its ability to repay loans and pay interest.
- Suppliers and creditors – information on whether amounts owed will be repaid when due, and on the continued existence of the business.
- Customers – information on the continued existence of the business and thus the probability of a continued supply of products, parts and after sales service.
- Government and other regulators – information on the allocation of resources and the compliance to regulations.
- Social responsibility groups, such as environmental groups – information on the use of the environment.
- The public – information on the role and contribution of businesses to society.
- Competitors – information on the relative strengths and weaknesses of their competition and for comparative and benchmarking purposes. Whereas the above categories of users share in the wealth of the company, competitors require the information mainly for strategic purposes.

A serious shortcoming of the reports on financial information as well as the conceptual frameworks is that they are largely based on what is perceived to be decision useful information. Until recently



the needs of especially external users had not been surveyed on a large scale. Consequently these reports and frameworks were based mainly on the limited available research, input from particular users groups and current perceptions as to what decision-useful information entails.

In 1994 AICPA appointed a special committee on financial reporting to complete an extensive survey of the information needs of investors and creditors in the United States of America (the Jenkins Report). The study focused on professional investors and creditors and their advisors who follow fundamental approaches to decision making and who cannot compel companies to produce the information needed for analysis.

The survey (AICPA, 1994a, p.25) identified five broad categories of business information which are required by users:

- Financial and non-financial data;
- Management's analysis of financial and non-financial data;
- Forward-looking information;
- Information about management and shareholders;
- Background to the company.

The Jenkins Report confirmed the importance of financial statements in providing information which influences users' decision making. The financial information provides a means of evaluating and comparing the results and position of businesses by measuring transactions or events in financial terms. This does not obviate the need of users for more information on operations, as users would prefer not to rely only on financial results. They also require operating data in order to understand the nature of the business and its performance relative to competitors. Operating data may be stated in terms of currency, products or time units, number of employees and so forth or may be stated qualitatively in the form of descriptions and opinions.



The report noted that users found that management's analysis enhanced their understanding of the business reasons for changes in the information from year to year. Management is the closest to the business and therefore the best qualified to provide such information for analytical purposes. The management review includes a discussion of the changes in financial, operating and performance data as well as key trends. Users require information about changes relating to market acceptance, productivity, costs of key resources, profitability, innovation, changes in financial position, liquidity and the identity and effect of unusual or non-recurring transactions and events.

Users also require the perspectives of management on the future, in particular on the opportunities and risks that arise from changes in the environment of the organisation. Information on flexibility assists users in identifying the most probable future opportunities and risks confronting the enterprise, and the most likely responses of the enterprise. Forward-looking information should include information on the threat of substitute products, the nature of competition, changes in the bargaining power of customers and suppliers, concentrations in company's assets, customers or suppliers and future sources of available funding. It should also include information on flexibility, being the ability of the organisation to adapt to the changing demands of its environment. Users require more information on management's plans for the future. These plans will be influenced by management's perspective on the volatility of the future environment and the corresponding level of flexibility that should be maintained in the enterprise. Such knowledge will assist users in their predictions and assessment of the general direction or changes in the direction of the company and is an important source of information on the opportunities and risks the company will probably face in the future.

MEANING AND FEATURES OF ACCOUNTING PRINCIPLES

For searching the goals of the accounting profession and for expanding knowledge in this field, a logical and useful set of principles and procedures are to be developed. We know that while driving our vehicles, follow a standard traffic rules. Without adhering traffic rules, there would be much chaos on the road. Similarly, some principles apply to accounting. Thus, the accounting



profession cannot reach its goals in the absence of a set rules to guide the efforts of accountants and auditors. The rules and principles of accounting are commonly referred to as the conceptual framework of accounting.

Accounting principles have been defined by the Canadian Institute of Chartered Accountants as “The body of doctrines commonly associated with the theory and procedure of accounting serving as an explanation of current practices and as a guide for the selection of conventions or procedures where alternatives exists. Rules governing the formation of accounting axioms and the principles derived from them have arisen from common experience, historical precedent statements by individuals and professional bodies and regulations of Governmental agencies”. According to Hendriksen (1997), Accounting theory may be defined as logical reasoning in the form of a set of broad principles that (i) provide a general frame of reference by which accounting practice can be evaluated, and (ii) guide the development of new practices and procedures. Theory may also be used to explain existing practices to obtain a better understanding of them. But the most important goal of accounting theory should be to provide a coherent set of logical principles that form the general frame of reference for the evaluation and development of sound accounting practices.

The American Institute of Certified Public Accountants (AICPA) has advocated the use of the word “Principle” in the sense in which it means “rule of action”. It discusses the generally accepted accounting principles as follows:

Financial statements are the product of a process in which a large volume of data about aspects of the economic activities of an enterprise are accumulated, analysed and reported. This process should be carried out in conformity with generally accepted accounting principles. These principles represent the most current consensus about how accounting information should be recorded, what information should be disclosed, how it should be disclosed, and which financial statement should be prepared. Thus, generally accepted principles and standards provide a common financial language to enable informed users to read and interpret financial statements.



Generally accepted accounting principles encompass the conventions, rules and procedures necessary to define accepted accounting practice at a particular time..... generally accepted accounting principles include not only broad guidelines of general application, but also detailed practices and procedures (Source: AICPA Statement of the Accounting Principles Board No. 4, “Basic Concepts and Accounting Principles underlying Financial Statements of Business Enterprises”).

According to ‘Dictionary of Accounting’ prepared by Prof. P.N. Abroal, “Accounting standards refer to accounting rules and procedures which are relating to measurement, valuation and disclosure prepared by such bodies as the Accounting Standards Committee (ASC) of a particular country”. Thus, we may define Accounting Principles as those rules of action or conduct which are adopted by the accountants universally while recording accounting transactions. Accounting principles are man-made. They are accepted because they are believed to be useful. The general acceptance of an accounting principle usually depends on how well it meets the following three basic norms: (a) Usefulness; (b) Objectiveness; and (c) Feasibility.

A principle is useful to the extent that it results in meaningful or relevant information to those who need to know about a certain business. In other words, an accounting rule, which does not increase the utility of the records to its readers, is not accepted as an accounting principle. A principle is objective to the extent that the information is not influenced by the personal bias or Judgement of those who furnished it. Accounting principle is said to be objective when it is solidly supported by facts. Objectivity means reliability which also means that the accuracy of the information reported can be verified. Accounting principles should be such as are practicable. A principle is feasible when it can be implemented without undue difficulty or cost. Although these three features are generally found in accounting principles, an optimum balance of three is struck in some cases for adopting a particular rule as an accounting principle. For example, the principle of making the provision for doubtful debts is found on feasibility and usefulness though it is less objective. This is because of the fact that such provisions are not supported by any outside evidence.



KINDS OF ACCOUNTING PRINCIPLES

In dealing with the framework of accounting theory, we are confronted with a serious problem arising from differences in terminology. A number of words and terms have been used by different authors to express and explain the same idea or notion. The various terms used for describing the basic ideas are: concepts, postulates, propositions, assumptions, underlying principles, fundamentals, conventions, doctrines, rules, axioms, etc. Each of these terms is capable of precise definition. But, the accounting profession has served to give them loose and overlapping meanings. One author may describe the same idea or notion as a concept and another as a convention and still another as postulate. For example, the separate business entity idea has been described by one author as a concept and by another as a convention. It is better for us not to waste our time to discuss the precise meaning of generic terms as the wide diversity in these terms can only serve to confuse the learner.

We do feel, however, that some of these terms/ideas have a better claim to be called ‘concepts’ while the rest should be called ‘conventions’. The term ‘Concept’ is used to connote the accounting postulates, i.e., necessary assumptions and ideas which are fundamental to accounting practice. In other words, fundamental accounting concepts are broad general assumptions which underline the periodic financial statements of business enterprises. The reason why some of these terms should be called concepts is that they are basic assumptions and have a direct bearing on the quality of financial accounting information. The term ‘convention’ is used to signify customs or tradition as a guide to the preparation of accounting statements. The following are the important accounting concepts and conventions:

Accounting Concepts	Accounting Conventions
Separate Business Entity Concept	Convention of Materiality



Money Measurement Concept	Convention of Conservatism
Dual Aspect Concept	Convention of consistency
Accounting Period Concept	
Cost Concept	
The Matching Concept	
Accrual Concept	
Realisation Concept	

ACCOUNTING CONCEPTS

The more important accounting concepts are briefly described as follows:

1. Separate Business Entity Concept

In accounting we make a distinction between business and the owner. All the books of accounts records day to day financial transactions from the view point of the business rather than from that of the owner. The proprietor is considered as a creditor to the extent of the capital brought in business by him. For instance, when a person invests Rs. 10 lakh into a business, it will be treated that the business has borrowed that much money from the owner and it will be shown as a 'liability' in the books of accounts of business. Similarly, if the owner of a shop were to take cash from the cash box for meeting certain personal expenditure, the accounts would show that cash had been reduced even though it does not make any difference to the owner himself. Thus, in recording a transaction the important question is how does it affects the



business? For example, if the owner puts cash into the business, he has a claim against the business for capital brought in.

In so far as a limited company is concerned, this distinction can be easily maintained because a company has a legal entity like a natural person it can engage itself in economic activities of buying, selling, producing, lending, borrowing and consuming of goods and services. However, it is difficult to show this distinction in the case of sole proprietorship and partnership. Nevertheless, accounting still maintains separation of business and owner. It may be noted that it is only for accounting purpose that partnerships and sole proprietorship are treated as separate from the owner (s), though law does not make such distinction. In fact, the business entity concept is applied to make it possible for the owners to assess the performance of their business and performance of those who manage the enterprise. The managers are responsible for the proper use of funds supplied by owners, banks and others.

2. Money Measurement Concept

In accounting, only those business transactions are recorded which can be expressed in terms of money. In other words, a fact or transaction or happening which cannot be expressed in terms of money is not recorded in the accounting books. As money is accepted not only as a medium of exchange but also as a store of value, it has a very important advantage since a number of assets and equities, which are otherwise different, can be measured and expressed in terms of a common denominator.

We must realise that this concept imposes two severe limitations. Firstly, there are several facts which though very important to the business, cannot be recorded in the books of accounts because they cannot be expressed in money terms. For example, general health condition of the Managing Director of the company, working conditions in which a worker has to work, sales policy pursued by the enterprise, quality of product introduced by the enterprise, though exert a great influence on the productivity and profitability of the enterprise, are not recorded in the books. Similarly, the fact that a strike is about to begin because employees are dissatisfied with



the poor working conditions in the factory will not be recorded even though this event is of great concern to the business. You will agree that all these have a bearing on the future profitability of the company.

Secondly, use of money implies that we assume stable or constant value of rupee. Taking this assumption means that the changes in the money value in future dates are conveniently ignored. For example, a piece of land purchased in 1990 for Rs. 2 lakh and another bought for the same amount in 1998 are recorded at the same price, although the first purchased in 1990 may be worth two times higher than the value recorded in the books because of rise in land prices. In fact, most accountants know fully well that purchasing power of rupee does change but very few recognise this fact in accounting books and make allowance for changing price level.

3. Dual Aspect Concept

Financial accounting records all the transactions and events involving financial element. Each of such transactions requires two aspects to be recorded. The recognition of these two aspects of every transaction is known as a dual aspect analysis. According to this concept every business transactions has dual effect. For example, if a firm sells goods of Rs. 5,000 this transaction involves two aspects. One aspect is the delivery of goods and the other aspect is immediate receipt of cash (in the case of cash sales). In fact, the term 'double entry' book keeping has come into vogue and in this system the total amount debited always equals the total amount credited. It follows from 'dual aspect concept' that at any point of time owners' equity and liabilities for any accounting entity will be equal to assets owned by that entity. This idea is fundamental to accounting and could be expressed as the following equalities:

$$\text{Assets} = \text{Liabilities} + \text{Owners Equity} \dots(1)$$

$$\text{Owners Equity} = \text{Assets} - \text{Liabilities} \dots(2)$$



The above relationship is known as the 'Accounting Equation'. The term 'Owners Equity' denotes the resources supplied by the owners of the entity while the term 'liabilities' denotes the claim of outside parties such as creditors, debenture-holders, bank against the assets of the business. Assets are the resources owned by a business. The total of assets will be equal to total of liabilities plus owners capital because all assets of the business are claimed by either owners or outsiders.

4. Going Concern Concept

Accounting assumes that the business entity will continue to operate for a long time in the future unless there is good evidence to the contrary. The enterprise is viewed as a going concern, that is, as continuing in operations, at least in the foreseeable future. In other words, there is neither the intention nor the necessity to liquidate the particular business venture in the predictable future. Because of this assumption, the accountant while valuing the assets does not take into account forced sale value of them. In fact, the assumption that the business is not expected to be liquidated in the foreseeable future establishes the basis for many of the valuations and allocations in accounting. For example, the accountant charges depreciation on fixed assets. It is this assumption which underlies the decision of investors to commit capital to enterprise. Only on the basis of this assumption accounting process can remain stable and achieve the objective of correctly reporting and recording on the capital invested, the efficiency of management, and the position of the enterprise as a going concern.

However, if the accountant has good reasons to believe that the business, or some part of it is going to be liquidated or that it will cease to operate (say within six-month or a year), then the resources could be reported at their current values. If this concept is not followed, International Accounting Standard requires the disclosure of the fact in the financial statements together with reasons.

5. Accounting Period Concept



This concept requires that the life of the business should be divided into appropriate segments for studying the financial results shown by the enterprise after each segment. Although the results of operations of a specific enterprise can be known precisely only after the business has ceased to operate, its assets have been sold off and liabilities paid off, the knowledge of the results periodically is also necessary. Those who are interested in the operating results of business obviously cannot wait till the end. The requirements of these parties force the businessman 'to stop' and 'see back' how things are going on. Thus, the accountant must report for the changes in the wealth of a firm for short time periods. A year is the most common interval on account of prevailing practice, tradition and government requirements. Some firms adopt financial year of the government, some other calendar year. Although a twelve month period is adopted for external reporting, a shorter span of interval, say one month or three month is applied for internal reporting purposes.

This concept poses difficulty for the process of allocation of long term costs. All the revenues and all the cost relating to the year in operation have to be taken into account while matching the earnings and the cost of those earnings for the any accounting period. This holds good irrespective of whether or not they have been received in cash or paid in cash. Despite the difficulties which stem from this concept, short term reports are of vital importance to owners, management, creditors and other interested parties. Hence, the accountants have no option but to resolve such difficulties.

6. Cost Concept

The term 'assets' denotes the resources land building, machinery etc. owned by a business. The money values that are assigned to assets are derived from the cost concept. According to this concept an asset is ordinarily entered on the accounting records at the price paid to acquire it. For example, if a business buys a plant for Rs. 5 lakh the asset would be recorded in the books at Rs. 5 lakh, even if its market value at that time happens to be Rs. 6 lakh. Thus, assets are recorded at their original purchase price and this cost is the basis for all subsequent accounting for the



business. The assets shown in the financial statements do not necessarily indicate their present market values. The term 'book value' is used for amount shown in the accounting records.

The cost concept does not mean that all assets remain on the accounting records at their original cost for all times to come. The asset may systematically be reduced in its value by charging 'depreciation', which will be discussed in detail in a subsequent lesson. Depreciation has the effect of reducing profit of each period. The prime purpose of depreciation is to allocate the cost of an asset over its useful life and not to adjust its cost. However, a balance sheet based on this concept can be very misleading as it shows assets at cost even when there are wide difference between their costs and market values. Despite this limitation you will find that the cost concept meets all the three basic norms of relevance, objectivity and feasibility.

7. The Matching concept

This concept is based on the accounting period concept. In reality we match revenues and expenses during the accounting periods. Matching is the entire process of periodic earnings measurement, often described as a process of matching expenses with revenues. In other words, income made by the enterprise during a period can be measured only when the revenue earned during a period is compared with the expenditure incurred for earning that revenue. Broadly speaking revenue is the total amount realised from the sale of goods or provision of services together with earnings from interest, dividend, and other items of income. Expenses are cost incurred in connection with the earnings of revenues. Costs incurred do not become expenses until the goods or services in question are exchanged. Cost is not synonymous with expense since expense is sacrifice made, resource consumed in relation to revenues earned during an accounting period. Only costs that have expired during an accounting period are considered as expenses. For example, if a commission is paid in January, 2002, for services enjoyed in November, 2001, that commission should be taken as the cost for services rendered in November 2001. On account of this concept, adjustments are made for all prepaid expenses, outstanding expenses, accrued income, etc, while preparing periodic reports.



8. Accrual Concept

It is generally accepted in accounting that the basis of reporting income is accrual. Accrual concept makes a distinction between the receipt of cash and the right to receive it, and the payment of cash and the legal obligation to pay it. This concept provides a guideline to the accountant as to how he should treat the cash receipts and the right related thereto. Accrual principle tries to evaluate every transaction in terms of its impact on the owner's equity. The essence of the accrual concept is that net income arises from events that change the owner's equity in a specified period and that these are not necessarily the same as change in the cash position of the business. Thus it helps in proper measurement of income.

9. Realisation Concept

Realisation is technically understood as the process of converting non-cash resources and rights into money. As accounting principle, it is used to identify precisely the amount of revenue to be recognised and the amount of expense to be matched to such revenue for the purpose of income measurement. According to realisation concept revenue is recognised when sale is made. Sale is considered to be made at the point when the property in goods passes to the buyer and he becomes legally liable to pay. This implies that revenue is generally realised when goods are delivered or services are rendered. The rationale is that delivery validates a claim against the customer. However, in case of long run construction contracts revenue is often recognised on the basis of a proportionate or partial completion method. Similarly, in case of long run instalment sales contracts, revenue is regarded as realised only in proportion to the actual cash collection. In fact, both these cases are the exceptions to the notion that an exchange is needed to justify the realisation of revenue.

ACCOUNTING CONVENTIONS

1. Convention of Materiality



Materiality concept states that items of small significance need not be given strict theoretically correct treatment. In fact, there are many events in business which are insignificant in nature. The cost of recording and showing in financial statement such events may not be well justified by the utility derived from that information. For example, an ordinary calculator costing Rs. 100 may last for ten years. However, the effort involved in allocating its cost over the ten year period is not worth the benefit that can be derived from this operation. The cost incurred on calculator may be treated as the expense of the period in which it is purchased. Similarly, when a statement of outstanding debtors is prepared for sending to top management, figures may be rounded to the nearest ten or hundred.

This convention will unnecessarily overburden an accountant with more details in case he is unable to find an objective distinction between material and immaterial events. It should be noted that an item material for one party may be immaterial for another. Actually, there are no hard and fast rules to draw the line between material and immaterial events and hence, It is a matter of judgement and common sense. Despite this limitation, It is necessary to disclose all material information to make the financial statements clear and understandable. This is required as per IAS-1 and also reiterated in IAS-5. As per IAS-1, materiality should govern the selection and application of accounting policies.

2. Convention of Conservatism

This concept requires that the accountants must follow the policy of “playing safe” while recording business transactions and events. That is why, the accountant follow the rule anticipate no profit but provide for all possible losses, while recording the business events. This rule means that an accountant should record lowest possible value for assets and revenues, and the highest possible value for liabilities and expenses. According to this concept, revenues or gains should be recognised only when they are realised in the form of cash or assets (i.e. debts) the ultimate cash realisation of which can be assessed with reasonable certainty. Further, provision must be made for all known liabilities, expenses and losses, Probable losses regarding all contingencies should



also be provided for. 'Valuing the stock in trade at market price or cost price which ever is less', 'making the provision for doubtful debts on debtors in anticipation of actual bad debts', 'adopting written down value method of depreciation as against straight line method', not providing for discount on creditors but providing for discount on debtors', are some of the examples of the application of the convention of conservatism.

The principle of conservatism may also invite criticism if not applied cautiously. For example, when the accountant create secret reserves, by creating excess provision for bad and doubtful debts, depreciation, etc. The financial statements do not present a true and fair view of state of affairs. American Institute of Certified Public Accountant have also indicated that this concept need to be applied with much more caution and care as over conservatism may result in misrepresentation.

3. Convention of Consistency

The convention of consistency requires that once a firm decided on certain accounting policies and methods and has used these for some time, it should continue to follow the same methods or procedures for all subsequent similar events and transactions unless it has a sound reason to do otherwise. In other words, accounting practices should remain unchanged from one period to another. For example, if depreciation is charged on fixed assets according to straight line method, this method should be followed year after year. Analogously, if stock is valued at 'cost or market price whichever is less', this principle should be applied in each subsequent year.

However, this principle does not forbid introduction of improved accounting techniques. If for valid reasons the company makes any departure from the method so far in use, then the effect of the change must be clearly stated in the financial statements in the year of change. The application of the principle of consistency is necessary for the purpose of comparison. One could draw valid conclusions from the comparison of data drawn from financial statements of one year with that of the other year. But the inconsistency in the application of accounting methods might significantly affect the reported data.



TYPES OF ACCOUNTING

The financial literature classifies accounting into two broad categories, viz, Financial Accounting and Management Accounting. Financial accounting is primarily concerned with the preparation of financial statements whereas management accounting covers areas such as interpretation of financial statements, cost accounting, etc. Both these types of accounting are examined in the following paragraphs.

