GOVERNMENT OF TAMILNADU

HIGHER SECONDARY FIRST YEAR

ACCOUNTANCY

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Department of School Education

Untouchability is Inhuman and a Crime

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Dear Students!

This Accountancy textbook is the source of knowledge to provide you with the basic understanding of Accountancy and to make use of your analytical ability to make you an excellent person in applying the accounting principles to real business situations through various activities given in the textbook.

The book contains 14 units, within which the subdivisions and various student activities are given in an organised way to make learning easy, systematic and a pleasure.

The method of using this book effectively to learn the concepts and methods contained in it and explanation of the important items included in the text book are given below to have a better learning experience.

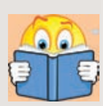
HOW TO USE THE BOOK

UNITS

Units are the broad divisions of the book which contain several subdivisions in each of them so that the students can have understanding of the specific substance in various parts of Accountancy education. Each unit gives the specialised knowledge on the content discussed. The units are to be learnt in the order given in the book to have continuity of learning and proper understanding of the subject matter.

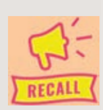
SUBDIVISIONS

All the 14 units in the textbook have been divided into subdivisions that give the basic theory and practice of Accountancy today in an orderly manner.



LEARNING OBJECTIVES

Learning objectives give the level of knowledge to be attained by the students while learning the contents given in the unit.



POINTS TO RECALL

These help in proper understanding of the unit contents by providing a base for learning by recalling what is learnt earlier.

KEY TERMS

The key terms are the important concepts that the students are to be thorough within each unit. The students must be clear about these concepts to have clarity of thought and an able learning about the subject matter.

This section of the unit gives the various information about the present or past events or useful practices in the field of Accountancy relevant to the subject matter discussed in the specific unit.

STUDENT ACTIVITY

This is an exercise given to the students to do as class work or home work or as field work on the chosen topic in each unit. Accountancy education requires practical exposure to various business environment around the world. Student activity will ensure practical application of the principles learnt in the real business situations and help to develop the analytical and entrepreneurial ability of the students.

This is an online support to enrich learning. Using a smart phone with applied QR code app, the students can have access to short lectures or demonstrations by experts or experienced teachers. This is to be a leisure time exercise or else teachers can display them in class rooms.

POINTS TO REMEMBER

It provides a summary of important subject matter discussed in the unit.

SELF-EXAMINATION QUESTIONS

This section contains theoretical questions and practical problems to be answered by the students. Multiple choice questions help in thorough understanding of the concepts and procedures.

CASE STUDY

Case study helps in application of accounting principles and practices learnt in real business environment by analysing a particular situation. It enables the students to reach higher levels of knowledge, namely, applying, analysing, evaluating and creating new models.

TO EXPLORE FURTHER

This section enables the students to make a further analysis of the concepts and methods learnt through browsing or learning from the reference books. This again is to enrich learning and to help the students to pursue higher education or professional courses.

GLOSSARY

This section helps in understanding the important terminologies used in the text book through comparison of corresponding Tamil terms.

We wish you a meaningful and successful learning.

Team of Authors.

SCOPE OF ACCOUNTANCY EDUCATION

"Accountancy" as a field of knowledge is all pervasive in nature. It offers enormous opportunities for higher education and employment both in India and abroad. The scope after higher secondary programme in Accountancy is given below:

EDUCATIONAL OPPORTUNITIES

Any of the following Degree Programmes can be pursued by the students both on regular mode and distance education mode	Any of the following professional courses/ programmes	Any of the following programmes in India or abroad after a formal degree programme anywhere in colleges, Universities	Any of the following professional courses/ programmes after a formal degree programme	Any of the research programme after a formal post graduation
• B.Com–Bachelor of Commerce (General) • B.Com–(Hons.) • B.Com–(Accounting & Finance) • B.Com–(Corporate Secretaryship) • B.Com–(Computer Applications) • B.Com–(International Business) • B.Com–(Bank Management) • B.B.A–(Bachelor of Business Administration) • B.B.M–(Bachelor of Bank Management) • B.Com–(Co-operation) • M.Com–(Master of Commerce–Five year Integrated programme)	• CA–Chartered Accountancy • CMA–Cost and Management Accountancy • CS–Company Secretaryship • BL–Bachelor of Law – Five year Integrated Programme • CIMA (Chartered Institute of Management Accountants • ACCA (Association of Chartered Certified Accountants (UK)) • CPA (Certified Public Accountant (USA)) • CFP–Certified Financial Planner(USA)	• M.Com– Master of Commerce • M.Com– (Accounting and Finance) • M.Com–(Corporate Secretaryship) • M.Com– (Computer Applications) • M.Com– (International Business and Banking) • M.Com– (Co operative Management) • M.B.A–Master of Business Administration • M.B.A–(Finance) • M.B.A–(Marketing) • M.B.A–(Human Resource Management) • M.B.A–(Advertisement and Salesmanship) • M.B.A–(Hospital Management) • MHRM (Master of Human Resource Management) • MLM (Master of Labour Management)	• Indian Administrative Service (IAS) • Indian Police Service (IPS) • Indian Foreign Service (IFS) • Indian Revenue Service (IRS) • Indian Audit and Account Service (IA&AS) • B.Ed., (Bachelor of Education) and followed by • M.Ed., (Master of Education) Programmes • PG Diploma programme	• M.Phil– Master of Philosophy • Ph.D– Doctor of Philosophy

EMPLOYMENT OPPORTUNITIES

Accounts assistant	Accountant
Audit assistant	Cost analyst
Investment consultant	Financial advisor
Tax practitioner	Chartered Accountant
Company Secretary	Cost and Management Accountant
Teaching	State and Central Government jobs

Details of some of the professional courses in India

Professional course	Name of the institute	Southern India Regional Office address	Chapters in Tamil Nadu
Chartered Accountancy	The Institute of Chartered Accountants of India www.icai.org	ICAI Bhawan, 122, Mahatma Gandhi Road Post box No.3314 Nungambakkam, Chennai - 600034	Coimbatore Erode Madurai Salem Tiruchirapalli Tirunelveli Tirupur Tuticorin Kanchipuram Kumbakonam Sivakasi
Company Secretaryship	The Institute of company secretaries of India www.icsi.edu	9,Wheat Crofts Road, Nungambakkam, Chennai-600034	Coimbatore Madurai Salem
Cost and Management Accountancy	The Institute of Cost Accountants of India www.icma.in	Southern India Regional Council, CMA Bhawan 4,Montieth Lane, Egmore Chennai - 600008	Coimbatore Erode Madurai Mettur-Salem Nellai-Pearl Neyveli Ranipet-Vellore Tiruchirapalli

SCOPE ABROAD

Accountancy students have a wide range of scope abroad.

1. Higher studies
2. Employment opportunities as
    - Teachers
    - Accountants
    - Auditors
    - Financial consultants
    - Export and Import consultants
    - Tax advisors
    - Project consultants.

Unit 1

INTRODUCTION TO ACCOUNTING

Contents

Points to recall

The following points are to be recalled before learning introduction to Accounting:

- Barter system
- Money as a medium of exchange
- Activities involving transfer of money or money's worth

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Learning Objectives

To enable the students to

- Understand the meaning and functions of accounting
- Analyse the importance of accounting
- Understand the basic accounting terminologies
- Analyse the role of an accountant

Key terms to know

- Accounting
- Accountant
- Cash basis
- Accrual basis

1.1 Introduction to Accounting

Business entities and other organisations carry on activities which involve exchange of money or money's worth or economic resources. Where the volume of these activities are large in number it is necessary that these are recorded for the purpose of taking important decisions as to whether the activities are viable, gainful and are to be continued or not. Information about the business and other organisations is required not only to the proprietors and managers of business and other organisations but also to various other interested users such as the government, investors, customers, employees and researchers.

Raising and utilising of finance for various purposes must be recorded systematically, scientifically and uniformly. It is very important because finance is the most important resource next to the human element for any economic activity. Hence, there is a need for principles, methods and procedures to be followed to record all these information and to derive from these information, the feasibility and benefit of the activities carried out. Accountancy provides the basic theory, principles and methods to be followed to account for all financial activities taking place in an organisation. Accounting the financial activities in a systematic way helps in ascertaining the efficiency of performance of these activities and provides data about the state of affairs of the organisation for further analysis and planning.

III 1)

Accounting is the language of business. The most important function of a language is to facilitate communication. The information about business entities regarding their operating performance and financial status can be obtained from the financial information recorded in the accounting records. This information is communicated to the interested users of business information such as proprietors, management, investors, customers and the government.

1.2 Evolution of Accounting

In India, 23 centuries ago, Chandragupta Maurya's Minister Kautilya wrote a book named 'Arthashastra', wherein some references can be traced regarding the way of maintaining accounting records.

In the earliest days of civilisation, accounting was done by stewards who managed the properties of wealthy people. They rendered accounts periodically to the owners of property. The stewardship accounting is said to be the root of accounting. Records of debit and credit were found in the 12^{th} century itself.

In 1494, Luca Pacioli an Italian developed double-entry book-keeping system. Due to the industrial revolution in the 18^{th} and 19^{th} centuries, large scale operations were carried on and joint stock companies emerged as an important form of organisation which required separation of ownership from management. Hence, to safeguard the interest of owners and investors, the business establishments required detailed information about business which paved the way for development of comprehensive financial accounting information system.

In the 20^{th} century, the need for analysis of financial information for managerial decision making caused emergence of Management Accounting as a separate branch of accounting.

Though accounting was individual centric in the initial stage of evolution of accounting, it has gradually developed into Social Responsibility Accounting in the 21^{st} century, due to the vast growth in business activities as a result of development in various fields. Thus, accounting has become inevitable in the modern world for business.

1.3 Meaning and Definition of Accounting

Student activity

Think: Before the evolution of money, commodities were exchanged for commodities. In such situations, how would people have maintained their accounts?

III 1)

Accounting is the systematic process of identifying, measuring, recording, classifying, summarising, interpreting and communicating financial information. Accounting gives information on:

(i) the resources available

(ii) how the available resources have been employed and

(iii) the results achieved by their use.

The profit earned or loss incurred during the accounting period, value and nature of assets, liabilities and capital can be ascertained from the information recorded in accounts.

According to the **American Institute of Certified Public Accountants** "Accounting is the art of recording, classifying and summarising in a significant manner and in terms of money, transactions and events which are in part, at least of a financial character and interpreting the results thereof".

II 1)

American Accounting Association has defined accounting as "the process of identifying, measuring, and communicating economic information to permit informed judgements and decisions by users of the information".

From the above definitions, the following attributes of accounting emerge:

(i) Accounting is an art. It requires the expertise and skill of accountants to design accounting system and policies, to decide the accounting process in order to suit the requirements of an organisation.

(ii) The transactions or events of a business must be recorded in monetary terms.

(iii) Accounting process involves recording, classifying and summarising of transactions and analysis and interpretation of the results.

(iv) The results of such analysis must be communicated to the persons who are interested in such information.

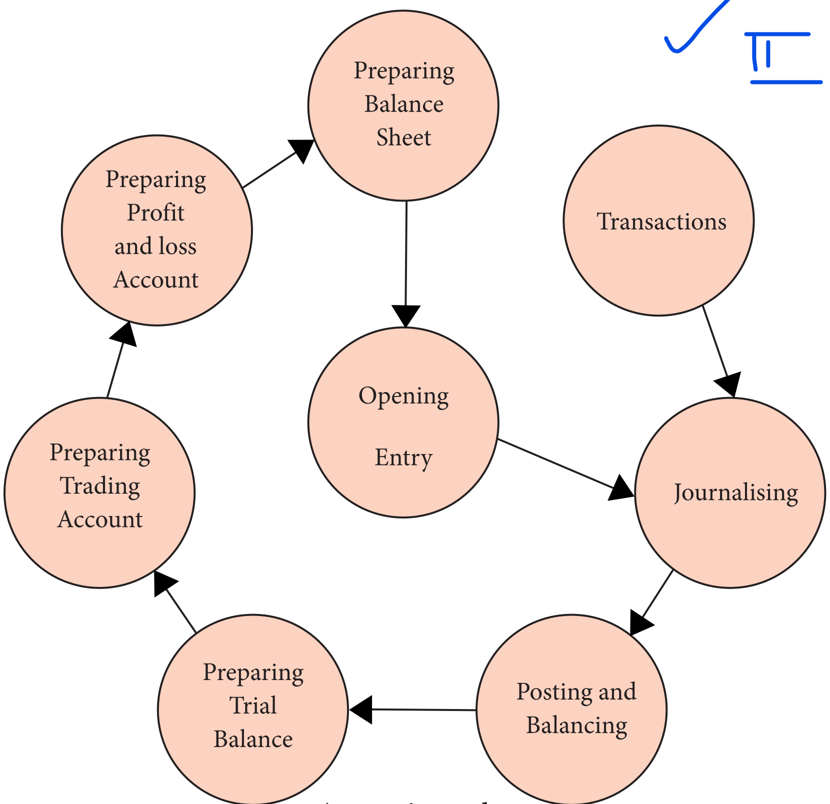
1.4 Accounting cycle

Accounting cycle is the sequence of steps involved in the accounting process. Accounting cycle starts with the identification and recording of financial transactions of an organisation and ends with the preparation of final accounts for the accounting year. The cycle continues for the next accounting year with the opening balances of assets and liabilities which are the closing balances of the preceding year. The steps involved are:

(i) Identifying the transactions and journalising

The first step in the accounting process is identifying the financial transactions of a business. All the monetary transactions are recorded in the books of original entry called journals. Recording the transactions in the journal is called journalising. Entries are made in the journals on the basis of source documents in the chronological order, i.e., the order of occurrence of the transactions.

II 3)



Accounting cycle

(ii) Posting and balancing

Transferring the entries from the journal to the ledger is called posting. In the ledger, entries are made in each account after classifying them under common heads. Finding the difference between the total of the debit column and credit column of all the ledger accounts is called balancing.

(iii) Preparation of trial balance

The list of ledger balances namely trial balance is prepared as the next step. On the basis of ledger balances the financial statements are prepared.

(iv) Preparation of trading account

Next step is preparation of trading account for a particular accounting period. All the direct revenues and direct expenses are transferred to trading account. The balance in the trading account is the gross profit or gross loss.

(v) Preparation of profit and loss account

Profit and loss account is prepared next for a particular accounting period. All the indirect revenues and indirect expenses along with gross profit or gross loss are transferred to profit and loss account. The balance in the profit and loss account is the net profit or net loss.

(vi) Preparation of balance sheet

A statement showing the balances of assets and liabilities namely balance sheet is prepared as the final step in the accounting process. It is prepared on a particular date, normally, on the last day of the accounting period.

The closing balances of an accounting year are taken as the opening balances for the next accounting year. The transactions identified and recorded for the next year are followed by posting and other steps.

The results are communicated to the users of accounting information for the purpose of analysis and decision making.

1.5 Objectives of Accounting

Following are the objectives of accounting:

(i) To keep a systematic record of financial transactions and events
(ii) To ascertain the profit or loss of the business enterprise
(iii) To ascertain the financial position or status of the enterprise
(iv) To provide information to various stakeholders for their requirements
(v) To protect the properties of an enterprise and
(vi) To ascertain the solvency and liquidity position of an enterprise

1.6 Functions of Accounting

The main functions of accounting are as follows:

(i) Measurement

The main function of accounting is to keep systematic record of transactions, post them to the ledger and ultimately prepare the final accounts. Accounting works as a tool for measuring the performance of the business enterprises. It also shows the financial position of the business enterprises.

(ii) Forecasting

With the help of the various tools of accounting, future performance and financial position of the business enterprises can be forecasted.

(iii) Comparison

Accounting helps to compare the actual performance with the planned performance. It is also possible to compare with the accounting policies. Through comparison of the actual financial results of the business enterprises with projected figures and standards, effective measures can be taken to enhance the efficiency of various operations.

(iv) Decision making

Accounting provides relevant information to the management for planning, evaluation of performance and control. This will help them to take various decisions concerning cost, price, sales, level of activity, etc.

DO YOU KNOW? Decision refers to choosing a desirable course of action from alternative courses of action.

(v) Control

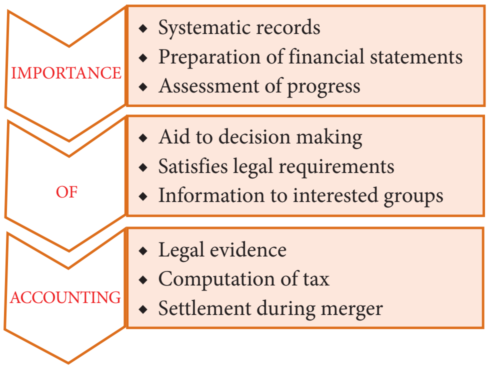
As accounting works as a tool of control, the strengths and weaknesses are identified to provide feedback on various measures adopted. It serves as a tool for evaluating compliance of business policies and programmes.

DO YOU KNOW? Control refers to comparison of actual performances with planned performances, measure deviation and take corrective action.

(vi) Assistance to government

Government needs full information on the financial aspects of the business for various purposes such as taxation, grant of subsidy, etc. Accounting provides relevant information about the business to exercise government control on business enterprises.

1.7 Importance of Accounting



Accounting is a basic necessity for all enterprises. Importance of accounting is enumerated as below:

(i) Systematic records

All the transactions of an enterprise which are financial in nature are recorded in a systematic way in the books of accounts. The records are classified under common heads and summaries are prepared.

(ii) Preparation of financial statements

Results of business operations and the financial position of the concern can be ascertained from accounting periodically through the preparation of financial statements namely, income statement or trading and profit and loss account and balance sheet. This helps in distribution of profits to the owners and to provide funds for future growth of the business.

(iii) Assessment of progress

Analysis and interpretation of financial data can be done to assess the progress made in different areas and to identify the areas of weaknesses. Management is provided with a complete picture of the liquidity, profitability and solvency of the business.

(iv) Aid to decision making

Management of a firm has to make routine and strategic decisions while discharging its functions. Accounting provides the relevant data to make appropriate decisions. Future policies and programmes can be planned by the management based on the accounting data provided.

(v) Satisfies legal requirements

Various legal requirements like maintenance of Provident Fund (PF) for employees, Employees State Insurance (ESI) contributions, Tax Deducted at Source (TDS), filing of tax returns are properly fulfilled with the help of accounting. Preparation of accounts and financial statements as per the legal requirements is also facilitated.

(vi) Information to interested groups

Accounting supplies appropriate information to different interested groups like owners, management,creditors, employees, financial institutions, tax authorities and the government.

(vii) Legal evidence

Accounting records are generally accepted as evidence in courts of law and other legal authorities in the settlement of disputes.

(viii) Computation of tax

Accounting records are the basic source for computation and settlement of income tax and other taxes.

(ix) Settlement during merger

When two or more business units decide to merger, accounting records provide information for deciding the terms of merger and any compensation payable as a consequence of merger.

DO YOU KNOW?

Two or more business units forming a single entity is known as merger.

1.8 Basic Accounting terminologies

Accounting is a versatile system which serves a large number of purposes in the modern business world. Hence, the following terminologies need to be understood.

Transaction	An activity which involves transfer of money or money's worth (goods, services, ideas) from one person to another.
Cash transaction	It is a transaction which involves immediate cash receipt or immediate cash payment.
Credit transaction	It is a transaction in which cash is not received or paid immediately, but will be received or paid later.
Account	It is the basic unit for measurement in accounting. It is used for identifying a person, or an item in accounting. An account is opened individually for a person, asset, expense, income, etc. In ledger, an account is a summary of transactions under a head.
Capital	It is the amount invested by the owner or proprietor in an organisation.
Drawings	It is the amount of cash or value of goods, assets, etc., withdrawn from the business by the owner for the personal use of the owner.
Voucher	Any written or printed document in support of a business transaction is called a voucher. Examples: cash receipt, invoice, cash memo, bank pay-in- slip, etc.
Invoice	It is a statement prepared by a seller of goods to be sent to the buyer. It shows details of quantity, price, value, etc. of the goods and any discount given, finally showing the net amount payable by the buyer.
Goods	It includes articles, things or commodities in which a business is dealing with. Example: Furniture will be goods for those who deal in furniture.
Purchases	Buying of goods with the intention of resale is called purchases.
Purchases returns or returns outward	When goods bought are returned to the suppliers, it is known as purchases returns or returns outward.
Sales	When goods meant for resale are sold, it is called sales.
Sales returns or returns inward	When goods sold are returned by the customers, it is called as sales returns or returns inward.
Stock	Unsold goods lying in a business on a particular date are known as stock.
Income	It is the amount receivable or realised from sale of goods and earnings from interest, dividend, commission, etc.
Expense	It is the amount incurred in order to produce and sell the goods and services.
Solvency	Solvency is the capability of a person or an enterprise to pay the debts.
Insolvency	Insolvency is the incapability of a person or an enterprise to pay the debts.
Asset	Any physical thing or right owned that has a monetary value is called asset.
Liability	It refers to the financial obligation of the business.
Debtor	A person who receives a benefit without giving money or money's worth immediately, but liable to pay in future or in due course of time.
Creditor	A person who gives a benefit without receiving money or money's worth immediately but to claim in future.

Depreciation	It refers to the gradual reduction in the value of fixed assets due to usage and passage of time.
Bad debt	It is a loss to the business arising out of failure of a debtor to pay the dues. It is irrecoverable debt.

1.9 Branches of Accounting

Depending on the informational needs of various users of accounting information, several branches or subfields of accounting have been developed.

The various branches of accounting are:

(i) Financial Accounting

It involves recording of financial transactions and events. It is historical in nature and records are maintained for transactions and events which have already occurred. It provides financial information to the users for taking decisions. It is concerned with identification, recording, classifying and summarising of financial transactions and events and ends up with the preparation of financial statements, namely, trading and profit and loss account or income statement and balance sheet and communication of the same to the interested users. Trading and profit and loss account shows the profit or loss made during an accounting period and the balance sheet shows the financial position of the business as on a particular date.

2)

(ii) Cost Accounting

It involves the collection, recording, classification and appropriate allocation of expenditure for the determination of the costs of products or services and for the presentation of data for the purposes of cost control and managerial decision making.

(iii) Management Accounting

It is concerned with the presentation of accounting information in such a way as to assist management in decision making and in the day-to-day operations of an enterprise. The information collected from financial accounting, cost accounting, etc. are grouped, modified and presented as per the requirements of management for discharging their functions and for decision making.

(iv) Social Responsibility Accounting

It is concerned with presentation of accounting information by business entities and other organisations from the view point of the society by showing the social costs incurred such as environmental pollution by the enterprise and social benefits such as infrastructure development and employment opportunities created by them. It arises because of corporate social responsibility.

(v) Human Resources Accounting

It is concerned with identification, quantification and reporting of investments made in human resources of an enterprise.

Student activity

Think: Do you think financial accounting, cost accounting and management accounting can be maintained by the same person?

1.10 Bases of Accounting

II
5)

There are three bases of accounting in common usage, namely

(i) Cash basis

(ii) Accrual or mercantile basis

(iii) Mixed or hybrid basis.

(i) Cash basis

Under cash basis of accounting, actual cash receipts and actual cash payments are recorded. In this basis, revenue is recognised when cash is received and expenses are recognised when cash is paid. Credit transactions are not recorded till cash is actually received or paid. Under this basis,

(a) Any income received

(b) Any expenditure paid

(c) Any asset purchased for which cash is paid

(d) Any liability paid during the accounting period whether related to the past, present or future is taken into account.