Financial accounting

As mentioned earlier, financial accounting deals with the preparation of financial statements for the basic purpose of providing information to various interested groups like creditors, banks, shareholders, financial institutions, government, consumers, etc. Financial statements, i.e. the income statement and the balance sheet indicate the way in which the activities of the business have been conducted during a given period of time.

Financial accounting is charged with the primary responsibility of external reporting. The users of information generated by financial accounting, like bankers, financial institutions, regulatory authorities, government, investors, etc. want the accounting information to be consistent so as to facilitate comparison. Therefore, financial accounting is based on certain concepts and conventions which include separate business entity, going concern concept, money measurement concept, cost concept, dual aspect concept, accounting period concept, matching concept, realization concept and conventions of conservatism, disclosure, consistency, etc. All such concepts and conventions would be dealt with detail in subsequent lessons.

The significance of financial accounting lies in the fact that it aids the management in directing and controlling the activities of the firm and to frame relevant managerial policies related to areas like production, sales, financing, etc. However, it suffers from certain drawbacks which are discussed in the following paragraphs. ·

- The information provided by financial accounting is consolidated in nature. It does not indicate a break-up for different departments, processes, products and jobs. As such, it becomes difficult to evaluate the performance of different sub-units of the organisation.



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- Financial accounting does not help in knowing the cost behaviour as it does not distinguish between fixed and variable costs.
 - The information provided by financial accounting is historical in nature and as such the predictability of such information is limited.

The management of a company has to solve certain ticklish questions like expansion of business, making or buying a component, adding or deleting a product line, deciding on alternative methods of production, etc. The financial accounting information is of little help in answering these questions.

The limitations of financial accounting, however, should not lead one to believe that it is of no use. It is the basic foundation on which other branches and tools of accounting analysis are based. It is the source of information, which can be further analysed and interpreted according to the tailor-made requirements of decision-makers.

Management accounting

Management accounting is ‘tailor-made’ accounting. It facilitates the management by providing accounting information in such a way so that it is conducive for policy making and running the day-to-day operations of the business. Its basic purpose is to communicate the facts according to the specific needs of decision-makers by presenting the information in a systematic and meaningful manner. Management accounting, therefore, specifically helps in planning and control. It helps in setting standards and in case of variances between planned and actual performances, it helps in deciding the corrective action.

An important characteristic of management accounting is that it is forward looking. Its basic focus is one future activity to be performed and not what has already happened in the past.

Since management accounting caters to the specific decision needs, it does not rest upon any well-defined and set principles. The reports generated by a management accountant can be of any duration— short or long, depending on purpose. Further, the reports can be prepared for the organisation as a whole as well as its segments.

Cost accounting



One important variant of management accounting is the cost analysis. Cost accounting makes elaborate cost records regarding various products, operations and functions. It is the process of determining and accumulating the cost of a particular product or activity. Any product, function, job or process for which costs are determined and accumulated, are called cost centres.

The basic purpose of cost accounting is to provide a detailed breakup of cost of different departments, processes, jobs, products, sales territories, etc., so that effective cost control can be exercised.

Cost accounting also helps in making revenue decisions such as those related to pricing, product-mix, profit-volume decisions, expansion of business, replacement decisions, etc.

The objectives of cost accounting, therefore, can be summarized in the form of three important statements, viz, to determine costs, to facilitate planning and control of business activities and to supply information for short- and long-term decision. Cost accounting has certain distinct advantages over financial accounting. Some of them have been discussed succeedingly. The cost accounting system provides data about profitable and non-profitable products and activities, thus prompting corrective measures. It is easier to segregate and analyse individual cost items and to minimize losses and wastages arising from the manufacturing process. Production methods can be varied so as to minimize costs and increase profits. Cost accounting helps in making realistic pricing decisions in times of low demand, competitive conditions, technology changes, etc.

Various alternative courses of action can be properly evaluated with the help of data generated by cost accounting. It would not be an exaggeration if it is said that a cost accounting system ensures maximum utilization of physical and human resources. It checks frauds and manipulations and directs the employer and employees towards achieving the organisational goal.

Classification of Accounts

1. Personal Accounts

Accounts which are related with accounts of individuals, firms, companies are known as personal accounts. The personal accounts may further be classified into three categories:

- (i) **Natural Personal Accounts:** Accounts of individuals relating to natural persons such as Akhil's A/c, Rajesh's A/c, Sohan's A/c are natural personal accounts. (



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- (ii) Artificial Personal Accounts: Accounts of companies, institutions such as Reliance Industries Ltd; Lions Club, M/s Sham & Sons, National College account are artificial personal accounts. These exist only in the eyes of law.
- (iii) Representative Personal Accounts: The accounts which represent some person such as wage outstanding account, prepaid insurance account, accrued interest account are considered as representative personal accounts.

2. Real Accounts

Real accounts are the accounts related to assets/properties. These may be classified into tangible real account and intangible real account. The accounts relating to tangible assets such as building, plant, machinery, cash, furniture etc. are classified as tangible real accounts. Intangible real accounts are the accounts related to intangible assets such as goodwill, trademarks, copyrights, franchisees, Patents etc.

3. Nominal Accounts

The accounts relating to income, expenses, losses and gains are classified as nominal accounts. For example Wages Account, Rent Account, Interest Account, Salary Account, Bad Debts Accounts.

Double entry system

The double entry system of accounting or bookkeeping means that every business transaction will involve two accounts (or more). For example, when a company borrows money from its bank, the company's Cash account will increase and its liability account Loans Payable will increase. If a company pays Rs.200 for an advertisement, its Cash account will decrease and its account Advertising Expense will increase.

- Double entry also allows for the accounting equation (assets = liabilities + owner's equity) to always be in balance. In our example involving Advertising Expense, the accounting equation remained in balance because expenses cause owner's equity to decrease. In that example, the asset Cash decreased and the owner's capital account within owner's equity also decreased.



- A third aspect of double entry is that the amounts entered into the general ledger accounts as debits must be equal to the amounts entered as credits.

Debits and credits are numbers recorded as follows:

- Debits are recorded on the left side of a T account in a ledger. Debits increase balances in asset accounts and expense accounts and decrease balances in liability accounts, revenue accounts, and capital accounts.
- Credits are recorded on the right side of a T account in a ledger. Credits increase balances in liability accounts, revenue accounts, and capital accounts, and decrease balances in asset accounts and expense accounts.
- Debit accounts are asset and expense accounts that usually have debit balances, i.e. the total debits usually exceeds the total credits in each debit account.
- Credit accounts are revenue (income, gains) accounts and liability accounts that usually have credit balances.

Merits of Double entry system

1. Scientific

The double-entry book-keeping system is a scientific system of book-keeping. Double-entry system has its own set of principles and rules. Under those principles and rules, two aspects of every financial transaction are recorded.

2. Systematic

A systematic technique is followed in recording financial transaction in double-entry book-keeping system. It records financial transactions in a systematic and chronological order with suitable narration of the financial transaction.



3. Complete

Double-entry system is a complete system of book-keeping. It records not only each and every financial transaction, but also each aspect of the transaction.

4. Accuracy

Double-entry book-keeping system is based on the double-entry principle which means 'for every debit amount there is a corresponding credit amount'. Such a method of debit and credit can help ensure arithmetical accuracy of the recordings of financial transactions.

5. Profit Or Loss

Double-entry book-keeping system helps to ascertain the true profit or loss of a business by preparing the profit and loss account for a given period.

6. Financial Position

Double-entry book-keeping system also helps to reveal information about the financial position of the business by preparing a statement called balance sheet.

7. Control

Double-entry book-keeping system keeps a detailed record of financial transactions. Therefore, the recording of financial transactions in books provides necessary information for the purpose of costs control.

8. Decision Making

Double-entry book-keeping system communicates financial information that is necessary for taking decisions by a business. Double-entry book-keeping system also provides necessary



information to different users such as owners, managers and creditors for their decision making purposes.

RULES FOR DEBIT AND CREDIT

Type of Accounts		Rules for debit	Rules for Credit
a)	Personal Account	Debit the receiver	Credit the giver
b)	Real Account	Debit what comes in	Credit what goes out
c)	Nominal Account	Debit all expenses and losses	Credit all incomes and gains

Accounting Equation

The recording of business transaction in books of accounts is based on a fundamental equation called Accounting Equation. Whatever business possesses in the form of assets is financed by proprietor or by outsiders. This equation expresses the equality of assets on one side and the claims of outsiders (liabilities) and owners or proprietors (capital) on the other side. Thus, an Accounting Equation is a mathematical expression which shows that the assets and liabilities of a firm are equal. In Mathematical form,

$$\text{Assets} = \text{Liabilities} + \text{Capital}$$

Whenever an asset is introduced in the business, a corresponding liability also appears. A business does not have any amount of its own. Hence, we can say that Business owns Nothing, And Owes



Nothing, (In simple words it can be said that on a particular date any business does not have neither any liability nor any asset of its own)

Every business concern, generally borrows money from outsiders in order to carry on its activities. In other words, every business concern owes money to outsiders. The assets are financed by the funds supplied by proprietors and outsiders. Money borrowed from outsiders is called liability.

The fact that business receives funds from proprietors and creditors and retains all of them in the form of various assets, it can be presented in terms of an equation as

$$\text{Assets} = \text{Capital} + \text{Liabilities or } A = C + L$$

$$\text{Liabilities} = \text{Assets} - \text{Capital or } L = A - C$$

$$\text{Capital} = \text{Assets} - \text{Liabilities or } C = A - L$$

Basic accounting terminologies

- (i) **Transaction:** It means an event or a business activity which involves exchange of money or money's worth between parties. The event can be measured in terms of money and changes the financial position of a person e.g. purchase of goods would involve receiving material and making payment or creating an obligation to pay to the supplier at a future date. Transaction could be a cash transaction or credit transaction. When the parties settle the transaction immediately by making payment in cash or by cheque, it is called a cash transaction. In credit transaction, the payment is settled at a future date as per agreement between the parties.
- (ii) **Goods/Services :** These are tangible article or commodity in which a business deals. These articles or commodities are either bought and sold or produced and sold. At times, what may be classified as 'goods' to one business firm may not be 'goods' to the other firm. e.g. for a machine manufacturing company, the machines are 'goods' as they are frequently made and sold. But for the buying firm, it is not 'goods' as the intention is to



use it as a long term resource and not sell it. Services are intangible in nature which are rendered with or without the object of earning profits.

- (iii) **Profit:** The excess of Revenue Income over expense is called profit. It could be calculated for each transaction or for business as a whole.
- (iv) **Loss:** The excess of expense over income is called loss. It could be calculated for each transaction or for business as a whole.
- (v) **Asset:** Asset is a resource owned by the business with the purpose of using it for generating future profits. Assets can be Tangible and Intangible. Tangible Assets are the Capital assets which have some physical existence. They can, therefore, be seen, touched and felt, e.g. Plant and Machinery, Furniture and Fittings, Land and Buildings, Books, Computers, Vehicles, etc. The capital assets which have no physical existence and whose value is limited by the rights and anticipated benefits that possession confers upon the owner are known as Intangible Assets. They cannot be seen or felt although they help to generate revenue in future, e.g. Goodwill, Patents, Trade-marks, Copyrights, Brand Equity, Designs, Intellectual Property, etc.

Assets can also be classified into Current Assets and Non-Current Assets.

Current Assets – An asset shall be classified as Current when it satisfies any of the following :

- (a) It is expected to be realised in, or is intended for sale or consumption in the Company's normal Operating Cycle,
- (b) It is held primarily for the purpose of being traded ,
- (c) It is due to be realised within 12 months after the Reporting Date, or
- (d) It is Cash or Cash Equivalent unless it is restricted from being exchanged or used to settle a Liability for at least 12 months after the Reporting Date.

Non-Current Assets – All other Assets shall be classified as Non-Current Assets. e.g. Machinery held for long term etc.

- (vi) **Liability:** It is an obligation of financial nature to be settled at a future date. It represents amount of money that the business owes to the other parties. E.g. when goods are bought



on credit, the firm will create an obligation to pay to the supplier the price of goods on an agreed future date or when a loan is taken from bank, an obligation to pay interest and principal amount is created.

Depending upon the period of holding, these obligations could be further classified into Long Term or non-current liabilities and Short Term or current liabilities.

Current Liabilities – A liability shall be classified as Current when it satisfies any of the following :

- (a) It is expected to be settled in the Company's normal Operating Cycle,
- (b) It is held primarily for the purpose of being traded,
- (c) It is due to be settled within 12 months after the Reporting Date, or
- (d) The Company does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting date (Terms of a Liability that could, at the option of the counterparty, result in its settlement by the issue of Equity Instruments do not affect its classification)

Non-Current Liabilities – All other Liabilities shall be classified as Non-Current Liabilities. E.g. Loan taken for 5 years, Debentures issued etc.

- (vii) Internal Liability : These represent proprietor's equity, i.e. all those amount which are entitled to the proprietor, e.g., Capital, Reserves, Undistributed Profits, etc.
- (viii) Working Capital : In order to maintain flows of revenue from operation, every firm needs certain amount of current assets. For example, cash is required either to pay for expenses or to meet obligation for service received or goods purchased, etc. by a firm. On identical reason, inventories are required to provide the link between production and sale. Similarly, Accounts Receivable generate when goods are sold on credit. Cash, Bank, Debtors, Bills Receivable, Closing Stock, Prepayments etc. represent current assets of firm. The whole of these current assets form the working capital of a firm which is termed as Gross Working Capital.

Gross Working capital = Total Current Assets = Long term internal liabilities plus long term debts plus the current liabilities minus the amount blocked in the fixed assets. There is another concept of working capital. Working capital is the excess of current assets over current liabilities. That is the amount of current assets that remain in a firm if all its



current liabilities are paid. This concept of working capital is known as Net Working Capital which is a more realistic concept.

Working Capital (Net) = Current Assets – Currents Liabilities.

- (ix) **Contingent Liability** : It represents a potential obligation that could be created depending on the outcome of an event. E.g. if supplier of the business files a legal suit, it will not be treated as a liability because no obligation is created immediately. If the verdict of the case is given in favour of the supplier then only the obligation is created. Till that it is treated as a contingent liability. Please note that contingent liability is not recorded in books of account, but disclosed by way of a note to the financial statements.
- (x) **Capital** : It is amount invested in the business by its owners. It may be in the form of cash, goods, or any other asset which the proprietor or partners of business invest in the business activity. From business point of view, capital of owners is a liability which is to be settled only in the event of closure or transfer of the business. Hence, it is not classified as a normal liability. For corporate bodies, capital is normally represented as share capital.
- (xi) **Drawings** : It represents an amount of cash, goods or any other assets which the owner withdraws from business for his or her personal use. e.g. if the life insurance premium of proprietor or a partner of business is paid from the business cash, it is called drawings. Drawings will result in reduction in the owners' capital. The concept of drawing is not applicable to the corporate bodies like limited companies.
- (xii) **Net worth** : It represents excess of total assets over total liabilities of the business. Technically, this amount is available to be distributed to owners in the event of closure of the business after payment of all liabilities. That is why it is also termed as Owner's equity. A profit making business will result in increase in the owner's equity whereas losses will reduce it.
- (xiii) **Non-current Investments** : Non-current Investments are investments which are held beyond the current period as to sale or disposal. e. g. Fixed Deposit for 5 years.
- (xiv) **Current Investments** : Current investments are investments that are by their nature readily realizable and are intended to be held for not more than one year from the date on which such investment is made. e. g. 11 months Commercial Paper.



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- (xv) Debtor : The sum total or aggregate of the amounts which the customer owe to the business for purchasing goods on credit or services rendered or in respect of other contractual obligations, is known as Sundry Debtors or Trade Debtors, or Trade Payable, or Book-Debts or Debtors. In other words, Debtors are those persons from whom a business has to recover money on account of goods sold or service rendered on credit. These debtors may again be classified as under: (i) Good debts : The debts which are sure to be realized are called good debts. (ii) Doubtful Debts : The debts which may or may not be realized are called doubtful debts.
- (iii) Bad debts : The debts which cannot be realized at all are called bad debts. It must be remembered that while ascertaining the debtors balance at the end of the period certain adjustments may have to be made e.g. Bad Debts, Discount Allowed, Returns Inwards, etc.
- (xvi) Creditor : A creditor is a person to whom the business owes money or money's worth. e.g. money payable to supplier of goods or provider of service. Creditors are generally classified as Current Liabilities.
- (xvii) Capital Expenditure : This represents expenditure incurred for the purpose of acquiring a fixed asset which is intended to be used over long term for earning profits there from. e. g. amount paid to buy a computer for office use is a capital expenditure. At times expenditure may be incurred for enhancing the production capacity of the machine. This also will be a capital expenditure. Capital expenditure forms part of the Balance Sheet.
- (xviii) Revenue expenditure : This represents expenditure incurred to earn revenue of the current period. The benefits of revenue expenses get exhausted in the year of the incurrence. e.g. repairs, insurance, salary & wages to employees, travel etc. The revenue expenditure results in reduction in profit or surplus. It forms part of the Income statement.
- (xix) Balance Sheet : It is the statement of financial position of the business entity on a particular date. It lists all assets, liabilities and capital. It is important to note that this statement exhibits the state of affairs of the business as on a particular date only. It describes what the business owns and what the business owes to outsiders (this denotes liabilities) and to the owners (this denotes capital). It is prepared after incorporating the resulting profit/losses of Income statement.



Unit – II

JOURNAL

Journal is a historical record of business transaction or events. The word journal comes from the French word “Jour” meaning “day”. It is a book of original or prime entry. Journal is a primary book for recording the day to day transactions in a chronological order i.e. the order in which they occur. The journal is a form of diary for business transactions. This is called the book of first entry since every transaction is recorded firstly in the journal.

Journal Entry

Journal entry means recording the business transactions in the journal. For each transaction, a separate entry is recorded. Before recording, the transaction is analysed to determine which account is to be debited and which account is to be credited.

The performa of journal is shown as follows:

JOURNAL

Date	Particulars	L.F.	Debit (Amount)	Credit (Amount)
(1)	(2)	(3)	(4)	(5)



--	--	--	--	--

Column 1 (Date): The date of the transaction on which it takes place is written in this column.

Column 2 (Particulars): In this column, the name of the accounts to be debited is written first, then the names of the accounts to be credited and lastly, the narration (i.e. a brief explanation of transaction) are entered.

Column 3 (L.F.): L.F. stands for ledger folio which means page of the ledger. In this column are entered the page numbers on which the various accounts appear in the ledger.

Column 4 (Dr. Amount): In this column, the amount to be debited against the 'Dr.' Account is written along with the nature of currency.

Column 5 (Cr. Amount): In this column the amount to be credited against the 'Cr.' Account is written along with the nature of currency.

Advantages of Using Journal

Journal is used because of the following advantages:

- A journal contains a permanent record of all the business transactions.
- The journal provides a complete chronological (in order of the time of occurrence) history of all business transactions and the task of later tracing of some transactions is facilitated.
- A complete information relating to one single business transaction is available in one place with all its aspects.
- The transaction is provided with an explanation technically called a narration.
- Use of the journal reduces the possibility of an error when transactions are first recorded in this book.
- The journal establishes the quality of debits and credits for a transaction and reconciles any problems. If a business purchases a bicycle, it is necessary to decide whether the bicycle represents ordinary goods or machinery. Further any amount paid is debited to bicycle account and credited to cash account.
- The use of journals avoids omission or duplication of transactions or parts of transaction. Without the journal the accountant would be forced to go to the individual account to enter



debits and credits. Therefore it is possible for accountant to miss part of a transaction, duplicate all or part of a transaction or incorrectly record debits and credits. Even with the Journal, it is still possible to omit transactions and make other errors. However, the Journal reduces these problems.

- Once a transaction is recorded in the journal, it is not necessary to post it immediately in the ledger accounts. In this, way, the journal allows the delayed posting.

In connection with the journal, the following points are to be remembered:

- For each transaction, the exact accounts should be debited and credited. For that, the two accounts involved must be identified to pass a proper journal entry.
- Sometimes, a journal entry may have more than one debit or more than one credit. This type of journal entry is called compound journal entry. Regardless of how many debits or credits are contained in a compound journal entry, all the debits are entered before any credits are entered. The aggregate amount of debits should be equal to the aggregate amount of credits.
- For a business, journal entries generally extend to several pages. Therefore, the total are cast at the end of each page, against the debit and credit columns, the following words and written in the particular column, which indicates, carried forward (of the amount on the next page) “Total c/f”.

The debits and credits totals of the page are then written on the next page in the amount columns; and opposite to that on the left, the following words are written in the particulars column to indicate brought forward (of the amount of the previous page) “Total b/f”. This process is repeated on every page and on the last page, “Grand Total” is cast.

RULES FOR DEBIT AND CREDIT

Type of Accounts		Rules for debit	Rules for Credit
a)	Personal Account	Debit the receiver	Credit the giver



b)	Real Account	Debit what comes in	Credit what goes out
c)	Nominal Account	Debit all expenses and losses	Credit all incomes and gains

Illustration: How will you classify the following into personal, real and nominal accounts?

- (i) Investments
- (ii) Freehold Premises
- (iii) Accrued Interest
- (iv) Punjab Agro Industries Corporation
- (v) Janata Allied Mechanical Works
- (vi) Salary Accounts
- (vii) Loose Tools Accounts
- (viii) Purchases Account
- (ix) Indian Bank Ltd.
- (x) Capital Account
- (xi) Brokerage Account
- (xii) Toll Tax Account
- (xiii) Dividend Received Account
- (xiv) Royalty Account
- (xv) Sales Account

Solution

Real Account: (i), (ii), (vii), (viii), (xv).

Nominal Account: (vi), (ix), (xi), (xii), (xiii), (xiv)

Personal Account: (iii), (iv), (v), (x).



Procedure for Journalizing

Journalism is the process of recording journal entries in the Journal. It is a systematic act of entering the transaction in a day book in order of their occurrence i.e., date-wise or event-wise. After analysing the business transactions, the following steps in journalising are followed:

- (i) Find out what accounts are involved in business transaction.
- (ii) Ascertain what is the nature of accounts involved?
- (iii) Ascertain the golden rule of debit and credit is applicable for each of the accounts involved.
- (iv) Find out what account is to be debited which is to be credited.
- (v) Record the date of transaction in the “Date Column”.
- (vi) Write the name of the account to be debited very near to the left hand side in the ‘Particulars Column’ along with the word ‘Dr’ on the same line against the name of the account in the ‘Particulars Column’ and the amount to be debited in the ‘Debit Amount column’ against the name of the account.
- (vii) Record the name of the account to be credited in the next line preceded by the word ‘To’ at a few space towards right in the ‘Particulars Column’ and the amount to be credited in the ‘Credit Amount Column’ in front of the name of the account.
- (viii) Record narration (i.e. a brief explanation of the transaction) within brackets in the following line in ‘Particulars Column’.
- (ix) A thin line is drawn all through the particulars column to separate one Journal entry from the other and it shows that the entry of a transaction has been completed.

Illustration: Analyse the following transactions.

- (a) Ramesh started his business with cash
- (b) Borrowed from Nikhil
- (c) Purchased furniture



-
- (d) Purchased furniture from Mohan on credit
 - (e) Purchased goods for cash
 - (f) Purchased goods from Ram on credit
 - (g) Sold goods for cash
 - (h) Sold goods to Hari on credit
 - (i) Received cash from Hari
 - (j) Paid cash to Ram
 - (k) Deposited into bank
 - (l) Withdrew cash for personal use
 - (m) Withdrew from bank for office use
 - (n) Withdrew from bank for personal use
 - (o) Received cash from a customer, Shyam
 - (p) Paid salary by cheque
 - (q) Received donation in cash
 - (r) Paid to Ram by cheque
 - (s) Paid salary
 - (t) Paid rent by cheque
 - (u) Goods withdrawn for personal use
 - (v) Paid an advance to suppliers of goods
 - (w) Received an advance from customers
 - (x) Paid interest on loan
 - (y) Paid instalment of loan
 - (z) Interest allowed by bank.



Solution

ANALYSIS OF TRANSACTIONS

Transactio	Accounts Involved	Nature of accounts	How affected	Whether to be debited or credited
a)	Cash A/c	Real	Cash is coming in	Debit
	Capital A/c	Personal	Ramesh is the giver	Credit
b)	Cash A/c	Real	Cash is coming in	Debit
	Loan form Nikhil a/c	Personal	Nikhil is the giver	Credit
c)	Furniture a/c	Real	Furniture is coming in	Debit
	Cash a/c	Real	Cash is going out	Credit
d)	Furniture a/c	Real	Furniture is coming in	Debit
	Mohan a/c	Personal	Mohan is the giver	Credit
e)	Purchases a/c	Real	Goods are coming in	Debit
	Cash a/c	Real	Cash is going out	Credit
f)	Purchases a/c	Real	Goods are coming in	Debit
	Ram's a/c	Personal	Ram is the giver	Credit
g)	Cash a/c	Real	Cash is coming in	Debit
	Sales a/c	Real	Goods are going out	Credit
h)	Hari's a/c	Personal	Hari is the receiver	Debit
	Sales a/c	Real	Goods are going out	Credit
i)	Cash a/c	Real	Cash is coming in	Debit
	Hari's a/c	Personal	Hari is the giver	Credit
j)	Ram's a/c	Personal	Ram is the receiver	Debit
	Cash a/c	Real	Cash is going out	Credit
k)	Bank a/c	Personal	Bank is the receiver	Debit



	Cash a/c	Real	Cash is going out	Credit
l)	Drawings a/c	Personal	Ramesh is the receiver	Debit
	Cash a/c	Real	Cash is going out	Credit
m)	Cash a/c	Real	Cash is coming in	Debit
	Bank a/c	Personal	Bank is the giver	Credit
n)	Drawings a/c	Personal	Ramesh is the receiver	Debit
	Bank a/c	Personal	Bank is the giver	Credit
o)	Cash a/c	Real	Cash is coming in	Debit
	Shyam's a/c	Personal	Shyam is the giver	Credit
p)	Salary a/c	Nominal	Salary is an expense	Debit
	Bank a/c	Personal	Bank is the giver	Credit
q)	Cash a/c	Real	Cash is coming in	Debit
	Donation a/c	Nominal	Donation is a gain	Credit
r)	Ram's a/c	Personal	Ram is the receiver	Debit
	Bank a/c	Personal	Bank is the giver	Credit
s)	Salary a/c	Nominal	Salary is an expense	Debit
	Cash a/c	Real	Cash is going out	Credit
t)	Rent a/c	Nominal	Rent is an expense	Debit
	Bank a/c	Personal	Bank is the giver	Credit
u)	Drawings a/c	Personal	Ramesh is the receiver	Debit
	Purchases a/c	Real	Goods are going out	Credit
v)	Advance to Suppliers A/c	Personal	Suppliers are the receiver	Debit
	Cash A/c	Real	Cash is going out	Credit
w)	Cash a/c	Real	Cash is coming in	Debit
	Adv. from Customers A/c	Personal	Customers are the givers	Credit
x)	Interest on Loan A/c	Nominal	Interest on loan is an expense	Debit



	Cash a/c	Real	Cash is going out	Credit
y)	Loan a/c	Personal	Interest on loan is an expense	Debit
	Cash a/c	Real	Cash is going out	Credit
z)	Bank a/c	Personal	Bank is the receiver	Debit
	Bank Interest a/c	Nominal	Bank interest is a gain	Credit

Illustration: Prepare Journal in the books of K.K. Co. from the following transactions:

1999		Rs.	1999		Rs.
Dec 1.	Started business with a capital of	50,000	Dec. 15	Purchased goods from Ram	4,000
Dec. 6	Paid into bank	20,000	Dec. 18	Paid wages to workers	300
Dec. 8	Purchased goods for cash	4,000	Dec. 20	Recd. from Pankaj Allowed him discount Rs. 50	1,000
Dec. 9	Paid to Ram	1,980	Dec. 22	Withdrawn from bank	3,000
Dec. 9	Discount allowed by him	20	Dec. 25	Paid Ram by cheque	500
Dec. 10	Cash sales	3,000	Dec. 31	Withdrawn for personal use	200
Dec. 12	Sold to Hari for cash	2,000			

Solution

IN THE BOOKS OF K.K. CO.

Journal

Date	Particulars	L.F.	Dr. Rs	Cr. Rs.
1999 Dec 1	Cash a/c Dr. To Capital A/c (Being business started with capital)		50,000	50,000



6	Bank A/c To Cash a/c (Being cash paid into bank)	Dr.	20,000	20,000
8.	Purchase a/c To Cash a/c (Being goods purchased for cash)	Dr.	4,000	4,000
9	Ram a/c To Cash a/c To Discount received a/c (Being cash paid to Ram and discount received Rs. 20)	Dr.	2,000	1,980 20
10.	Cash A/c To sales a/c (Being goods sold for cash)	Dr.	3,000	3,000
12.	Cash a/c To Sales a/c (Being goods sold for cash)	Dr.	2,000	2,000
15	Purchases a/c To Ram a/c (Being goods purchased from ram)	Dr.	4,000	4,000
18.	Wages a/c To Cash a/c (Being Wages paid)	Dr.	300	300
20.	Cash a/c Discount allowed a/c Dr. To Pankaj a/c (Being cash received from Pankaj and allowed him	Dr.	1,000 50	1,050



	discount Rs. 50)			
22	Cash a/c Dr. To Bank a/c (Being cash withdrawn from bank)		3,000	3,000
25	Ram a/c Dr. To Bank a/c (Being paid by cheque)		500	500
31.	Drawings a/c Dr. To Cash a/c (Being withdrawn for personal use)		200	200
	Grand Total		90,050	90,050

Goods Account

Generally, the term goods include every type of property such as Land, Building, Machinery, Furniture, Cloth etc. However, in accountancy its meaning is restricted to only those articles which are purchased by a businessman with an intention to sell it. For example, if a businessman purchased typewriter, it will be goods for him if he deals in typewriter but if he deals in other business say clothes then typewriter will be asset for him and clothes will be goods.

Sub-Division of Goods Accounts

The goods account is not opened in accounting books and it is to be noted goods includes purchases, sales, sales returns, purchases return of goods. However, purchase account, sales account, sales return account and purchase return account are opened in the books of account.

Purchases Account: This is opened for goods purchased on cash and credit.



Sales Account: This account is opened for the goods sold on cash and credit.

Purchase Returns Account or Return Outward Account: This account is opened for the goods returned to suppliers.

Sales Returns Account or Return Inward Account: This account is opened for the goods returned by customers.

Opening Entry

In case of going concern at the beginning of the new year, new books of accounts are opened and the balances relating to personal and real Accounts appearing in the books at the close of the previous year are brought forward in new books. The entry for this purpose in the books is called opening entry.

The opening entry is passed by debiting all assets and crediting all liabilities including capital. If the amount of capital is not given then this can be found out with the help of the accounting equation:

$$\text{Assets} = \text{Liabilities} + \text{capital}$$

$$\text{Capital} = \text{Assets} - \text{Liabilities}$$

Illustration: On 1st April 1998, Singh's assets and liabilities stood as follows:

Assets: Cash Rs. 6,000, Bank Rs. 17,000, Stock Rs. 3,000; Bills receivable 7,000; Debtors 3,000; Building 70,000; Investments 30,000; Furniture 4,000

Liabilities: Bills payable 5000, Creditors 9000, Ram's loan 13,000

Pass on opening Journal entry.

Date	Particulars		L.F	Debit Amount	Credit Amount
1998					



April 1	Cash account	Dr.		6,000	
	Bank account	Dr.		17,000	
	Stock account	Dr.		3,000	
	Bills receivable account	Dr.		7,000	
	Debtors account	Dr.		3,000	
	Building account	Dr.		70,000	
	Investment account	Dr.		30,000	
	Furniture	Dr.		4,000	
	To Bills payable account				5,000
	To Creditor's account				9,000
	To Ram's loan account				13,000
	To Singh's capital				1,13,000
	(Being the opening balances of assets and liabilities)				
				1,40,000	1,40,000

IMPORTANT CONSIDERATIONS FOR RECORDING THE BUSINESS TRANSACTIONS

1. Trade Discount

Trade discount is usually allowed on the list price of the goods. It may be allowed by producer to wholesaler and by wholesaler to retailer for purchase of goods in large quantity. It is not recorded in the books of account and entry is made only with the net amount paid or received, for example, purchased goods of list price Rs. 8,000 at 15% trade discount from X. In this case the following entry will be passed:

Date	Particulars		L.F	Debit Amount	Credit Amount
	Purchases Account	Dr.		6,800	



	To X				6,800
(Being goods purchased at 15% trade discount Less list price)					

2. Amount paid or received in full settlement or cash discount

Cash discount is a concession allowed by seller to buyer to encourage him to make early cash payment. It is a Nominal Account. The person who allows discount, treat it as an expenses and debits is his books and it is called discount allowed and the person who receives discount, treat as an income and it is called discount received and credits in his books of account “Discount Received Account.” For example, X owes Rs. 6,000 to Y. He pays Rs. 5,950 in full settlement against the amount due. In the books of X the journal entry will be:

Date	Particulars		L.F	Debit Amount	Credit Amount
	Y	Dr.		6,000	
	To Cash account To Discount received account (Being Cash paid and discount received)				5,950 50
	In the books of Y				
	Cash account Discount allowed account To X (Being cash received and discount allowed)	Dr. Dr.		5,950 50	6,000

3. Goods distributed as free samples



Some times business distributes goods as free samples for the purpose of advertisement. In this case Advertisement Account is debited and Purchases Accounts is credited. For example, goods costing Rs. 8000 were distributed as free sample. to record this transactions following entry will be passed:

Date	Particulars		L.F	Debit Amount	Credit Amount
	Advertisement Account	Dr.		8,000	
	To Purchases Account				8,000

4. Interest on capital

Interest paid on capital is an expense. Therefore interest account should be debited. On the other hand the capital of the business is increases. So the capital account should be credited. The entry will be as follows:

Interest on Capital Account Dr.
To Capital Account

5. Interest charged on Drawings

If the interest is charged on drawings then it will be an increase in the income of business, so interest on drawings will be credited. On the other hand there will be increase in Drawings or decrease in Capital. So Drawings Account will be debited. To record this, following entry will be passed:

Drawing Account or Dr.
Capital Account Dr.
To Interest on Drawing Account

6. Depreciation charged on Fixed Assets

Depreciation is the gradual, permanent decrease in the value of an assets due to wear and tear and many other causes. Depreciation is an expense so the following entry will be passed:

Depreciation Account Dr.



To Asset Account

7. Bad Debts

Sometimes a debtor of business fails to pay the amount due from him. Reasons may be many e.g. he may become insolvent or he may die. Such irrecoverable amount is a loss to the business. To record this following entry will be passed:

Bad Debts Account Dr.
To Debtor's Account

8. Bad Debts Recovered

When any amount becomes irrecoverable from any customer or debtor his account is closed in the books. If in future any amount is recovered from him then his personal account will not be credited because that does not exist in the books. So the following entry is passed:

Cash Account Dr.
To Bad Debts Recovered Account

9. Purchase and Sale of investment

When business has some surplus money it may invest this amount in shares, debentures or other types of securities. When these securities are purchased, these are recorded at the purchase price paid. At the time of sale of investment the sale price of an investment is recorded in the books of accounts. The following entry is passed to record the purchase of investment:

Investment Account Dr.
To Cash Account

In case of sale of these securities the entry will be:

Cash Account Dr.
To Investment Account

10. Loss of Goods by Fire/Accident/theft

A business may suffer loss of goods on account of fire, theft or accident. It is a business loss and a nominal account. It also reduces the goods at cost price, and increases the loss/expenses of the business. The entry will be passed as:

Loss by fire/Accident/theft Account Dr (for loss)
Insurance Company Account Dr. (for insurance claim admitted)



To Purchases Account

11. Income Tax Paid

Income Tax paid should be debited to Capital Account or Drawings Account and credited to cash Account in case of sole proprietorship and partnership firms. The reason behind this is that income tax is a personal expense for the sole trader and partners because it is paid on income of proprietor. The entry will be as follows:

Capital Account Dr.
Drawing Account Dr.
To Cash Account

12. Bank Charges

Bank provide various services to their customers. Bank deducts some charges by debiting the account of customers. It is an expenses for the business. To record this following entry will be passed in the books of businessman/customer:

Bank Charges Account Dr.
To Bank Account

13. Drawings Account

It is a personal account of the proprietor. When the businessman withdraws cash or goods form the business for his personal/domestic use it is called as 'drawings'. Drawings reduce the capital as well as goods/cash balance of the business. The journal entry is:

Drawings Account Dr.
To Cash Account
To Purchases Account

14. Personal expenses of the proprietor

When the private expenses such as life insurances premium, income tax, home telephone bill, tuition fees of the son of the proprietor etc. are paid out of the cash or bank account of business it should be debited to the Drawing Account of the proprietor. The journal entry is:



Capital/Drawings Account Dr.

To Cash/Bank

15. Sale of Asset/Property

When the asset of a business is sold, there may occur a profit or loss on its sale. It should be noted carefully that sales account is never credited on the sale of asset. The journal entry is:

- (i) In case there is a profit on sale of Property/Assets

Cash/Bank Account Dr.

To Asset/Property Account

To Profit on sale of Asset Account

- (ii) In case of a loss on sale of asset

Cash/Bank Account Dr.

Loss on sale of Asset Account Dr.

To Asset Account

16. Amount paid or Received on behalf of customer

(i) When the business entity pays the amount on behalf of old reputed customers such as carriage in anticipation of recovering the same later on, carriage account should not be opened because carriage is not the expense of the seller. It should be debited/charged to customer's Personal account. The journal entry is:

Customer/Debtor's Account Dr.

To Cash/Bank Account

ii) When the business entity receives the amount on behalf of customers from the third party as mutually settled between the third party and the customer, the account of the third party/person making the payment should not be opened in the books of the receiving entity. The journal entry in the books of the entity is:

Cash/Bank Account Dr.



To Customer/Debtor's Account

17. Amount paid on behalf of creditors

When the creditors/supplier instructs the business entity to make payment on their behalf, the amount so paid should be debited to creditors account and liability of the business will decrease accordingly. The journal entry is:

Suppliers/Creditors Account Dr.

To Cash/Bank Account

18. The events affecting business but they do not involve any transfer/exchange of money for the time being, they would not be recorded in the financial books. Examples of them are:

(i) On 1st January 2006 placed on order to Geeta & Sons for the supply of goods worth Rs. 1,00,000.

(ii) Babanjot, a B.Com. graduate has been appointed Sales Assistant on a salary of Rs. 5,000 p.m. on Jan., 2006.

(iii) Raman, a proprietor contracted with Bahia Builders Ltd. for the renovation of the building at an estimated cost of Rs. 5,00,000.

(iv) (iv) A shop in Adalt Bazar Patiala contracted to be taken on a rent @ Rs. 4,000 pm

19. Paid wages/installation charges for erection of machinery

Wages and installation charges are the expenses of nominal nature. But for erection of machinery no separate account should be opened for such expenses because these expenses are of capital nature and it will be merged/debited to the cost of assets i.e. machinery. The journal entry is:

Machinery Account Dr.

To Cash/Bank Account

(Being wages/installation charges paid for the erection of machinery)

SUBSIDIARY BOOKS

Introduction



Business entities carry on transactions of different nature. The types of transactions depend on the nature of business and the management policy. Many transactions may be of repetitive type, that is, similar nature of transactions take place repeatedly in a business entity. Therefore, transactions can be classified and grouped conveniently according to their nature. Generally, transactions are of two types: cash and non cash transactions (credit). Cash receipts and payments can be grouped in one category and credit transactions in another category. Thus, in practice, for easy, convenient, speedy and appropriate maintenance of accounts, the main journal may be sub-divided in such a way that a separate book is used for each category or group of transactions which are repetitive and sufficiently large in number. Each subdivision of the books is a special journal and a book of primary record or a book of primary entry or subsidiary book.

Journal entries are not passed when records are made in subsidiary books. When journal is the only book of prime entry it is possible for only one book-keeper to enter transaction in it at a time. In case of business entities having large volume of transactions, one person cannot do all the recording work by himself. There is a need for sub-division of the book-keeping work leading to the sub-division of the journal into parts or subsidiary journals.

Meaning of subsidiary books

Subsidiary books are sub-divisions of journal in each of which transactions of similar nature are recorded. These are the books of prime entry. Instead of recording in one journal, the transactions are recorded in a number of prescribed books.

Types of subsidiary books

The number of subsidiary books may vary according to the requirements of each business. Based on the nature of business and the volume of transactions, the following subsidiary books are maintained:

- (i) Subsidiary book for entering cash transactions - Cash book
- (ii) Subsidiary books (special journal) for entering non-cash transactions:



-
- (a) Purchases book or purchases journal – for recording only credit purchase of goods in which the trader deals.
 - (b) Sales book or sales journal – for recording only credit sale of goods dealt in by the trader.
 - (c) Purchases returns or returns outward book – for recording return of goods purchased by the trader, for which no cash is immediately received.
 - (d) Sales returns or returns inward book – for recording the goods returned (out of previous sale) by customers for which no cash is immediately paid.
 - (e) Bills receivable book – to record bills drawn or promissory notes received.
 - (f) Bills payable book – to record bills accepted or promissory notes given.
 - (iii) Journal proper – The general journal or all purpose journal to record transactions which do not find a place in the above seven subsidiary books.

Advantages of subsidiary books

The advantages of maintaining subsidiary books can be summarised as under:

(i) Proper and systematic record of business transactions

All the business transactions are classified and grouped conveniently as cash and non cash transactions, which are further classified as credit purchases, credit sales, returns, etc. As separate books are used for each type of transactions, individual transactions are properly and systematically recorded in the subsidiary books.

(ii) Convenient posting

All the transactions of a particular nature are recorded at one place, i.e., in one of the subsidiary books. For example, all credit purchases of goods are recorded in the purchases book and all credit sales of goods are recorded in the sales book. It facilitates posting to purchases account, sales account and concerned personal accounts.

(iii) Division of work

As journal is sub-divided, the work will be sub-divided and different persons can work on different books at the same time and the work can be speedily completed.