(ii) Accrual or mercantile basis

Under accrual basis of accounting, the revenue whether received or not, but has been earned or accrued during the accounting period and expenses incurred whether paid or not are recorded. In other words, revenue is recognised when it is earned or accrued and expenses are recognised when these are incurred. Under this basis,

(a) Any income earned whether received or not

(b) Any expenditure incurred whether paid or not

(c) Any asset purchased whether cash is paid or not

(d) Any liability incurred whether paid or not during the accounting period is recorded.

Under section 128(1) of the Indian Companies Act, 2013, all the companies are required to maintain the books of accounts according to the accrual basis of accounting.

(iii) Hybrid or mixed basis

This basis is a combination of cash basis and accrual basis of accounting. Under mixed basis of accounting, both cash basis and accrual basis are followed. Revenues and assets are generally recorded on cash basis whereas expenses and liabilities are generally taken on accrual basis.

1.11 Users of Accounting information

Student activity

Think: 'Accounting is useful only to the owner of the business' – Do you agree?

There are several persons who need the accounting information for various purposes. They can be classified into two:

(A) Internal users and

(B) External users

II 4)

A) Internal Users

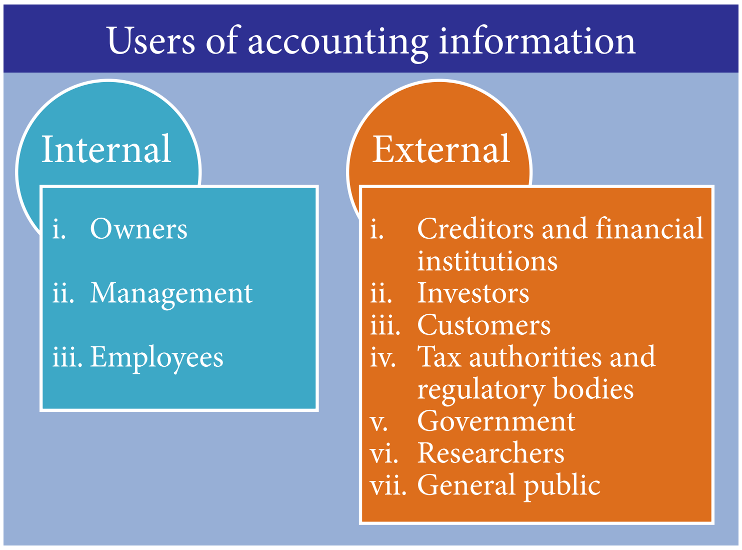
The internal users are owners, management and employees who are within the organisation.

(i) Owners

The owners of a business provide capital to be used in the business. They are interested to know whether the business has earned profit or not during a particular period and also its financial position on a particular date. They want accounting reports in order to have an appraisal of performance and also for an assessment of future prospects to ensure that they will get their expected returns from the business and get back their capital safely.

(ii) Management

Accounting data are the basis for most of the decisions made by the management. The trends in sales and purchases, relationship of expenses to the sales, efficiency of employees, comparative profitability of different departments, capital structure and solvency position are some of the vital data required by management for planning and controlling the business operations. Financial statements and other reports prepared under financial accounting provide this information to the management.



DO YOU KNOW?

Capital structure refers to the mix of a firm's permanent long-term financing represented by debt, preference share capital and equity shareholders' funds.

(iii) Employees

The employees are interested in the profit earning capacity of the business which will affect their remuneration, working conditions and retirement benefits and stability and growth of the enterprise.

B) External users

External users are the persons who are outside the organisation but make use of accounting information for their purposes. They are:

(i) Creditors and financial institutions

Suppliers of goods and services, commercial banks, public deposit holders and debentureholders are included in this category. They are interested in knowing the liquidity position and repaying capacity of the business to ensure the safety of getting the amount due to them or interest and the principal amount.

(ii) Investors

III 4) a)

Persons who are interested in investing their funds in an organisation should know about the financial condition of a business unit while making their investment decisions. They are more concerned about future earnings and risk bearing capacity of the organisation which will affect the return to the investors.

II 4)

(iii) Customers

Customers who buy and use the products and services of business enterprises are interested in knowing the details of the products and the prices charged to them. They are interested in knowing the stability and profitability of an enterprise to ensure continued supply of the products or services by the enterprise.

(iv) Tax authorities and other regulatory bodies

Accounting information helps the tax authorities in computing income tax and taxes on goods and services and other taxes to be collected from business units. Other regulatory bodies also require information about revenues, expenses and other financial aspects of business to ensure that the enterprises comply with statutory requirements.

(v) Government

III 4) b)

The scarce resources of the country are used by business enterprises. Information about performance of business units in different industries helps the government in policy formulation for development of trade and industry, allocation of scarce resources, grant of subsidy, etc. Government also administers prices of certain commodities. In such cases, government agencies have to ensure that the guidelines for pricing are followed.

(vi) Researchers

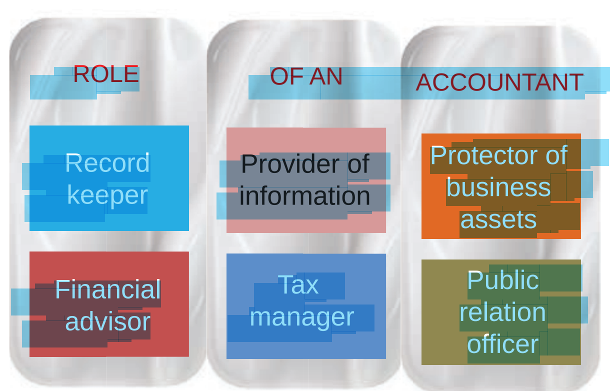
Researchers to carry out their research can use accounting information and make use of the published financial statements for analysis and evaluation.

(vii) General public

From accounting information, the general public at large can get a view of the earning capacity and stability of the enterprise as well as the social responsibility measures undertaken by the enterprise particularly in its area of operation and also the employment opportunities provided to the local people.

1.12 Role of an accountant

An accountant designs the accounting procedures for an enterprise. He plays several roles in an organisation as follows:



(i) Record keeper

The accountant maintains a systematic record of financial transactions. He also prepares the financial statements and other financial reports.

(ii) Provider of information to the management

III 5)

The accountant assists the management by providing financial information required for decision making and for exercising control.

(iii) Protector of business assets

The accountant maintains records of assets owned by the business which enables the management to protect and exercise control over these assets. He advises the management about insurance of various assets and the maintenance of the same.

(iv) Financial advisor

The accountant analyses financial information and advises the business managers regarding investment opportunities, strategies for cost savings, capital budgeting, provision for future growth and development, expansion of enterprise, etc.

(v) Tax manager

The accountant ensures that tax returns are prepared and filed correctly on time and payment of tax is made on time. The accountant can advise the managers regarding tax management, reducing tax burden, availing tax exemptions, etc.

(vi) Public relation officer

The accountant provides accounting information to various interested users for analysis as per their requirements.

Points to remember

- Accounting is termed as the language of the business.
- There are various branches of accounting such as financial accounting, cost accounting, management accounting, social responsibility accounting and human resource accounting.
- There are three bases of accounting namely cash basis, accrual or mercantile basis and mixed or hybrid basis.
- There are several persons who need the accounting information - internal users and external users.
- Accountants have several roles and responsibilities.

Self-examination questions

AEILFK

I Multiple choice questions

Choose the correct answer

1. The root of financial accounting system is

   (a) Social accounting (b) Stewardship accounting
   (c) Management accounting (d) Responsibility accounting

2. Which one of the following is not a main objective of accounting?

   (a) Systematic recording of transactions
   (b) Ascertainment of the profitability of the business
   (c) Ascertainment of the financial position of the business
   (d) Solving tax disputes with tax authorities

3. Which one of the following is not a branch of accounting?

   (a) Financial accounting (b) Management accounting
   (c) Human resources accounting (d) None of the above.

4. Financial position of a business is ascertained on the basis of

   (a) Journal (b) Trial balance
   (c) Balance Sheet (d) Ledger

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5. Who is considered to be the internal user of the financial information?
   (a) Creditor (b) Employee (c) Customer ~~(d)~~ Government

Answers

1 (b)	2 (d)	3 (d)	4 (c)	5 (b)

II Very short answer questions

1. Define accounting.
2. List any two functions of accounting.
3. What are the steps involved in the process of accounting?
4. Who are the parties interested in accounting information?
5. Name any two bases of recording accounting information.

III Short answer questions

1. Explain the meaning of accounting.
2. Discuss briefly the branches of accounting.
3. Discuss in detail the importance of accounting.
4. Why are the following parties interested in accounting information?
   (a) Investors (b) Government
5. Discuss the role of an accountant in the modern business world.

CASE STUDY

A Self-Help Group (SHG) is an informal, self-managed voluntary group of 5-20 individuals, who come together to address their common problems and are generally engaged in credit and savings activities operating on principles of mutuality and solidarity. Most SHG members are minimally educated. Regardless, every SHG should be aware of the status of its outstanding loans to members, the status of its loans from external institutions and the member payments due. Book-keeping is a difficult task for SHGs.

Now, discuss on the following points:

How do SHGs maintain their accounting?

Do you think that financial accounting system is suitable for all businesses?

To explore further

Can each business unit follow its own way for maintaining accounting records?
Will it serve the requirements of different users of accounting information?

Reference

1. M C Shukla, T S Grewal and S C Gupta, Advanced Accounts, 19th ed., 2017, S.Chand Publishing, New Delhi.
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3. S P Jain and K L Narang, Advanced Accountancy Vol – I, 2016, Kalyani Publishers, New Delhi.
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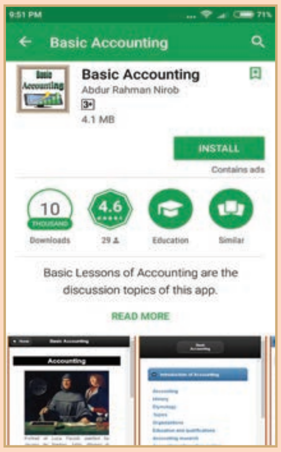
ICT CORNER

INTRODUCTION TO ACCOUNTANCY

Lets get introduced to
Basic Accounting

Steps:

- This is an Android app activity. Open the Browser and type the URL given (or) Scan the QR Code. (Or) search for "Basic Accounting" in google play store. Install and open the app. This is Hands on Lesson.
- Select any one of the topic you want to learn. Open "Introduction to Accounting.
- In the Next page you have sub menus. Select one by one and go through the lesson.



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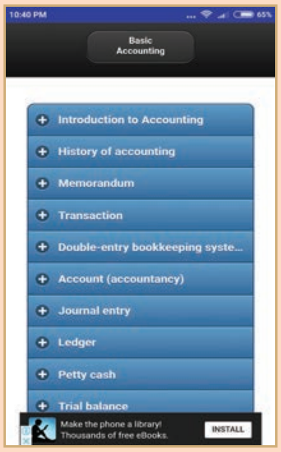

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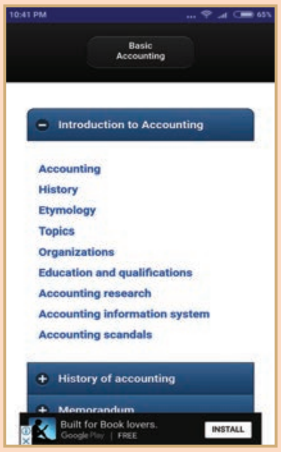

Step3

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URL:

https://play.google.com/store/apps/details?id=com.paradigmsc.basicaccounting

(or) scan the QR Code

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Unit 2

CONCEPTUAL FRAMEWORK OF ACCOUNTING

Contents

Points to recall

The following points are to be recalled before learning conceptual framework of accounting:

- Meaning and definition of Accounting
- Functions of Accounting
- Users of Accounting
- Basic Accounting terminologies

AESHH8

Learning Objectives

To enable the students to

- Understand the meaning, definition and features of book-keeping
- Evaluate the advantages and limitations of book-keeping
- Understand the accounting concepts and conventions
- Understand the meaning of and need for Accounting Standards

Key terms to know

- Book-keeping
- Accountancy
- Accounting concepts
- Accounting Standards

2.1 Book-keeping-An introduction

The first tstep in the accounting process is identifying and recording of transactions in the books of accounts. This is necessary for any business as the transactions happening in a business entity must be recorded so that the information is available for further analysis.

Book-keeping forms the base for the preparation of financial statements and interpretation which are the important functions of accounting. In a broad sense, accounting includes book-keeping also. In a small business, the entire accounting work may be performed by a single accountant. In a large firm, there may be a separate person or department for book-keeping work.

2.1.1 Meaning of book-keeping

Book-keeping is the process of recording financial transactions in the books of accounts. It is the primary stage in the accounting process. It includes recording the transactions and classifying the same under proper heads. Book-keeping work is of routine nature. Transactions may be recorded in the accounting note books and ledgers or may be recorded in a computer.

2.1.2 Definition of book-keeping

"Book-keeping is an art of recording business dealings in a set of books". - *J.R.Batliboi.*

"Book-keeping is the science and art of recording correctly in the books of account all those business transactions of money or money's worth". -*R.N.Carter*.

2.1.3 Features of book-keeping

Following are the features of book-keeping:

(i) It is the process of recording transactions in the books of accounts.
(ii) Monetary transactions only are recorded in the accounts.
(iii) Book-keeping is the primary stage in the accounting process.
(iv) Book-keeping includes journalising and ledger posting.

2.1.4 Objectives of book-keeping

Following are the objectives of book-keeping:

(i) To have a complete and permanent record of all business transactions in chronological order and under appropriate headings.
(ii) To facilitate ascertainment of the profit or loss of the business during a specific period.
(iii) To facilitate ascertainment of financial position.
(iv) To know the progress of the business.
(v) To find out the tax liabilities.
(vi) To fulfil the legal requirements.

2.1.5 Advantages of Book-keeping

Book-keeping has the following advantages:

(i) Transactions are recorded systematically in chronological order in the book of accounts. Thus, book-keeping provides a permanent and reliable record for all business transactions.
(ii) Book-keeping is useful to get the financial information.
(iii) It helps to have control over various business activities.
(iv) Records provided by business serve as a legal evidence in case of any dispute.
(v) Comparison of financial information over the years is possible. Also comparison of financial information of different business units is facilitated.
(vi) Book-keeping is useful to find out the tax liability.

2.1.6 Limitations of book-keeping

Book-keeping has the following limitations:

(i) Only monetary transactions are recorded in the books of accounts.

(ii) Effects of price level changes are not considered.

(iii) Financial data recorded are historical in nature, i.e., only past data are recorded.

2.2 Book-keeping Vs. Accounting

Following are the differences between book-keeping and accounting:

S. No	Basis of distinction	Book-keeping	Accounting
1	Scope	It is concerned with recording and classifying the business transactions.	It is concerned with recording, classifying, summarising, analysing and interpreting the financial data.
2	Stage	Book-keeping is the primary stage in accounting. It is the base for accounting.	Apart from the primary stage, it includes secondary stage of analysis and interpretation.
3	Nature of job	It is routine and clerical in nature.	It is analytical in nature.
4	Knowledge required	It requires basic knowledge of the principles of journalising and posting.	It requires thorough knowledge of accounting principles, procedures and practices.
5	Skill required	Analytical skill is not required for book-keeping.	It requires analytical skill.

2.3 Relationship among Book-keeping, Accounting and Accountancy

Book-keeping is part of Accounting. It is the primary stage in accounting. It is the process of recording transactions in the books of accounts. Accounting is part of Accountancy. Accounting is the process of reording, classifying, analysing and interpreting of financial data. Accountancy is the systematic knowledge of accounting process and contains the standards, principles, policies and procedures to be followed in accounting.

Accountancy

Accounting

Book-keeping

2.4 Accounting Principles

Accounting principles are the basic norms and assumptions developed and established as the basis for accounting system. These principles are adopted by the accountants universally. These accounting principles provide uniformity and consistency in the accounting methods and process. Such accounting principles are known as Generally Accepted Accounting Principles (GAAP).

Accounting principles provide the basic framework within which the accounting records and accounting reports are to be prepared. Accounting standards have been issued by national and international regulatory authorities to ensure uniformity of accounting procedure and accounting results. These accounting standards and GAAPs provide the theoretical base of accounting. Accounting principles may be accounting concepts or accounting conventions. Accounting concepts are the basic assumptions whereas conventions are the guidelines based upon practice or usage.

Accounting concepts are the basic assumptions or conditions upon which accounting has been laid. Accounting concepts are the results of broad consensus. The word concept means a notion or abstraction which is generally accepted. Accounting concepts provide unifying structure to the accounting process and accounting reports.

The word convention refers to traditions or usage. The accounting conventions are the usage or practices which are followed as a guide to the preparation of accounting statements.

The utility of these accounting conventions have been recognised by regulatory authorities of accountancy in making financial statements more realistic, reliable, and useful to all concerned parties.

The important accounting concepts and conventions are discussed below:

(i) Business entity concept

This concept implies that a business unit is separate and distinct from the owner or owners, that is, the persons who supply capital to it.

Based on this concept, accounts are prepared from the point of view of the business and not from the owner's point of view. Hence, the business is liable to the owner for the capital contributed by him/her.

According to this concept, only business transactions are recorded in the books of accounts. Personal transactions of the owners are not recorded. But, their transactions with the business such as capital contributed to the business or cash withdrawn from the business for the personal use will be recorded in the books of accounts. It implies that the business itself owns assets and owes liabilities.

(ii) Money measurement concept

This concept implies that only those transactions, which can be expressed in terms of money, are recorded in the accounts. Since, money serves as the medium of exchange transactions expressed in money are recorded and the ruling currency of a country is the measuring unit for accounting.

Transactions which do not involve money will not be recorded in the books of accounts. For example, working conditions in the work place, strike by employees, efficiency of the management, etc. will not be recorded in the books, as they cannot be expressed in terms of money.

It helps in understanding of the state of affairs of the business as money serves as a common measure by means of which heterogeneous facts about the business are recorded. For example, if a business has 5 computers, 2 tables and 3 chairs, the assets cannot be added to give useful information, unless, they are expressed in monetary terms ₹ 1,00,000 for computers, ₹ 10,000 for tables and ₹ 1,500 for chairs.

(iii) Going concern concept

It is the basic assumption that business is a going concern and will continue its operations for a foreseeable future. Going concern concept influences accounting practices in relation to valuation of assets and liabilities, depreciation of the fixed assets, treatment of outstanding and prepaid expenses and accrued and unearned revenues. For example, assets are generally valued at historical cost. Any increase or decrease in the value of assets in the short period is ignored.

(iv) Cost concept

An asset is recorded in the books on the basis of the historical cost, that is, the acquisition cost. Cost of acquisition will be the base for all further accounting. It does not mean that the asset will always be shown at cost. It is recorded at cost at the time of its purchase, but is systematically reduced in its book value by charging depreciation.

The cost concept has the following limitations:

a) In an inflationary situation, when prices of commodities increase, valuing the assets at historical cost may not represent the true position of the business.

b) The results of business units established at different dates are not comparable if assets are recorded on historical basis.

c) Assets which do not have acquisition cost such as human resources are not recognised under this concept.

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(v) Dual aspect concept

Dual Aspect Concept

According to this concept, every transaction or event has two aspects, i.e., dual effect.

For example, when Arun starts a business with cash ₹ 5,00,000, on the one hand, the business gets cash of ₹ 5,00,000 and on the other hand, a liability arises, that is, the business has to pay Arun a sum of ₹ 5,00,000.

This is the concept which recognises the fact that for every debit, there is a corresponding and equal credit. This is the basis of the entire system of double entry book-keeping.

From this concept arises the basic accounting equation, that is,

Capital + Liabilities = Assets

(vi) Periodicity concept

This concept deals with preparing accounts for a particular period. As the proprietors, investors, creditors, employees and the government are interested in knowing the performance of the business unit periodically, it becomes necessary to select a particular period, normally one year for measuring performance. Hence, financial statements are prepared after every accounting period and not at the end of its life.

This concept helps the business in distribution of income to the owners and comparing and evaluating performance of different periods.

(vii) Matching concept

According to this concept, revenues during an accounting period are matched with expenses incurred during that period to earn the revenue during that period. This concept is based on accrual concept and periodicity concept. Periodicity concept fixes the time frame for measuring performance and determining financial status.

All expenses paid during the period are not considered, but only the expenses related to the accounting period are considered.

On the basis of this concept, adjustments are made for outstanding and prepaid expenses and accrued and unearned revenues. Also due provisions are made for depreciation of the fixed assets, bad debt, etc., relating to the accounting period. Thus, it matches the revenues earned during an accounting period with the expenses incurred during that period to earn the revenues before sharing any profit or loss.

(viii) Realisation concept

According to realisation concept, any change in value of an asset is to be recorded only when the business realises it. When assets are recorded at historical value, any change in value is to be accounted only when it realises.

(ix) Objective evidence concept

Objective evidence concept requires that all accounting transactions recorded should be based on objective evidence. The objective evidence includes documentary evidence like cash receipts, invoices, etc. It ensures authenticity, accuracy and reliability of transactions entered in the books of accounts.

(x) Accrual concept

According to accrual concept, the effects of the transactions are recognised on mercantile basis, i.e., when they occur and not when cash is paid or received. Revenue is recognised when it is earned and expenses are recognised when they are incurred. All expenses and revenues related to the accounting period are to be considered irrespective of the fact that whether revenues are received in cash or not and whether expenses are paid in cash or not. For example, i) Credit sale is recognised as sale though the amount has not been received immediately. ii) Rent for the month of March-2018 has not been paid and if the accounting period is 1.4.2017 to 31.3.2018, it will still be recorded as an expense for the accounting year 2017-2018 because it had become due.

(xi) Convention of consistency

The consistency convention implies that the accounting policies must be followed consistently from one accounting period to another. The results of different years will be comparable only when same accounting policies are followed from year to year. For example, if a firm follows the straight line method of charging depreciation since its purchase or construction, the method should be followed without any change. However, it does not mean that changes are not possible.

ACCOUNTING PRINCIPLES

Business entity	Owner and business are two di erent entities
Money measurement	Only monetary transactions are recorded
Going concern	Business will continue for a foreseeable future
Co	Assets are recorded at co price
Dual aspect	Every transaction has two aspects – debit aspect and credit aspect
Periodicity	Accounts are closed at the end of accounting period. It is generally one year
Matching	Expenses relating to a particular period are to be matched with revenues relating to that period.
Realisation	Revenue should be recorded only when it is realised.
Objective evidence	Every transaction mu have a supporting evidence
Accrual	Transaction is recorded when it is entered into and not when settlement takes place.
Consistency	Accounting rules and practices should be continuously observed
Full disclosure	Accounts mu disclose full and fair information
Materiality	Relatively important and significant monetary items are to be recorded and disclosed in the financial atements
Conservatism	While recording transactions, only the prospective losses and not the prospective incomes should be considered

Change in accounting policy can be incorporated in the following circumstances:

(a) To comply with the provisions of law

(b) To comply with accounting standards issued and

(c) To reflect true and fair view of state of affairs of the business.

(xii) Convention of full disclosure

It implies that the accounts must be prepared honestly and all material information should be disclosed in the accounting statement. This is important because the management is different from the owners in most of the organisations.

The disclosure should be full, fair and adequate so that the users of the financial statements can make correct assessment about the financial position and performance of the business unit.

(xiii) Convention of materiality

According to this convention, financial statements should disclose all material items which might influence the decisions of the users of financial statements. Hence, any item which is not significant and is not relevant to the users need not be disclosed in the financial statements.

This principle is basically an exception to the full disclosure principle. The term materiality is subjective in nature. Materiality depends on the amount involved in the transaction, size of the business, nature of information, requirements of the person making decision, etc. An item material to one person may be immaterial to another person.

(xiv) Convention of conservatism or prudence

It is a policy of caution or playing safe. While recording the business transactions one has to anticipate no income but provide for all possible losses.