(iv) Efficiency



The sub-division of work gives the advantage of specialisation. When the same work is done by a person repeatedly the person becomes efficient in handling it. Thus, specialisation leads to efficiency in accounting work.

(v) Helpful in decision making

Subsidiary books provide complete details about every type of transactions separately. Hence, the management can use the information as the basis for deciding its future actions. For example, information regarding sales returns from the sales returns book will enable the management to analyse the causes for sales returns and to adopt effective measures to remove deficiencies.

(vi) Prevents errors and frauds

Internal check becomes more effective as the work can be divided in such a manner that the work of one person is automatically checked by another person. With the use of internal check, the possibility of occurrence of errors or fraud may be avoided or minimised.

(vii) Availability of requisite information at a glance

When all transactions are entered in one journal, it is difficult to locate information about a particular item. When subsidiary books are maintained, details about a particular type of transaction can be obtained from subsidiary books. The maintenance of subsidiary books helps in obtaining the necessary information at a glance.

(viii) Detailed information available

As all transactions relating to a particular item are entered in a subsidiary book, it gives detailed information. It is easy to arrive at monthly or quarterly totals.

(ix) Saving in time

As there are many subsidiary books, work of entering can be done simultaneously by many persons. Thus, it saves time and accounting work can be completed quickly.

(x) Labour of posting is reduced

Labour of posting is reduced as posting is made in periodical totals to the impersonal account, for example, Purchases account.

Purchases book



Purchases book is a subsidiary book in which only credit purchases of goods are recorded. When business wants to know the information about the credit purchases of goods at a glance, the information can be made available if purchases of goods on credit are separately recorded.

Goods here mean the items in which the business entity is dealing. In other words, it is the item which is purchased for regular sales. For example, furniture will be treated as goods in the case of the firm dealing in furniture. For other firms, which are not dealing in furniture it will be an asset. Hence, while recording transactions in the purchases book, it must be ascertained whether the credit purchase is related to the item in which the firm is dealing. Purchases of assets and purchase of goods for cash are not entered in purchases book.

Format of purchases book / purchases journal

Date	Particulars (Name of the suppliers and details of goods purchased)	Invoice No.	L.F.	Amount `	
				Details	Total
(i)	(ii)	(iii)	(iv)	(v)	(vi)
Purchase A/c Dr.					

(i) Date

In the date column, the date of purchases of goods on credit is recorded.

(ii) Particulars

In this column the name of the supplier from whom goods have been purchased and details of goods purchased are given. It contains the name, quantity, quality and rate of goods purchased, trade discount and any other specification and specialties of the goods are recorded in this column.

(iii) Invoice number

Invoice is the statement prepared by the seller of goods. It contains details about the goods, its price and other expenses incurred. The invoice number is entered in this column.



(iv) **Ledger Folio (L.F.)**

The page number of the ledger in which the supplier's account appears is recorded in this column. Purchases of goods must be posted to the personal accounts of suppliers. Purchases book contains the page number of supplier's account in the ledger. It helps in posting and also in checking the records.

(v) **Amount column (Details)**

Amount column is divided into two parts, i.e., details and total. The details column is used to record the amount of various individual items purchased from a particular supplier. The amount of trade discount allowed is deducted. This column is used for adjustment of additions and subtractions.

(vi) **Total amount column (Total)**

The net amount payable to the supplier of goods is recorded in the total amount column.

Invoice

Entries in the purchases day book are made from invoices which are popularly known as bills. Invoice is a business document or bill or statement, prepared and sent by the seller to the buyer giving the details of goods sold, such as quantity, quality, price, total value, etc. Thus, the invoice is a source document of prime entry both for the buyer and the seller.

Trade discount

Trade discount is a deduction given by the supplier to the buyer on the list price or catalogue price of the goods. It is given as a trade practice or when goods are purchased in large quantities. It is shown as a deduction in the invoice. Trade discount is not recorded in the books of accounts. Only the net amount is recorded. Example: Suppose the sale of goods for Rs.10,000 was made and 10% was allowed as trade discount, the entry regarding sales will be made for Rs.9,000 (10,000 – 10 per cent of 10,000). In the same way, purchaser of goods will also record purchases as Rs.9,000).

Illustration 1

Record the following transactions in the purchases book of Shanthi Furniture Mart:



2017 March 1	Purchased from Mohan Furniture Mart, Madurai 20 chairs @ Rs. 450 each 2 tables @ RS.1,000 each Less: Trade discount @ 10%
March 6	Purchased for cash from Welcome Furniture, Vellore 2 almirahs @ Rs. 2,000 each
March 7	Bought from Ramesh & Co., Royapettah 2 stools @ Rs.500 each 10 rolling chairs @ Rs. 200 each Delivery charges and cartage Rs.150
March 20	Purchased 2 computers for office use from Anandan & Co., Adyar on credit for Rs.15,550 each
March 21	Purchased from Kamal & Co., Karaikkal 10 chairs @ Rs.750 each 15 steel cabinets @ Rs. 1,500 each Packing and delivery charges Rs. 250 Less: Trade discount @ 10%



Solution

In the books of Shanthi Furniture Mart Purchases book / Purchases journal

Date	Particulars	Invoice No.	L.F.	Amount Rs.	
				Details	Total
2017	Mohan Furniture Mart, Madurai				
March 1	20 chairs @ ` 450 each 2 tables @ ` 1,000 each Less: Trade discount @ 10%			9,000 2,000	
March 7	Ramesh & Co., Royapettah 2 stools @ ` 500 each 10 rolling chairs @ ` 200 each Add: Delivery charges and cartage			11,000 1,100 1,000 2,000	9,900
March 21	Kamal & Co., Karaikal 10 chairs @ ` 750 each 15 steel cabinets @ ` 1,500 each Less: Trade discount @ 10% Add: Packing and delivery charges Purchases A/c Dr.			3,000 150 7,500 22,500 30,000 3,000 27,000 250	3,150 27,250
					<u>40,300</u>

Notes

1. Trade discount is allowed on the purchase price of goods excluding delivery charges and cartage.
2. Delivery charges and cartage are direct expenses, chargeable from purchaser, so they are added to the amount payable.
3. Purchases on 6th March, 2017 will not be recorded in the purchases book, because it is cash purchases.
4. Purchases of computers on 20th March, 2017 and typewriter purchased on March 25th will not be recorded in the purchases book, because they are assets for the firm dealing in furniture and are for office use.



Posting from purchases book

After the transactions are recorded in the purchases book, posting them to ledger involves two steps:

Step 1: Posting to personal accounts of creditors: Every day, each entry is posted to the Purchases account’.

Step 2: Posting to purchases account: Generally, at the end of the month, the purchases book is totaled. The monthly total of purchases is posted to the debit side of purchases account by writing the words ‘To Sundry creditors A/c’.

Illustration 2

From the following transactions of Ram Home Appliances for July, 2017 prepare purchases book and ledger accounts connected with this book:

2017 July 5	Purchased on credit from Kannan & Co. 50 iron boxes @ Rs.500 each 10 grinders @ Rs. 3,000 each
July 6	Purchased for cash from Siva & Bros. 25 fans @ Rs.1,250 each
July 10	Purchased from Balan & Co. on credit 20 grinders @ Rs. 2,500 each 10 mixies @ RS. 3,000 each Trade discount 10% Delivery charges Rs. 1,000
July 20	Purchased on credit, one copier machine from Kumar for Rs. 35,000

Solution

In the books of Ram Home Appliances Purchases book

Date	Particulars	Invoice No.	L.F.	Amount`	
				Details	Total



2017		Kannan & Co.			25,000	55,000
	July 5	50 iron boxes @ ` 500			30,000	
		10 grinders @ ` 3,000				
	July 10	Balan & Co.			50,000	
		20 grinders @ ` 2,500			30,000	
		10 Mixies @ ` 3,000				
		Less: Trade discount 10%			80,000	
					8,000	
		Add: Delivery charges			72,000	73,000
					1,000	
Purchases A/c Dr.						1,28,000

Ledger Accounts

Dr. Purchases A/c

Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
2017 July 31	To Sundry creditors		1,28,000				

Dr. Kannan & Co. Account

Cr.

Date	Particulars	J.F.	Amount `	Date	Particulars	J.F.	Amount `
				2017 July 5	By Purchases A/c		55,000

Dr. Balan & Co. Account

Cr.

Date	Particulars	J.F.	Amount `	Date	Particulars	J.F.	Amount `
				2017 July 10	By Purchases A/c		73,000



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

Purchases returns book

After purchases of goods, the business unit may find that some of the goods are not upto the satisfactory level because of the following reasons:

- (a) Goods may be defective.
- (b) They might have been damaged in transit.
- (c) Quantities delivered may not agree with the invoice.
- (d) They might have been received quite late (off-season).
- (e) They might not be as per the samples or specifications.
- (f) There may be a breach of agreement.

Therefore, the buyer may return them to the suppliers.

Purchases returns book is a subsidiary book in which transactions relating to return of previously purchased goods to the suppliers, for which cash is not immediately received are recorded. Since goods are going out to the suppliers, they are also known as returns outward and the book is called as 'returns outward book or returns outward journal'. This book is prepared like purchases book and details are entered as mentioned in the format given below:

Format

Purchases returns book

Date	Particulars	L.F.	Debit Note No.	Details		Remarks
				Details	Total	
Date of return	Names of persons to whom goods are returned and the details of goods returned Purchases Returns A/c Cr.	Posting reference		Detailed calculations		

Posting from the purchases returns book



After the transactions are recorded in the purchases returns book, posting them to ledger involves two steps:

Step 1: Posting to personal accounts of creditors: Every day, each entry in purchases returns book is posted to the debit side of the respective personal account of the creditor by writing the words ‘To Purchases Returns account’.

Step 2: Posting to Purchases returns account: At the end of the month, the aggregate of the purchases returns is ascertained. It is the total purchases returns for the month and is posted to the credit side of purchases returns account by debiting ‘Sundry creditors account’.

Debit note – the source document for returns outward

A ‘debit note’ is a document, bill or statement sent to the person to whom goods are returned. This statement informs that the supplier’s account is debited to the extent of the value of goods returned. It contains the description and details of goods returned, name of the party to whom goods are returned and net value of the goods so returned with reason for return.

Illustration 3

Enter the following transactions in the purchases returns book of Hari who is dealing in automobiles and post them into the ledger.

2017 Jan. 5	Returned to Anand 5 clutch plates @ ` 200 each, not in accordance with order.
Jan. 14	Returned to Chandran 4 brake shoes @ ` 200 each and 10 rear view mirrors @ ` 350 each, due to inferior quality.

Solution

In the books of Hari



Purchases returns book

Date	Particulars	Debit Note No.	L.F.	Amount		Remarks
				Details	Total	
2017 Jan 5	Anand 5 clutch plates @ ` 200 each				1,000	Not in accordance with order Due to inferior quality
Jan 14	Chandran 4 brake shoes @ ` 200 each		800			
	10 rear view mirrors @ ` 350 each		3,500		4,300	
Purchases Returns A/c Cr.					5,300	

Ledger Accounts

Dr.				Purchases returns A/c				Cr.	
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount		
				2017 Jan 31	By Sundry creditors A/c		5,300		

Dr.				Anand Account				Cr.	
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount		
2017 Jan 5	To Purchases returns A/c		1,000						

Dr.				Chandran Account				Cr.	
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount		
2017 Jan 14	To Purchases returns A/c		4,300						

Sales book

Sales book is a subsidiary book maintained to record credit sale of goods. Goods mean the items in which the business is dealing. These are meant for regular sale. Cash sale of goods and sale of property and assets whether for cash or on credit are not recorded in the



sales book. This book is also named as sales day book, sold day book, sales journal or sale register.

The preparation of the sales book is similar to that of purchases book. The entries are made in the sales book on the basis of copies of the invoice sent to the buyer.

Format

Sales Book

Date	Particulars	L.F.	Invoice No.	Amount `	
				Details	Total
Date of sale	Name of the customers and the details of goods sold	Posting reference	Detailed calculations		Net amount of the invoice
Sales A/c Cr.					

In the date column of the sales book, the date of credit sales is recorded. Particulars column contains the name of party purchasing goods or the party to whom goods have been sold. It also shows the details of goods as regards its quantity, quality, other descriptions and the rate of trade discount allowed. In Ledger Folio (L.F.) column the page number of debtors account in the ledger is recorded for reference. The amount of various items of the goods sold is entered in the details column. Adjustments for trade discount, packing charges, etc., are made in the details column. In the total column, the net amount payable by individual customer is recorded. The total of the amount column is the total credit sales during the period.

Posting from sales book

After the transactions are recorded in the sales book, posting them to ledger involves two steps:

Step 1: Posting to personal accounts of debtors: Every day, each entry is posted to the debit side of the respective personal account of the debtor.



Step 2: Posting to Sales account: At the end of the month, the aggregate of the sales is posted to the credit side of sales account by writing the words 'By Sundry debtors A/c'.

From the transactions given below, prepare the sales book of Kumar Stationery for July 2017.

2017 July 5	Sold on credit to Saravana Traders of Sayalkudi
	10 packs of A4 sheets @ ` 250 per pack
	10 dozens of writing pads @ ` 850 per dozen
	Less : 10% trade discount for both

July 8	Sold to Raja for cash
	15 packs of A4 sheets @ ` 250 per pack
July 20	Sold to Mohan & Co. of Mudukulathur
	5 white boards @ ` 2,200 each
	10 dozens of writing pads @ ` 850 per dozen
July 23	Sold on credit to Narayanan old motor car for ` 5,000
July 28	Sold to Kumaran for cash 15 packets of marker pens @ ` 250 per packet

Solution

In the books of Kumar Stationery Sales book

Date	Particulars	Invoice No.	L. F.	Amount	
				Details `	Total `
2017 July 5	Saravana Traders, Sayalkudi 10 packs of A4 Sheets @ ` 250 per pack			2,500	
July 20	10 dozens writing pads @ ` 850			8,500	9,900



per dozen Less: 10% Trade discount Mohan & Co., Mudukulathur 5 white boards @ ` 2,200 each 10 dozens writing pads @ ` 850 per dozen					
				11,000	19,500
				1,100	
			11,000	8,500	
Sales A/c Cr.					29,400

Dr.				Sales A/c		Cr.	
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
				2017 July 31	By Sundry debtors A/c		29400

Dr.				Saravana traders A/c		Cr.	
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
2017 July 5	To Sales A/c		9,900				

Dr.				Mohan & Co. A/c		Cr.	
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
2017 July 20	To Sales A/c		19,500				

Note:

(a) Sales on 8th July and 28th July will not be recorded in the sales because they are cash sales.



(b) Sale of old motor car on 23rd July will not be recorded in the sales book, because motor car is an asset for the firm dealing in stationery.

Sales returns book

Sales returns book is a subsidiary book, in which, details of return of goods sold for which cash is not immediately paid are recorded. Just as goods may be returned to suppliers, goods may be returned by customers for the following reasons:

- (i) Defect in the goods
- (ii) Delay in the dispatch of goods to the customers
- (iii) Over-supply of goods
- (iv) Goods not being in accordance with the samples and specifications
- (v) Violation of the terms of the contract, etc.

Goods returned by the customers is known as 'returns inwards'.

This book is not concerned with the return of assets or return of goods for which cash is paid. This book is prepared just like the other day books.

Posting from sales returns book

After the transactions are recorded in the sales returns book, posting them to ledger involves two steps:

Step 1: Posting to personal accounts of debtors: Each entry in the sales returns book is posted to the credit side of the respective personal account of the debtor on daily basis by writing the words 'By Sales returns account'.

Step 2: Posting to Sales returns account: At the end of the month, the aggregate of the sales returns is posted to the debit side of sales returns account by writing the words 'To Sundry debtors A/c'.

Credit note – Source document for returns inward



A credit note is prepared by the seller and sent to the buyer when goods are returned indicating that the buyer's account is credited in respect of goods returned. Credit note is a statement prepared by a trader who receives back from his customer the goods sold. It contains details such as the description of goods returned by the buyer, quantity returned and also their value.

Format

Sales returns book

Date	Name of suppliers	L.F.	Credit Note No.	Amount `		Remarks
				Details	Total	
Date of return	Names of persons from whom goods are received back and details of goods returned	Posting reference		Detailed calculations	Net amount of the invoice	
	Sales returns a/c Dr.					

Enter the following transactions in returns inward book of Magesh a textile dealer:

2017 April 6	Returned by Shankar 30 shirts each costing Rs. 150 due to inferior quality.
April 8	Amar Tailors returned 10 T-shirts, each costing Rs. 100, on account of being not in accordance with their order.
April 21	Prema Stores returned 12 Salwar sets each costing Rs. 200, being not in accordance with

Solution

In the books of Magesh Sales returns book

Date	Particulars	L.F.	Credit Note No.	Amount		Remarks
				Details `	Total	
2017 April 6	Shankar					Due to inferior



April 8	30 Shirts @ ` 150 Amar Tailors			4,500		quality Not in accordance with the order Not in accordance with the order
April 21	10 T-Shirts @ ` 100 Prema Stores			1,000		
	12 Salwar sets @ `200 Sales Returns A/c Dr.			2,400	7,900	
					7900	

Ledger Accounts

Dr.				Sales returns A/c				Cr.			
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount				
2017 April 30	To Sundry debtors A/c		7,900								

Dr.				Shankar A/c				Cr.			
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount				
				2017 April 6	By Sales returns A/c		4,500				

Dr.				Amar Tailors A/c				Cr.			
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount				
				2017 April 8	By Sales returns A/c		1,000				

Dr.				Prema Stores A/c				Cr.			
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount				
				2017 April 21	By Sales returns A/c		2,400				



Illustration 6

Record the following transactions of Vijay Electrical & Co., in the purchases book, purchases returns book, sales book and sales returns book.

2017

- Jan 1 Purchased on credit from Preethi & Co.,
25 table fans @ ` 1,400 each
10 fans @ ` 2,000 each
Add: Auto charges @ ` 100
- Jan 5 Sold on credit to Sheela & co.,
10 electric iron box @ ` 1,250 each
20 electric stoves @ ` 450 each
Less: 10% Trade discount
- Jan 10 Purchased for cash from Brinda & Co.,
10 electric stoves @ ` 1,300 each
- Jan 18 Returned to Preethi & Co.,
5 table fans being defective for which cash is not received
- Jan 20 Purchased from Sathya & Co.,
10 fans @ ` 1,200 each
Less: Trade discount 5%
- Jan 21 Sheela & Co., returned 3 electric iron boxes as defective for which cash is not paid
- Jan 23 Purchased from Elizabeth & Co., 10 water purifiers @ ` 4,700 each on credit
- Jan 25 Sold on credit to M/s. Bhavani & Co., 7 fans @ ` 1,450 each
- Jan 27 Returned to Sathya & Co., 2 damaged fans for which cash is not received



Solution

In the books of Vijay Electrical & Co. Purchases Book

Date	Particulars	In voic e No .	L.F.	Amount `	
				Details	Total
2017 Jan. 1	Preethi & Co. 25 table fans @ ` 1400 each 10 fans @ ` 2,000 each Add: Auto charges			35,000 20,000	
				55,000 100	55,100
Jan. 20	Sathya & Co. 10 fans @ ` 1,200 each			12,000 600	11,400
Jan. 23	Less: Trade discount (5%) Elizabeth & Co 10 water purifiers @ ` 4,700 each Purchases A/c Dr.				47,000 1,13,500

Sales Book

Date	Particulars	Invoic e No.	L.F.	Amount	
				Details	Total
2017 Jan. 5	Sheela & Co. 10 electric iron boxes @ ` 1,250 each 20 electric stoves @ ` 450 each Less: Trade discount (10%)			12,500 9,000 ----- 21,500	



				2,150	
				-----	19,350
Jan. 25	M/s. Bhavani & Co. 7 fans @ ` 1,450 each				10,150
Sales A/c Cr.					29,500

Purchases Returns Book

Date	Particulars	Debit Note No.	L.F.	Amount		Remarks
				Details	Total	
2017					7,000	
Jan. 18	Preethi & Co. 5 table fans @ ` 1,400 each				2,280	Being defective Damaged fans
Jan. 27	Sathya & Co. 2 fans @ ` 1,140 each (List Price – Trade discount) (1,200 – 60)					
Purchase Returns A/c Cr.						9,280

Sales Returns Book

Date	Particulars	Debit Note No.	L.F.	Amount		Remarks
				Details	Total	



2017 Jan. 21	Sheela & Co. 3 electric Iron boxes @ ` 1,125 each (List Price – Trade discount) (1,250 – 125)				3,375	Being defective
	Sales Returns A/c Dr.				3,375	

Meaning of cash book

Cash book is the book in which only cash transactions are recorded in the chronological order. The cash book is the book of original entry or prime entry as cash transactions are recorded for the first time in it. Cash transactions here may include bank transactions also. Cash receipts are recorded on the debit side while cash payments are recorded on the credit side.

Cash Book – A subsidiary book and principal book of accounts

All the cash transactions are recorded first in the cash book. It is therefore a subsidiary book. When cash book is maintained, there is no need for preparing cash account and bank account in the ledger because in the cash book cash receipts and cash payments are compared and the cash and bank balances at the end are arrived at. Thus, it serves as a ledger account also. Hence, the cash book, unlike any other subsidiary book, is both a subsidiary book and a principal book.