For example, the closing stock in the factory is valued at ₹ 35,000 at cost price and ₹ 25,000 at its realisable price. But while recording in the books the value of ₹ 25,000 will be considered being the lower of the two. According to realisation concept, any increase in value is not to be accounted unless it has materialised. The conservatism convention puts further restriction on it. Any unrealised gain is not to be anticipated but provision can be made against all possible losses.

DO YOU KNOW?

Going concern concept, Convention of consistency and Accrual concept are considered as fundamental accounting assumptions.

2.5 Accounting Standards (AS)

Student activity

Think: In your school, there are some basic rules to be followed by every student. What are they? What will happen if there is no such rule?

Accounting Standards provide the framework and norms to be followed in accounting so that the financial statements of different enterprises become comparable. It is necessary to standardise the accounting principles to ensure consistency, comparability, adequacy and reliability of financial reporting.

In the words of Kohler, "*Accounting standards are codes of conduct imposed by customs, law or professional bodies for the benefit of public accountants and accountants generally*"

Thus, Accounting Standards are written policy documents issued by the expert accounting body or by government or other regulatory body covering the aspects of recognition, measurement, treatment, presentation and disclosure of accounting transactions and events in the financial statements.

2.5.1 Need for accounting standards

The need for accounting standards is as follows:

(i) To promote better understanding of financial statements

(ii) To help accountants to follow uniform procedures and practices

(iii) To facilitate meaningful comparison of financial statements of two or more entities.

(iv) To enhance reliability of financial statements

(v) To meet the legal requirements effectively

2.6 International Financial Reporting Standards (IFRS)

International Financial Reporting Standards (IFRS) are issued by the International Accounting Standard Board (IASB). IFRS is a set of International Accounting Standards stating how particular types of transactions and other events should be reported in financial statements. IFRS are issued to develop Accounting Standards that would be acceptable worldwide and to improve financial reporting internationally.

2.7 Accounting Standards in India

In India, Standards of Accounting is issued by the Institute of Chartered Accountants of India (ICAI). The Council of the Institute of Chartered Accountants of India constituted Accounting Standards Board (ASB) on 21st April, 1977 recognising the need for Accounting Standards in India. ASB formulates Accounting Standards so that such standards may be established by the Council of the Institute in India. The ASB will consider the applicable law, custom, usage, business environment and the International Accounting Standards while framing Accounting Standards (AS) in India.

Due to globalisation, the accounts prepared in India must be compatible with accounts prepared in other countries. This has resulted in the existing AS being converged with the IFRS. This convergence has resulted in what is known as Ind AS. Ind AS are basically the International Accounting Standards which have been modified in accordance with Indian accounting practices, customs and traditions. Presently, all big companies have to follow Ind AS rules, but smaller business units are allowed to continue using AS. In future, it is expected that all business entities in India will migrate to Ind AS.

Student activity

Visit *icai.org*. Refer under Resources, Accounting Standards and Ind AS.

Points to remember

- There are established accounting principles available which are to be applied in the preparation of accounting records and financial statements.
- The Accounting Standards are designed to ensure uniformity in the accounting methods and practices.

Self-examination questions

I Multiple choice questions

Choose the correct answer

1. The business is liable to the proprietor of the business in respect of capital introduced by the person according to
   (a) Money measurement concept
   (b) Cost concept
   (c) Business entity concept
   (d) Dual aspect concept
2. The concept which assumes that a business will last indefinitely is
   (a) Business Entity
   (b) Going concern
   (c) Periodicity
   (d) Conservatism
3. GAAPs are:
   (a) Generally Accepted Accounting Policies
   (b) Generally Accepted Accounting Principles
   (c) Generally Accepted Accounting Provisions
   (d) None of these
4. The rule of stock valuation 'cost price or realisable value' whichever is lower is based on the accounting principle of:
   (a) Materiality
   (b) Money measurement
   (c) Conservatism
   (d) Accrual
5. In India, Accounting Standards are issued by
   (a) Reserve Bank of India
   (b) The Cost and Management Accountants of India
   (c) Supreme Court of India
   (d) The Institute of Chartered Accountants of India

Answer

1 (c)	2 (b)	3 (b)	4 (c)	5 (d)

II Very short answer questions

1. Define book-keeping.
2. What is meant by accounting concepts?
3. Briefly explain about realisation concept.
4. What is "Full Disclosure Principle" of accounting.
5. Write a brief note on 'Consistency' assumption.

III Short answer questions

1. What is matching concept? Why should a business concern follow this concept?
2. "Only monetary transactions are recorded in accounting". Explain the statement.
3. "Business units last indefinitely". Mention and explain the concept on which the statement is based.
4. Write a brief note on Accounting Standards.

CASE STUDY

Magesh started a new trading business. He buys and sells packing materials. He wants to be honest in doing his business. He has plans to establish his business in the future. He has little accounting knowledge but has excellent business skills. At the end of his first year of trading, he wanted to value his closing stock. He finds some of the goods are damaged. If he wants to sell them, then he has to spend some amount for making them in a saleable condition. He also takes some money from his business bank account for his personal use. But, he forgot to record that.

Now, discuss on the following points

- Does every businessman need accounting knowledge?
- Identify some of the accounting concepts in this case study.
- How should his closing stock be valued?
- Is it possible for him to compare his business results with that of his competitors?

To explore further

Is it possible to compare the accounting records of an Indian company with that of an International company? Do all the countries follow the same accounting practices?

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Unit 3

BOOKS OF PRIME ENTRY

Contents

Points to recall

The following points are to be recalled before learning books of prime entry:

- Business entity concept
- Money measurement concept
- Dual aspect concept
- Realisation concept
- Accrual concept
- Materiality concept
- Cost concept

Learning Objectives

To enable the students to

- Understand the meaning and principles of double entry system
- Analyse the transactions on the basis of accounting equation approach
- Apply the rules of double entry system to pass journal entries for transactions

AFB9KI

Key terms to know

- Source documents
- Cash receipt
- Invoice
- Debit note
- Credit note
- Pay-in-slip
- Cheque
- Double entry system
- Accounting equation
- Golden rules of accounting
- Journal entry

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3.1 Introduction

Student activity

Think: A trader sold goods on credit to one of his customers for ₹ 2,000. After two days, the customer returned some of the goods worth ₹ 300, which were in damaged condition. The trader received back the goods. Later, when the customer paid ₹ 1,700, the trader demanded for full payment. He forgot about the returned goods. How can this situation be avoided?

Accounting process starts with identifying transactions involving money or money's worth and recording these financial transactions in the books of accounts. Transactions are recorded as and when they take place based on authentic documents or proofs or evidences. The authentic proofs are called as the source documents.

3.2 Source documents

Source documents are the authentic evidences of financial transactions. These documents show the nature of transaction, the date, the amount and the parties involved. Source documents include cash receipt, invoice, debit note, credit note, pay-in-slip, salary bills, wage bills, cheque record slips, etc. They are the bases of recording transactions in the books of accounts. They also serve as legal evidence in case of any legal dispute. The source documents commonly used are discussed below:

(i) Cash receipt/voucher

It is a document that shows the date, amount and details of cash purchases and cash sales or other cash transactions. Business persons receive cash receipt for cash purchases and issue cash receipt for cash sales.

Specimen of a cash voucher

TNPL

TAMIL NADU NEWSPRINT AND PAPERS LIMITED
CASH PAYMENT VOUCHER

Organization Name : Tamilnadu Newsprint & Papers Limited			
Invoice Type		Voucher No	
Party Code		Party Name	
Party Address			
Party Site		Payment Mode	
Po No		Chq.Party Name	
BIC Code		A/C No	
Pay Group		Pay Group Desc	

Transaction Details

Invoice No	Due Date	Invoice Date	Voucher No	Voucher Date	Amount
				TOTAL	

Prepared By | Checked By | Approved By

Acknowledgement

Received ₹ --------- /-
Rupees in words :---------------------- Only

Signature with Date

PAYMENTS - OTHERS

(ii) Invoice

Invoice is used for credit purchases and credit sales. The date, amount and details of credit purchases and credit sales are given in the invoices. Invoice is generally prepared by the seller in three copies. The first copy is given to the purchaser, the second copy is sent along with the goods for checking and the third is retained by the seller and used as the source document for recording the transaction.

Specimen of an invoice

TNPL

TAMILNADU NEWSPRINT AND PAPERS LIMITED
(A Government of Tamil Nadu Enterprise)
KAGITHAPURAM - 639 136, Karur District, Tamilnadu.

EXTRA COPY — DEALER

Telephone : (04324) -
Fax : (04324) -
Mobile :
E-mail :

TAX INVOICE

CIN :

SUPPLIER : TAMILNADU NEWSPRINT AND PAPERS LIMITED KAGITHAPURAM-639136. TAMILNADU STATE : STATE CODE : GSTIN :	GST INVOICE NO. DATE : AR INVOICE NO. DATE :
BILL TO : PAN : ADDRESS : STATE : STATE CODE : GSTIN :	SHIP TO : PAN : ADDRESS : STATE : STATE CODE : GSTIN :
P.O.NO. : SALES ORDER : DATE : DEALER CODE : DEALER NAME :	RANGE & DIVISION : COMMISSIONERATE :
DELIVERY ID : TRANSPORTER : TRUCK NO : RR/LR NO. :	(Rs.) BASIC PRICE : VALUE AFTER DISCOUNT : + FIXED FREIGHT : + INSURANCE : TAXABLE AMOUNT : SGST @ 6% : CGST @ 6% :
HSN CODE : DESCRIPTION : ITEM CODE : SUBSTANCE(GSM) : SIZE(CM) : REAM WT : REELS/BUNDLES(NO.) : REAMS(KG) :	NET AMOUNT : AMOUNT IN WORDS : PAYMENT DETAILS : Amount By Date % Discount
UNIT CODE (UQC) : QUANTITY(MT) : LIST PRICE : Rate / MT :	Int% | From | To | If Paid After
LC N NO :	

Whether tax is payable on reserve charge basic:

E. & O. E.	DESP / F-04.	Prepared by	For Tamil Nadu Newsprint and Papers Limited
Subject to Terms and Conditions given overleaf. REGD. OFFICE : 67, Mount Road, Guindy,Chennai - 600 032.		Checked by	Authorised Signatory

(iii) Debit note

A buyer may return the goods to the seller in various situations such as when goods are defective or damaged, goods do not meet the specifications, etc. When goods are returned by a buyer, the buyer prepares a debit note and sends it to the seller. It contains details such as the description of the goods, quantity returned and also their value. Two copies are prepared in general, one copy is sent to the seller and another one is retained by the buyer. It is a document issued by a buyer stating the amount owed by the seller. A debit note is also called as debit memo.

Specimen of a debit note

GSTIN :
STATE :
STATE CODE :

Tamil Nadu Newsprint and Papers Limited
(A Govt. of Tamil Nadu Enterprise)
Kagithapuram-639 136, Karur District, Tamilnadu.
Telephone Nos: ____________
Fax: ______________

DEBIT NOTE

GST SERIAL NO	:		**DATE**	
TRANSACTION NO	:		**TRANSACTION DATE**	
SALES ORDER NO	:		**SALES ORDER DATE**	
ORIGINAL AR INVOICE NO	:		**ORIGINAL AR INVOICE DATE**	
ORIGINAL GST INVOICE	:		**ORIGINAL GST INV DATE**	

RANGE & DIVISION :
COMMISSIONERATE :

RECIPIENT	**SHIP TO**
BILLTO	CODE :
CODE :	CUSTOMER :
NAME :	ADDRESS :
ADDRESS :	STATE :
STATE :	STATE CODE :
STATE CODE :	GSTIN / UIN :
GSTIN / UIN :	PAN :
PAN :	

S. No.	DESCRIPTION	HSNCODE	ITEM NO.	INV QTY	UOM	RATE(Rs.)	AMOUNT(Rs.)
						Taxable Amount	
						CGST@6%	
						SGST@6%	
						NET AMOUNT	

Taxable Amount (in words)	:
Tax Amount (in words)	:
Net Amount (in words)	:

Narration :

Dealer Code & Name

For TAMILNADU NEWSPRINT AND PAPERS LIMITED

Prepared By

Authorised Signatory

Whether tax is payable on reverse charge basis: No
E.&O.E

Student activity

Think: A customer has returned the goods to his supplier along with a debit note. But, the supplier does not agree with the customer's claim that the goods are damaged. Can the customer consider his debit note as a valid source document and enter the purchases returns?

(iv) Credit note

It is a statement prepared by the seller who receives back from his customer the goods sold. It contains details such as the description of the goods, quantity returned and also their value. It is a document sent by a seller to the buyer, stating that a certain amount is owed to the buyer. It is also called as credit memo.

Specimen of a credit note

GSTIN :
STATE :
STATE CODE :

Tamil Nadu Newsprint and Papers Limited
(A Govt. of Tamil Nadu Enterprise)
Kagithapuram-639 136, Karur District, Tamilnadu.
Telephone Nos: ____________
Fax: _______________

CREDIT NOTE

GST SERIAL NO :		DATE	
TRANSACTION NO :		TRANSACTION DATE	
SALES ORDER NO :		SALES ORDER DATE	
ORIGINAL AR INVOICE NO :		ORIGINAL AR INVOICE DATE	
ORIGINAL GST INVOICE :		ORIGINAL GST INV DATE	

RANGE & DIVISION :
COMMISSIONERATE :

RECIPIENT	**SHIP TO**
BILLTO	CODE :
CODE :	CUSTOMER :
NAME :	ADDRESS :
ADDRESS :	STATE :
STATE :	STATE CODE :
STATE CODE :	GSTIN / UIN :
GSTIN / UIN :	PAN :
PAN :	

S. No.	DESCRIPTION	HSNCODE	ITEM NO.	INV QTY	UOM	RATE(Rs.)	AMOUNT(Rs.)
						Taxable Amount	
						CGST@6%	
						SGST@6%	
						NET AMOUNT	

Taxable Amount (in words) :
Tax Amount (in words) :
Net Amount (in words) :
Narration :

Dealer Code & Name

For TAMILNADU NEWSPRINT AND PAPERS LIMITED

Prepared By

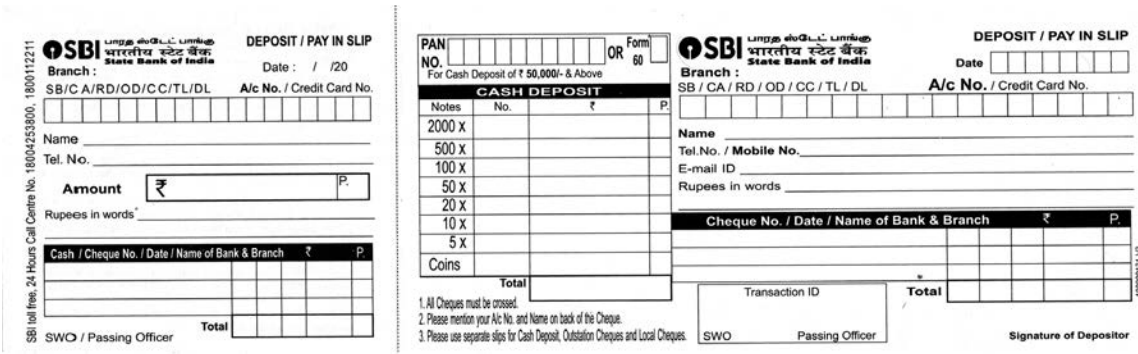
Authorised Signatory

Whether tax is payable on reverse charge basis: No
E.&O.E

(v) Pay-in slip

When cash or cheque is deposited in bank, a form is to be filled by a customer and submitted to the banker along with cash or cheque. This is called as pay-in slip or deposit slip. The main part of this will be retained by the bank and the counterfoil duly stamped and signed by the banker is returned to the customer.

Specimen of a pay-in slip


SBI toll free, 24 Hours Call Centre No. 18004253800, 1800112211

SBI भारतीय स्टेट बैंक State Bank of India — DEPOSIT / PAY IN SLIP

Branch : Date : / /20

SB/C A/RD/OD/CC/TL/DL A/c No. / Credit Card No.

Name

Tel. No.

Amount ₹ P.

Rupees in words

Cash / Cheque No. / Date / Name of Bank & Branch	₹	P.
Total		

SWO / Passing Officer

PAN NO. OR Form 60 — For Cash Deposit of ₹ 50,000/- & Above

CASH DEPOSIT

Notes	No.	₹	P.
2000 x			
500 x			
100 x			
50 x			
20 x			
10 x			
5 x			
Coins			
Total			

1. All Cheques must be crossed.
2. Please mention your A/c No. and Name on back of the Cheque.
3. Please use separate slips for Cash Deposit, Outstation Cheques and Local Cheques.

SBI भारतीय स्टेट बैंक State Bank of India — DEPOSIT / PAY IN SLIP

Branch : Date

SB / CA / RD / OD / CC / TL / DL A/c No. / Credit Card No.

Name

Tel.No. / Mobile No.

E-mail ID

Rupees in words

Cheque No. / Date / Name of Bank & Branch	₹	P.
Total		

Transaction ID

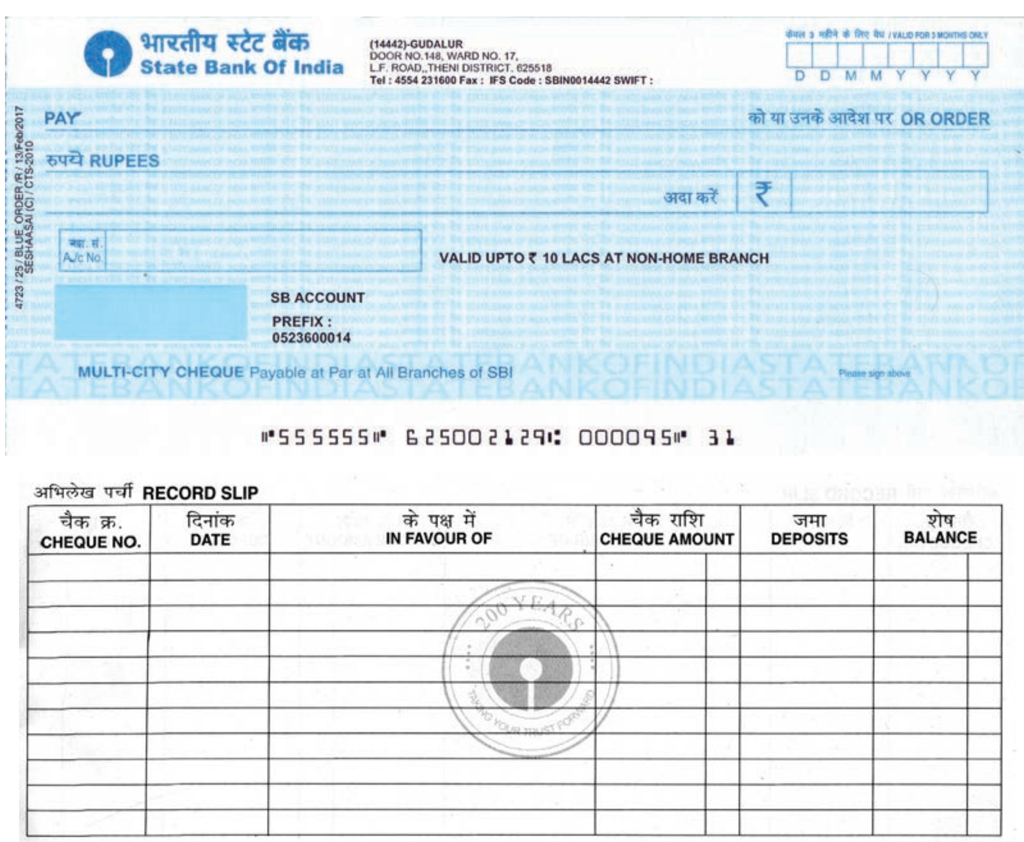
SWO Passing Officer

Signature of Depositor

(vi) Cheque

Cheque is a negotiable instrument. Cheque book is issued by a bank to its customers for withdrawing money for own use or for making payment to others. By issue of cheque, a bank is directed to pay a specific amount of money from a person's account either to the same person or to the person in whose favour the cheque has been issued. Each cheque book has record slips for entering the details of cheques issued. It remains with the account holder for future reference.

Specimen of a cheque and record slip


भारतीय स्टेट बैंक State Bank Of India

(14442)-GUDALUR
DOOR NO.148, WARD NO. 17,
L.F. ROAD, THENI DISTRICT. 625518
Tel : 4554 231600 Fax : IFS Code : SBIN0014442 SWIFT :

D D M M Y Y Y Y

PAY को या उनके आदेश पर OR ORDER

रुपये RUPEES

अदा करें ₹

खा. सं. A/c No.

VALID UPTO ₹ 10 LACS AT NON-HOME BRANCH

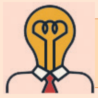
SB ACCOUNT
PREFIX :
0523600014

MULTI-CITY CHEQUE Payable at Par at All Branches of SBI

⑈555555⑈ 625002129⑆ 000095⑈ 31

अभिलेख पर्ची RECORD SLIP

चैक क्र. CHEQUE NO.	दिनांक DATE	के पक्ष में IN FAVOUR OF	चैक राशि CHEQUE AMOUNT	जमा DEPOSITS	शेष BALANCE

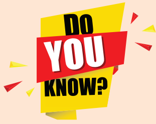


Student activity

Think: Crossed cheque is preferred to a bearer cheque. Why?

3.3 Double entry system

Double entry system of book keeping is a scientific and complete system of recording the financial transactions of an organisation. According to this system, every transaction has a two fold effect. That is, there are two aspects involved, namely, receiving aspect and giving aspect. It is denoted by debit (Dr.) and credit (Cr.). The basic principle of double entry system is that for every debit there must be an equivalent and corresponding credit. Debit denotes an increase in assets or expenses or a decrease in liabilities, income or capital. Credit denotes an increase in liabilities, income or capital or a decrease in assets or expenses.



'Dr.' is abbreviation of 'addebitare', the Italian word and debere, the Latin word meaning 'debit'. Hence, though there is no 'r' in the word debit. It has been abbreviated as 'Dr.' based on the Italian and Latin words having 'r' in these.

3.3.1 Definition

"Every transaction involving money or money's worth has two fold aspects, the receiving of a value on the one hand and the giving of the same value on the other. This two fold nature in all transactions must be recorded in the books and this gives rise to the term Double Entry Book keeping".

– Munro and Palmer

"Every business transaction has a two-fold effect and that it affects two accounts in opposite directions and if a complete record is to be made of each such transaction it is necessary to debit one account and credit another account. It is this recording of two fold effect of every transaction that has given rise to the term Double Entry".

– J.R Batliboi

3.3.2 Principles of double entry system

Following are the principles of double entry system:

(i) In every business transaction, there are two aspects.

(ii) The two aspects involved are the benefit or value receiving aspect and benefit or value giving aspect.

(iii) These two aspects involve minimum two accounts; at least one debit and at least one credit.

(iv) For every debit, there is a corresponding and equivalent credit. If one account is debited the other account must be credited.

3.3.3 Advantages of double entry system

Following are the advantages of double entry system:

(i) Accuracy

In this system, the two aspects of each transaction are recorded in the books of accounts. This helps in checking the accuracy in accounting.

(ii) Ascertainment of business results

Details regarding expenses, losses, incomes, gains, assets, liabilities, debtors, creditors, etc., are readily available. This helps to ascertain the net profit earned or loss incurred during an accounting period and also to know the financial position as on a particular date.

(iii) Comparative study

The business results of the current year can be compared with those of the previous years and also with other business firms. It facilitates business planning for future.

(iv) Common acceptance

The business records maintained under this system are accepted by financial institutions, government and others, because it is a systematic and scientific system.

3.4 Transaction

Transaction involves transfer of money or money's worth (goods or services or ideas) from one person to another. Transaction can be classified into cash transaction, bank transaction and credit transaction.

(a) Cash transaction

When immediate cash is involved in a transaction, it is called cash transaction. For example, goods are sold for cash ₹ 5,000. In this case, cash ₹ 5,000 comes into the business and goods worth ₹ 5,000 go out of the business.

(b) Bank transaction

In a transaction, if bank is involved, it is a bank transaction. Bank transaction includes the following:

(i) Cash deposited into the bank

(ii) Income of the business directly received by the bank

(iii) Receipts through Cash Deposit Machine (CDM)

(iv) Payment made by the customers of the business through debit card, credit card, net banking, National Electronic Funds Transfer (NEFT), Real Time Gross Settlement (RTGS), etc.

(v) Cash withdrawn from the bank

(vi) Bank charges levied by the bank

(vii) Payments made by the bank as per standing instructions

(viii) Payments made by cheque

(ix) Payments made by the business through debit card, net banking, NEFT and RTGS

DO YOU KNOW?

Automated Teller Machine (ATM): ATM is a computerised machine that provides the customers of banks the facility of accessing their account for dispensing cash and to carry out other financial and non-financial transactions without the need to actually visit their bank branch.

Cash Deposit Machine (CDM): It is an ATM like machine that allows depositing cash directly into a customer's account without any manual intervention of the bank employee. There is no need to fill deposit slips.

Debit card: The debit cards are used to withdraw cash from an ATM, to purchase goods and services at Point of Sale (POS) and in E-commerce (online purchase). A customer can use debit card for the money he has in the bank account with some restrictions.

Credit card: The credit cards are used to purchase goods and services at Point of Sale (POS) and in E-commerce (online purchase). A customer can use credit card within the limit specified by the bank even if there is inadequate balance in the account The bank may charge interest and other charges for credit card usage.

NEFT: National Electronic Funds Transfer (NEFT) is a nation-wide payment system facilitating one-to-one funds transfer. Under this scheme, any person can electronically transfer funds from any bank branch to any person having an account with any other bank branch in the country.

RTGS: The acronym 'RTGS' stands for Real Time Gross Settlement, which can be defined as the continuous (real-time) settlement of funds transfers individually on an order by order basis.

(c) Credit transaction

When settlement is not made by cash or through bank immediately in a transaction, it is called credit transaction. But, the amount is to be settled within a specified period. For example, purchase of goods on credit for ₹ 3,000. In this case, goods worth ₹ 3,000 come into the business and a liability of creditors worth ₹ 3,000 arises.

3.5. Account

Every transaction has two aspects and each aspect affects minimum one account. An account is the basic unit of identification in accounting. A ledger account is a summary of relevant transactions at one place relating to a particular head. Account is the systematic presentation of all material information regarding a particular person or item at one place, under one head.

3.6. Approaches of recording transactions

There are two approaches for recording transactions, namely, i) Accounting equation approach and ii) Traditional approach.

3.6.1. Accounting equation approach

The relationship of assets with that of liabilities to outsiders and to owners in the equation form is known as accounting equation.

Under the double entry system of book keeping, every transaction has two fold effect, which causes the changes in assets and liabilities or capital in such a way that an accounting equation is completed and equated.

Capital + Liabilities = Assets

Capital can also be called as owner's equity and liabilities as outsider's equity.

Accounting equation is a mathematical expression which shows that the total of assets is equal to the total of liabilities and capital. This is based on the dual aspect concept of accounting. This means that total claims of outsiders and the proprietor against a business enterprise will always be equal to the total assets of the business enterprise.

As the revenues and expenses will affect capital, the expanded equation may be given as under:

Assets = Liabilities + Capital + Revenues – Expenses

Therefore, under this approach, accounts are classified into five categories: (i) Asset account, (ii) Liability account, (iii) Capital account, (iv) Revenue account and (v) Expense account as follows:

Account

Asset | Liability | Capital | Revenue | Expense

(i) **Asset account**

Any physical thing or right owned that has a monetary value is called asset. The assets are grouped and shown separately; for example, Land and Buildings account, Plant and Machinery account.

(ii) **Liability account**

Financial obligations of the enterprise towards outsiders are shown under separate heads as liabilities; for example, creditors account, expenses outstanding account.

(iii) **Capital account**

Financial obligations of a business enterprise towards its owners are grouped under this category; for example, capital contributed by owner.

(iv) **Revenue account**

Accounts relating to revenues of an enterprise are grouped under this category, for example; revenues from sale of goods, rent received.

(v) **Expense account**

Expenses incurred and losses suffered for earning revenue are grouped under this category; for example, purchase of goods, salaries paid.

A transaction may have the effect on either side of the equation by the same amount or it may have the effect on one side of the equation only, by both increasing and decreasing it by an equal amount.

Recording of transactions as per accounting equation approach is explained below:

(a) Increase in capital and increase in asset

Commenced business with cash ₹ 1,00,000

Effects: (i) Cash comes in → Increase in asset

(ii) Capital provided by the owner → Increase in capital of owner

Capital	=	Assets
Capital	=	Cash
(+) ₹ 1, 00,000	=	(+) ₹ 1, 00,000

(b) Decrease in liability and decrease in asset

Paid creditors ₹ 10,000

Effects: (i) Cash goes out → Decrease in asset

(ii) Creditors are paid → Decrease in liability

Liabilities	=	Assets
Creditors	=	Cash
(–) ₹ 10,000	=	(–) ₹ 10,000

(c) Decrease in one asset and increase in another asset

Bought furniture costing ₹ 5,000 by paying cash

Effects: (i) Furniture comes in → Increase in asset

(ii) Cash goes out → Decrease in asset

Liabilities	=	Assets
Liabilities	=	Cash + Furniture
	=	(–) ₹ 5,000 (+) ₹ 5,000

(d) Decrease in one liability and increase in another liability

Accepted a bill drawn by creditors for ₹ 10,000

Effects: (i) Bills payable arises → Increase in liability

(ii) Reduction in creditors → Decrease in liability

Liabilities	=	Assets
+ Bills payable – Creditors	=	Assets
(+) ₹ 10,000 (–) ₹ 10,000	=	Assets

(e) Transactions affecting more than two accounts:

Goods costing ₹ 30,000 sold for ₹ 40,000

Effects: (i) Goods go out → Decrease in assets

(ii) Cash comes in → Increase in assets

(iii) Sold goods at a profit → Increase in capital

Liabilities + Capital	=	Assets
Capital	=	Cash – Stock
(+) ₹ 10,000	=	(+) ₹ 40,000 (–) ₹ 30,000

Illustration 1

Complete the missing items.

	Assets ₹ =	**Liabilities ₹ +**	**Capital ₹**
(a)	30,000	20,000	?
(b)	60,000	25,000	?
(c)	?	25,000	30,000
(d)	?	10,000	80,000
(e)	25,000	?	15,000
(f)	40,000	?	30,000

Solution

	Assets ₹ =	Liabilities ₹ +	Capital ₹
(a)	30,000	20,000	**10,000**
(b)	60,000	25,000	**35,000**
(c)	**55,000**	25,000	30,000
(d)	**90,000**	10,000	80,000
(e)	25,000	**10,000**	15,000
(f)	40,000	**10,000**	30,000

Illustration 2

Show the accounting equation on the basis of the following transactions for Rani, who is dealing in automobiles.

(i)	Started business with cash	₹ 80,000
(ii)	Goods bought on credit from Ramesh	₹ 10,000
(iii)	Purchased furniture for cash	₹ 6,000
(iv)	Paid creditors by cash	₹ 8,000
(v)	Purchased goods for cash	₹ 2,000
(vi)	Paid rent by cash	₹ 500

Solution

In the books of Rani
Accounting Equation

Transaction	Assets				Capital ₹	Creditors ₹
	Cash ₹	Stock ₹	Furniture ₹			
(i) Started business with cash	+80,000				+80,000	
Equation	**+80,000**			=	**+80,000**	
(ii) Credit purchases		+10,000				+10,000
Equation	**+80,000**	**+10,000**		=	**+80,000**	**+10,000**
(iii) Cash purchase of furniture	–6,000		+6,000			
Equation	**+74,000**	**+10,000**	**+6,000**	=	**+80,000**	**+10,000**
(iv) Paid creditors by cash	–8,000					–8,000
Equation	**+66,000**	**+10,000**	**+6,000**	=	**+80,000**	**+2,000**
(v) Purchased goods for cash	–2,000	+2,000				
Equation	**+64,000**	**+12,000**	**+6,000**	=	**+80,000**	**+2,000**
(v) Paid rent by cash	–500				–500	
Equation	**+63,500**	**+12,000**	**+6,000**	=	**+79,500**	**+2,000**

Illustration 3

Selvi is a dealer in furniture. Show the accounting equation for the following transactions.

(i)	Started business with cash	₹ 1,00,000
(ii)	Deposited cash into bank	₹ 60,000
(iii)	Borrowed loan from bank	₹ 25,000
(iv)	Bought goods and paid by cheque	₹ 10,000
(v)	Cash withdrawn for personal use	₹ 5,000
(vi)	Cash withdrawn from bank for office use	₹ 3,000

Solution

In the books of Selvi
Accounting Equation

Transaction	Assets					Bank loan ₹
	Cash ₹	Stock ₹	Bank ₹		Capital ₹	
(i) Started business with cash	+1,00,000			=	+1,00,000	
Equation	**+1,00,000**				**+1,00,000**	
(ii) Deposited cash with bank	– 60,000		+60,000			
Equation	**+40,000**		**+60,000**	=	**+1,00,000**	
(iii) Borrowed loan from bank			+25,000			+25,000
Equation	**+40,000**		**+85,000**	=	**+1,00,000**	**+25,000**
(iv) Bought goods and paid by cheque		+10,000	–10,000			
Equation	**+40,000**	**+10,000**	**+75,000**	=	**+1,00,000**	**+25,000**
(v) Cash withdrawn for personal use	– 5,000				–5,000	
Equation	**+35,000**	**+10,000**	**+75,000**	=	**+95,000**	**+25,000**
(vi) Cash withdrawn from bank for office use	+3,000		–3,000			
Equation	**+38,000**	**+10,000**	**+72,000**	=	**+95,000**	**+25,000**

Illustration 4

Show the effect of following business transactions on the accounting equation.

(i)	Anbu started business with cash ₹ 20,000; goods ₹ 12,000 and machine	₹ 8,000
(ii)	Purchased goods from Ramani on credit	₹ 7,000
(iii)	Payment made to Ramani in full settlement	₹ 6,900
(iv)	Sold goods to Rajan on credit costing ₹ 5,400 for	₹ 6,000
(v)	Received from Rajan ₹ 5,800 in full settlement of his account	
(vi)	Wages outstanding	₹ 400

Solution

Accounting Equation

Transaction	Assets					Capital ₹	Liabilities ₹
	Cash ₹	Stock ₹	Machine ₹	Debtors ₹			
(i) Started business with cash, stock & machine	+20,000	+12,000	+8,000			+40,000	
Equation	**+20,000**	**+12,000**	**+8,000**		=	**+40,000**	
(ii) Credit purchases		+7,000					+7,000
Equation	**+20,000**	**+19,000**	**+8,000**		=	**+40,000**	**+7,000**
(iii) Payment made to Ramani in full settlement	–6,900					+100	–7,000
Equation	**+13,100**	**+19,000**	**+8,000**		=	**+40,100**	

(iv) Credit sales		−5,400		+6,000		+600	
Equation	**+13,100**	**+13,600**	**+8,000**	**+6,000**	=	**+40,700**	
(v) Cash receipt from Rajan. in full settlement	+5,800			−6,000		−200	
Equation	**+18,900**	**+13,600**	**+8,000**		=	**+40,500**	
(vi) Wages outstanding						−400	+400
Equation	**+18,900**	**+13,600**	**+8,000**		=	**+40,100**	**+400**

3.6.2 Traditional approach

Under this approach, the two fold aspects (debit and credit) in each transaction are recorded in the journal by following double entry system. For the purpose of recording the transactions, accounts are classified into personal and impersonal accounts.

3.6.2.1 Classification of accounts:

Under double entry system of book keeping, for the purpose of recording the various financial transactions, the accounts are classified as personal accounts and impersonal accounts.

(i) **Personal account**: Account relating to persons is called personal account. The personal account may be natural, artificial or representative personal account.

- (a) **Natural person's account:** Natural person means human beings. Example: Vinoth account, Malini account.
- (b) **Artificial person's account:** Artificial person refers to the persons other than human beings recognised by law as persons. They include business concerns, charitable institutions, etc. Example: BHEL account, Bank account.
- (c) **Representative personal accounts:** These are the accounts which represent persons natural or artificial or a group of persons. Example: Outstanding salaries account, Prepaid rent account. When expenses are outstanding, it is payable to a person. Hence, it represents a person.

(ii) **Impersonal accounts**: All accounts which do not affect persons are called impersonal accounts. These are further classified into a) Real accounts and b) Nominal accounts.

- (a) **Real account:** All accounts relating to tangible and intangible properties and possessions are called real accounts.
  1. **Tangible real accounts:** These include accounts of properties and possessions which can be seen and touched. These have physical existence. Example: Plant, Machinery, Building, Furniture, Stock.
  2. **Intangible real accounts**: These include accounts of properties and possessions which can not be seen and touched. These do not have physical existence. Example: Goodwill, Patents, Copy rights.
- (b) **Nominal account:** The accounts relating to expenses, losses, revenues and gains are called nominal accounts. Example: Salaries, wages, rental income, interest income, etc. These are temporary accounts and are transferred to Trading and Profit and Loss account depending on whether these are direct or indirect respectively.

Classification of account

- Account
  - Personal
    - Natural
    - Artificial
    - Representative
  - Impersonal
    - Real
      - Tangible
      - Intangible
    - Nominal

3.7 Accounting rules

All the above classified accounts have two rules each, one related to debit and another related to credit for recording the transactions which are termed as golden rules of accounting or rules of double entry system.

Golden rules of double entry system

Personal account	Debit the receiver	Credit the giver
Real account	Debit what comes in	Credit what goes out
Nominal account	Debit all expenses and losses	Credit all incomes and gains

Illustration 5

Classify the following into personal, real and nominal accounts.

(a) Capital
(b) Building
(c) Carriage inwards
(d) Cash
(e) Commission received
(f) Bank
(g) Purchases
(h) Chandru
(i) Outstanding wages

Solution

Sl. No.	Items	Classification
(a)	Capital	Personal account
(b)	Building	Real account
(c)	Carriage inwards	Nominal account
(d)	Cash	Real account
(e)	Commission received	Nominal account
(f)	Bank	Personal account
(g)	Purchases	Nominal account
(h)	Chandru	Personal account
(i)	Outstanding wages	Personal account

DO YOU KNOW?

- Purchases is treated as a nominal account as it is an expenditure and sales is treated as a nominal account as it is a revenue to the business.
- Purchases, Purchases returns, Sales and Sales returns may also be treated as real accounts as they are related to goods.

3.8 Journal entries

The word journal has been derived from the French word 'Jour' which means day. So, journal means daily. Transactions are recorded daily in the journal as and when the transactions take place. As soon as a transaction takes place, its debit and credit aspects are analysed and recorded in the journal together with a short description called narration. This facilitates making entries in the ledger. Since transactions are first recorded in the journal, it is called book of original entry or prime entry or primary entry or preliminary entry, or first entry. Journalising is the beginning of the accounting process for the financial transactions.

3.8.1 Meaning

Journal is the book of original entry in which business transactions are recorded in chronological order, that is, in the order of occurrence. Transactions are recorded for the first time in the journal. Entries are made in the journal based on source documents. Record of business transactions in the journal is known as Journal entry. The process of recording the transactions in journal is called as journalising.

According to Professor Carter, "The journal as originally used, is a book of prime entry in which transactions are copied in order of date from a memorandum or waste book. The entries as they are copied are classified into debits and credits, so as to facilitate their being correctly posted, afterwards in the ledger".

3.8.2 Format of Journal

The format of journal is given below:

In the books of..........

Journal

Date	Particulars	L.F.	Debit ₹	Credit ₹

A journal contains five columns; Date, Particulars, L.F., Debit and Credit.

Date column: In this column the date of the transaction is recorded.

Particulars column: The accounts involved in the transaction are recorded in this column. The account debited is recorded first with the word 'Dr.' entered towards the end of the row and the account credited is entered in the next line after leaving a little space on the left and preceded by the word 'To'.

Leder Folio column (L.F.): The page number of ledger in which the accounts debited and credited are maintained is recorded here. Folio means page and ledger folio means page number of ledger. This L.F. helps in cross verification of accounts in the ledger and helps in audit of accounts.

Debit column: The amount to be debited is recorded in this column. The unit of measurement, that is, amount expressed in the currency of the country is recorded in this column. For example, in India amount is recorded in rupees (₹).

Credit column: The amount to be credited is recorded in this column. The unit of measurement, that is, the currency of the country is written in this column. For example, in India amount is recorded in rupees (₹).

Narration: A short description of each transaction is written under each entry which is called narration.

Tutorial note

(i) While entering the date, the year may be written at the top, then the month and then the particular date.

(ii) The narration must be simple and complete. The words 'Being' or 'For' may also be prefixed before the narration.

(iii) It is customary to write 'Dr' and 'To' in the journal entries.

(iv) L.F. column is filled when the transaction is posted to the ledger. In computerised accounting, it is the reference number.

(v) The amount columns of a journal may be totalled at the end of the each page and the grand total may be given at the end of the month.

(vi) To show each journal entry separately, a line may be drawn after narration in particulars column.

(vii) When transactions of similar nature take place on the same date, they may be combined while they are journalised.

3.8.3 Steps in journalising

The process of analysing the business transactions under the heads of debit and credit and recording them in the journal is called journalising. An entry made in the journal is called a journal entry. The following steps are followed in journalising:

(1) Analyse the transactions and identify the accounts (based on aspects) which are involved in the transaction.

(2) Classify the above accounts under Personal account, Real account or Nominal account

(3) Apply the rules of debit and credit for the above two accounts.

(4) Find which account is to be debited and which account is to be credited by the application of rules of double entry system

(5) Record the date of transaction in the date column.

(6) Enter the name of the account to be debited in the particulars column very close to the left hand side of the particulars column followed by the abbreviation 'Dr.' at the end in the same line. Against this, the amount to be debited is entered in the debit amount column in the same line.

(7) Write the name of the account to be credited in the second line starting with the word 'To' prefixed a few spaces away from the margin in the particulars column. Against this, the amount to be credited is entered in the credit amount column in the same line.

(8) Write the narration within brackets in the next line in the particulars column.

3.8.4 Different types of journal entries

The journal entries may be of the following types:

(i) Single entry
(ii) Compound entry
(iii) Opening entry
(iv) Closing entry
(v) Rectifying entry
(vi) Adjusting entry
(vii) Transferring entry

(i) **Single entry:** Single entry is an entry in which only two accounts are involved, one account is debited and another is credited.

(ii) **Compound entry:** Compound entry is an entry in which more than two accounts are involved. Either more than one account is debited or more than one account is credited or both.

(iii) **Opening entry:** Through opening entry the balances of assets and liabilities at the end of the previous accounting year are brought forward to the current accounting year. This is dealt in unit 6.

(iv) **Closing entry:** At the end of the accounting period, the nominal accounts are closed by transferring to trading account or profit and loss account. All direct expenses and direct revenues are transferred to Trading Account. All indirect expenses and indirect revenues are transferred to Profit and Loss Account. This is dealt in unit 6.

(v) **Rectifying entry:** Rectifying entries are passed to make correction of errors in accounting. This is dealt in unit 9.

(vi) **Adjusting entry:** Adjusting entry is the entry made for the transactions which remain unrecorded or require adjustment after closing the accounts for the accounting year. This is dealt in unit 13.

(vii) **Transfer entry:** Transfer entry is the entry through which amount is transferred from one account to another account.

3.8.5 Application of rules of double entry system

Rules of double entry system of book-keeping are applied for business transactions as follows:

(i) **Personal account**

'Debit the receiver and Credit the giver'. In case of personal accounts, the rule is debit the account of the person who receives the benefit and credit the account of the person who gives the benefit.

Example	:	Paid Anbu ₹ 10,000 by cheque
Accounts affected	:	Anbu account and Bank account
Nature of accounts	:	Both are personal accounts in nature
Rule	:	Debit the receiver and credit the giver
Applying the rule	:	Anbu is the receiver and the Bank is the giver
Debit		Anbu account
Credit		Bank account

(ii) **Real account**

'Debit what comes in and Credit what goes out'. In case of real accounts, the rule is debit what comes in and credit what goes out.

Example	:	Furniture purchased for cash ₹ 5,000
Accounts affected	:	Furniture account and Cash account
Nature of accounts	:	Both are real accounts in nature
Rule	:	Debit what comes in and credit what goes out
Applying the rule	:	Furniture comes in and cash goes out
Debit		Furniture account
Credit		Cash account

(iii) **Nominal account**

'Debit all expenses and losses and Credit all incomes and gains'. For nominal accounts, the rule is debit all expenses and losses and credit all incomes and gains.

Example	:	Paid rent of ₹ 5,000 in cash
Accounts affected	:	Rent account and cash account
Nature of accounts	:	Rent is a nominal account and cash account is a real account
Rule	:	Debit all the expenses and losses and credit all the incomes and gains
Applying the rule	:	Rent is an expense and cash goes out
Debit		Rent account
Credit		Cash account

3.8.6 Analysis of transactions

Example 1

Transaction: Somu commenced printing business with cash ₹ 50,000.

Analysis: This is a cash transaction as cash is involved.

Transaction	Accounts involved	Nature of accounts	How affected in business	Debit / Credit
Somu commenced business with cash ₹ 50,000	Cash A/c Somu's capital A/c	Real A/c Personal A/c	Cash comes in Somu is the giver	Debit Credit

Journal entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Cash A/c To Somu's capital A/c (Somu commenced business with capital)	Dr.		50,000	50,000

Example 2

Transaction: Bought goods for cash ₹ 4,000

Analysis: This is a cash transaction as cash is involved.

Transaction	Accounts involved	Nature of accounts	How affected in business	Debit / Credit
Bought goods for cash ₹ 4,000	Purchases A/c Cash A/c	Nominal A/c Real A/c	Expenses made Cash goes out	Debit Credit

Journal entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Purchases A/c To Cash A/c (Cash purchase made)	Dr.		4,000	4,000

Example 3

Transaction: Purchased goods from Rahul for ₹ 10,000 on credit

Analysis: This is a credit transaction.

Transactions	Accounts involved	Nature of accounts	How affected in business	Debit / Credit
Purchased goods from Rahul for ₹ 10,000 on credit	Purchases A/c Rahul A/c	Nominal A/c Personal A/c	Expenses made Rahul is the giver	Debit Credit

Journal entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Purchases A/c	Dr.		10,000	
	To Rahul A/c				10,000
	(Bought goods from Rahul on credit)				

Example 4

Transaction: Cash paid to Rahul ₹ 4,000

Analysis: This is a cash transaction as cash is involved.

Transaction	Accounts involved	Nature of accounts	How affected in business	Debit / Credit
Paid Rahul ₹ 4,000	Rahul A/c Cash A/c	Personal A/c Real A/c	Rahul is the receiver Cash goes out	Debit Credit

Journal entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Rahul A/c	Dr.		4,000	
	To Cash A/c				4,000
	(Paid Rahul)				

Example 5

Transaction: Withdrew cash for personal use ₹ 8,000

Analysis: This is a cash transaction as cash is involved.