Importance of cash book

Importance of cash book is discussed below:

(i) Serves as both journal and ledger



When cash book is maintained, it is not necessary to open a separate cash account in the ledger. Thus, cash book serves the purpose of a journal and a ledger.

(ii) Saves time and labour

When cash transactions are recorded through journal entries, a lot of time and labour will be involved. To avoid this, all cash transactions are straightaway recorded in the cash book, which saves time and labour.

(iii) Shows the cash and bank balance

It helps to know the cash and bank balance at any point of time by comparing the total cash receipts and cash payments.

(iv) Benefit of division of labour

As cash book is a separate subsidiary book, an independent person can maintain it. Hence, business can get the benefit of division of labour.

(v) Effective cash management

Cash book provides all information regarding total receipts and payments of the business concern during a particular period. It helps in formulating effective policy for cash management.

(vi) Prevents errors and frauds

Balance as per cash book and the balance in the cash box can be compared daily. If there is any deficit or surplus, it can be found easily. It helps in preventing any fraud or error in cash dealings.

Types of cash book

The main cash book may be of various types and following are the three most common types.

- (i) Simple or single column cash book (only cash column)
- (ii) Cash book with cash and discount column (double column cash book)
- (iii) Cash book with cash, discount and bank columns (three column cash book).



Apart from the main cash book, petty cash book may also be prepared to enter the petty expenses, i.e., expenses involving small amount.

Single column cash book

Single column cash book or simple cash book, like a ledger account has only one amount column, i.e., cash column on each side. Only cash transactions are recorded in this book. All cash receipts and payments are recorded systematically in this book.

The format of simple cash book is given as under:

Dr.					Simple Cash Book				
Cr.									
Date	Receipts	R.N.	L.F.	Amount	Date	Payments	V.N	L.F.	Amount
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)

The format of simple cash book shows that it has been divided into two parts. The left hand side is 'Debit' which represents all cash receipts and the right hand side is 'Credit', showing all cash payments.

Columns (1) and (6) – Date: Date of receiving cash is recorded in the debit side and date of paying cash is recorded in the credit side.

Column (2) Receipts: Receipts column shows name of persons or parties from whom cash has been received, income received, sale of asset like plant, cash sales and other receipts.

Column (3) Receipt Number (R.N.): This column contains the serial numbers of the cash receipts.



Columns (4) and (9) – Ledger Folio (L.F.): This column is provided both on the debit and credit side of the cash book. It is used for reference. The Ledger page number of every account in the cash book is recorded in this column. This column facilitates vouching and verification of transactions recorded.

Columns (5) and (10) – Amount: This is the last column of the cash book on both the debit and credit sides. In case of cash receipt, the amount of actual cash receipts and in case of payments, the amount of actual cash payment is recorded. The opening balance of cash is recorded on the debit side and the closing balance is the balancing figure on the credit side. Opening balance or capital contributed by cash in case of new business is the first item on the debit side and the closing balance is the last item on the credit side.

The word ‘To’ is conventionally used before different accounts at the debit side of cash book in particulars column. The word ‘By’ is used before the different accounts at the credit side of the cash book in particulars column.

Column (7) Payments: The accounts to which payments are made are recorded here such as names of persons to whom payment has been made, expenses paid, assets purchased, cash purchases, etc.

Column (8) Voucher Number (V.N.): This column contains the serial number of the voucher towards which payment is made.

Balancing of single column cash book

Since the cash book serves as cash account, it must be balanced regularly. The balancing procedure is the same like any other ledger account. It must be remembered that one cannot pay more cash than what one has received. Therefore, the total of receipts is always more than (or at least equal to, but never less than) the credit total (payments) and the cash book always shows a debit balance (or nil balance, but never credit balance).

Illustration 1



Enter the following transactions in a simple cash book of Kunal:

2017 Jan.		Rs.
1	Cash in hand	11,200
5	Received from Ramesh	300
7	Paid rent	30
8	Sold goods for cash	300
10	Paid Mohan	700
27	Purchased furniture for cash	200
31	Paid salaries	100

Solution

In the books of Kunal

Dr. **Cash Book (Single column)** **Cr.**

Date	Receipts	L. F.	Amount	Date	Payments	L.F.	Amount
2017 Jan 1	To Balance b/d		11,200	2017 Jan 7	By Rent A/c		30
5	To Ramesh A/c		300	10	By Mohan A/c		700
8	To Sales A/c		300	27	By Furniture A/c		200
				31	By Salaries A/c		100
				31	By Balance c/d		10,770
			11,800				11,800



Feb 1	To Balance b/d	10,770		
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Explanation

Jan 1: Cash in hand is the opening balance with the firm. This would have been the closing balance on 31st December, 2017. Cash account always has debit balance so it has been shown in the debit side of the cash book.

Jan 5: It is a receipt from Ramesh, so it has been recorded in receipt side (debit side) of the cash book.

Jan 7: Payment of rent will decrease cash, so it has been recorded in payment side (credit side) of the cash book.

Jan 8: Cash sales of goods will bring cash and increases the cash balance, so it has been recorded in the debit side of the cash book.

Jan 10: Payment to Mohan decreases cash, so it has been recorded in the credit side.

Jan 27: Purchase of furniture for cash reduces cash, so it has been recorded in credit side.

Jan 31: Payment of salaries in cash reduces cash, so it has been recorded in the credit side of cash book.

Illustration 2

Enter the following transactions in a single column cash book of Pradeep for April, 2017

April		Rs.
1	Commenced business with cash	27,000
5	Bought goods for cash	6,000
10	Goods sold for cash	11,000



13	Paid into bank	5,000
14	Goods sold to Sangeetha for cash	9,000
17	Goods purchased from Preethi on credit	13,000
21	Purchased stationery by cash	200
25	Paid Murugan by cash	14,000
26	Commission paid by cash	700
29	Drew from bank for office use	4,000
30	Rent paid by cheque	3,000

Solution

In the books of Pradeep

Dr.				Cr.			
Cash Book (Single column)							
Date	Receipts	L.F.	Amount	Date	Payments	L.F.	Amount
2017			27,000	2017	By Purchases A/c		6,000
April 1			11,000	April 5	By Bank A/c		5,000
10	To Pradeep's		9,000	13	By Stationery A/c		200
14	capital A/c		4,000	21	By Murugan A/c		14,000
29	To Sales A/c			25	By Commission A/c		700
	To Sales A/c			26	By Balance c/d		25,100
	To Bank A/c			30			
			51,000				51,000
May 1	To Balance b/d		25,100				

Note: The transaction dated April 17th will not be recorded in the cash book as it is a credit transaction. The transaction on 30th is not recorded as the payment is made through bank which does not involve cash.

Posting from single column cash book

Since cash book serves as 'journal' as well as 'ledger account', there is no need for preparing separate cash account and posting thereto. But entering cash transactions in cash book means recording only cash aspect of each transaction. The other aspect of the



transaction remains to be posted. When the related accounts are posted, the double entry will be completed. The procedure for posting is:

- Credit the accounts mentioned on the receipts (or) debit side by entering 'By Cash account' and
- Debit the accounts mentioned on the payment (or) credit side by entering 'To Cash account'.

For example, for illustration 2, posting is made to sales account and purchases account as follows:

Dr.				Sales				Cr.			
Date	Particulars	L.F.	Amount `	Date	Particulars	L.F.	Amount `				
2017 April				2017 April 10 14	By Cash A/c By Cash A/c		11,000 9,000				

Dr.				Purchases A/c				Cr.			
Date	Particulars	L.F.	Amount `	Date	Particulars	L.F.	Amount `				
2017 April 5	To Cash A/c		6,000	2017 April							



Unit – III

Ledger

Introduction

Ledger account is a summary statement of all the transactions relating to a person, asset, liability, expense or income which has taken place during a given period of time and it shows their net effect. From the transactions recorded in the journal, the ledger account is prepared. Ledger is known as principal book of accounts. It is a book which contains all sets of accounts, namely, personal, real and nominal accounts. Account wise balance can be determined from the ledger. The ledger accounts are prepared based on journal entries passed.

The balances in the ledger accounts show the net effect of transactions during a particular period in various accounts. The personal accounts give the net amount due to creditors and the net amount due from debtors, real accounts show the values of assets and nominal accounts show incomes and expenses. The financial statements can be prepared from the ledger balances.

Ledger may be maintained in the business enterprises in the form of a bound register or in the form of loose sheets with spiral binding. Normally one page or one sheet may be provided for one account. An index is provided in the beginning of the ledger giving details of the accounts contained in it such as specific code for each account, page number, etc. Where computerised accounting is followed, once the transactions are recorded in the journal, ledger accounts are automatically prepared.

Utilities of ledger

Following are the utilities of ledger:

(i) Quick information about a particular account



Ledger account helps to get all information about a particular account like sales, purchases, machinery, etc., at a glance. For example, where there are several transactions with a debtor, the net amount due from a debtor can be known from the ledger account.

(ii) Control over business transactions

From the ledger balances extracted, a thorough analysis of account balances can be made which helps to have control over the business transactions.

(iii) Trial balance can be prepared

With the balances of ledger accounts, trial balance can be prepared to check the arithmetical accuracy of entries made in the journal and ledger.

(iv) Helps to prepare financial statements

From the ledger balances extracted, financial statements can be prepared for ascertaining net profit or loss and the financial position.

Format of ledger account

The ledger account is prepared in T format. It is divided into two parts. Left side is debit side and right side is credit side. Each side contains four columns. The name or title of the account is placed at the top middle and the details are entered in the ledger. The format of ledger account is given below:

Dr.		Name of the ledger account				Cr.	
Date	Particulars	J.F.	Amount`	Date	Particulars	J.F.	Amount`

Following are the details contained in the various columns in the ledger:

Date : Date of the transaction is recorded in this column.

Particulars : The account debited or credited is recorded in this column. On the debit side, the entries are made starting with 'To' and on the credit side, entries are made starting with 'By'.



Journal Folio (J.F.): In this column, the page number of the journal or subsidiary books from which the entry has been posted to the ledger is noted.

Amount : The amount of the transaction is recorded in this column.

Distinction between journal and ledger

Following are the differences between journal and ledger:

Basis	Journal	Ledger
1. Recording	As and when transactions take place entries are made in journal.	In ledger, entries may be posted either on the same day or at the end of a specified period such as weekly or fortnightly especially when subsidiary books are maintained.
2. Stage of recording	Recording in the journal is the first stage	Recording in the ledger is the second stage, which is done on the basis of entries made in the journal.
3. Order of recording	Entries are made in the chronological order, i.e., datewise in the order of occurrence.	Entries are made accountwise.
4. Process	The process of recording in journal is called journalising	The process of recording in the ledger is called posting.
5. Facilitating preparation of trial balance	Amount from the journal does not serve as the basis for preparing trial balance.	Ledger balances serve as the basis for preparing trial balance.



6. Basis of entries	Entries in the journal are made on the basis of source documents.	Posting is done in ledger on the basis of journal entries.
7. Net position	Net position of an account cannot be ascertained from journal.	Net position of an account can be ascertained from ledger account.

Procedure for posting

The process of transferring the debit and credit items from the journal to the ledger accounts is called posting. The procedure of posting from journal to ledger is as follows:

- (a) Locate the ledger account that is debited in the journal entry. Open the respective account in the ledger, if already not opened. Write the name of the account in the top middle. If already opened, locate the account from the ledger index. Now entries are to be made on the debit side of the account.
- (b) Record the date of the transaction in the date column on the debit side of that account.
- (c) Record the name of the account credited in the journal with the prefix 'To' in particulars column.
- (d) Record the amount of the debit in the 'amount column'.
- (e) Locate the ledger account that is credited in the journal entry. Open the respective account in the ledger, if already not opened. Write the name of the account in the top middle. If already opened, locate the account from the ledger index. Now entries are to be made on the credit side of the account. Record the date of the transaction in the date column. Record the name of the account debited in the journal entry in the particulars column with the prefix 'By' and write the amount in the amount column.

Illustration 1

Pass journal entries for the following transactions and post them in the ledger accounts.

2017



- June 1 Basu started business with cash Rs.50,000
 4 Purchased furniture by paying cash for Rs. 6,000
 7 Purchased machinery on credit from Harish Rs. 10,000
 10 Bought goods for cash Rs. 4,000
 18 Paid insurance premium Rs.100

Solution

In the books of Basu

Journal entries

Date	Particulars	L.F.	Debit Rs.	Credit Rs.
2017 June 1	Cash A/c Dr. To Basu's capital A/c (Started business with cash)		50,000	50,000
4	Furniture A/c Dr. To Cash A/c (Furniture bought for cash)		6,000	6,000
7	Machinery A/c Dr. To Harish A/c (Machinery bought on credit from Harish)		10,000	10,000
10	Purchases A/c Dr. To Cash A/c (Goods bought for cash)		4,000	4,000
18	Insurance premium A/c Dr. To Cash A/c (Insurance premium paid)		100	100

Ledger accounts

Dr.

Cash account

Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2017 June 1	To Basu's capital A/c		50,000	2017 June 4	By Furniture A/c		6,000 4,000



				10	By Purchases A/c		100
				18	By Insurance premium A/c		

Dr. Basu's Capital account Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
				2017 June 1	By Cash A/c		50,000

Dr. Furniture account Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2017 June 4	To Cash A/c		6,000				

Dr. Machinery account Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2017 June 7	To Harish A/c		10,000				

Dr. Harish account Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
				2017 June 7	By Machinery A/c		10,000

Dr. Purchases account Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2017 June 10	To Cash A/c		4,000				

Dr. Insurance premium account Cr.



Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2017 June 18	To Cash A/c		100				

Posting of opening journal entry

In case of existing business enterprises, opening entry is made at the beginning of the accounting period to bring into account the balances of accounts which were not closed in the preceding accounting period. The accounts not closed are capital, liabilities and assets appearing in the balance sheet of the previous year. The entry passed is as follows:

Assets A/c (individually) Dr. xxx
 To Liabilities A/c (individually) xxx
 To Capital A/c xxx

While posting the opening entry in the individual ledgers, the term balance brought down (balance b/d) is used. The steps involved in posting the opening entry are as follows:

Step 1: The items debited in the opening entry are entered on the debit side of respective accounts. The words 'To Balance b/d' are written in the particulars column with respective amounts in the amount column, date being the first day of the accounting period.

Step 2: The items credited in the opening entry are entered on the credit side of respective accounts. The words 'By Balance b/d' are written in the particulars column with respective amounts in the amount column, date being the first day of the accounting period.

Illustration 2

Prepare necessary ledger accounts in the books of Joy from the following opening entry:

In the books of Joy

Journal entries

Date	Particulars	L.F.	Debit `	Credit `
2017	Cash A/c Dr.		45,000	



Jan 1	Stock A/c Dr.		50,000	
	Sohan A/c Dr.		35,000	
	Furniture A/c Dr.		50,000	
	To Ram A/c			20,000
	To Joy's capital A/c			1,60,000
	(Balances of assets and liabilities brought forward)			

Solution
Ledger accounts

Dr.		Cash account				Cr.	
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2017 Jan 1	To Balance b/d		45,000				

Dr.		Stock account				Cr.	
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2017 Jan 1	To Balance b/d		50,000				

Dr.		Sohan account				Cr.	
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2017 Jan 1	To Balance b/d		35,000				

Dr.		Furniture account				Cr.	
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Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2017 Jan 1	To Balance b/d		50,000				

Dr.				Cr.			
Ram account							
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
				2017 Jan 1	To Balance b/d		20,000

Dr.				Cr.			
Joy's Capital account							
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
				2017 Jan 1	To Balance b/d		1,60,000

Posting of compound journal entry

When a journal entry has more than one debit or more than one credit or both, it is called a compound entry. For items debited in the compound entry, entries are made on the debit side in the respective accounts with the respective amount debited. For items credited in the compound entry, entries are made on the credit side in the respective accounts with the respective amount credited. Posting of such entries to ledger accounts is explained in illustration 3.

Illustration 3

Journalise the following transactions and post them to ledger. On May 20, 2018, Ram paid salaries ₹ 15,000; Electricity charges Rs. 8,000 and wages Rs. 2,000.

Solution

In the books of Ram Journal entries



Date	Particulars	L.F.	Debit Rs.	Credit Rs.
2018	Salaries A/c Dr.		15,000	
May 20	Electricity charges A/c Dr.		8,000	
	Wages A/c Dr.		2,000	
	To Cash A/c			25,000
	(Expenses paid)			

Ledger accounts

Dr.				Cr.			
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2018	To Cash A/c		15,000				
May 20							

Dr.				Cr.			
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2018	To Cash A/c		8,000				
May 20							

Dr.				Cr.			
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2018	To Cash A/c		2,000				
May 20							

Dr.				Cr.			
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
				2018	By Salaries A/c		15,000
				May 20	By Electricity charges A/c		8,000
					By Wages A/c		2,000

Balancing of ledger accounts

After posting the transactions, the business person is interested to know the position of various accounts. For this purpose, the accounts are balanced at the end of the accounting



period or after a certain period to ascertain the net balance in each account. Balancing means that the debit side and credit side amounts are totalled and the difference between the total of the two sides is placed in the amount column as 'Balance c/d' on the side having lesser total, so that the total of both debit and credit columns are equal.

When the total of the debit side is more than the total of credit side the difference is debit balance and is placed on the credit side as 'By Balance c/d'. If the credit side total is more than the total of debit side, the difference is credit balance and is placed on the debit side as 'To Balance c/d'.

Procedure for balancing an account

Following is the procedure for balancing an account:

- (i) The debit and credit columns of an account are to be totaled separately.
- (ii) The difference between the two totals is to be ascertained.
- (iii) The difference is to be placed in the amount column of the side having lesser total. 'Balance c/d' is to be entered in the particulars column against the difference and in the date column the last day of the accounting period is entered.
- (iv) Now both the debit and credit columns are to be totalled and the totals will be equal. The totals of both sides are to be recorded in the same line horizontally. The total is to be distinguished from other figures by drawing lines above and below the amount.
- (v) The difference has to be brought down to the opposite side below the total. 'Balance b/d' is to be entered in the particulars column against the difference brought down and in the date column, the first day of the next accounting period is entered.
- (vi) If the total on the debit side of an account is higher, the balancing figure is debit balance and if the credit side of an account has higher total, the balancing figure is credit balance. If the two sides are equal, that account will show nil balance.

The rules for determining the balance is as follows:

Total of debit	>	Total of credit	=	Debit balance (By balance c/d and To balance b/d)
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Total of credit	>	Total of debit	=	Credit balance (To balance c/d and By balance b/d)
Total of debit	=	Total of credit	=	Nil balance

It may be noted that totaling of a ledger account is known as casting. At the time of balancing an account, debit balance is the balancing figure on the credit side and credit balance is the balancing figure on the debit side. This balance is known as closing balance. The closing balance of an accounting period is the opening balance of the next accounting period.

Note

- (i) Cash account cannot have a credit balance
- (ii) Balances in real accounts and personal accounts are carried forward to the next accounting year.
- (iii) Balances in the nominal accounts are not carried forward to next accounting year. They are closed by transferring to trading and profit and loss account.
- (iv) Instead of the abbreviations c/d and b/d the abbreviations c/o and b/o (carried over and brought over) may be recorded if the balance is taken to the next successive page. If the balance is taken to a different non-successive page the abbreviation c/f and b/f (carried forward and brought forward) may be used.

Illustration 4

Thmizhanban started book selling business on 1st January, 2018. Following are the transactions took place in his business for the month of January, 2018. Pass journal entries and prepare ledger accounts.

2018

Jan. 1 Started business with cash Rs.3,00,000



2 Opened bank account by depositing Rs.2,00,000

5 Goods bought from Tamilnadu Textbook Corporation for cash Rs. 10,000

15 Sold goods to MM Traders for cash Rs. 5,000

22 Purchased goods from X and Co. for Rs. 15,000 and the payment is made through net banking.

25 Sold goods to Y and Co. for Rs. 30,000 and the payment is received through NEFT

Solution

In the books of Thamizhanban

Journal entries

Date	Particulars	L.F.	Debit Rs.	Credit Rs.
2018 Jan. 1	Cash A/c Dr. To Thamizhanban's capital A/c (Started business with cash)		3,00,000	3,00,000
2	Bank A/c Dr. To Cash A/c (Cash deposited with the bank)		2,00,000	2,00,000
5	Purchases A/c Dr. To Cash A/c (Goods purchased for cash)		10,000	10,000
15	Cash A/c Dr. To Sales A/c (Goods sold for cash)		5,000	5,000
22	Purchases A/c Dr. To Bank A/c		15,000	15,000



	(Goods purchased and payment made through net banking)			
25	Bank A/c Dr. To Sales A/c (Goods sold and the payment is received through NEFT)		30,000	30,000

Dr.				Cr.			
Cash account							
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2018 Jan. 1 15	To Thamizhanban's capital A/c To Sales A/c		3,00,000 5,000 <hr/> 3,05,000	2018 Jan. 2 5 31	By Bank A/c By Purchases A/c By Balance c/d		2,00,000 10,000 <hr/> 95,000 <hr/> 3,05,000
Feb. 1	To Balance b/d		95,000				

Dr.				Cr.			
Thamizhanban's capital account							
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2018 Jan. 31	To Balance c/d		3,00,000 <hr/> 3,00,000	2018 Jan. 1	By Cash A/c		3,00,000 <hr/> 3,00,000
				Feb. 1	By Balance b/d		3,00,000

Dr.				Cr.			
Bank account							
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2018 Jan. 2	To Cash A/c		2,00,000	2018 Jan. 22	By Purchases A/c		15,000



25	To Sales A/c		30,000	31	By Balance c/d		2,15,000
			2,30,000				2,30,000
Feb. 1	To Balance b/d		2,15,000				

Dr.				Purchases account				Cr.			
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.				
2018 Jan. 5 22	To Cash A/c To Bank A/c		10,000 15,000	2018 Jan. 31	By Balance c/d		25,000				
			25,000				25,000				
Feb. 1	To Balance b/d		25,000								

Dr.				Sales account				Cr.			
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.				
2018 Jan. 31	To Balance c/d		35,000	2018 Jan. 15 25	By Cash a/c By Bank a/c		5,000 30,000				
			35,000				35,000				
				Feb. 1	To Balance b/d		35,000				

Illustration 6

The following are the transactions of Kumaran, dealing in stationery items. Prepare ledger accounts.

2017



June 5 Started business with cash Rs.2,00,000

8 Opened bank account by depositing Rs. 80,000

12 Bought goods on credit from Sri Ram for Rs.30,000

15 Sold goods on credit to Selva for Rs.10,000

22 Goods sold for cash Rs. 15,000

25 Paid Sri Ram Rs. 30,000 through NEFT

28 Received a cheque from Selva and deposited the same in bank Rs.10,000

Solution

Ledger accounts

Dr.				Cash account				Cr.
Date	Particulars	J.F.	Amount	Date	Particulars	J. F.	Amount `	
2017				2017				
June 5	To Kumaran's capital A/c		2,00,000	June 8	By Bank A/c		80,000	
22	To Sales A/c		15,000	25	By Balance c/d		1,35,000	
			<u>2,15,000</u>				<u>2,15,000</u>	
July 1	To Balance b/d		1,35,000					

Dr.				Kumaran's Capital account				Cr.
Date	Particulars	J.F.	Amount	Date	Particulars	J. F.	Amount `	
2017				2017				
June 30	To Balance b/d		2,00,000	June 5	By Cash A/c		2,00,000	
			<u>2,00,000</u>				<u>2,00,000</u>	



				July 1	By Balance b/d		2,00,000
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Dr.				Bank account				Cr.			
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.				
2017 June 8	To Cash A/c		80,000	2017 June 25	By Sri Ram A/c		30,000				
28	To Selva A/c		10,000	30	By Balance c/d		60,000				
			<u>90,000</u>				<u>90,000</u>				
July 1	Balance b/d		60,000								

Dr.				Purchases account				Cr.			
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.				
2017 June 12	To Sri Ram A/c		30,000	2017 June 30	By Balance c/d		30,000				
			<u>30,000</u>				<u>30,000</u>				
July 1	To Balance b/d		30,000								

Dr.				Sri Ram account				Cr.			
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.				
2017 June 25	To Bank A/c		30,000	2017 June 12	By Purchases A/c		30,000				
			<u>30,000</u>				<u>30,000</u>				

Dr.				Selva account				Cr.			
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.				
2017 June 15	To Sales A/c		10,000	2017 June 28	By Bank A/c		10,000				
			<u>10,000</u>				<u>10,000</u>				

Dr. **Selva account** **Cr.**



Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2017 June 30	To Balance c/d		25,000	2017 June 15	By Selva A/c		10,000
				22	By Cash a/c		15,000
			<u>25,000</u>				<u>25,000</u>
				July 1	By Balance b/d		25,000

After posting the journal entries to ledger accounts and extracting the balance of ledger accounts, the trial balance is prepared. Trial balance is a statement which shows debit and credit balances of all accounts in the ledger. It helps to test the arithmetical accuracy of entries made in the journal and ledger.



Unit – IV

Trial Balance

Introduction

Trial balance is a statement containing the debit and credit balances of all ledger accounts on a particular date. It is arranged in the form of debit and credit columns placed side by side and prepared with the object of checking the arithmetical accuracy of entries made in the books of accounts and to facilitate preparation of financial statements.

The fundamental principle of the double-entry system of book-keeping is that every debit has a corresponding and equal credit and vice-versa. Therefore, the total of the debit balances must be equal to the total of the credit balances. When such an agreement between the total of all debit balances and the total of all credit balances takes place, it offers an immediate and apparent proof of arithmetical accuracy of the book-keeping work on a particular day. At the same time, it should not be taken as the conclusive proof of arithmetical accuracy as certain errors such as error of principle, compensating errors and complete omission of a transaction are not disclosed by the trial balance.

Though the trial balance can be prepared on any day (at the end of the month, quarter, etc.), it is normally prepared at the end of the accounting period.

The preparation of trial balance is the third step in the accounting process. The first step is recording the business transactions in subsidiary books or journal. The second step is preparing ledger accounts on the basis of subsidiary books or journal.

Need for preparing trial balance

Trial balance helps to check the arithmetical accuracy of entries made in the accounting records. Trial balance serves as a lubricant for the smooth movement and completion of the accounting cycle, because, it is with the help of the trial balance that discrepancies in the book keeping work are detected. If these discrepancies are not detected and set right, the cycle cannot be completed properly. The trial balance helps in discovering errors



which may have been committed in the accounting records. However, in computerised accounting system, once the transactions are recorded in the journals, all the other records are made simultaneously, i.e., ledger postings, trial balance and final accounts. Hence, arithmetic errors and errors in posting the entries from journal to ledger and further will not occur in computerised accounting.

Definition of trial balance

“A trial balance is a statement, prepared with the debit and credit balances of the ledger accounts to test the arithmetical accuracy of the books”.

– J.R. Batliboi

Features of trial balance

Following are the features of trial balance:

- (a) Trial balance contains the balances of all ledger accounts.
- (b) It is prepared on a specific date. That is why, the word, “as on...” is used at the top.
- (c) When double entry system is followed, the totals of the debit and the credit columns of the trial balance must be equal. Thus, trial balance helps to check the arithmetical accuracy of entries made in the books of accounts.
- (d) If there is a difference between the totals of debit column and credit column of the trial balance, it is an indication of errors being committed somewhere.
- (e) If both the debit column and the credit column of the trial balance have the same total, it does not mean that there is no mistake in accounting, since some errors are not disclosed by the trial balance.

Objectives of preparing trial balance

Trial balance is prepared with the following objectives:

(i) Test of arithmetical accuracy

Trial balance is the means by which the arithmetical accuracy of the book-keeping work is checked. When the totals of debit column and credit column in the trial balance are



equal, it is assumed that posting from subsidiary books, balancing of ledger accounts, etc. are arithmetically correct. However, there may be some errors which are not disclosed by trial balance.

(ii) Basis for preparing final accounts

Financial statements, namely, trading and profit and loss account and balance sheet are prepared on the basis of summary of ledger balances obtained from the trial balance.

(iii) Location of errors

When the trial balance does not tally, it is an indication that certain errors have occurred. The errors may have occurred at one or more of the stages of accounting process, namely, journalising or recording in subsidiary books, totalling subsidiary books, posting in ledger accounts, balancing the ledger accounts, carrying ledger account balances to the trial balance, totalling the trial balance columns, etc. Hence, the errors should be located and rectified before preparing the financial statements.

(iv) Summarised information of ledger accounts

The summary of ledger accounts is shown in the trial balance. Ledger accounts have to be seen only when details are required in respect of an account.

Limitations of trial balance

The following are the limitations of trial balance:

- (a) It is possible to prepare trial balance of an organisation, only if the double entry system is followed.
- (b) Even if some transactions are omitted, the trial balance will tally.
- (c) Trial balance may tally even though errors are committed in the books of account.
- (d) If trial balance is not prepared in a systematic way, the final accounts prepared on the basis of trial balance may not depict the actual state of affairs of the concern.
- (e) Agreement of trial balance is not a conclusive proof of arithmetical accuracy of entries made in the accounting records. This is because there are certain errors which are



not disclosed by trial balance such as complete omission of a transaction, compensating errors and error of principle.

Methods of preparing trial balance

A trial balance can be prepared in the following methods:

(i) Balance method

In this method, the balance of every ledger account either debit or credit, as the case may be, is recorded in the trial balance against the respective accounts. The balance method is widely used, as it helps in the preparation of financial statements.

(ii) Total method

Under this method, the total amounts on the debit side of the ledger accounts and the total amounts on the credit side of the ledger accounts are ascertained and recorded in the trial balance. This method is not commonly used as it cannot help in the preparation of financial statements.

(iii) Total and Balance method

This method is a combination of both total method and balance method. Under this method, four columns are provided, namely, (a) totals of debit side of the ledger accounts, (b) totals of the credit side of the ledger accounts (c) debit balances of ledger accounts and (d) credit balances of the ledger accounts. This method is not in practice.

Balance method

Following are the steps to be followed to prepare trial balance under this method:

Step 1: Calculate the balances of all ledger accounts including the cash book.

Step 2: Record the names of the accounts in the particulars column and the amounts of debit balances in the debit column and credit balances in the credit column.



Step 3: Enter the page number of ledger from which the balance is taken in the Ledger Folio column.

Step 4: Total the debit and credit columns. It must be equal. If not equal, locate the errors and make the trial balance agree.

Trial balance is prepared in the following format under the balance method:

Trial balance as on ...

S. No.	Name of account / Particulars	L.F.	Debit balance Rs.	Credit balance Rs.

Specimen of a trial balance

Trial balance of _____ as on _____

S.No.	Particulars	L.F.	Debit Rs.	Credit Rs.
1	Cash in hand		xxx	
2	Cash at bank		xxx	
3	Bills receivable		xxx	
4	Sundry debtors		xxx	
5	Opening stock		xxx	
6	Plant and Machinery		xxx	
7	Land and Building (Premises)		xxx	
8	Furniture and Fixtures		xxx	
9	Vehicles		xxx	
10	Goodwill		xxx	
11	Investment		xxx	
12	Drawings		xxx	



13	Purchases		xxx	
14	Sales returns		xxx	
15	Carriage inwards		xxx	
16	Carriage outwards		xxx	
17	Rent paid		xxx	
18	Commission paid		xxx	
19	Interest paid		xxx	
20	Bad debts		xxx	
21	Insurance premium		xxx	
22	General expenses		xxx	
23	Sundry expenses		xxx	
24	Electricity charges		xxx	
25	Selling expenses		xxx	
26	Travelling expenses		xxx	
27	Wages		xxx	
28	Sales			xxx
29	Purchases returns			xxx
30	Capital			xxx
31	Bank loan			xxx
32	Sundry creditors			xxx
33	Bills payable			xxx
34	Bank overdraft			xxx
35	Rent received			xxx
36	Interest received			xxx



37	Provision for bad debts			xxx
	Total		xxx	xxx

Note

1. If the value of closing stock is known on the day when trial balance is prepared, then opening stock and closing stock are adjusted with purchases. Hence, opening stock will not appear in the trial balance. Closing stock and adjusted purchases will appear in the trial balance. If the value of closing stock is not known then opening stock and purchases will appear in the trial balance. Thus, either opening stock and purchases or closing stock and adjusted purchases will appear in the trial balance.

2. Under balance method, if an account does not have a balance, it is excluded.

Note

There are certain accounts which have only debit balances. Similarly, certain accounts have only credit balances. The following chart gives examples of such accounts:

For example, the following transactions took place in the business of Rathna Kumar, who deals in textiles.

2017

January

1	Commenced business with capital	5,00,000
5	Bought furniture for cash	6,000
10	Purchased goods for cash	10,000
15	Bought goods on credit from Jeyanthi	25,000
18	Returned goods to Jeyanthi	2,500
20	Sold goods for cash	32,000
25	Sold goods to Elizabeth on credit	72,000



30	Paid salaries to Krishnan by cash	7,000
31	Received commission from Kumar by cash	2,800
31	Received cash from Elizabeth	22,000

The journal entries, ledger postings and trial balance for the transactions will appear as below in the books of Rathna Kumar.

In the books of Rathna Kumar
Journal entries

Date	Particulars	L. F.	Debit Rs.	Credit Rs.
2017 Jan 1	Cash A/c Dr. To Rathna Kumar's capital A/c (Business commenced with capital)		5,00,000	5,00,000
5	Furniture A/c Dr. To Cash A/c (Furniture purchased for cash)		6,000	6,000
10	Purchases A/c Dr. To Cash A/c (Goods purchased for cash)		10,000	10,000
15	Purchases A/c Dr. To Jeyanthi A/c (Credit purchases from Jeyanthi)		25,000	25,000
18	Jeyanthi A/c Dr. To Purchases returns a/c (Goods returned to Jeyanthi)		2,500	2,500
20	Cash A/c Dr. To Sales A/c (Goods are sold for cash)		32,000	32,000
25	Elizabeth A/c Dr. To Sales A/c (Goods sold on credit)		72,000	72,000
30	Salaries A/c Dr. To Cash A/c (Salary paid by cash)		7,000	7,000
31	Cash A/c Dr. To Commission A/c (Commission received by cash)		2,800	2,800
31	Cash A/c Dr. To Elizabeth A/c		22,000	22,000



	(Cash received from Elizabeth)			
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Ledger

Dr.		Cash Account				Cr.	
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
2017 Jan 1	To Rathnakumar's capital A/c		5,00,000	2017 Jan 5	By Furniture A/c		6,000
20	To Sales A/c		32,000	10	By Purchases A/c		10,000
31	To Commission A/c		2,800	30	By Salaries		7,000
31	To Elizabeth A/c		22,000	31	By Balance c/d		5,33,800
			<u>556800</u>				<u>556800</u>
Feb 1	To Balance b/d		5,33,800				

Dr.		Rathna Kumar's Capital Account				Cr.	
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
2017 Jan 31	To Balance c/d		5,00,000	2017 Jan 1	By Cash A/c		5,00,000
			<u>5,00,000</u>				<u>5,00,000</u>
				Feb 1	By Balance b/d		5,00,000

Dr.		Furniture Account				Cr.	
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
2017 Jan 5	To Cash A/c		6,000	2017 Jan 31	By Balance c/d		6,000
			<u>6,000</u>				<u>6,000</u>
Feb 1	To Balance b/d		6,000				



Dr.				Purchases Account		Cr.	
Date	Particulars	J.F	Amount `	Date	Particulars	J.F	Amount `
2017 Jan 10	To Cash A/c		10,000	2017 Jan 31	By Balance c/d		35,000
15	To Jayanthi A/c		25,000				<u>35,000</u>
			<u>35,000</u>				
Feb 1	To Balance b/d		35,000				

Dr.				Jeyanthi Account		Cr.	
Date	Particulars	J.F	Amount `	Date	Particulars	J. F	Amount `
2017 Jan 18	To Purchases returns A/c		2,500	2017 Jan 15	By Purchases A/c		25,000
			22,500				<u>25,000</u>
31	To Balance c/d		<u>25,000</u>	Feb 1	By Balance b/d		<u>22,500</u>

Dr.				Purchases returns Account		Cr.	
Date	Particulars	J.F	Amount `	Date	Particulars	J.F	Amount `
2017 Jan 31	To Balance c/d		2,500	2017 Jan 18	By Jeyanthi A/c		2,500
			<u>2,500</u>				<u>2,500</u>
				Feb 1	By Balance b/d		<u>2,500</u>

Dr.				Sales Account		Cr.	
Date	Particulars	J.F.	Amount `	Date	Particulars	J.F	Amount `
2017 Jan 31	To Balance c/d		1,04,000	2017 Jan 20	By Cash A/c		32,000
				25	By Elizabeth A/c		72,000



			1,04,000				1,04,000
				Feb 1		By Balance b/d	1,04,000

Dr.				Elizabeth Account				Cr.			
Date	Particulars	J.F	Amount `	Date	Particulars	J.F	Amount `				
2017 Jan 25	To Sales A/c		72,000	2017 Jan 31	By Cash A/c		22,000				
			72000				50,000				
Feb 1	To Balance b/d		50,000	31	By Balance c/d		72000				

Dr.				Salaries Account				Cr.			
Date	Particulars	J.F	Amount `	Date	Particulars	J.F	Amount `				
2017 Jan 30	To Cash A/c		7,000	2017 Jan 31	By Balance c/d		7,000				
			7,000				7,000				
Feb 1	To Balance b/d		7,000								

Dr.				Commission Account				Cr.			
Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount				
2017 Jan 31	To Balance c/d		2,800	2017 Jan 31	By Cash A/c		2,800				
			2,800				2,800				
				Feb 1	By Balance b/d		2,800				

Trial balance under balance method

Trial balance as on 31st January, 2017

S.No	Particulars	L.F.	Debit balance	Credit balance
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1	Cash A/c		5,33,800	-
2	Rathnakumar's capital A/c		-	5,00,000
3	Furniture A/c		6,000	-
4	Purchases A/c		35,000	-
5	Jeyanthi A/c		-	22,500
6	Purchases returns A/c		-	2,500
7	Sales A/c		-	1,04,000
8	Elizabeth A/c		50,000	-
9	Salaries A/c		7,000	-
10	Commission A/c		-	2,800
	Total		6,31,800	6,31,800

Total method

Steps to be followed to prepare trial balance under total method are given below:

Step 1: Calculate the totals of debit side and credit side of all the ledger accounts including cash book individually.

Step 2: Enter the name of the account in the particulars column and enter the debit total in the debit column and credit total in the credit column for each account separately.

Step 3: Enter the page number of ledger from which the balance is taken in the Ledger Folio column.

Step 4: Find the sum of the debit total and credit total columns. It must be equal. If not equal, locate the errors and make the trial balance agree.

For the above example, trial balance will be prepared under total method as follows:

Trial balance as on 31st January, 2017 (total method)

S. No	Particulars	L.F.	Debit total	Credit total
1	Cash A/c		5,56,800	23,000



2	Rathnakumar's capital A/c		-	5,00,000
3	Furniture A/c		6,000	-
4	Purchases A/c		35,000	-
5	Jeyanthi A/c		2,500	25,000
6	Purchases returns A/c		-	2,500
7	Sales A/c		-	1,04,000
8	Elizabeth A/c		72,000	22,000
9	Salaries A/c		7,000	-
10	Commission A/c		-	2,800
	Total		6,79,300	6,79,300

Total and Balance method

Steps to be followed to prepare trial balance under total and balance method are given below:

Step 1: Calculate the totals of debit and credit columns of all ledger accounts and calculate the balances in each ledger account.

Step 2: Enter the name of the account in the particulars column and enter the debit total in the debit total column and credit total in the credit total column for each account separately. Also enter the debit balances in the debit balance column and credit balances in the credit balance column for each account.

Step 3: Enter the page number of ledger from which the balance is taken in the Ledger Folio column

Step 4: Total all the amount columns. Total of debit total column and total of credit total column must be equal. Also total of debit balance column and total of credit balance column must be equal. If not equal, locate the errors and make the trial balance agree.

For the above example, trial balance will be prepared under total and balance method as follows:



S.No.	Particulars	L.F	Debit total	Credit total	Debit balance	Credit balance
1	Cash A/c	.	5,56,800	23,000	5,33,800	-
2	Rathnakumar's capital A/c	.	-	5,00,000	-	5,00,000
3	Furniture A/c	.	6,000	-	6,000	-
4	Purchases A/c	.	35,000	-	35,000	-
5	Jeyanthi A/c	.	2,500	25,000	-	22,500
6	Purchases returns A/c	.	-	2,500	-	2,500
7	Sales A/c	.	-	1,04,000	-	1,04,000
8	Elizabeth A/c	.	72,000	22,000	50,000	-
9	Salaries A/c	.	7,000	2,800	7,000	-
10	Commission A/c	.	-	-	-	2,800
	Total		6,79,300	6,79,300	6,31,800	6,31,800

Suspense account

After transferring all the ledger account balances, if the trial balance does not tally, steps must be taken to locate and rectify errors. If the errors cannot be rectified, then trial balance is tallied by transferring the difference between the total of debit balances and the total of credit balances to a temporary account, called suspense account for timely preparation of the financial statements. If the trial balance shows lesser debit total, suspense account will be debited. Similarly, if the trial balance shows lesser credit total, suspense account will be credited. Later, when errors are located and rectified, the trial balance will get tallied.