Transactions	Accounts involved	Nature of accounts	How affected in business	Debit / Credit
Withdrew cash for personal use ₹ 8,000	Drawings A/c Cash A/c	Personal A/c Real A/c	Propreitor is the receiver Cash goes out	Debit Credit

Journal entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Drawings A/c	Dr.		8,000	
	To Cash A/c				8,000
	(Cash withdrawn for personal use)				

Example 6

Transaction: Cash deposited into bank ₹ 5,000

Analysis: This is a cash transaction as cash is involved.

Transaction	Accounts involved	Nature of accounts	How affected in business	Debit / Credit
Cash deposited into bank ₹5,000	Bank A/c Cash A/c	Personal A/c Real A/c	Bank is the receiver Cash goes out	Debit Credit

Journal entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Bank A/c Dr. To Cash A/c (Cash deposited into bank)		5,000	 5,000

Example 7

Transaction: Paid salary by cheque ₹ 3,000

Analysis: This is a bank transaction as bank is involved.

Transaction	Accounts involved	Nature of accounts	How affected in business	Debit / Credit
Paid salary by cheque ₹ 3,000	Salary A/c Bank A/c	Nominal A/c Personal A/c	Expense made Bank is the giver	Debit Credit

Journal entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Salaries A/c Dr. To Bank A/c (Salary paid by cheque)		3,000	 3,000

Example 8

Transaction: Sold goods to Mahesh on credit ₹ 9,000

Analysis: This is a credit transaction.

Transaction	Accounts involved	Nature of accounts	How affected in business	Debit / Credit
Sold goods to Mahesh on credit ₹ 9,000	Mahesh A/c Sales A/c	Personal A/c Nominal A/c	Mahesh is the receiver Revenue earned	Debit Credit

Journal entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Mahesh A/c Dr. To Sales A/c (Sold goods to Mahesh on credit)		9,000	 9,000

Example 9

Transaction: Goods sold to Mahendran for cash ₹ 5,000

Analysis: This is a cash transaction as cash is involved.

Transaction	Accounts involved	Nature of accounts	How affected in business	Debit / Credit
Cash sales made to Mahendran for ₹ 10,000	Cash A/c Sales A/c	Real A/c Nominal A/c	Cash comes in Revenue earned	Debit Credit

Journal entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Cash A/c	Dr.		5,000	
	To Sales A/c				5,000
	(Cash sales made)				

Example 10

Transaction: Borrowed loan from Bank ₹ 10,000

Analysis: This is a cash transaction as cash is involved.

Transaction	Accounts involved	Nature of accounts	How affected in business	Debit / Credit
Borrowed loan from Bank ₹10,000	Bank A/c Bank loan A/c	Personal A/c Personal A/c	Bank is the receiver Bank is the giver	Debit Credit

Journal entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Bank A/c	Dr.		10,000	
	To Bank loan A/c				10,000
	(Borrowed loan from bank)				

Example 11

Transaction: Received commission of ₹ 5,000 by cash

Analysis: This is a cash transaction as cash is involved.

Transaction	Accounts involved	Nature of accounts	How affected in business	Debit / Credit
Received commission ₹ 5,000	Cash A/c Commission A/c	Real A/c Nominal A/c	Cash comes in Receipt of commission	Debit Credit

Journal entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Cash A/c	Dr.		5,000	
	To Commission received A/c				5,000
	(Commision received)				

Example 12

Transaction: Paid ₹ 4,800 in full settlement of ₹ 5,000 due to the creditor, Keerthana.

Analysis: This is a cash transaction as cash is involved.

Transaction	Accounts involved	Nature of accounts	How affected in business	Debit / Credit
Paid ₹ 4,800 in full settlement of ₹ 5,000 to Keerthana	Keerthana A/c	Personal A/c	Keerthana is the receiver	Debit
	Cash A/c	Real A/c	Cash goes out	Credit
	Discount received A/c	Nominal A/c	Discount is a gain	Credit

Journal entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Keerthana A/c	Dr.		5,000	
	To Cash A/c				4,800
	To Discount received A/c				200
	(Paid Keerthana in full settlement)				

Example 13

Transaction: Dinesh, a customer is declared insolvent and 40 paise in a rupee is received from the estate for his due ₹ 10,000.

Analysis: This is a cash transaction as cash is involved.

Transaction	Accounts involved	Nature of accounts	How affected in business	Debit / Credit
Dinesh who owed ₹ 10,000, became insolvent and 40 paise in a rupee is received from his estate	Cash A/c	Real A/c	Cash comes in	Debit
	Bad debts A/c	Nominal A/c	Bad debts is a loss	Debit
	Dinesh A/c	Personal A/c	Dinesh is the giver	Credit

Journal entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Cash A/c	Dr.		4,000	
	Bad debts A/c	Dr.		6,000	
	To Dinesh A/c				10,000
	(Cash received in final settlement on insolvency)				

Tutorial note

Though the procedure for analysis of transactions, classification of accounts and rules for recording transactions under accounting equation approach and traditional approach are different, the accounts affected and entries in affected accounts remain the same under both approaches. In other words, accounts to be debited and credited to record the dual aspect remain the same under both the approaches.

Illustration 6

Jeyaseeli is a sole proprietor having a provisions store. Following are the transactions during the month of January, 2018. Journalise them.

Jan.		₹
1	Commenced business with cash	80,000
2	Deposited cash with bank	40,000
3	Purchased goods by paying cash	5,000

4	Purchased goods from Lipton & Co. on credit	10,000
5	Sold goods to Joy and received cash	11,000
6	Paid salaries by cash	5,000
7	Paid Lipton & Co. by cheque for the purchases made on 4th Jan.	
8	Bought furniture by cash	4,000
9	Paid electricity charges by cash	1,000
10	Bank paid insurance premium as per standing instructions	300

Solution

In the books of Jeyaseeli
Journal entries

Date	Particulars		L.F.	Debit ₹	Credit ₹
2018 Jan. 1	Cash A/c	Dr.		80,000	
	To Jeyaseeli's Capital A/c				80,000
	(Jeyaseeli commenced business with cash)				
2	Bank A/c	Dr.		40,000	
	To Cash A/c				40,000
	(Deposited cash into bank)				
3	Purchases A/c	Dr.		5,000	
	To Cash A/c				5,000
	(Goods purchased by cash)				
4	Purchases A/c	Dr.		10,000	
	To Lipton & Co. A/c				10,000
	(Goods purchased on credit)				
5	Cash A/c	Dr.		11,000	
	To Sales A/c				11,000
	(Cash sales made)				
6	Salaries A/c	Dr.		5,000	
	To Cash A/c				5,000
	(Salaries paid)				
7	Lipton & Co. A/c	Dr.		10,000	
	To Bank A/c				10,000
	(Payment made by cheque)				
8	Furniture A/c	Dr.		4,000	
	To Cash A/c				4,000
	(Furniture bought for cash)				
9	Electricity charges A/c	Dr.		1,000	
	To Cash A/c				1,000
	(Electricity charges paid)				
10	Insurance premium A/c	Dr.		300	
	To Bank A/c				300
	(Insurance premium paid)				

Illustration 7

Ananth is a trader dealing in textiles. For the following transactions, pass journal entries for the month of January, 2018.

Jan.		₹
1	Commenced business with cash	70,000
2	Purchased goods from X and Co. on credit	30,000
3	Cash deposited into bank	40,000
4	Bought a building from L and Co. on credit	95,000
5	Cash withdrawn from bank for office use	5,000
6	Cash withdrawn from bank for personal use of Ananthu	4,000
7	Towels given as charities	3,000
8	Shirts taken over by Ananth for personal use	12,000
9	Sarees distributed as free samples	3,000
10	Goods (table clothes) used for office use	200

Solution

In the books of Ananth
Journal entries

Date	Particulars	L.F.	Debit ₹	Credit ₹
2018 Jan. 1	Cash A/c Dr. To Ananth's capital A/c (Commenced business with cash)		70,000	70,000
2	Purchases A/c Dr. To X and Co. A/c (Credit purchases made)		30,000	30,000
3	Bank A/c Dr. To Cash A/c (Cash deposited into bank)		40,000	40,000
4	Buildings A/c Dr. To L and Co. A/c (Building bought on credit)		95,000	95,000
5	Cash A/c Dr. To Bank A/c (Cash withdrawn from bank for office use)		5,000	5,000
6	Drawings A/c Dr. To Bank A/c (Cash withdrawn from bank for personal use)		4,000	4,000
7	Charities A/c Dr. To Purchases A/c (Goods given for charities)		3,000	3,000
8	Drawings A/c Dr. To Purchases A/c (Goods taken over for personal use)		12,000	12,000

9	Sales promotion A/c Dr. To Purchases A/c (Goods distributed as free samples)		3,000	3,000
10	Office expenses A/c Dr. To Purchases A/c (Goods used for office use)		200	200

Illustration 8

Bragathish is a trader dealing in electronic goods who commenced his business in 2015. For the following transactions took place in the month of March 2018, pass journal entries.

March		₹
1.	Purchased goods from Y and Co. on credit	60,000
2.	Sold goods to D and Co. on credit	30,000
3.	Paid Y and Co. through bank in full settlement	58,000
4.	D and Co. accepted a bill drawn by Bragathish	30,000
5.	Sold goods to L on credit	20,000
6.	Sold goods to M on credit	40,000
7.	Received a cheque from M in full settlement and deposited the same to the bank	39,000
8.	Goods returned to Y and Co.	4,000
9.	L became insolvent and only 90 paise per rupee is received by cash in final settlement	
10.	Goods returned by M	3,000

Solution

In the books of Bragathish
Journal entries

Date	Particulars	L.F.	Debit ₹	Credit ₹
2018 March 1	Purchases A/c Dr. To Y and Co. A/c (Goods purchased on credit)		60,000	60,000
2	D and Co. A/c Dr. To Sales A/c (Credit sales made to D and Co.)		30,000	30,000
3	Y and Co. A/c Dr. To Bank A/c To Discount received A/c (Payment made to Y and Co. and discount received)		60,000	58,000 2000
4	Bills Receivable A/c Dr. To D and Co. A/c (Bills received from D and Co.)		30,000	30,000
5	L A/c Dr. To Sales A/c (Goods sold on credit to L)		20,000	20,000

6	M A/c Dr. To Sales A/c (Goods sold on credit to M)		40,000	 40,000
7	Bank A/c Dr. Discount allowed A/c Dr. To M A/c (Cheque received and discount allowed)		39,000 1,000	 40,000
8	Y and Co. A/c Dr. To Purchases returns A/c (Goods returned to Y and Co.)		4,000	 4,000
9	Cash A/c (20,000 × 0.9) Dr. Bad debts A/c Dr. To L A/c (Cash received from L in final settlement)		18,000 2,000	 20,000
10	Sales returns A/c Dr. To M A/c (Goods returned by M)		3,000	 3,000

Illustration 9

Valluvar is a sole trader dealing in textiles. From the following transactions, pass journal entries for the month of March, 2018.

March		₹
1	Commenced business with cash	90,000
	with goods	60,000
2	Purchased 20 readymade shirts from X and Co. on credit	10,000
3	Cash deposited into bank through Cash Deposit Machine	30,000
4	Purchased 10 readymade sarees from Y and Co. by cash	6,000
5	Paid X and Co. through NEFT	
6	Sold 5 sarees to A and Co. on credit	4,000
7	A and Co. deposited the amount due in Cash Deposit Machine	
8	Purchased 20 sarees from Z & Co. and paid through debit card	12,000
9	Stationery purchased for and paid through net banking	6,000
10	Bank charges levied	200

Solution

In the books of Valluvar
Journal entries

Date	Particulars	L.F.	Debit ₹	Credit ₹
2018 March 1	 Cash A/c Dr. Stock A/c Dr. To Valluvar's Capital A/c (Valluvar commenced business with cash and goods)		 90,000 60,000	 1,50,000

2	Purchases A/c Dr. To X and Co. A/c (Credit purchases made)			10,000	10,000
3	Bank A/c Dr. To Cash A/c (Deposited cash into bank)			30,000	30,000
4	Purchases A/c Dr. To Cash A/c (Goods purchased by cash)			6,000	6,000
5	X and Co. A/c Dr. To Bank A/c (Deposited cash into bank)			10,000	10,000
6	A and Co. A/c Dr. To Sales A/c (Credit sales made to A and Co.)			4,000	4,000
7	Bank A/c Dr. To A and Co. A/c (Money received through CDM)			4,000	4,000
8	Purchases A/c Dr. To Bank A/c (Purchases made)			12,000	12,000
9	Stationery A/c Dr. To Bank A/c (Stationery purchased)			6,000	6,000
10	Bank charges A/c Dr. To Bank A/c (Bank charges levied)			200	200

Illustration 10

Deri is a sole trader dealing in automobiles. From the following transactions, pass journal entries for the month of January, 2018.

Jan.		₹
1	Commenced business with cash	1,00,000
	with goods	2,00,000
	with buildings	5,00,000
2	Purchased goods from A and Co. on credit	3,00,000
3	Cash deposited into bank	80,000
4	Purchased goods from B and Co. and payment made through debit card	5,000
5	Paid A and Co. through RTGS	
6	Sold goods to C and Co. and cheque received	50,000
7	Deposited the cheque received from C and Co. with the bank	
8	Purchased goods from Z & Co. and paid through debit card	12,000
9	Stationery purchased for and paid through net banking	6,000
10	Income tax of Deri is paid by cheque	10,000

Solution

In the books of Deri
Journal entries

Date	Particulars		L.F.	Debit ₹	Credit ₹
2018					
Jan. 1	Cash A/c	Dr.		1,00,000	
	Stock A/c	Dr.		2,00,000	
	Buildings A/c	Dr.		5,00,000	
	To Deri's capital A/c				8,00,000
	(Deri commenced business with cash, goods and buildings)				
2	Purchases A/c	Dr.		3,00,000	
	To A and Co. A/c				3,00,000
	(Credit purchases made)				
3	Bank A/c	Dr.		80,000	
	To Cash A/c				80,000
	(Amount deposited in the bank)				
4	Purchases A/c	Dr.		5,000	
	To Bank A/c				5,000
	(Goods purchased through credit card)				
5	A and Co. A/c	Dr.		3,00,000	
	To Bank A/c				3,00,000
	(Payment through RTGS)				
6	Cash A/c	Dr.		50,000	
	To Sales A/c				50,000
	(Sales made and cheque received)				
7	Bank A/c	Dr.		50,000	
	To Cash A/c				50,000
	(Cheque received from C and Co. deposited in the bank)				
8	Purchases A/c	Dr.		12,000	
	To Bank A/c				12,000
	(Goods purchased by debit card)				
9	Stationery A/c	Dr.		6,000	
	To Bank A/c				6,000
	(Stationery purchased through net banking)				
10	Drawings A/c	Dr.		10,000	
	To Bank A/c				10,000
	(Income tax of the owner paid)				

Illustration 11

Chandran is a sole trader dealing in sports items. From the following transactions, pass journal entries for the month of March, 2018.

March		₹
1	Commenced business with cash	4,00,000
2	Cash deposited into bank	3,00,000
3	Purchased goods from Ravi and payment made through net banking	90,000
4	Sales made to Kumar, who deposited the money through CDM	10,000

5	Sales made to Vivek, who made the payment by debit card	60,000
6	Sold goods to Keerthana, who made the payment through credit card	50,000
7	Dividend directly received by bank	2,000
8	Money withdrawn from ATM	3,000
9	Salaries paid through ECS	6,000
10	Cricket bats donated to a trust	10,000

Solution

In the books of Chandran
Journal entries

Date	Particulars		L.F.	Debit ₹	Credit ₹
2018 March 1	Cash A/c To Chandran's capital A/c (Capital contributed by Chandran)	Dr.		4,00,000	4,00,000
2	Bank A/c To Cash A/c (Cash deposited into bank)	Dr.		3,00,000	3,00,000
3	Purchases A/c To Bank A/c (Goods purchased and payment made by net banking)	Dr.		90,000	90,000
4	Bank A/c To Sales A/c (Sales made and money received through CDM)	Dr.		10,000	10,000
5	Bank A/c To Sales A/c (Sales made and money credited through debit card)	Dr.		60,000	60,000
6	Bank A/c To Sales A/c (Sales made and money credited through credit card)	Dr.		50,000	50,000
7	Bank A/c To Dividend A/c (Dividend directly received by bank)	Dr.		2,000	2,000
8	Cash A/c To Bank A/c (Cash withdrawn through ATM)	Dr.		3,000	3,000
9	Salaries A/c To Bank A/c (Salaries paid through ECS)	Dr.		6,000	6,000
10	Donation A/c To Purchases A/c (Cricket bats donated to a trust)	Dr.		10,000	10,000

Illustration 12

Deepak is a dealer in stationery items. From the following transactions, pass journal entries for the month of January and February, 2018.

		₹
Jan.		
1	Commenced business with cash	2,00,000
2	Opened a bank account by depositing cash	1,00,000
3	'A 4 papers' sold on credit to Padmini and Co.	60,000
4	Bills received from Padmini and Co. for the amount due	
5	Bills received from Padmini and Co. discounted with the bank	58,000
Feb.		
15	Bills of Padmini and Co. dishonoured	

Solution

In the books of Deepak
Journal entries

Date	Particulars		L.F.	Debit ₹	Credit ₹
2018					
Jan. 1	Cash A/c	Dr.		2,00,000	
	To Deepak's capital A/c				2,00,000
	(Capital contributed by Deepak)				
2	Bank A/c	Dr.		1,00,000	
	To Cash A/c				1,00,000
	(Cash deposited with the bank)				
3	Padmini and Co. A/c	Dr.		60,000	
	To Sales A/c				60,000
	(Credit sales to Padmini and Co.)				
4	Bills receivable A/c	Dr.		60,000	
	To Padmini and Co. A/c				60,000
	(Bill received for the amount due)				
5	Bank A/c	Dr.		58,000	
	Discount A/c	Dr.		2,000	
	To Bills receivable A/c				60,000
	(Bills receivable discounted with the bank)				
Feb. 15	Padmini and Co. A/c	Dr.		60,000	
	To Bank A/c				60,000
	(Bill discounted with the bank dishonoured)				

3.8.7 Advantages of journal

Following are the advantages of journal:

(i) Complete information about the business transactions can be obtained on time basis as the transactions are recorded in chronological order.

(ii) Correctness of the entry can be checked through narration.

(iii) Journal forms the basis for posting the entries in the ledger.

Points to remember

- Transactions are recorded in the books of account with the help of source documents.
- There are two aspects involved in every business transaction namely debit and credit.
- Every debit has a corresponding and equal credit.
- Every credit has a corresponding and equal debit.
- Accounts can be classified into personal, real and nominal.
- Assets = Capital + Liabilities
- Transactions are first recorded in journal.

Golden rules of accounting:

Personal account	Debit the receiver	Credit the giver
Real account	Debit what comes in	Credit what goes out
Nominal account	Debit all expenses and losses	Credit all incomes and gains

Self-examination questions

AFK5M6

I Multiple choice questions

Choose the correct answer:

1. Accounting equation signifies
   (a) Capital of a business is equal to assets
   (b) Liabilities of a business are equal to assets
   (c) Capital of a business is equal to liabilities
   (d) Assets of a business are equal to the total of capital and liabilities

2. 'Cash withdrawn by the proprietor from the business for his personal use' causes
   (a) Decrease in assets and decrease in owner's capital
   (b) Increase in one asset and decrease in another asset
   (c) Increase in one asset and increase in liabilities
   (d) Increase in asset and decrease in capital

3. A firm has assets of ₹ 1,00,000 and the external liabilities of ₹ 60,000. Its capital would be
   (a) ₹ 1,60,000 (b) ₹ 60,000
   (c) ₹ 1,00,000 (d) ₹ 40,000

4. The incorrect accounting equation is
   (a) Assets = Liabilities + Capital (b) Assets = Capital + Liabilities
   (c) Liabilities = Assets + Capital (d) Capital = Assets – Liabilities

5. Accounting equation is formed based on the accounting principle of
   (a) Dual aspect (b) Consistency
   (c) Going concern (d) Accrual

6. Real account deals with
   (a) Individual persons (b) Expenses and losses
   (c) Assets (d) Incomes and gains

7. Which one of the following is representative personal account?
   (a) Building A/c (b) Outstanding salary A/c
   (c) Mahesh A/c (d) Balan & Co

8. Prepaid rent is a
   (a) Nominal A/c (b) Personal A/c
   (c) Real A/c (d) Representative personal A/c

9. Withdrawal of cash from business by the proprietor should be credited to
   (a) Drawings A/c (b) Cash A/c
   (c) Capital A/c (d) Purchases A/c

10. In double entry system of book keeping, every business transaction affects
   (a) Minimum of two accounts (b) Same account on two different dates
   (c) Two sides of the same account (d) Minimum three accounts

Answers

1. (d)	2. (a)	3. (d)	4. (c)	5. (a)	6. (c)	7. (b)	8. (d)	9. (b)	10. (a)

II Very short answer questions

1. What are source documents?
2. What is accounting equation?
3. Write any one transaction which
   a) Decreases the assets and decreases the liabilities
   b) Increases one asset and decreases another asset
4. What is meant by journalising?
5. What is real account?
6. How are personal accounts classified?
7. State the accounting rule for nominal account.
8. Give the golden rules of double entry accounting system.

III Short answer questions

1. Write a brief note on accounting equation approach of recording transactions.
2. What is an Account? Classify the accounts with suitable examples.
3. What are the three different types of personal accounts?
4. What is the accounting treatment for insurance premium paid on the life of the proprietor?
5. State the principles of double entry system of book keeping.
6. Briefly explain about steps in journalising.
7. What is double entry system? State its advantages.

IV Exercises

1. Complete the accounting equation

(a)	Assets	=	Capital	+	Liabilities
	₹ 1,00,000	=	₹ 80,000	+	?
(b)	Assets	=	Capital	+	Liabilities
	₹ 2,00,000	=	?	+	₹ 40,000
(c)	Assets	=	Capital	+	Creditors
	?	=	₹ 1, 60,000	+	₹ 80,000

2. For the following transactions, show the effect on accounting equation.

(a) Raj Started business with cash	₹ 40,000
(b) Opened bank account with a deposit of	₹ 30,000
(c) Bought goods from Hari on credit for	₹ 12,000
(d) Raj withdrew cash for personal use	₹ 1,000
(e) Bought furniture by using debit card for	₹ 10,000
(f) Sold goods to Murugan and cash received	₹ 6,000
(g) Money withdrawn from bank for office use	₹ 1,000

3. Prepare accounting equation for the following transactions.
   (a) Murugan commenced business with cash ₹ 80,000
   (b) Purchased goods for cash ₹ 30,000
   (c) Paid salaries by cash ₹ 5,000
   (d) Bought goods from Kumar for ₹ 5,000 and deposited the money in CDM.
   (e) Introduced additional capital of ₹ 10,000

4. What will be the effect of the following on the accounting equation?
   (a) Sunil started business with ₹ 1,40,000 cash and goods worth ₹ 60,000
   (b) Purchased furniture worth ₹ 20,000 by cash
   (c) Depreciation on furniture ₹ 800
   (d) Deposited into bank ₹ 40,000
   (e) Paid electricity charges through net banking ₹ 500
   (f) Sold goods to Ravi costing ₹ 10,000 for ₹ 15,000
   (g) Goods returned by Ravi ₹ 7,500 (costing ₹ 5,000)

5. Create an accounting equation on the basis of the following transactions:
   (i) Rakesh started business with a capital of ₹ 1,50,000
   (ii) Deposited money with the bank ₹ 80,000
   (iii) Purchased goods from Mahesh and paid through debit card ₹ 25,000
   (iv) Sold goods (costing ₹ 10,000) to Mohan for ₹ 14,000 who pays through debit card
   (v) Commission received by cheque and deposited the same in the bank ₹ 2,000
   (vi) Paid office rent through ECS ₹ 6,000
   (vii) Sold goods to Raman for ₹ 15,000 of which ₹ 5,000 was received at once

6. Create an accounting equation on the basis of the following transactions:
   (i) Started business with cash ₹ 80,000 and goods ₹ 75,000
   (ii) Sold goods to Shanmugam on credit for ₹ 50,000
   (iii) Received cash from Shanmugam in full settlement ₹ 49,000
   (iv) Salary outstanding ₹ 3,000
   (v) Goods costing ₹ 1,000 given as charity
   (vi) Insurance premium paid ₹ 3000
   (vii) Out of insurance premium paid, prepaid is ₹ 500

7. Enter the following transactions in the journal of Manohar who is dealing in textiles:

2018 March		₹
1	Manohar started business with cash	60,000
2	Purchased furniture for cash	10,000
3	Bought goods for cash	25,000
6	Bought goods from Kamalesh on credit	15,000
8	Sold goods for cash	28,000
10	Sold goods to Hari on credit	10,000
14	Paid Kamalesh	12,000
18	Paid rent	500
25	Received from Hari	8,000
28	Withdrew cash for personal use	4,000

8. Pass journal entries in the books of Sasi Kumar who is dealing in automobiles.

2017 Oct		₹
1	Commenced business with goods	40,000
3	Cash introduced in the business	60,000
4	Purchased goods from Arul on credit	70,000
6	Returned goods to Arul	10,000
10	Paid cash to Arul on account	60,000
15	Sold goods to Chandar on credit	30,000
18	Chandar returned goods worth	6,000
20	Received cash from Chandar in full settlement	23,000
25	Paid salaries through ECS	2,000
30	Sasi Kumar took for personal use goods worth	10,000

9. Journalise the following transactions in the books of Ramesh who is dealing in computers:

2018 March	
1	Ramesh started business with cash ₹ 3,00,000, Goods ₹ 80,000 and Furniture ₹ 27,000.
2	Money deposited into bank ₹ 2,00,000
3	Bought furniture from M/s Jayalakshmi Furniture for ₹ 28,000 on credit.
4	Purchased goods from Asohan for ₹ 5,000 by paying through debit card.