Illustration 1

State whether the balance of each of the following accounts should be placed in the debit or the credit column of the trial balance:

- 1) Sundry debtors
- 2) Sundry creditors
- 3) Cash in hand
- 4) Bank overdraft



5) Salary 6) Discount allowed 7) Plant and machinery 8) Furniture

Solution

S.No.	Name of account	Debit balance	Credit balance
1	Sundry debtors	Debit	
2	Sundry creditors		Credit
3	Cash in hand	Debit	
4	Bank overdraft		Credit
5	Salary	Debit	
6	Discount allowed	Debit	
7	Plant and machinery	Debit	
8	Furniture	Debit	

Illustration 2

From the following balances extracted from the books of Raju a trader on automobiles, prepare trial balance as on 31st March, 2017:

Particulars	Rs.	Particulars	Rs.
Cash in hand	5,500	Direct expenses	5,000
Discount received	300	Carriage outwards	3,500
Creditors	15,000	Capital	45,000
Buildings	50,000	Purchases	49,700
Opening stock	6,000	Sales	59,400

Solution

In the books of Raju
Trial balance as on 31st March, 2017



S. No	Name of account	L.F.	Debit balance	Credit balance
1	Cash in hand		5,500	
2	Discount received			300
3	Creditors			15,000
4	Buildings		50,000	
5	Opening stock		6,000	
6	Direct expenses		5,000	
7	Carriage outwards		3,500	
8	Capital			45,000
9	Purchases		49,700	
10	Sales			59,400
	Total		1,19,700	1,19,700

Illustration 3

From the following balances extracted from the books of Pearl, a trader, prepare trial balance as on 31st March, 2017.

Particulars	Rs.	Particulars	Rs.
Capital	44,000	Interest on investment	2,000
Bills receivable	5,000	Customs duty	3,000
Wages	800	Computer	20,000
Drawings	4,000	Sales	72,000
Purchases	75,000	Opening stock	10,200

Solution

In the books of Pearl

Trial balance as on 31st March, 2017

S. No.	Name of account	L.F.	Debit balance	Credit balance
1	Capital			44,000
2	Bills receivable		5,000	
3	Wages		800	



4	Drawings		4,000	
5	Purchases		75,000	
6	Interest on investment			2,000
7	Customs duty		3,000	
8	Computer		20,000	
9	Sales			72,000
10	Opening stock		10,200	
	Total		1,18,000	1,18,000

Illustration 4

The following balances are extracted from the books of Prabhu, as on 31st March, 2017.

Prepare trial balance and transfer the difference if any to suspense account.

Particulars	Rs.	Particulars	Rs.
Discount allowed	250	Loan borrowed	7,000
Cash in hand	4,200	Lighting	12,000
Capital	50,000	Commission paid	3,000
Salaries	12,000	Purchases	29,050
Furniture	7,500	Sales	35,000

Solution

In the books of Prabhu Trial balance as on 31st March, 2017

S. No.	Name of account	L.F.	Debit balance	Credit balance
1	Discount allowed		250	
2	Cash in hand		4,200	
3	Capital			50,000
4	Salaries		12,000	
5	Furniture		7,500	
6	Loan borrowed			7,000
7	Lighting		12,000	
8	Commission paid		3,000	
9	Purchases		29,050	
10	Sales			35,000
11	Suspense account*		24,000	
	Total		92,000	92,000



* **Note:** Since the credit balance is more than the debit balance, the difference is transferred to suspense account.

Illustration 5

The following trial balance has certain errors. Redraft it.

Trial balance as on 31st March, 2017

Name of account	Debit balance	Credit balance
Building	60,000	
Machinery	17,000	
Returns outward	2,600	
Bad debts	2,000	
Cash	400	
Discount received	3,000	
Bank overdraft	10,000	
Creditors	50,000	
Purchases	1,00,000	
Capital		72,800
Fixtures		5,600
Sales		1,04,000
Debtors		60,000
Interest received		2,600
Total	2,45,000	2,45,000

Solution

Redrafted Trial balance as on 31st March, 2017

Name of account	Debit balance Rs.	Credit balance Rs.
-----------------	-------------------	--------------------



Building	60,000	
Machinery	17,000	
Returns outward		2,600
Bad debts	2,000	
Cash	400	
Discount received		3,000
Bank overdraft		10,000
Creditors		50,000
Purchases	1,00,000	
Capital		72,800
Fixtures	5,600	
Sales		1,04,000
Debtors	60,000	
Interest received		2,600
Total	2,45,000	2,45,000

Notes:

Trial balance is prepared on a particular date. The date must be mentioned in the title of trial balance.

- A trial balance is prepared with the help of balances of ledger accounts.
- Trial balance is prepared to check the arithmetical accuracy of entries made in the books of accounts.
- Under balance method, the debit balances of the accounts are to be written in debit column, and the credit balances of the accounts are to be written in the credit column of trial balance. Under balance method, if an account does not have a balance, it is excluded.
- If the trial balance does not tally, the difference between debit and credit columns should be taken to a temporary account called 'suspense account' if financial statements are to be prepared immediately.

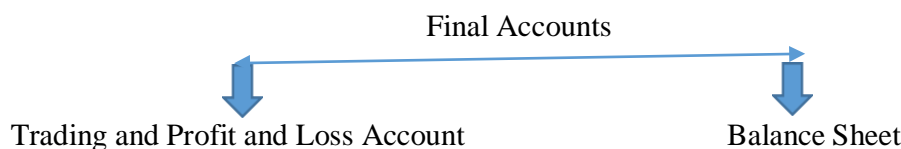


Unit V

Final Accounts

Introduction to final accounts

Business entities raise funds, acquire assets and incur various expenses for the purpose of carrying on business operations and earning income from such operations. These transactions are first recorded in the journal and then classified under common heads in the ledger. Preparation of trial balance from ledger balances helps to verify the arithmetical accuracy of entries made in the books of accounts, but it is not the end in itself. The business entities are interested in knowing periodically the results of business operations carried on and the financial soundness of the business. In other words, they want to know the profitability and the financial position of the business. These can be ascertained by preparing the final accounts or financial statements. The final accounts are usually prepared at the end of the accounting period on the basis of balances of ledger accounts shown by the trial balance.



The final accounts or financial statements include the following:

- a. Income Statement or Trading and Profit and Loss Account and
- b. Position Statement or Balance Sheet.

The purposes of preparing the financial statements are:

- i. To ascertain the financial performance of an enterprise and
- ii. To ascertain the financial position of an enterprise.

The income statement and balance sheet are prepared for these purposes respectively. Income statement gives the manner in which the profit or loss for an



accounting period is arrived at. The revenues earned and expenses incurred to earn the revenues during the period are shown in the income statement under appropriate heads as per matching principle. All the nominal accounts and accounts relating to goods during an accounting period are to be considered only in the relevant accounting period and are not to be carried forward. Moreover, only these items are to be compared for determining the financial performance. Hence, at the close of the accounting period, all nominal accounts (i.e. expenses, losses, revenues, gains, purchases, purchases returns, sales and sales returns) are to be closed by transferring to the income statement or trading and profit and loss account.

While transferring the items, it is desirable that the results of buying and selling of goods and the results of overall operations and financial performance are given separately. Hence, income statement is divided into two parts. The first part, i.e., trading account shows the results of buying and selling and the second part shows the results of overall financial performance. The second part may also be presented in such a manner to give the operating results and overall financial performance separately. All the direct expenses and items relating to goods are transferred to trading account which is the first part of income statement. All indirect expenses and losses and indirect incomes and gains are transferred to profit and loss account along with the net result of trading account.

Closing entries and Opening entry

Closing entries

Balances of all the nominal accounts are required to be closed on the last day of the accounting year to facilitate the preparation of trading and profit and loss account. It is done by passing necessary closing entries in the journal proper. Purchases has debit balance and purchases returns has credit balance. At the end of the accounting year, the balance in purchases returns account is closed by transferring to purchases account.

Similarly, sales account has credit balance and sales returns has debit balance. At the end of the accounting year, the balance in sales returns account is closed by transferring to sales account. The various closing entries are as follows:



4. For closing sales and closing stock, i.e., items that appear on the credit side of trading account

Particulars	Debit `	Credit `
Sales A/c Dr.	xxx	
Closing stock A/c Dr. To Trading A/c	xxx	xxx
(Closing of various items by transferring them to trading account)		

5. For transfer of gross profit or gross loss to profit and loss account

(a) For gross profit

Particulars	Debit `	Credit `
Trading A/c Dr. To Profit and loss A/c	xxx	xxx
(Transfer of gross profit to the profit and loss account)		

(b) For gross loss

Particulars	Debit `	Credit `
Profit and loss A/c Dr. To Trading A/c	xxx	xxx
(Transfer of gross loss to the profit and loss account)		

6. For closing indirect expenses and losses, i.e., items that appear on the debit side of profit and loss account

Particulars	Debit `	Credit `
Profit and loss A/c Dr.	xxx	
To Office expenses A/c		xxx
To Administration expenses A/c		xxx
To Selling expenses A/c		xxx
To Distribution expenses A/c		xxx
To Financial expenses A/c		xxx
To Provisions A/c		xxx
To Depreciation A/c		xxx
To Other indirect expenses and losses A/c (individually)		xxx
(Closing of various items by transferring them to profit and loss account)		



7. For closing the indirect incomes, i.e. items that appear on the credit side of profit and loss account

Particulars	Debit `	Credit `
Discount earned A/c Dr.	xxx	
Commission earned A/c Dr.	xxx	
Other indirect incomes A/c (individually) Dr.	xxx	
To Profit and loss A/c		xxx
(Closing of various items by transferring them to profit and loss account)		

8. For transfer of net profit or net loss to capital account

(a) For net profit

Particulars	Debit `	Credit `
Profit and loss A/c Dr.	xxx	
To Capital A/c		xxx
(Transfer of net profit to capital account)		

(b) For net loss

Particulars	Debit `	Credit `
Capital A/c Dr.	xxx	
To Profit and loss A/c		xxx
(Transfer of net loss to capital account)		

Opening entry

The balances of various accounts which are not closed at the end of the accounting period are carried forward to the next accounting period. In fact, the balances appearing in the balance sheet at the end of an accounting period become the opening balances for the next accounting period. Hence, at the beginning of every accounting year, an opening entry is made in the journal proper to bring forward the balances in various accounts. The entry passed is as follows:



Particulars	Debit ₹	Credit ₹
Assets A/c (individually) Dr.	xxx	
To Liabilities A/c (individually)		xxx
To Capital A/c		xxx
(Assets and liabilities brought forward)		

Trading account

Trading refers to buying and selling of goods with the intention of making profit. The trading account is a nominal account which shows the result of buying and selling of goods for an accounting period. According to J. R. Batliboi, “The trading account shows the results of buying and selling of goods. In preparing this account, the general establishment charges are ignored and only the transactions in goods are included.”

Trading account is prepared to find out the difference between the revenue from sales and cost of goods sold. Cost of goods sold refers to directly related cost. Direct cost includes the purchase price of goods purchased and all other expenses which are incurred to bring the goods to the business premises or godown and to make these ready for sale. All the goods purchased during the accounting period may not be sold during the same accounting period. Hence, it is necessary to calculate the cost of goods sold during the period. Matching principle is applied here. Hence, the cost of stock not sold must be deducted, i.e., value of closing stock must be deducted. But if there is any opening stock of goods that will be sold during the accounting period, it is to be added to the cost of purchases made during the period. If there is cost of goods manufactured, it must also be added to find out the cost of goods sold.

Cost of goods sold = Opening stock + Net purchases + Direct expenses – Closing stock

If the amount of sales exceeds the cost of goods sold, the difference is gross profit. On the other hand, the excess of cost of goods sold over the amount of sales results in gross loss.

Sales – Cost of goods sold = Gross profit
Sales – Gross profit = Cost of goods sold



Need for preparation of trading account

Preparation of trading account serves the following purposes:

(i) Provides information about gross profit or gross loss

It shows the gross profit or gross loss of the business for an accounting year. This helps the business persons to find out gross profit ratio by expressing the gross profit as a percentage of sales. It helps to compare and analyse with the ratios of the previous years. Thus, it provides data for comparison, analysis and planning for a future period.

(ii) Provides an opportunity to safeguard against possible losses

If the ratio of gross profit has decreased in comparison to the preceding years, effective measures can be taken to safeguard against future losses. For example, the sale price of goods may be increased or steps may be taken to analyse and control the direct expenses.

(iii) Provides information about direct expenses and direct incomes

All the expenses incurred on the purchase of goods are direct expenses. They are recorded in the trading account. Trading account also shows sales revenue, which is a direct income. With the help of trading account, percentage of such expenses on sales revenue can be calculated and compared with similar ratios of the previous years. Thus, it enables the management to have control over the direct expenses.

Preparation of trading account

Trading account is a nominal account. The opening stock, net purchases and all expenses relating to purchase of goods are shown on the debit side and the net sales and closing stock are shown on the credit side of it.

A) Items shown on the debit side of the trading account

The following are the items shown on the debit side of the trading account:

(i) Opening stock

The stock of goods remaining unsold at the end of the previous year is the opening stock of the current year. This item will not be there in a newly started business. It will not appear if it is adjusted with purchases. As opening stock would have been sold during the year, the cost of opening



stock is included in trading account.

(ii) Purchases and purchases returns

Goods which have been bought for resale are termed as purchases. Goods purchased which are returned to suppliers are termed as purchases returns or returns outward. Purchases include both cash purchases and credit purchases. Net purchases, i.e., purchases minus purchases returns are shown in the debit side of the trading account.

(iii) Direct expenses

All the expenses incurred on the purchase of goods and for bringing the goods to the godown or place of business and to make them to saleable condition are known as direct expenses. They are debited to trading account. Direct expenses include the following:

(a) Carriage inwards or Freight inwards

Amount paid for transporting the goods purchased to the godown or business premises is called carriage inwards or carriage on purchases or freight inwards.

(b) Wages

Amount paid to workers who are directly engaged in loading, unloading and handling of goods purchased is known as wages.

(c) Dock Charges

These are the charges levied for shipping the cargo while entering or leaving docks. When they are paid on import of goods, they are treated as direct expenses.

(d) Octroi

This is a tax levied by the local authority when the purchased goods enter the municipal limits.

(e) Import duty

Taxes paid on import of goods are known as import duties.

(f) Royalty

This is the amount paid to the owner of a mine or a patent for using owner's right. When the royalty is based on cost of production or output, it is treated as a direct expense.



(g) Coal, gas, fuel and power

Cost incurred towards coal, gas and fuel to make the goods saleable is also considered as direct expenses.

(iv) Cost of goods manufactured

If the sole proprietor is also engaged in manufacture of goods, a separate account, namely, manufacturing account is to be prepared in which expenses incurred for manufacture of goods will be entered. Examples of such expenses are raw materials, coal, gas, fuel, water, power, factory rent, packaging, factory lighting, royalty on manufactured goods, etc. The total cost of goods manufactured is transferred to the debit side of trading account.

B) Items shown on the credit side of the trading account

Following are the items shown on the credit side of the trading account:

(a) Sales and Sales returns

Both cash and credit sales of goods will be included in sales. The sales account will show credit balance whereas the sales returns account will show debit balance. The amount of net sales is shown on the credit side of the trading account by deducting sales returns from sales.

(b) Closing stock

The goods remaining unsold at the end of the accounting period are known as closing stock. They are valued at cost price or net realisable value (market price) whichever is lower as per Accounting Standard 2 (Revised).

Closing of trading account

The difference between the totals of two sides of the trading account indicates either gross profit or gross loss. If the total of the credit side is more, the difference represents gross profit. On the other hand, if the total of the debit side is higher, the difference represents gross loss. The gross profit or gross loss is transferred to profit and loss account.



Format of trading account

Dr.		Trading account for the year ended . .		Cr.	
Particulars			Particulars		
To Opening stock		xxx	By Sales	xxx	
To Purchases	xxx	xxx	Less: Sales returns	xxx	xxx
Less: Purchases returns	xxx	xxx	By Closing stock		xxx
To Direct expenses:		xxx	By Gross loss c/d*		xxx
Carriage/Freight inwards		xxx			
Wages		xxx			
Dock charges		xxx			
Octroi		xxx			
Royalty					
Import duty		xxx			
To Cost of goods		xxx			
manufactured		xxx			xxx
To Gross profit c/d*					

*The difference in trading account will be either gross profit or gross loss.

The heading of the trading account contains the words 'for the year ended.....' as it discloses the sales and cost of goods sold of the business for the whole accounting year.

Illustration 1

From the following information, prepare trading account for the year ended 31.12.2016.

Particulars	₹
Opening stock (1.1.2016)	10,000
Purchases	26,100
Sales	40,600
Closing Stock (31.12.2016)	13,500



Solution:

Dr. Trading account for the year ended 31st December, 2016 Cr.

Particulars	₹	Particulars	₹
To Opening stock	10,000	By Sales	40,600
To Purchases	26,100	By Closing stock	13,500
To Gross profit c/d	18,000		
	54,100		54,100

Illustration 2

From the following balances extracted from the books of M/s. Lavanya and sons, prepare trading account for the year ended 31st March, 2017:

Particulars	₹	Particulars	₹
Opening stock	16,500	Carriage inwards	1,200
Purchases	45,000	Wages	4,800
Sales	72,000	Fuel and power	3,200
Purchases returns	500	Closing stock	18,000
Sales returns	1,500		



Solution

In the books of M/s. Lavanya and sons

Dr. **Trading account for the year ended 31st March, 2017** Cr.

Particulars	₹	₹	Particulars	₹	₹
To Opening stock		16,500	By Sales	72,000	
To Purchases	45,000		Less: Sales returns	1,500	70,500
Less: Purchases returns	500	44,500	By Closing stock		18,000
To Carriage inwards		1,200			
To Wages		4,800			
To Fuel and power		3,200			
To Gross profit c/d					
		88,500			88,500

Illustration 3

From the following information, prepare trading account for the year ending 31st December, 2017.

Particulars	₹	Particulars	₹
Opening stock	50,000	Dock charges on purchases	4,000
Cost of goods manufactured	12,000	Import duty on purchases	3,500
Cash purchases	60,000	Wages	11,000
Cash sales	85,000	Sales returns	3,000
Purchases returns	2,000	Credit purchases	35,000
Carriage inwards	4,000	Credit sales	60,000
Freight outwards	3,000	Other direct expenses	7,000
Coal and fuel	2,500		



Solution

Dr. **Trading account for the year ended 31st December, 2017** Cr.

Particulars	₹	₹	Particulars	₹	₹
To Opening stock		50,000	By Sales:		
To Cost of goods manufactured		12,000	Cash	85,000	
To Purchases:			Credit	60,000	
Cash	60,000			1,45,000	
Credit	35,000		Less: Sales returns	3,000	1,42,000
	95,000		By Gross loss c/d		45,000
Less: Purchases returns	2,000	93,000			
To Carriage inwards		4,000			
To Coal and fuel		2,500			
To Dock charges on Purchases		4,000			
To Import duty on Purchases		3,500			
To Wages		11,000			
To Other direct expenses					
		1,87,000			1,87,000

Note: Freight outwards will not appear in trading account as it is not a direct expense.

Illustration 4

Compute cost of goods sold from the following information:

Particulars	₹
Opening stock	8,000
Purchases	60,000
Direct expenses	5,000
Indirect expenses	6,000
Closing stock	9,000

Solution

$$\begin{aligned} \text{Cost of goods sold} &= \text{Opening stock} + \text{Net purchases} + \text{Direct expenses} - \text{Closing stock} \\ &= 8,000 + 60,000 + 5,000 - 9,000 \end{aligned}$$



= ₹ 64,000

Note: Indirect expenses do not form part of cost of goods sold.

Illustration 5

Find out the amount of sales from the following information.

Particulars	₹
Opening stock	20,000
Purchases less returns	70,000
Direct expenses	10,000
Closing stock	30,000
Gross profit margin (on sales)	20%

Solution

$$\begin{aligned}\text{Cost of goods sold} &= \text{Opening stock} + \text{Net purchases} + \text{Direct expenses} - \text{Closing stock} \\ &= 20,000 + 70,000 + 10,000 - 30,000 \\ &= ₹ 70,000\end{aligned}$$

Let the sales be	100
Less: Gross profit (20% on sales, i.e., 100)	<u>20</u>
Cost of goods sold	<u>80</u>

Therefore, percentage of Gross profit on Cost of goods sold is $20/80 \times 100 = 25\%$

$$\text{Gross profit} = 25\% \text{ on } ₹ 70,000 \text{ i.e.: } \frac{25}{100} \times 70,000 = ₹ 17,500$$

$$\begin{aligned}\text{Sales} &= \text{Cost of goods sold} + \text{Gross profit} \\ &= 70,000 + 17,500 = ₹ 87,500\end{aligned}$$

Profit and loss account

Profit and loss account is the second part of income statement. It is a nominal account in nature. A business entity is interested in knowing not only the gross profit or loss but also the net profit earned or net loss incurred during the year. Hence, profit and loss account is prepared to ascertain the net profit or net loss during the year. Profit and loss account contains all the items of indirect expenses and losses and indirect incomes and gains in addition to gross profit or gross loss pertaining to the accounting period. The difference is net profit or net loss. According to Prof.



Carter, “A Profit and Loss Account is an account into which all gains and losses are collected, in order to ascertain the excess of gains over the losses or vice-versa”.

Need for preparing profit and loss account

Profit and loss account is prepared for the following purposes:

(i) Ascertainment of net profit or net loss

The profit and loss account discloses the net profit available to the proprietor or net loss to be borne by him. Ascertainment of profitability helps in planning for the growth and efficiency of a business enterprise. Inter-firm comparison and intra-firm comparison of profit and loss account items help in assessing efficiency in comparison with other enterprises and other departments of the same enterprise respectively.

(ii) Comparison of profit

The net profit of the current year can be compared with the profit of the previous years. It helps to know whether the business is conducted efficiently or not.