5	Purchased goods from Guna and paid through net banking for cash ₹ 10,000
6	Purchased goods from Kannan and paid through credit card ₹ 20,000
7	Purchased goods from Shyam on credit for ₹ 50,000
8	Bill drawn by Shyam was accepted for ₹ 50,000
9	Paid half the amount owed to M/s Jayalakshmi Furniture by cheque
10	Shyam's bill was paid

10. Raja has a hotel. The following transactions took place in his business. Journalise them.

Jan.		₹
1	Started business with cash	3,00,000
2	Purchased goods from Rajiv on credit	1,00,000
3	Cash deposited with the bank	2,00,000
20	Borrowed loan from bank	1,00,000
22	Withdrew from bank for personal use	800
23	Amount paid to Rajiv in full settlement through NEFT	99,000
25	Paid club bill of the proprietor by cheque	200
26	Paid electricity bill of the proprietor's house through debit card	2,000
31	Lunch provided at free of cost to a charity	1,000
31	Bank levied charges for locker rent	1,000

11. From the following transactions of Shyam, a stationery dealer, pass journal entries for the month of August 2017.

Aug.	
1	Commenced business with cash ₹ 4,00,000, Goods ₹ 5,00,000
2	Sold goods to A and money received through RTGS ₹ 2,50,000
3	Goods sold to Z on credit for ₹ 20,000
5	Bill drawn on Z and accepted by him ₹ 20,000
8	Bill received from Z is discounted with the bank for ₹ 19,000
10	Goods sold to M on credit ₹ 12,000
12	Goods distributed as free samples for ₹ 2,000
16	Goods taken for office use ₹ 5,000
17	M became insolvent and only 0.80 per rupee is received in final settlement
20	Bill of Z discounted with the bank is dishonoured

12. Mary is a rice dealer having business for more than 5 years. Pass journal entries in her books for the period of March, 2018.

March		₹
1	Ricebags bought on credit from Sibi	20,000
2	Electricity charges paid through net banking	500
3	Returned goods bought from Sibi	5,000
4	Ricebags taken for personal use	1,000
5	Advertisement expenses paid	2,000
6	Goods sold to Mano	20,000
7	Goods returned by Mano	5,000
8	Payment received from Mano through NEFT	

Student activity

Fill in the missing information in the following journal entries:

Date	Particulars		L.F.	Debit ₹	Credit ₹
	……………………….A/c To ……………………A/c (Goods purchased for cash ₹ 20,000)	Dr.		---------	 ---------
	……………………….A/c ……………………….A/c To Niha A/c (Received ₹ 18,800 from in full settlement of the due ₹ 19,000)	Dr. Dr.		--------- ---------	 ---------

Student activity

Write the narration with reference to the following journal entries.

In the books of Shyam

Journal entries

Date	Particulars		L.F.	Debit ₹	Credit ₹
2018 April 1	Cash A/c To Shyam's capital A/c (……………………………………………………………………)	Dr.		3,00,000	 3,00,000
2	Bank A/c To Cash A/c (……………………………………………………………………)	Dr.		2,70,000	 2,70,000

CASE STUDY

Pearlita is a trader. She buys and sells electronic goods. She maintains double entry book- keeping. She purchases and sells goods both on cash and credit bases. If the purchased goods are not in good condition, she sends them back to her supplier. At the same time, she also accepts if her customers return the goods sold to them, when the goods are not in good condition. She maintains a bank account for her business. She receives and pays money through bank transactions.

Now, discuss on the following:

- Why does she maintain double entry book keeping?
- Do all the business units engage in credit transaction?
- Can you think of some business units that have only cash transactions?
- Is it necessary for Pearlita to maintain a separate bank account for business?
- What will happen if she uses her personal bank account for her business transactions?
- Identify the business documents involved in this case study.
- Can you think of some assets and liabilities for Pearlita's business?

To explore further

For small business entities generally full set of accounts ay not be maintained. Is it possible to calculate profit or loss for such entities? How?

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Unit 4

LEDGER

Contents

Points to recall

The following points are to be recalled before learning Ledger:

- Classification of accounts
- Golden rules of double entry system of book keeping
- Steps in journalising the transactions and passing journal entries

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Learning Objectives

To enable the students to

- Understand the meaning of ledger account
- Understand the procedure for posting
- Post the journal entries to the ledger accounts and balance the ledger accounts

Key terms to know

- Ledger
- Ledger posting
- Balancing the ledger account
- Debit balance
- Credit balance

4.1 Introduction

Student activity

Think: A trader has been selling goods both on cash and credit bases. Most of the goods are sold on credit. The owner has lost track of 'who has to pay how much?' Is there any quick way to get this information?

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. Accountwise balance can be determined from the ledger. The ledger accounts are prepared based on journal entries passed.

Transaction

↓

Journal / Subsidiary books

↓

Ledger

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.

4.2 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.

4.3 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.

4.4 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.

4.5 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.

Tutorial note

The name of the account in the top never appears in the particulars column. In the particulars column the account entered is the other account in the journal entry.

Student activity

Think: What will happen if an account debited or credited is left out while posting from journal to ledger?

Illustration 1

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

2017

June 1 Basu started business with cash ₹ 50,000

4 Purchased furniture by paying cash for ₹ 6,000

7 Purchased machinery on credit from Harish ₹ 10,000

10 Bought goods for cash ₹ 4,000

18 Paid insurance premium ₹ 100

Solution

In the books of Basu

Journal entries

Date	Particulars	L.F.	Debit ₹	Credit ₹
2017	Cash A/c Dr.		50,000	
June 1	To Basu's capital A/c			50,000
	(Started business with cash)			

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.	₹	Date	Particulars	J.F.	₹
2017				2017			
June 1	To Basu's capital A/c		50,000	June 4	By Furniture A/c		6,000
				10	By Purchases A/c		4,000
				18	By Insurance premium A/c		100

Dr. Basu's Capital account Cr.

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

Dr. Furniture account Cr.

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

Dr. Machinery account Cr.

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

Dr. Harish account Cr.

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

Dr. Purchases account Cr.

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

Dr. **Insurance premium account** Cr.

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

4.5.1 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					
Jan 1	Cash A/c	Dr.		45,000	
	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.	₹	Date	Particulars	J.F.	₹
2017							
Jan 1	To Balance b/d		45,000				

Dr. **Stock account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2017 Jan 1	To Balance b/d		50,000				

Dr. **Sohan account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2017 Jan 1	To Balance b/d		35,000				

Dr. **Furniture account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2017 Jan 1	To Balance b/d		50,000				

Dr. **Ram account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
				2017 Jan 1	By Balance b/d		20,000

Dr. **Joy's capital account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
				2017 Jan 1	By Balance b/d		1,60,000

4.5.2 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 ₹ 8,000 and wages ₹ 2,000.

Solution

In the books of Ram
Journal entries

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

Ledger accounts

Dr. **Salaries account** **Cr.**

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

Dr. **Electricity charges account** **Cr.**

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

Dr. **Wages account** **Cr.**

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

Dr. **Cash account** **Cr.**

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

Student activity

Think: What will happen to the ledger account postings? Do you think that it will continue for an indefinite period of time? Where will the accounting process stop?

4.6 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'.

4.6.1 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 totalled separately.

(ii) The difference between the two totals is to be ascertained.

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(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)
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 totalling 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.

Tutorial 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 ₹ 3,00,000

2 Opened bank account by depositing ₹ 2,00,000

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

15 Sold goods to MM Traders for cash ₹ 5,000

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

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

Solution

In the books of Thamizhanban
Journal entries

Date	Particulars		L.F.	Debit ₹	Credit ₹
2018					
Jan. 1	Cash A/c	Dr.		3,00,000	
	To Thamizhanban's capital A/c				3,00,000
	(Started business with cash)				
2	Bank A/c	Dr.		2,00,000	
	To Cash A/c				2,00,000
	(Cash deposited with the bank)				
5	Purchases A/c	Dr.		10,000	
	To Cash A/c				10,000
	(Goods purchased for cash)				
15	Cash A/c	Dr.		5,000	
	To Sales A/c				5,000
	(Goods sold for cash)				
22	Purchases A/c	Dr.		15,000	
	To Bank A/c				15,000
	(Goods purchased and payment made through net banking)				
25	Bank A/c	Dr.		30,000	
	To Sales A/c				30,000
	(Goods sold and the payment is received through NEFT)				

Dr. **Cash account** **Cr.**

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2018				2018			
Jan. 1	To Thamizhanban's capital A/c		3,00,000	Jan. 2	By Bank A/c		2,00,000
				5	By Purchases A/c		10,000
15	To Sales A/c		5,000	31	By Balance c/d		**95,000**
			3,05,000				3,05,000
Feb. 1	To Balance b/d		95,000				

Dr. **Thamizhanban's capital account** **Cr.**

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2018				2018			
Jan. 31	To Balance c/d		**3,00,000**	Jan. 1	By Cash A/c		3,00,000
			3,00,000				3,00,000
				Feb. 1	By Balance b/d		3,00,000

Dr. **Bank account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2018				2018			
Jan. 2	To Cash A/c		2,00,000	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.	₹	Date	Particulars	J.F.	₹
2018				2018			
Jan. 5	To Cash A/c		10,000	Jan. 31	By Balance c/d		**25,000**
22	To Bank A/c		15,000				
			25,000				25,000
Feb. 1	To Balance b/d		25,000				

Dr. **Sales account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2018				2018			
Jan. 31	To Balance c/d		**35,000**	Jan. 15	By Cash A/c		5,000
				25	By Bank A/c		30,000
			35,000				35,000
				Feb. 1	By Balance b/d		35,000

4.6.2 Direct ledger posting

Illustration 5

Prepare cash account from the following transactions for the month of January 2018.

Jan 1 Commenced business with cash ₹ 62,000

3 Goods purchased for cash ₹ 12,000

10 Goods sold for cash ₹ 10,000

12 Wages paid ₹ 4,000

25 Furniture purchased for cash ₹ 6,000

Solution

Dr. **Cash account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2018				2018			
Jan 1	To Capital A/c		62,000	Jan 3	By Purchases A/c		12,000
10	To Sales A/c		10,000	12	By Wages A/c		4,000
				25	By Furniture A/c		6,000
				31	By Balance c/d		**50,000**
			72,000				72,000
Feb 1	To Balance b/d		50,000				

Illustration 6

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

2017

June	5	Started business with cash ₹ 2,00,000
	8	Opened bank account by depositing ₹ 80,000
	12	Bought goods on credit from Sri Ram for ₹ 30,000
	15	Sold goods on credit to Selva for ₹ 10,000
	22	Goods sold for cash ₹ 15,000
	25	Paid Sri Ram ₹ 30,000 through NEFT
	28	Received a cheque from Selva and deposited the same in bank ₹ 10,000

Solution

Ledger accounts

Dr. Cash account Cr.

Date	Particulars	J.F.	₹	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**
			2,15,000				2,15,000
July 1	To Balance b/d		1,35,000				

Dr. Kumaran's capital account Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2017				2017			
June 30	To Balance c/d		**2,00,000**	June 5	By Cash A/c		2,00,000
			2,00,000				2,00,000
				July 1	By Balance b/d		2,00,000

Dr. Bank account Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2017				2017			
June 8	To Cash A/c		80,000	June 25	By Sri Ram A/c		30,000
28	To Selva A/c		10,000	30	By Balance c/d		**60,000**
			90,000				90,000
July 1	To Balance b/d		60,000				

Dr. Purchases account Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2017				2017			
June 12	To Sri Ram A/c		30,000	June 30	By Balance c/d		**30,000**
			30,000				30,000
July 1	To Balance b/d		30,000				

Dr. **Sri Ram account** **Cr.**

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2017				2017			
June 25	To Bank A/c		30,000	June 12	By Purchases A/c		30,000
			30,000				30,000

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

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2017				2017			
June 15	To Sales A/c		10,000	June 28	By Bank A/c		10,000
			10,000				10,000

Dr. **Sales account** **Cr.**

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2017				2017			
June 30	To Balance c/d		**25,000**	June 15	By Selva A/c		10,000
				22	By Cash A/c		15,000
			25,000				25,000
				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.

DO YOU KNOW?

The three accounting concepts – business entity, duality and money measurement - associated with double-entry book keeping are applied in ledger.

Points to remember

- Left side of the ledger account is Debit [Dr.]
- Right side of the ledger account is Credit [Cr.]
- For each type of asset, liability, expense and income, separate ledger accounts are prepared.
- If the total on the debit side exceeds the total on the credit side, it results in debit balance.
- If the total on the credit side exceeds the total on the debit side, it results in credit balance.
- Closing balance of the current year in the ledger account is the opening balance of the next year.

Self-examination questions

I Multiple choice questions

Choose the correct answer

1. Main objective of preparing ledger account is to
   (a) Ascertain the financial position
   (b) Ascertain the profit or loss
   (c) Ascertain the profit or loss and the financial position
   (d) Know the balance of each ledger account

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2. The process of transferring the debit and credit items from journal to ledger accounts is called
   (a) Casting (b) Posting
   (c) Journalising (d) Balancing

3. J.F means
   (a) Ledger page number (b) Journal page number
   (c) Voucher number (d) Order number

4. The process of finding the net amount from the totals of debit and credit columns in a ledger is known as
   (a) Casting (b) Posting
   (c) Journalising (d) Balancing

5. If the total of the debit side of an account exceeds the total of its credit side, it means
   (a) Credit balance (b) Debit balance
   (c) Nil balance (d) Debit and credit balance

6. The amount brought into the business by the proprietor should be credited to
   (a) Cash account (b) Drawings account
   (c) Capital account (d) Suspense account

Answer

1 (d)	2 (b)	3 (b)	4 (d)	5 (b)	6 (c)

II Very short answer questions

1. What is a ledger?
2. What is meant by posting?
3. What is debit balance?
4. What is credit balance?
5. What is balancing of an account?

III Short answer questions

1. Distinguish between journal and ledger.
2. What is ledger? Explain its utilities.
3. How is posting made from the journal to the ledger?
4. Explain the procedure for balancing a ledger account.

IV Exercises

1. Journalise the following transactions and post them to ledger.

2016	₹
Jan 1 Started business with cash	10,000
5 Paid into bank	5,000
7 Purchased goods from Ram for cash	1,000

(**Answer:** Cash A/c ₹ 4,000 Dr.; Bank A/c ₹ 5,000 Dr.;
Capital A/c ₹ 10,000 Cr.; Purchases A/c ₹ 1,000 Dr.)

2. Pass journal entries for the following transactions and post them to ledger.

2017		₹
Aug. 1	Dharma started business with cash	70,000
6	Cash received from Ganesan	10,000
10	Rent paid	3000
20	Received commission from Anand	5000

(**Answer:** Cash A/c ₹ 82,000 Dr.; Capital A/c ₹ 70,000 Cr.; Ganesan A/c ₹ 10,000 Cr.; Rent A/c ₹ 3,000 Dr.; Commission received A/c ₹ 5,000 Cr.)

3. The following balances appeared in the books of Vinoth on Jan 1, 2018
Assets: Cash ₹ 40,000; Stock ₹ 50,000; Amount due from Ram ₹ 20,000;
Machinery ₹ 40,000 Liabilities: Amount due to Vijay ₹ 10,000
Pass the opening journal entry and post them to Vinoth's Capital account.

(**Answer:** Vinoth's Capital A/c ₹ 1,40,000 Cr.)

4. Prepare Furniture A/c from the following transactions

2016		₹
Jan 1	Furniture in hand	2,000
1	Purchased furniture for cash	4,000
30	Sold furniture	400

(**Answer:** Furniture A/c ₹ 5,600 Dr.)

5. The following balances appeared in the books of Kumaran on April 1, 2017.
Assets: Cash ₹ 1,00,000; Stock ₹ 40,000; Amount due from Rohit ₹ 10,000;
Furniture ₹ 10,000; **Liabilities:** Amount due to Anush ₹ 40,000;
Kumaran's capital ₹ 1,20,000
Find the capital and show the ledger posting for the above opening balances.

(**Answer:** Cash A/c ₹ 1,00,000 Dr.; Stock A/c ₹ 40,000 Dr.; Rohit A/c ₹ 10,000 Dr.; Furniture A/c ₹ 10,000 Dr.; Anush A/c ₹ 40,000 Cr.; Kumaran's capital ₹ 1,20,000 Cr.)

6. Give journal entries and post them to cash account.

2016		₹
June 1	Commenced business with cash	1,10,000
10	Introduced additional capital	50,000
28	Withdrawn for personal use	20,000

(**Answer:** Cash A/c ₹ 1,40,000 Dr.)

7. Give Journal entries for the following transactions and post them to Cash a/c and Sales A/c.

2017		₹
Aug 10	Sold goods and cheque received but not deposited	30,000
14	Sold goods on credit to Gopi	12,000
20	Received cash from Gopi	12,000

(**Answer:** Sales A/c ₹ 42,000 Cr.; Cash A/c ₹ 42,000 Dr.)

8. Enter the following transactions in the books of Ganesan and post them into ledger.

2017		₹
Oct 1	Started business with cash	25,000
5	Deposited into bank	12,500
10	Purchased furniture and payment by cheque	2,000
15	Goods purchased for cash	5,000
19	Sold goods to Vasu on credit	4,000
22	Goods worth ₹ 500 taken for personal use	

(**Answer:** Cash A/c ₹ 7,500Dr.; Capital A/c ₹ 25,000Cr.; Bank A/c ₹ 10,500 Dr.; Furniture A/c ₹ 2,000 Dr.; Purchases A/c ₹ 4,500 Dr.; Sales A/c ₹ 4,000 Cr.; Vasu A/c ₹ 4,000 Dr.; Drawings A/c ₹ 500 Dr.)

9. Journalise the following transactions in the books of Vasu and post them to ledger accounts.

2017 Nov 1 Cash in hand ₹ 1,00,000; Cash at bank: ₹ 30,000

2 Vasu sold goods to Jothi for ₹ 25,000 against a cheque and deposited the same in the bank

4 Received as commission ₹ 5,000

8 Bank paid ₹ 15,000 directly for insurance premium of Vasu.

15 Cash deposited into bank ₹ 30,000

20 Cash withdrawn from bank for personal use ₹ 45,000.

(**Answer:** Bank A/c ₹ 25,000 Dr.; Commission received A/c ₹ 5,000 Cr.; Capital A/c ₹ 1,30,000 Cr.; Cash A/c ₹ 75,000 Dr.; Drawings A/c ₹ 60,000 Dr.; Sales A/c ₹ 25,000 Cr.)

10. Prepare Anand's account from the following details.

2017		₹
July 1	Credit balance of Anand's A/c	4,000
15	Amount paid to Anand	2,000
18	Goods purchased from Anand on credit	8,000
20	Paid to Anand	3,960
	Discount allowed by him	40
25	Goods purchased from Anand	5,000

(**Answer:** Anand A/c ₹ 11,000 Cr.)

11. Show the direct ledger postings for the following transactions:

2017

June 1 Raja commenced business with cash ₹ 50,000,

6 Sold goods for cash ₹ 8,000

8 Sold goods to Devi on credit ₹ 9,000

15 Goods purchased for cash ₹ 4,000

20 Goods purchased from Shanthi on credit ₹ 5,000

(**Answer:** Cash A/c ₹ 54,000 Dr.; Capital A/c ₹ 50,000 Cr.; Sales A/c ₹ 17,000 Cr.; Devi A/c ₹ 9,000 Dr. Purchases A/c ₹ 9,000 Dr.; Shanthi A/c ₹ 5,000 Cr.)

CASE STUDY

Imagine you have been called for an interview with an auditor. The auditor shows you the following ledger account of Mr. Raheem, a dealer in food products.

Dr. **SitaA/c** **Cr.**

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F	Amount ₹
2017				2017			
April 1	To Balance b/d		7,000	April 12	By Bank A/c		5,000
Sept. 25	To Sales A/c		10,000	May 2	By Cash A/c		2,000
Dec. 29	To Sales A/c		10,000	Oct. 3	By Sales returns A/c		1,000
				Nov. 17	By Cash A/c		3,000
				Dec. 21	By Bank A/c		4,000
				2018			
				Mar. 31	By Balance c/d		**12,000**
			27,000				27,000
2018							
Apr 1	To Balance b/d		12,000				

The auditor wants you to explain each posting in the above account and also to state where will the double entry for each posting be found.

To explore further

'**Accounts of debtors will always have debit balance**'. - *Do you agree*?

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Unit 5

TRIAL BALANCE

Contents

Points to recall

The following points are to be recalled before learning trial balance:

- Rules of double entry
- Balancing ledger accounts
- Dual aspect concept

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Learning Objectives

To enable the students to

- Understand the meaning and features of trial balance
- Understand the objectives of preparing trial balance
- Prepare the trial balance

Key terms to know

- Trial balance
- Debit balance
- Credit balance
- Arithmetical accuracy

5.1 Introduction

Student activity

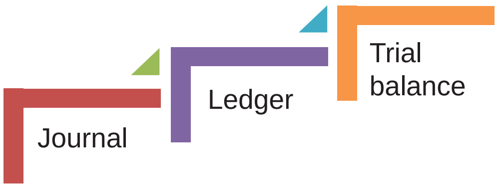
Think: Do you think that the ledger account postings are error free? If not, how do you make sure that the entries are correct?

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.



5.2 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.

5.3 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

5.4 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.

5.5 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.

5.6 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.

5.7 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.