(iii) Control on expenses

Profit and loss account helps in comparing various expenses with the expenses of the previous years. The percentage of individual expenses to net sales can be calculated and compared with

the similar ratios of previous years. Such a comparison will be helpful in taking effective steps for controlling unnecessary expenses.

(iv) Helpful in the preparation of balance sheet

A balance sheet can be prepared only after ascertaining the net profit or loss through profit and loss account. Net profit or loss is shown in the balance sheet. Thus, it facilitates preparation of balance sheet.

Preparation of profit and loss account

The amount of gross profit or gross loss brought down from the trading account is the first item in the profit and loss account. All the indirect expenses and losses are debited to profit and loss account. Indirect expenses include office and administrative expenses, selling expenses, distribution expenses, etc. As the profit and loss account is a nominal



account, all the indirect expenses and losses are shown on the debit side and all the indirect incomes and gains are shown on the credit side.

Items shown on the debit side of profit and loss account are as follows:

(i) Gross loss

If trading account discloses gross loss, it is shown on the debit side of the profit and loss account.

(ii) Indirect expenses

Expenses which are not connected with purchase of goods are indirect expenses, i.e., expenses incurred in administration, office, selling and distribution of goods are indirect expenses.

(a) Office and administrative expenses

Expenses incurred for office and administration such as salary of office employees, office rent, lighting, postage, printing, legal charges, audit fee, depreciation and maintenance of office equipment, etc. are classified as office and administrative expenses.

(b) Selling and distribution expenses

Expenses incurred for selling, promotion of sales and distribution of goods such as advertisement charges, commission to salesmen, carriage outwards, bad debts, godown rent, packing charges, etc., are classified as selling and distribution expenses.

(c) Other indirect expenses and losses

The expenses such as interest on loan, repair charges, depreciation, charity, loss on sale of fixed assets and abnormal losses such as loss due to fire, theft, etc. not covered by insurance are shown under this category.

Items shown on the credit side of profit and loss account are as follows:

(i) Gross profit

The first item on the credit side of profit and loss account is the gross profit brought down from the trading account if there is gross profit.



(ii) Other incomes and gains

All items of indirect incomes and gains are shown on the credit side of the profit and loss account. Income from investments, rent earned, discount received, commission earned, interest earned and dividend received are indirect incomes. Profit on sale of fixed assets and investments are examples of gains.

12.4.3 Closing of profit and loss account

After debiting indirect expenses and losses and crediting all indirect incomes and gains, if the total of the credit side of the profit and loss account exceeds the debit side, the difference is

termed as net profit. On the other hand, if the total in the debit side exceeds the credit side, the difference is termed as net loss. Net profit or net loss is transferred to the capital account.

Format of profit and loss account

Dr. **Profit and loss account for the year ended** **Cr.**

Particulars	₹	Particulars	₹
To Gross loss b/d	xxx	By Gross profit b/d	xxx
To Office and administrative expenses:		By Indirect incomes:	
Salaries	xxx	Rent earned	xxx
Rent, rates and taxes	xxx	Discount received	xxx
Printing and stationery	xxx	Commission earned	xxx
Postage	xxx	Interest on drawings	xxx
Legal charges	xxx	Interest on investments	xxx
Audit fees	xxx	Dividend on shares	xxx
Establishment expenses	xxx	Bad debts recovered	xxx
Trade expenses	xxx	Profit on sale of fixed assets	xxx
General travelling expenses	xxx	Apprenticeship premium	xxx
Lighting	xxx	Miscellaneous receipts	xxx
Insurance premium	xxx	By Net loss*	xxx



To Selling and distribution expenses:		(transferred to capital account)	
Carriage outwards	XXX		
Advertisement	XXX		
Commission	XXX		
Brokerage	XXX		
Bad debts or provision for bad debts	XXX		
Export duty	XXX		
Packing charges	XXX		
To Other expenses and losses:			
Repairs	XXX		
Depreciation	XXX		
Interest charges	XXX		
Discount allowed	XXX		
Provision for discount on debtors	XXX		
Bank charges	XXX		
Interest on capital	XXX		
Donation and charity	XXX		
Loss on sale of fixed assets	XXX		
Abnormal loss due to fire, theft etc. not covered by insurance	XXX		
Miscellaneous expenses	XXX		
To Net profit*	XXX		
(transferred to capital account)			
	XXX		XXX

Illustration 6

From the following information, prepare profit and loss account for the year ended 31st March, 2018.

Particulars	₹	Particulars	₹
Gross profit b/d	1,50,000	Advertisement expenses	3,800
Carriage outward	25,500	Bad debts	8,500
Office rent	7,000	Dividend received	9,000
Office stationery	3,500	Discount received	4,600
Distribution expenses	2,000	Rent received	7,000



Solution

Dr. Profit and Loss Account for the year ended 31st March, 2018 Cr.

Particulars	₹	Particulars	₹
To Carriage outward	25,500	By Gross profit b/d	1,50,000
To Office rent	7,000	By Dividend received	9,000
To Office stationery	3,500	By Discount received	4,600
To Distribution expenses	2,000	By Rent received	7,000
To Advertisement expenses	3,800		
To Bad debts	8,500		
To Net profit transferred to capital account			
	1,20,300		
	1,70,600		1,70,600

Illustration 7

From the following information, prepare profit and loss account for the year ended 31st December, 2017.

Particulars	₹	Particulars	₹
Gross profit b/d	60,000	Interest received	2,100
Freight outward	15,000	Financial charges	4,000
Packing charges (on sales)	12,000	Repairs on vehicles used in office	8,000
Salesmen commission paid	1,300	Depreciation on vehicles used in office	3,000
Promotional expenses	10,200	Interest paid	9,000
Office telephone expenses	22,400	Rent received	7,000
Bad debts recovered	4,000	Carriage inwards	4,000



Solution

Dr. **Profit and Loss Account for the year ended 31st December, 2017** Cr.

Particulars	₹	Particulars	₹
To Freight outward	15,000	By Gross profit b/d	60,000
To Packing charges	12,000	By Bad debts recovered	4,000
To Salesmen commission	1,300	By Interest received	2,100
To Promotional expenses	10,200	By Rent received	7,000
To Office telephone expenses	22,400	By Net loss transferred to	
To Financial charges	4,000	capital account	11,800
To Repairs on vehicles	8,000		
To Depreciation on vehicles	3,000		
To Interest paid			
	84,900		84,900

Note: Carriage inwards will not appear in profit and loss account as it is a direct expense.

Balance sheet

Balance sheet is a statement which gives the position of assets and liabilities on a particular date. Assets are the resources owned by the business. Liabilities are the claims against the business. After ascertaining the net profit or net loss of the business enterprise, a business person would like to know the financial position of the business. For this purpose, balance sheet is prepared which contains amounts of all the assets and liabilities of the business enterprise as on a particular date. The statement so prepared is called 'balance sheet' because it gives the balances of ledger accounts which are still there, after the closure of all nominal accounts by transferring to the trading and profit and loss account. Balances of all the personal and real accounts are grouped into assets and liabilities. In the balance sheet, liabilities are shown on the left hand side and assets on the right hand side.



According to J.R. Batliboi, “A Balance Sheet is a statement prepared with a view to measure the exact financial position of a business on a certain fixed date.”

Need for preparing a balance sheet

The purposes of preparing a balance sheet are as follows:

- (a) The main purpose of preparing a balance sheet is to ascertain the true financial position of the business at a particular point of time.
- (b) It helps in comparing the cost of various assets of the business such as the amount of closing stock, amount due from debtors, amount of fictitious assets, etc. Moreover as assets and liabilities of similar nature are grouped and presented in balance sheet, a comparative study of these assets and liabilities is facilitated. It helps in comparing the various liabilities of the business.
- (c) It helps in finding out the solvency position of the firm. The firm’s solvency position is favourable if the assets exceed the external liabilities. The firm’s solvency position is not favourable if the external liabilities exceed the assets.

Characteristics of balance sheet

The following are the characteristics of a balance sheet:

- (a) A balance sheet is a part of the final accounts. However, the balance sheet is a statement and not an account. It has no debit or credit sides and as such the words ‘To’ and ‘By’ are not used before the names of the accounts shown therein.
- (b) A balance sheet is a summary of the personal and real accounts, which have balances. Personal and real accounts having debit balances are shown on the right hand side known as assets side, whereas personal and real accounts having credit balances are shown on the left hand side known as liabilities side.
- (c) The totals of the two sides of the balance sheet must be equal. If the totals are not equal, it indicates existence of error. It must satisfy the accounting equation, ie., $\text{Assets} = \text{Capital} + \text{Liabilities}$, following the dual aspect concept.



(d) Balance sheet is prepared on a particular date and not for a fixed period. It discloses the financial position of a business on a particular date. It gives the balances only for the date on which it is prepared.

(e) It shows the financial position of the business according to the going concern concept.

Grouping and Marshalling of assets and liabilities in a balance sheet

The assets and liabilities shown in the balance sheet are grouped and presented in a particular order. The term ‘grouping’ means showing the items of similar nature under a common heading. For example, the amount due from various customers will be shown under the head ‘Sundry debtors.’ Similarly, under the head ‘Current assets’, the balance of cash, bank, debtors, stock and other current assets will be shown.

‘Marshalling’ is the arrangement of various assets and liabilities in a proper order. Marshalling can be made in one of the following two ways:

(a) In the order of liquidity

According to this method, an asset which is most easily convertible into cash, i.e., cash in hand is shown first and then will follow those assets which are comparatively less easily convertible, so that the least liquid asset i.e., goodwill is shown last. In the same way, the liabilities which are to be paid at the earliest will be shown first. In other words, current liabilities are shown first, then fixed or long-term liabilities and finally the proprietor’s capital.

(b) In the order of permanence

This method is exactly the reverse of the first method. Asset which is more permanent, i.e., goodwill is shown first followed by assets which are less permanent. Similarly, those liabilities which are to be paid last will be shown first. In other words, the proprietor’s capital is shown first, then fixed or long-term liabilities and lastly the current liabilities. Joint stock companies are required under the Companies Act to prepare their balance sheet in the order of permanence.



Methods of drafting a balance sheet

The balance sheet of business concern can be presented in the following two forms.

- a) Horizontal form
- b) Vertical form

a) Horizontal form of balance sheet

In the horizontal form, assets are shown on right hand side of the balance sheet and the liabilities are shown on the left hand side of the balance sheet.

Balance sheet of ... as on...

Liabilities	₹	₹	Assets	₹	₹
Capital	xxx		Fixed assets:		
Add: Net profit/ Less: Net loss	xxx		i) Intangible assets		
	xxx		Goodwill		xxx
Less: Drawings	xxx	xxx	Patent rights		xxx
			Copy rights		xxx
Reserves		xxx	Trade marks		xxx
Long term loans		xxx	Computer software		xxx
Current liabilities:			ii) Tangible assets		
Bank overdraft, Cash credit	xxx		Land		xxx
Outstanding expenses	xxx		Buildings	xxx	
Unearned income	xxx		Less: Depreciation	xxx	xxx
Short term loans from banks	xxx		Plant and machinery	xxx	
Sundry creditors	xxx		Less: Depreciation	xxx	xxx
Bills payable	xxx	xxx	Vehicles	xxx	
Provisions			Less: Depreciation	xxx	xxx
Provision for employee benefits		xxx	Furniture and Fittings	xxx	
Provision for tax		xxx	Less: Depreciation	xxx	xxx
			Investments		xxx



			Current assets		
			Stock		XXX
			Advances given		XXX
			Sundry debtors		XXX
			Bills receivable		XXX
			Prepaid expenses		XXX
			Accrued income		XXX
			Cash at bank		XXX
			Cash in hand		XXX
			Fictitious assets		
			Preliminary expenses		XXX
		XXX			XXX

b) Vertical form of balance sheet

The balance sheet of a sole proprietor can be presented in a vertical statement form as given below:

Balance sheet of ... as on...

Particulars	₹	₹
Current assets:		
Stock in trade	XXX	
Sundry debtors	XXX	
Marketable securities	XXX	
Prepaid expenses	XXX	
Accrued income	XXX	
Bills receivable	XXX	
Advances given	XXX	
Cash at bank	XXX	
	XXX	



Cash in hand		
Total Current assets		XXX
Less: Current liabilities:	XXX	
Sundry creditors	XXX	
Bills payable	XXX	
Bank overdraft	XXX	
Short term loans	XXX	
Outstanding expenses		
Total current liabilities		XXX
Net working capital		XXX
Add: Long term investments		XXX
Add: Fixed Assets:	XXX	
Goodwill	XXX	
Land and building	XXX	
Plant and machinery	XXX	
Furniture		
Total fixed assets		XXX
Capital Employed (both owner's funds and outsiders' funds)		XXX
Less: Long term liabilities:		
Loans	XXX	
Total long term liabilities		
Net Assets		XXX
		XXX
Represented by:		
Owners' Capital	XXX	
Reserves and surplus	XXX	XXX
Proprietor's fund		XXX

Preparation of Balance Sheet

There is no prescribed format for preparing the balance sheet of sole proprietor and partnership. For Joint Stock Company, the format of preparing balance sheet is given under Schedule III of Indian Companies Act, 2013. After transferring all nominal accounts, the items left out in trial balance are real account and personal accounts. These are grouped under assets (debit balance) and liabilities (credit balance) and presented in a balance sheet.



Classification of assets and liabilities

The resources acquired by the business entity out of funds provided by owners or creditors are called assets. These are the resources owned by the business. Assets of a business include cash, stock, plant and machinery, etc.

A) Classification of assets

According to the nature of assets, they may be classified into the following:

a) Fixed assets

Fixed assets are those assets which are acquired or constructed for continued use in the business and last for many years such as land and building, plant and machinery, motor vehicles, furniture, etc. According to Finney and Miller, “Fixed assets are assets of a relatively permanent nature used in the operations of business and not intended for sale.” As the purpose of keeping such assets is not to sell but to use them, changes in their realisable values are ignored and these are always shown in the balance sheet at cost less depreciation. Fixed assets can be classified into i) Tangible fixed assets ii) Intangible fixed assets.

i) Tangible fixed assets

Tangible fixed assets are those which have physical existence or which can be seen and felt. Examples: plant and machinery, building and furniture.

ii) Intangible fixed assets

Intangible fixed assets are those which do not have any physical existence or which cannot be seen or touched. Examples: goodwill, trade-marks, copy rights and patents. Intangible assets are as much valuable as tangible assets because they also help the firm in earning profits. For example, goodwill helps in attracting customers and patents represent the know-how which helps in producing the goods.

b) Current assets

Current assets are those assets which are either in the form of cash or can be easily converted into cash in the normal course of business or within one year. In the words of Hovard and Upton, “The current assets are usually defined as those assets which are



convertible into cash through the normal course of business within a short time, ordinarily in a year.” Current assets include cash in hand, cash at bank, short-term investments, bills receivable, debtors, prepaid expenses, accrued income, closing stock, etc. Among these, closing stock is valued at cost or realisable value whichever is lower and debtors are shown after deducting a reasonable provision for bad and doubtful debts.

c) Liquid assets

Liquid assets are the assets which are either in the form of cash or which can be immediately converted into cash within a very short period of time, such as cash at bank, bills receivable, short-term investments, debtors and accrued incomes. In other words, if prepaid expenses and closing stock are excluded from current assets, the balance is known as liquid assets.

d) Investments

Amount invested outside the business in shares, debentures, bonds and other securities is called investments. If it is invested for a period more than a year they are called long-term investments. If they are invested for a period less than a year they are short term investments and shown under current assets.

e) Wasting assets

These are the assets which get exhausted gradually in the process of excavation. Examples: mines and quarries.

f) Fictitious or Nominal assets

These are assets only in name but not in reality. These assets are not really assets but are shown on the assets side only for the purpose of writing off by transferring them to the profit and loss account gradually over a period of time in future. Such assets include the expenditures, the benefit of which lasts for more than a year, not yet written off, such as advertisement expenses, preliminary expenses, etc.

B) Classification of liabilities

Liabilities or equities are claims against the business entity. These are the amounts owed by a business entity to the outsiders (outsiders equity) and owners (owners equity).



Liabilities may be classified according to their nature as follows:

(a) Fixed or long-term liabilities

The liabilities which are to be repaid after one year or more are termed as long-term liabilities. Example: Long-term loans.

(b) Current or short-term liabilities

The liabilities which are expected to be paid within the normal operating cycle or one year are termed as current or short-term liabilities. These include bank overdraft, creditors, bills payable, outstanding expenses, etc.

(c) Contingent liabilities

These are the liabilities which are not certain at the time of preparation of balance sheet. These liabilities may or may not occur. These are the liabilities which will become payable only on the happening of some specific event which itself is not certain, otherwise these need not be paid. Such liabilities are as follows:

- Liabilities for bills discounted

In case a bill discounted with the bank is dishonoured by the acceptor on the due date, the firm will become liable to the bank.

- Liability in respect of a suit pending in a court of law

This would become an actual liability if the suit is decided against the firm.

- Liability in respect of a guarantee given for another person

The firm would be liable to pay the amount if the person for whom the guarantee is given fails to meet his obligation.



Differences between trial balance and balance sheet

The following are the differences between trial balance and balance sheet:

Basis	Trial balance	Balance sheet
1. Nature	Trial balance is a list of ledger balances on a particular date.	Balance sheet is a statement showing the position of assets and liabilities on a particular date.
2. Purpose	Trial balance is prepared to check the arithmetical accuracy of the accounting entries made.	Balance sheet is prepared to ascertain the financial position of a business.
3. Contents	It is a summary of balances of all accounts – personal, real and nominal accounts.	It is a statement showing the closing balances of only personal and real accounts.
4. Format	The trial balance contains columns for debit balances and credit balances.	The items are grouped as assets and liabilities.
5. Stage	It is prepared before the preparation of final accounts.	It is prepared after preparing trial balance and trading and profit and loss account.
6. Period	It can be prepared periodically, say at the end of the month, quarterly, half yearly, etc.	It is generally prepared at the end of the accounting period.
7. Order	Balances shown in the trial balance need not be in order.	Balances shown in the balance sheet must be in order.
8. Compulsion	Preparation of trial balance is not compulsory.	Preparation of the balance sheet is compulsory in certain cases.

Illustration 8

From the following balances of Niruban, prepare balance sheet as on 31st December, 2017.

Particulars	Dr. ₹	Cr. ₹
Plant and machinery	8,00,000	
Land and building	6,00,000	
Furniture	1,50,000	
Cash in hand	20,000	
Bank overdraft		1,80,000
Debtors and Creditors	3,20,000	2,40,000



Bills receivable and Bills payable	1,00,000	60,000
Closing stock	4,00,000	
Investments (short-term)	80,000	
Capital		15,00,000
Drawings	1,30,000	
Net Profit		6,20,000
	26,00,000	26,00,000

Solution

In the books of Niruban

Balance sheet as on 31st December, 2017

Liabilities	₹	₹	Assets	₹	₹
Capital	15,00,000		Land and building		6,00,000
Add: Net profit	6,20,000		Plant and machinery		8,00,000
	21,20,000		Furniture		1,50,000
Less: Drawings	1,30,000	19,90,000	Investments (short-term)		80,000
Creditors		2,40,000	Stock in trade		4,00,000
Bills payable		60,000	Debtors		3,20,000
Bank overdraft		1,80,000	Bills receivable		1,00,000
			Cash in hand		
		24,70,000			24,70,000

Illustration 9

From the following trial balance of Sharan, prepare trading and profit and loss account for the year ending 31st December, 2017 and balance sheet as on that date. The closing stock on 31st December, 2017 was valued at ₹ 2,50,000.

Debit Balances		Credit Balances	
Stock (1-1-2017)	2,00,000	Sundry creditors	12,000
Purchases	7,50,000	Purchases returns	30,000
Carriage inwards	75,000	Sales	10,20,000
Wages	3,65,000	Commission received	53,000
Salaries	1,20,000	Capital	33,00,000



Repairs	12,000		
Rent and taxes	2,80,000		
Cash in hand	97,000		
Land	21,50,000		
Drawings	1,66,000		
Bank deposits	2,00,000		
	44,15,000		44,15,000

Solution

In the books of Sharan

Dr. Trading and profit and loss account for the year ending 31st December, 2017 Cr.

Particulars			Particulars		
To Opening stock		2,00,000	By Sales		10,20,000
To Purchases	7,50,000		By Stock (closing)		2,50,000
Less: Purchases returns	30,000	7,20,000	By Gross loss c/d		90,000
To Carriage inwards		75,000			
To Wages		3,65,000			
		13,60,000			13,60,000
To Gross loss b/d		90,000	By Commission received		53,000
To Salaries		1,20,000	By Net loss		
To Repairs		12,000	(transferred to capital account)		4,49,000
To Rent and taxes					
		5,02,000			5,02,000

Balance sheet as on 31st December, 2017

Liabilities			Assets		
Capital	33,00,000		Land		21,50,000
Less: Net loss	4,49,000		Stock in trade		2,50,000
	28,51,000		Bank deposits		2,00,000
Less: Drawings	1,66,000	26,85,000	Cash in hand		97,000
Sundry creditors					
		26,97,000			26,97,000