5.7.1 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 ₹	Credit balance ₹

Specimen of a trial balance

Trial balance of _______ as on _______

S.No.	Particulars	L.F.	Debit ₹	Credit ₹
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**

Tutorial note

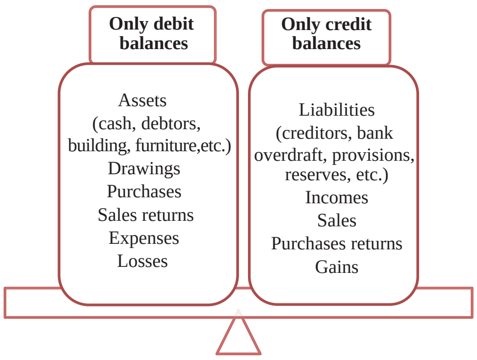
1. If the value of closing stock is known on the day when trial balance is prepared, then opening stock and closing stock are adjusted with purchases. Hence, opening stock will not appear in the trial balance. Closing stock and adjusted purchases will appear in the trial balance. If the value of closing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

Student activity

Think: Analyse the above format. Can you identify accounts that have only debit balances/ credit balances always?

Tutorial 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 ₹	Credit ₹
2017	Cash A/c Dr.		5,00,000	
Jan 1	To Rathna Kumar's capital A/c			5,00,000
	(Business commenced with capital)			

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 (Cash received from Elizabeth)		22,000	22,000

Ledger

Dr. **Cash Account** **Cr.**

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F	Amount ₹
2017				2017			
Jan 1	To Rathnakumar's capital A/c		5,00,000	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 A/c		7,000
31	To Elizabeth A/c		22,000	31	By Balance c/d		5,33,800
			5,56,800				5,56,800
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				2017			
Jan 31	To Balance c/d		5,00,000	Jan 1	By Cash A/c		5,00,000
			5,00,000				5,00,000
				Feb 1	By Balance b/d		**5,00,000**

Dr. **Furniture Account** **Cr.**

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F	Amount ₹
2017				2017			
Jan 5	To Cash A/c		6,000	Jan 31	By Balance c/d		6,000
			6,000				6,000
Feb 1	To Balance b/d		**6,000**				

Dr. **Purchases Account** **Cr.**

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F	Amount ₹
2017				2017			
Jan 10	To Cash A/c		10,000	Jan 31	By Balance c/d		35,000
15	To Jayanthi A/c		25,000				
			35,000				35,000
Feb 1	To Balance b/d		**35,000**				

Dr. **Jeyanthi Account** **Cr.**

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F	Amount ₹
2017				2017			
Jan 18	To Purchases returns A/c		2,500	Jan 15	By Purchases A/c		25,000
31	To Balance c/d		22,500				
			25,500				25,000
				Feb 1	By Balance b/d		**22,500**

Dr. **Purchases returns Account** **Cr.**

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F	Amount ₹
2017				2017			
Jan 31	To Balance c/d		2,500	Jan 18	By Jeyanthi A/c		2,500
			2,500				2,500
				Feb 1	By Balance b/d		**2,500**

Dr. **Sales Account** **Cr.**

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F	Amount ₹
2017				2017			
				Jan 20	By Cash A/c		32,000
Jan 31	To Balance c/d		1,04,000	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				2017			
Jan 25	To Sales A/c		72,000	Jan 31	By Cash A/c		22,000
				31	By Balance c/d		50,000
			72,000				72,000
Feb 1	To Balance b/d		**50,000**				

Dr. Salaries Account Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F	Amount ₹
2017				2017			
Jan 30	To Cash A/c		7,000	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				2017			
Jan 31	To Balance c/d		2,800	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 ₹
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**

5.7.2 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**

5.7.3 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**

Note: Students will be tested on balance method only

5.8 Suspense account

Student activity

Think: Do you think the trial balance tallies all the time? What should be done when it does not tally?

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	₹	Particulars	₹
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	₹	Particulars	₹
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 accoount.

Particulars	₹	Particulars	₹
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 ₹	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**

DO YOU KNOW?

Duality concept is applied in trial balance. This concept requires two aspects to be entered for every transaction. This means that there are at least two accounts involved for every transaction.

Points to remember

- 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 prepared immediately.

Self-examination questions

AGLNTR

I Multiple choice questions

Choose the correct answer

1. Trial balance is a
   (a) Statement (b) Account (c) Ledger (d) Journal

2. After the preparation of ledger, the next step is the preparation of
(a) Trading account (b) Trial balance (c) Journal (d) Profit and loss account

3. The trial balance contains the balances of
(a) Only personal accounts (b) Only real accounts
(c) Only nominal accounts (d) All accounts

4. Which of the following is/are the objective(s) of preparing trial balance?
(a) Serving as the summary of all the ledger accounts
(b) Helping in the preparation of final accounts
(c) Examining arithmetical accuracy of accounts
(d) a, b and c

5. A list which contains balances of accounts to know whether the debit and credit balances are matched is
(a) Journal (b) Day book (c) Trial balance (d) Balance sheet

6. Which of the following method(s) can be used for preparing trial balance?
(a) Balance method (b) Total method
(c) Total and Balance method (d) a, b and c

7. While preparing the trial balance, the accountant finds that the total of the credit column is short by ₹ 200. This difference will be
(a) Debited to suspense account
(b) Credited to suspense account
(c) Adjusted to any of the debit balance
(d) Adjusted to any of the credit balance

8. The account which has a debit balance and is shown in the debit column of the trial balance is
(a) Sundry creditors account (b) Bills payable account
(c) Drawings account (d) Capital account

9. The difference of totals of both debit and credit side of trial balance is transferred to:
(a) Trading account (b) Difference account
(c) Suspense account (d) Miscellaneous account

10. Trial balance is prepared:
(a) At the end of the year (b) On a particular date
(c) For a year (d) None of the above

Answer

1 (a)	2 (b)	3 (d)	4 (d)	5 (c)	6 (d)	7 (b)	8 (c)	9 (c)	10 (b)

II Very short answer questions

1. What is trial balance?
2. Give the format of trial balance.
3. What are the methods of preparation of trial balance?

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

(i)	Carriage outwards	(ii)	Carriage inwards	(iii)	Sales
(iv)	Purchases	(v)	Bad debts	(vi)	Interest paid
(vii)	Interest received	(viii)	Discount received	(ix)	Capital
(x)	Drawings	(xi)	Sales returns	(xii)	Purchase returns

III Short answer questions

1. What are the objectives of preparing trial balance?
2. What are the limitations of trial balance?
3. 'A trial balance is only a prima facie evidence of the arithmetical accuracy of records'. Do you agree with this statement? Give reasons.

IV Exercises

1. Prepare a trial balance with the following information:

Name of the account	₹	Name of the account	₹
Purchases	1,00,000	Sales	1,50,000
Bank Loan	75,000	Creditors	50,000
Debtors	1,50,000	Cash	90,000
Stock	35,000	Capital	1,00,000

(**Answer:** Trial balance total ₹ 3,75,000)

2. Prepare the trial balance from the following information:

Name of the account	₹	Name of the account	₹
Bank loan	2,00,000	Purchases	1,80,000
Bills payable	1,00,000	Sales	3,00,000
Stock	70,000	Debtors	4,00,000
Capital	2,50,000	Bank	2,00,000

(**Answer:** Trial balance total ₹ 8,50,000)

3. Prepare the trial balance from the following balances of Chandramohan as on 31st March, 2017.

	₹		₹
Capital	1,24,500	Bank overdraft	5,800
Drawings	2,000	Motor car	20,000
Loan borrowed	7,000	General expenses	2,500
Sales	53,400	Building	1,10,000
Purchases	40,000	Stock	16,200

(**Answer:** Trial balance total ₹ 1,90,700)

4. Prepare the trial balance from the following balances of Babu as on 31st March, 2016.

	₹		₹
Cash in hand	7,000	Bills receivable	7,000
Sundry debtors	5,400	Sundry creditors	11,800
Salaries	6,800	Capital	25,000
Bad debts	200	Purchases	45,000
Opening stock	15,400	Sales	50,000

(**Answer:** Trial balance total ₹ 86,800)

5. Prepare the trial balance from the following balances of Rajesh as on 31st March, 2017.

	₹		₹
Bills receivable	13,000	Drawings	7,000
Bank charges	750	Sundry debtors	17,100
Conveyance charges	350	Bills payable	12,000
Discount received	1,300	Capital	25,900
Cash in hand	1,000		

(Answer: Trial balance total ₹ 39,200)

6. The following balances are extracted from the books of Ravichandran on 31st December, 2016. Prepare the trial balance.

	₹		₹
Capital	1,50,000	Sales	75,000
Debtors	22,800	Return inwards	1,000
Rent received	500	Discount allowed	800
Bank overdraft	3,100	Discount received	1,000
Creditors	5,500	Wages	2,900
Premises	1,46,000	Salaries	3,500
Opening stock	10,000	Commission paid	1,100
Purchases	45,000	General expenses	2,000

(Answer: Trial balance total ₹ 2,35,100)

7. From the following balances, prepare trial balance of Baskar as on 31st March, 2017. Transfer the difference, if any, to suspense account.

	₹		₹
Opening stock	40,000	Debtors	25,000
Capital	90,000	Carriage inwards	16,500
Sales	1,77,200	Bills receivable	20,000
Salaries	12,000	Commission received	5,550
Bills payable	9,450	Cash at bank	17,000
Telephone charges	2,350	Furniture	19,000
Creditors	16,000	Plant & Machinery	55,800
Purchases	85,000	Repairs	550

(Answer: Suspense account: ₹ 5,000 (Dr.) Trial balance Total: ₹ 2,98,200)

8. Correct the following trial balance:

Particulars	Debit Balance ₹	Credit Balance ₹
Opening Stock	1,00,000	
Salaries	36,000	
Creditors	1,32,000	
Bank	35,000	
Carriage inwards	18,000	
Rent received	9,000	
Discount allowed	6,000	

Purchases	3,48,000	
Bills payable	60,000	
Debtors		45,000
Carriage outwards		15,000
Capital		1,63,000
Returns inward		9,000
Discount received		12,000
Trade expenses		18,000
Sales		3,68,000
Building		1,14,000
Total	**7,44,000**	**7,44,000**

(**Answer:** Trial balance total ₹ 7,44,000)

Student activity

Imagine that you start a small shop with an investment of ₹ 10,000. Record imaginary business transactions for 10 days [include cash and credit transactions]. Prepare journal, ledger and trial balance with them.

CASE STUDY

Mary runs a textile store. She has prepared the following trial balance from her ledger balances. Her trial balance does not tally. She needs your help to check whether what she has done is correct.

S. No.	Name of account	L.F.	Debit balance ₹	Credit balance ₹
1	Capital		50,000	
2	Discount received			3,000
3	Rent paid			15,000
4	Salaries paid		1,000	
5	Purchases of textiles			20,000
6	Sale of textiles			30,000
7	Salesmen commission paid			9,000
8	Transport charges paid		6,000	
9	Cash balance		32,000	
	Total		**89,000**	**77,000**

To explore further

Is it possible to find out the profit earned by the business by preparing trial balance? What can be done to know the profit?

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Unit 6

SUBSIDIARY BOOKS - I

Contents

Learning Objectives

To enable the students to

- Understand the meaning and kinds of subsidiary books
- Apply the knowledge of accounting process in the preparation of subsidiary books
- Understand the method of recording of bill transactions
- Post entries from subsidiary books to ledger accounts

Points to recall

The following points are to be recalled before learning subsidiary books:

- Goods
- Cash purchases
- Credit purchases
- Cash sales
- Credit sales
- Purchases returns
- Sales returns
- Assets
- Ledger account

AGVJVE

Key terms to know

- Purchases book
- Sales book
- Purchases returns book
- Sales returns book
- Debit note
- Credit note
- Bill of exchange
- Bills receivable book
- Bills payable book
- Journal proper

6.1 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.

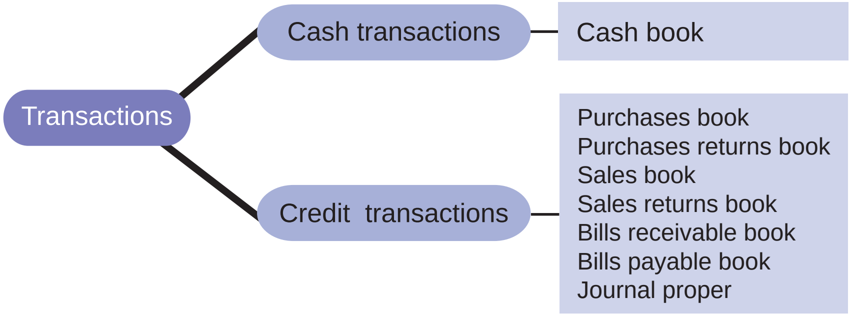
Journal entries are not passed when records are made in subsidiary books. When journal is the only book of prime entry it is possible for only one book-keeper to enter transaction in it at a time. In case of business entities having large volume of transactions, one person cannot do all the recording 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.

6.2 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.

6.3 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.

6.4 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.

Student activity

Think: Visit some business units in your area. Find out the books maintained by them. Do they maintain special subsidiary books? If not, discuss with them the need and guide them on maintaining the special subsidiary books.

6.5 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.

6.5.1 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.

6.5.2 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 ₹10,000 was made and 10% was allowed as trade discount, the entry regarding sales will be made for ₹ 9,000 (10,000 – 10 per cent of 10,000). In the same way, purchaser of goods will also record purchases as ₹ 9,000).

Student activity

Think: Is trade discount the same as cash discount?

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 @ ₹ 450 each
 2 tables @ ₹ 1,000 each
 Less: Trade discount @ 10%

March 6 Purchased for cash from Welcome Furniture, Vellore
 2 almirahs @ ₹ 2,000 each

March 7 Bought from Ramesh & Co., Royapettah
 2 stools @ ₹ 500 each
 10 rolling chairs @ ₹ 200 each
 Delivery charges and cartage ₹ 150

March 20 Purchased 2 computers for office use from Anandan & Co., Adyar
 on credit for ₹15,550 each

March 21 Purchased from Kamal & Co., Karaikkal
 10 chairs @ ₹ 750 each
 15 steel cabinets @ ₹ 1,500 each
 Packing and delivery charges ₹ 250
 Less: Trade discount @ 10%

March 25 Purchased from Jemini & Sons, Chennai
2 typewriters @ ₹ 7,750 for office use

Solution

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

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

Tutorial note

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.

Student activity

Think: Why the purchase of typewriter is not recorded? How do you record this transaction?

6.5.3 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 credit side of the respective personal account of the creditor by entering the words 'By Purchases account'.

Step 2: **Posting to purchases account:** Generally, at the end of the month, the purchases book is totalled. 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 @ ₹ 500 each
	10 grinders @ ₹ 3,000 each
July 6	Purchased for cash from Siva & Bros.
	25 fans @ ₹ 1,250 each
July 10	Purchased from Balan & Co. on credit
	20 grinders @ ₹ 2,500 each
	10 mixies @ ₹ 3,000 each
	Trade discount 10%
	Delivery charges ₹ 1,000
July 20	Purchased on credit, one copier machine from Kumar for ₹ 35,000

Solution

In the books of Ram Home Appliances
Purchases book

Date	Particulars	Invoice No.	L.F.	Amount ₹	
				Details	Total
2017					
July 5	**Kannan & Co.**				
	50 iron boxes @ ₹ 500			25,000	
	10 grinders @ ₹ 3,000			30,000	55,000
July 10	**Balan & Co.**				
	20 grinders @ ₹ 2,500			50,000	
	10 Mixies @ ₹ 3,000			30,000	
				80,000	
	Less: Trade discount 10%			8,000	
				72,000	
	Add: Delivery charges			1,000	73,000
	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.

6.6 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.	Amount ₹		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		

6.6.1 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'.

6.6.2 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.

Student activity

Think: Do you think the supplier will accept the debit note sent by the customer, as it is? If not, why will he not accept?

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**					Not in accordance with order
	5 clutch plates @ ₹ 200 each				1,000	
Jan 14	**Chandran**					
	4 brake shoes @ ₹ 200 each			800		Due to inferior quality
	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				

6.7 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.

6.7.1 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'.

Illustration 4

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	**Saravana Traders, Sayalkudi**				
July 5	10 packs of A4 Sheets @ ₹ 250 per pack			2,500	
	10 dozens writing pads @ ₹ 850 per dozen			8,500	
				11,000	
	Less: 10% Trade discount			1,100	9,900
July 20	**Mohan & Co., Mudukulathur**				
	5 white boards @ ₹ 2,200 each			11,000	
	10 dozens writing pads @ ₹ 850 per dozen			8,500	19,500
	Sales A/c Cr.				**29,400**

Ledger Accounts

Dr. **Sales A/c** **Cr.**

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
				2017	By Sundry		
				July 31	debtors A/c		29,400

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.

6.8 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.

6.8.1 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'.

6.8.2 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.					

Illustration 5

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

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

Solution

In the books of Magesh

Sales returns book

Date	Particulars	L.F.	Credit Note No.	Amount Details ₹	Amount Total ₹	Remarks
2017						
April 6	**Shankar**					
	30 Shirts @ ₹ 150			4,500		Due to inferior quality
April 8	**Amar Tailors**					
	10 T-Shirts @ ₹ 100			1,000		Not in accordance with the order
April 21	**Prema Stores**					
	12 Salwar sets @ ₹200			2,400	7,900	Not in accordance with the order
	Sales Returns A/c Dr.				**7,900**	

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

Student activity

Think: Visit a stationery shop nearby. Observe its business activities for a week. After having discussed with the shop keeper, prepare a list of purchased and sold items by the shop. Record them in the appropriate books.

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

Sales Book

Date	Particulars	Invoice No.	L.F.	Amount ₹ Details	Amount ₹ Total
2017					
Jan. 5	**Sheela & Co.**				
	10 electric iron boxes @ ₹ 1,250 each			12,500	
	20 electric stoves @ ₹ 450 each			9,000	
				21,500	
	Less: Trade discount (10%)			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 ₹ Details	Amount ₹ Total	Remarks
2017						
Jan. 18	**Preethi & Co.**					Being
	5 table fans @ ₹ 1,400 each				7,000	defective
Jan. 27	**Sathya & Co.**					
	2 fans @ ₹ 1,140 each				2,280	Damaged
	(List Price – Trade discount)					fans
	(1,200 – 60)					
	Purchase Returns A/c Cr.				**9,280**	

Sales Returns Book

Date	Particulars	Credit Note No.	L.F.	Amount ₹ Details	Amount ₹ Total	Remarks
2017						
Jan. 21	**Sheela & Co.**					
	3 electric Iron boxes @ ₹ 1,125 each				3,375	Being
	(List Price – Trade discount)					defective
	(1,250 – 125)					
	Sales Returns A/c Dr.				**3,375**	

Student activity

Think: Prepare a flow chart/mind map to show how entries are posted from subsidiary books to ledger?

6.9 Bills of exchange

6.9.1 Introduction

To increase the sales, a seller sells the goods on credit to his customers. If sale is made on credit, cash will not be received immediately. The seller may draw a bill on the customer for the amount due from him. If the customer accepts it, the seller can get the same discounted with the bank and get cash immediately.

6.9.2 Definition of bill of exchange

According to the Negotiable Instruments Act, 1881, "Bill of exchange is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of a certain person or to the bearer of the instrument".

6.9.3 Features of bills of exchange

An analysis of the definition given above, highlights the following important features of a bill of exchange:

(i) It is a written document.
(ii) It is an unconditional order.
(iii) It is an order to pay a certain sum of money.
(iv) It is signed by the drawer.
(v) It bears stamp or it is drafted on a stamp paper.
(vi) It is to be accepted by the acceptor.
(vii) The amount of the bill is paid to the drawer or the endorsee.

6.9.4 Specimen of bill of exchange

Bill of exchange

Stamp

328, Bazaar Street,
Saidapet, Chennai-15
01.06.2017

₹ 10,000/-

Three months after date pay to me or to my order the sum of Rupees Ten Thousand only for value received

To
Thiru. Jothi Kumar,
430, Mint Street,
Chennai- 1.

Ramesh Babu

6.9.5 Important terms

Explanation of some terms connected with bill of exchange is given below:

(i) Drawing of a bill

The seller (creditor) prepares the bill in the form presented above. The act of preparing the bill by the seller or creditor in its complete form with the signature is known as 'drawing' a bill.

(ii) Parties

There are three parties to a bill of exchange as under:

(a) ***Drawer:*** The person who prepares the bill is called the drawer, i.e., a creditor

(b) ***Drawee:*** The person who has to make the payment or who accepts to make the payment is called the drawee, i.e., a debtor

(c) ***Payee:*** The person who receives the payment is payee. He may be a third party or the drawer of the bill.

In the above specimen, drawer and payee is Ramesh Babu. Jothi Kumar is the drawee.

(iii) Acceptance

In a bill, drawee gives his/her acceptance by writing the word 'accepted' and signs the same with the date. Now the bill becomes a legal document enforceable in the court of law.

(iv) Due date and days of grace

When a bill is drawn payable after a specified period, the date on which the payment should be made is called '**Due date**'. In the calculation of the due date, three extra days are added to the specified period of the bills called '**Days of grace**'. If the date of maturity falls on a holiday, the bill will be due for payment on the preceding day.

Example:

Date of bill	Period of bill	Days of grace	Due date
1st March	2 months	3	4th May
12th July	1 month	3	14th August, since 15th August (being Independence day) is a public holiday.
1st October	30 days	3	3rd November

DO YOU KNOW?

If the maturity date falls on an emergency holiday, succeeding day will be the due date for payment.

(v) Endorsement

Endorsement means signing on the face or back of a bill for the purpose of transferring the title of the bill to another person. The person who endorses is called the "Endorser". The person to whom a bill is endorsed is called the "Endorsee". The endorsee is entitled to collect the money.

(vi) Discounting

When the holder of a bill is in need of money before the due date of a bill, cash can be received by discounting the bill with the banker. This process is referred to as the discounting of bill. The banker deducts a small amount of the bill which is called discount and pays the balance in cash immediately to the holder of the bill.

(vii) Retiring of bill

An acceptor may make the payment of a bill before its due date and may discharge the liability on the bill. It is called as retirement of a bill. Usually, the holder of the bill allows a concession called rebate to the drawee for the unexpired period of the bill.

(viii) Renewal

When the acceptor of a bill knows in advance that he/she will not be able to meet the bill on its due date, he/she may request the drawer for extension of time for payment. The drawer of the bill may agree to cancel the original bill and draw a new bill for the amount due with interest thereon. This is referred to as renewal.

(ix) Dishonour

Dishonour of the bill means the non payment of the amount of the bill, when it is presented for payment.

6.10 Bills receivable book

Bills receivable refers to bills drawn, the payment for which has to be received. In case of credit sales of goods, the entity may draw a bill on the buyer (debtor), for a certain period. This is called bills receivable for the business entity and bills payable for the debtor who has accepted the bill. Where number of bills receivable is large, then a separate bills receivable book may be maintained by a business entity to record the details of bills receivable. Such bills are drawn on debtor for a specified amount payable at sight on or after specified period. Bills receivable book contains the details of bills drawn and its disposal. The format of the bills receivable book is given below:

Format

Bills receivable book

Date of receipt of bill	From whom bill is received	Term of the bill	Due date of the bill	L.F.	Amount of the Bill ₹	Remark
(i)	(ii)	(iii)	(iv)	(v)	(vi)	(vii)

(i) **Date:** In this column, the date of the acceptance of the bill is recorded.

(ii) **From whom received:** In this column, the name of the debtor, who has accepted the bill and promised to make its payment, is recorded. The bill legally comes into existence after its acceptance.

(iii) **Term or period:** The bill is drawn for a specified period. This period may be one month, two months, three months, etc. or even 60 days, 90 days, 120 days, etc. Period of the bill for which the bill has been drawn is mentioned here.

(iv) **Due date:** Due date is the date on which the payment of the bill is actually due. It is also known as date of maturity. In order to calculate the due date, three days of grace is added to the term of the bill.

(v) **Ledger Folio (L.F.):** This column contains the page number of the ledger in which the account of the acceptor of the bill appears.

(vi) **Amount of the bill:** The actual amount of the bill is recorded in this column.

(vii) **Remark:** This column contains the details of disposal of the bill, whether the bill has been discounted or endorsed, honoured or dishonoured etc.

6.11 Bills payable book

Details recorded in the bills payable book are the names of the parties whose bills are accepted, date of the bills payable, due date, amount, etc. The individual accounts of the parties whose bills are accepted will be debited with the corresponding amount in the bills payable book. The specimen of bills payable book is given below:

Format

Bills payable book

Date of acceptance of the bill	To whom acceptance is given	Term of the bill	Due date of the bill	L.F.	Amount of the bill ₹	Remark
(i)	(ii)	(iii)	(iv)	(v)	(vi)	(vii)

These columns record almost the same particulars which are recorded in the bills receivable book. When there is credit purchases of goods, the business entity may accept a bill drawn by the supplier or creditor. It is called bills payable for the business entity. Where there are large number of such bills payable, a separate bills payable book may be maintained. Thus, bills payable book is a subsidiary book maintained to record the details of bills payable.

The preparation of the bills receivable and bills payable book is explained through the following example:

2017 July 1	Acceptance received from Nirmala for ₹ 5,000 payable after 3 months.
July 20	Acceptance given to Shailaja's bill for ₹ 3,000 payable after 3 months.
July 31	Acceptance received from Faisal for ₹ 1,000 payable after 60 days.
Aug. 5	Farid's bill for ₹ 1,000 payable after 6 months accepted.
Aug.11	Mohan's acceptance for ₹ 700 payable after 90 days received.

The bills receivable and bills payable books are prepared as follows:

Bills Receivable Book

Date	From whom received	Term	Due date	L.F.	Amount ₹	Remark
2017			2017			
July 1	Nirmala	3 months	October 4		5,000	
July 31	Faisal	60 days	October 1		1,000	
Aug 11	Mohan	90 days	November 12		700	
	Total				**6,700**	

Note: On 31st July, for Faisal bill, due date is 1st October, since 2nd October, (being Gandhi Jayanthi) is a public holiday.

Bills Payable Book

Date	To whom accepted	Term	Due date	L.F.	Amount ₹	Remark
2017			2017			
July 20	Shylaja	3 months	October 23		3,000	
			2018			
Aug 5	Farid	6 months	February 8		1,000	
	Total				**4,000**	

6.12 Journal proper

Journal proper is a residuary book which contains record of transactions, which do not find a place in the subsidiary books such as cash book, purchases book, sales book, purchases returns book, sales returns book, bills receivable book and bills payable book. Thus, journal proper or general journal is a book in which the residual transactions which cannot be entered in any of the sub divisions of journal are entered. The usual entries that are passed through this journal are given below:

(i) Opening journal entry	(ii) Closing journal entry
(iii) Adjusting entries	(iv) Transfer entries
(v) Rectifying entries	(vi) Miscellaneous entries

(i) Opening journal entry

At the end of the accounting year, all nominal accounts are closed but the business has to be carried on with previous year's assets and liabilities. Hence, these accounts are to be brought into the accounts of the current year. Journal entry made in the beginning of the current year with the balances of assets and liabilities of the previous year is opening journal entry. In this entry, asset accounts are debited, liabilities and capital accounts are credited.

Example

Ramnath carried forward the following items. Make the opening entry in journal proper as on 1st January, 2017.

Cash	₹ 30,000	Stock	₹ 15,000
Furniture	₹ 3,000	Sundry Creditors	₹ 10,000

Opening Entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
2017	Cash A/c	Dr.		30,000	
Jan 1	Stock A/c	Dr.		15,000	
	Furniture A/c	Dr.		3,000	
	To Sundry creditors A/c				10,000
	To Capital A/c				38,000
	(Balance of assets and liabilities brought forward)				

(ii) Closing journal entry

At the end of the accounting period, all the ledger accounts relating to purchases, sales, purchases returns, sales returns, stock and other accounts concerning expenses, losses, incomes and gains are closed by transfer to trading and profit and loss account so that financial statements can be prepared. It should be noted that closing entries are made for nominal accounts only.

Example: Salaries account ₹ 10,000. The closing entry as on 31st December, 2017 is:

Closing Entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
2017	Profit and Loss A/c	Dr.		10,000	
December 31	To Salaries A/c				10,000
	(Salaries A/c transferred to Profit and Loss A/c)				

iii) Adjusting entries

After preparing the trial balance, but before preparing the final accounts, if any adjustment is required in the accounts for items or transactions left out, adjusting entries are made.

Example

Book value of the machinery as on 1st January, 2017 ₹ 1,00,000. Rate of depreciation is 10% p.a. Adjusting entry as on 31st December, 2017 is:

Adjusting Entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
2017	Depreciation A/c (1,00,000 × 10%) Dr.		10,000	
Dec 31	To Machinery A/c			10,000
	(Depreciation written off)			

(iv) Transfer entries

Transfer entries are passed in the journal proper for transferring an item entered in one account to another account. For example, transferring net profit of ₹ 5,000 to capital account, the following entry is passed:

Transfer Entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Profit and Loss A/c Dr.		5,000	
	To Capital A/c			5,000
	(Net profit transferred to capital account)			

(v) Rectifying entries

Rectifying entries are passed for rectifying errors which are committed in the books of accounts.

Example

Purchase of furniture by a stationery dealer for ₹ 10,000 was debited to purchases account. Pass rectifying entry on December 31, 2017.

Rectifying Entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
2017	Furniture A/c Dr.		10,000	
Dec 31	To Purchases A/c			10,000
	(Wrong debit to purchases account rectified)			

(vi) Miscellaneous entries

These are entries which do not occur frequently such as:

(i) Credit purchases and credit sale of assets which cannot be recorded through purchases or sales book.

(ii) Endorsement, renewal and dishonor of bill of exchange which cannot be recorded through bills book.

(iii) Other adjustments like interest on capital, bad debts, reserves, etc.

(iv) Goods withdrawn by the owner for personal use.

(v) Goods distributed as samples for sales promotion.

(vi) Loss of goods by fire, theft and spoilage.

Points to remember

- Business transactions are entered in the subsidiary books before they are posted to the ledger.
- Sales book is meant for recording sales of goods on credit.
- Sales book is prepared with the help of invoices sent to the customers.
- Sales returns book is prepared based on the credit notes issued to the customers.
- Purchases book is meant for recording purchases of goods on credit.
- Purchases returns book is prepared based on the credit notes received from the suppliers.
- At the end of each month, totals of the sales, purchases, and returns b are transferred to the sales, purchases, and returns accounts respectively.

Self-examination questions

AH5FX2

I Multiple choice questions

Choose the correct answer

1. Purchases book is used to record
   (a) all purchases of goods (b) all credit purchases of assets
   (c) all credit purchases of goods (d) all purchases of assets

2. A periodic total of the purchases book is posted to the
   (a) debit side of the purchases account (b) debit side of the sales account
   (c) credit side of the purchases account (d) credit side of the sales account

3. Sales book is used to record
   (a) all sales of goods (b) all credit sales of assets
   (c) all credit sales of goods (d) all sales of assets and goods

4. The total of the sales book is posted periodically to the credit of
   (a) Sales account (b) Cash account
   (c) Purchases account (d) Journal proper

5. Purchase returns book is used to record
   (a) returns of goods to the supplier for which cash is not received immediately
   (b) returns of assets to the supplier for which cash is not received immediately
   (c) returns of assets to the supplier for which cash is received immediately
   (d) None of the above

6. Sales return book is used to record
   (a) Returns of goods by the customer for which cash is paid immediately
   (b) Returns of goods by the customer for which cash is not paid immediately
   (c) Returns of assets by the customer for which cash is not paid immediately
   (d) Returns of assets by the customer for which cash is paid immediately

7. Purchases of fixed assets on credit basis is recorded in
   (a) Purchases book (b) Sales book
   (c) Purchases returns book (d) Journal proper

8. The source document or voucher used for recording entries in sales book is
   (a) Debit note (b) Credit note
   (c) Invoice (d) Cash receipt

9. Which of the following statements is not true?
   (a) Cash discount is recorded in the books of accounts
   (b) Assets purchased on credit are recorded in journal proper
   (c) Trade discount is recorded in the books of accounts
   (d) 3 grace days are added while determining the due date of the bill

10. Closing entries are recorded in
   (a) Cash book (b) Ledger
   (c) Journal proper (d) Purchases book

Answer

1. (c)	2. (a)	3. (c)	4. (a)	5. (a)	6. (b)	7. (d)	8. (c)	9. (c)	10. (c)

II Very short answer questions

1. Mention four types of subsidiary books.
2. What is purchases book?
3. What is purchases returns book?
4. What is sales book?
5. What is sales returns book?
6. What is debit note?
7. What is credit note?
8. What is journal proper?
9. Define bill of exchange.
10. What is an opening entry?
11. What is an invoice?

III Short answer questions

1. Give the format of purchases book.
2. Mention the subsidiary books in which the following transactions are recorded.
   (i) Sale of goods for cash
   (ii) Sale of goods on credit
   (iii) Purchases of goods on credit
   (iv) When the proprietor takes goods for personal use
   (v) Goods returned to suppliers for which cash is not received immediately
   (vi) Asset purchased as credit.
3. What are the advantages of subsidiary books?

4. Write short notes on:
   (a) Endorsement of a bill and
   (b) Discounting of a bill

IV Exercises

1. Enter the following transactions in the Purchases book of M/s. Subhashree Electric Co., which deals in electric goods.

2017	
April 5	Purchased from Karthik Electric Co., on credit
	10 Electric iron box @ ₹ 2,500 each
	5 electric stoves @ ₹ 2,000 each
April 19	Purchased on credit from Khaitan Electric Co.,
	3 electric heaters @ ₹ 6,000 each
April 25	Purchased from Polar Electric Co., on credit
	10 Fans @ ₹ 2,000 each
April 29	Purchased from M & Co. for cash
	10 electric stoves @ ₹ 3,000 each

(**Answer:** Purchases A/c. (Dr.) ₹ 73,000)

2. From the following transactions write up the Sales day book of M/s. Ram & Co., a stationery merchant.

2017	
Jan. 1	Sold to Anbu& Co., on credit 20 reams of white paper @ ₹ 150 per ream
Jan. 2	Sold to Jagadish& Sons on credit 6 dozen pens @ ₹ 360 per dozen
Jan. 10	Sold old newspapers for cash @ ₹ 620
Jan. 15	Sold on credit M/s. Elango& Co., 10 drawing boards @ ₹ 170 per piece
Jan. 20	Sold to Kani & Co., 4 writing tables at ₹ 1,520 per table for cash

(**Answer:** Sales A/c (Cr.) ₹ 6,860)

3. Prepare Purchases book and Sales book in the books of Santhosh Textiles Ltd., from the following transactions given for April, 2017.

2017	
April 1	Purchased goods from Prasad, Kancheepuram on credit
	100 meters Silk @ ₹ 450 per meter
	75 meters Velvet @ ₹ 180 per meter
April 10	Sold goods to Rathinam, Chennai on credit
	60 meters Silk @ ₹ 490 per meter
	50 meters Velvet @ ₹ 210 per meter
April 18	Nathan & Sons purchased from us on credit
	100 meters Silk @ ₹ 510 per meter

April 20 Purchased goods from Hari Ram & Sons, Madurai on credit
50 rolls kada cloth @ ₹ 730 per roll
80 rolls cotton cloth @ ₹ 650 per roll

April 24 Purchased from Mohan, Karur for cash
Shirting cloth @ ₹ 7,000
Sarees @ ₹ 25,000

(**Answer:** Purchases A/c (Dr.): ₹ 1,47,000 & Sales A/c (Cr.) ₹ 90,900)

4. From the following information, prepare purchase day book and purchases returns book for the month of June, 2017 and post them into ledger accounts in the books of Robert Furniture Mart.

2017

June 1 Purchased from Balu Traders 20 chairs @ ₹ 150 each on credit

June 13 Bought from Subash @ Co., on credit
2 Almirah @ ₹ 3,100 each
10 tables @ ₹ 1,500 each
15 chairs @ ₹ 200 each
Less: 10 % Trade discount on all items
Add: Freight charges ₹ 220

June 21 Returned 2 damaged chairs to Balu Traders and cash not received

June 24 Purchased from Sunrise Furniture Mart on credit
25 Almirahs @ ₹ 1,300 each

June 27 Purchased from Mouli Traders on credit
10 executive tables @ ₹ 3,275 each

June 29 Returned 3 Almirahs to Sunrise Furniture Mart and cash not received

(**Answer:** Purchases A/c(Dr.): ₹ 90,250 Purchases Returns A/c (Cr.) ₹ 4,200)

5. Record the following transactions in the sales book and sales returns book of M/s. Ponni & Co., and post them to ledger.

2017

Aug 1 Sold goods to Senthil as per Invoice No. 68 for ₹ 20,500 on credit

Aug 4 Sold goods to Madhavan as per Invoice No. 74 for ₹ 12,800 on credit

Aug 7 Sold goods to Kanagasabai as per Invoice No. 78 for ₹ 7,500 on credit

Aug 15 Returns inward by Senthil as per Credit Note no. 7 for ₹ 1,500 for which cash is not paid

Aug 20 Sold goods to Selvam for ₹ 13,300 for cash

Aug 25 Sales returns of ₹ 1,800 by Madhavan as per Credit Note No. 11 for which cash is not paid

(**Answer:** Sales A/c (Cr.) ₹ 40,800; Sales Returns A/c (Dr.) ₹ 3,300;
Senthil A/c (Dr.) ₹ 19,000; Madhavan A/c (Dr.) ₹ 11,000
& Kanagasabai A/c (Dr.) ₹ 7,500)

6. From the following information, prepare the necessary subsidiary books for Nalanda Book Stores.

2017	
Dec. 1	Bought from M/s. Umadevi on credit 100 copies Business Statistics Book @ ₹ 80 each 100 copies Accountancy Book @ ₹ 150 each
Dec. 7	Sold to Sridevi & Co., on credit 240 copies Business Statistics @ ₹ 90 each 250 copies Accountancy books @ ₹ 170 each
Dec. 10	Bought from Subha & Co., 40 Copies Economics books @ ₹ 80 each Less: 15% Trade Discount
Dec. 15	Returned to M/s. Uma Devi 10 copies of damaged Accountancy book for which cash is not received
Dec. 18	Sold to Gupta Bros., on credit 200 copies of Economics book @ ₹ 95 each
Dec. 26	Returned 6 copies of Economics books to Subha & Co.,

(**Answer:** Purchases A/c (Dr.) ₹ 25,720, Sales A/c (Cr.) ₹ 83,100,
Purchases Returns A/c (Cr.) ₹ 1,908)

7. Prepare necessary subsidiary books in the books of Niranjan and also Sachin account and Mukil account from the following transactions for the month of February, 2017.

2017		₹
Feb. 1	Purchased goods from Mukil Traders on credit	12,480
Feb. 4	Goods sold to Sachin Traders on credit	15,000
Feb. 6	Sold goods to Manish Traders on credi	12,100
Feb. 7	Sachin Traders returned goods for which cash is not paid	1,200
Feb. 9	Returned goods to Mukil Traders for which cash is not received	1,500
Feb. 10	Sold goods to Manish & Co., on credit	13,300
Feb. 14	Purchased from Mukil Traders on credit	15,200

(**Answer:** Purchases A/c (Dr.) ₹ 27,680; Sales A/c (Cr.) ₹ 40,400,
Purchases Returns A/c (Cr.) ₹ 1,500, Sales Returns A/c (Dr.) ₹ 1,200;
Mukil A/c (Cr.) ₹ 26,180; Sachin A/c (Dr.) ₹ 13,800)

CASE STUDY

Mr. Joseph started a trading business of selling readymade clothes. In the earlier period, he dealt only with cash, because he felt that would be risk-free. But, later on, he had to give credit period for his regular customers in order to retain them. For some customers, when they made bulk purchase, he offered them some discount. That brought him even more customers. But, some of his customers are not prompt in making the payment.

He expanded his business and employed few staff. As the credit transactions were numerous, he found it difficult to maintain properly. One of his friends, who is a Chartered Accountant advised him to maintain subsidiary books.

Discuss on the following points.

- What could be the reason for Joseph's feeling that dealing in cash is risk free?
- What type of discount is offered by Joseph?
- Suggest some ways to Joseph for making his customers to pay on time.
- Do you think that maintaining the subsidiary books will be useful to Joseph?
- What business documents are needed to maintain the subsidiary books?

To explore further

How do you make sure that the subsidiary books are maintained without any error?

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Unit 7

SUBSIDIARY BOOKS - II

CASH BOOK

Contents

Points to recall

The following points are to be recalled before learning Subsidiary books-II cash book:

- Golden rules of accounting
- Journal entries
- Ledger account
- Subsidiary books

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Learning Objectives

To enable the students to

- Understand the meaning and importance for cash book
- Apply the rules of double entry system in the preparation of various types of cash book
- Understand the meaning and types of petty cash book
- Prepare petty cash book

Key terms to know

- Cash book
- Petty cash book
- Bank overdraft
- Cheque

7.1 Introduction

Student activity

Think: A stationery shop keeper maintains only one register to record all her business transactions. She finds it difficult to know and check her shop's cash balance at the end of the day. Is there any way to help her? She needs your suggestion.

In any business, many transactions take place every day involving cash such as cash sales, receipts from debtors, cash purchases, payment to creditors and payment towards different expenses. It is therefore necessary, that all the cash transactions are recorded in a separate book, i.e., cash book. Cash book is the most important subsidiary book, because it keeps the initial record of cash transactions of the business. Cash book is maintained by every business, whether small or large in size. It is simply because every business is very cautious about its cash management, i.e., cash receipts and cash payments. The cash book presents the true position of cash transactions. Cash book also serves as a documentary evidence for the available cash balance.

7.2 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.

7.3 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.

7.4 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.

7.5 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.

7.6 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.

Student activity

Think: Credit transactions are not recorded in the cash book. Where will they be recorded?

7.6.1 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.		₹
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				2017			
Jan 1	To Balance b/d		11,200	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				

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.

Student activity

Think: In cash book, receipts are entered on the debit side and payments are entered on the credit side. Why?

Illustration 2

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

April		₹
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. **Cash Book (Single column)** **Cr.**

Date	Receipts	L.F.	Amount ₹	Date	Payments	L.F.	Amount ₹
2017				2017			
April 1	To Pradeep's capital A/c		27,000	April 5	By Purchases A/c		6,000
				13	By Bank A/c		5,000
10	To Sales A/c		11,000	21	By Stationery A/c		200
14	To Sales A/c		9,000	25	By Murugan A/c		14,000
29	To Bank A/c		4,000	26	By Commission A/c		700
				30	By Balance c/d		**25,100**
			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.

7.6.2 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				2017			
April				April 10	By Cash A/c		11,000
				14	By Cash A/c		9,000

Dr. **Purchases A/c** **Cr.**

Date	Particulars	L.F.	Amount ₹	Date	Particulars	L.F.	Amount ₹
2017				2017			
April 5	To Cash A/c		6,000	April			

7.7 Cash discount and trade discount

a) Cash discount

Cash discount is allowed to the parties making prompt payment within the stipulated period of time or early payment. It is discount allowed (loss) for the creditor and discount received (gain) for the debtor who makes payment. The discount is allowed when payment is received or made and hence, the entry for discount is also passed with the entry of payment. The earlier the payment, the more may be the discount. Cash discount motivates the debtor to make the payment at an earlier date to avail discount facility. For example, the terms may be.

"5% discount will be allowed if the payment is made within one month.

3% discount will be allowed if the payment is made within two months".

Discount allowed account will be shown on the debit side of profit and loss account and discount received account will be shown on the credit side of profit and loss account. When cash discount is allowed in respect of sale of goods or services, the seller allows cash discount to the buyer when payment is made.

b) 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 ₹ 10,000 was made and 10% was allowed as trade discount, the entry regarding sales will be made for ₹ 9,000 (10,000 – 10 per cent of 10,000). In the same way, purchaser of goods will also record purchases as ₹ 9,000).

7.7.1 Differences between cash discount and trade discount

Following are the difference between cash discount and trade discount:

Basis	Cash discount	Trade discount
1. Purpose	Cash discount is allowed to encourage the buyers of goods to make payment at an early date.	Trade discount is allowed to encourage buyers to buy goods in large quantities.
2. Time of allowance	Cash discount is allowed by the seller or creditor to the buyer or debtor at the time of making payment.	Trade discount is allowed by the seller to the buyer when goods are sold.

3. Amount of discount	Cash discount is related to time. The earlier the payment, the more will be the cash discount.	Trade discount is generally related to the quantity of purchase or sale. The more the purchases, the more will be the rate and amount of discount.
4. Recording in books of accounts	Cash discount is recorded in the books of account. Cash discount allowed is shown on the debit side of cash book. Cash discount received is shown on the credit side of the cash book.	Trade discount is not recorded in the books of account. No journal entry is made for the same. Details are just shown in the purchases or sales book.
5. Deduction from invoice value	Cash discount is not deducted from the invoice value of goods.	Trade discount is deducted from the list price of the goods.

7.8 Double column cash book (Cash book with cash and discount column)

It is a cash book with cash and discount columns. As there are two columns, i.e., discount and cash columns, both on debit and credit sides, this cash book is known as 'double column cash book'.

The double column cash book is prepared on the lines of simple cash book. It has only one additional column, i.e., discount column on each side. Discount column represents discount allowed on the debit side and discount received on the credit side.

In the discount columns, cash discount, i.e., cash discount allowed and cash discount received are recorded. The net amount received is entered in the amount column on the debit side and the net amount paid is entered in the amount column on the credit side. For the seller who allows cash discount, it is a loss and hence it is debited and shown on the debit side of the cash book. For the person making payment, discount received is a gain because less payment is made and it is credited and shown on the credit side of the cash book.

The cash columns are balanced. Discount columns are not balanced, since debit represents discount allowed and credit represents discount received. They are totalled, separately.

The format of double column cash book is given below:

Dr. **Cash book with cash and discount columns** **Cr.**

Date	Receipts	R.N	L.F	Amount ₹		Date	Payments	R.N	L.F.	Amount ₹	
				Discount	Cash					Discount	Cash

Student activity

Think: Cash account cannot have a credit balance. Why?

7.8.1 Balancing the double column cash book

The cash columns should be balanced as usual and the balance should be carried forward to the next date or period.

However, discount columns are not to be balanced. They are to be totalled on the debit side and credit side separately. The total of discount column on the debit side represents total discount allowed to customers and is debited to discount allowed account. Total of discount column on the credit side represents total discount received and is credited to discount received account. The periodical totals of discount columns are posted as under:

(i) Debit Discount allowed account as 'To Sundry Accounts as per Cash book', with the periodical total of the discount allowed column.

(ii) Credit Discount received account as 'By Sundry Accounts as per Cash Book' with the periodical total of the discount received column.

Illustration 3

Enter the following transactions in a cash book with cash and discount columns:

2017		₹
Jan 1	Cash in hand	11,500
Jan 5	Paid to Ramanathan by depositing in cash deposit machine	300
	Discount allowed by him	10
Jan 8	Purchased goods for cash	400
Jan 10	Cash received from Rajagopal	980
	Discount allowed	20
Jan 15	Sold goods for cash	400
Jan 21	Paid cash to Shanthi	295
	Discount received	5
Jan 25	Paid wages by cash	50
Jan 31	Paid to Sanjeev ₹ 390 in full settlement of his account	400

Solution

Dr. **Cash book with cash and discount columns** **Cr.**

Date	Receipts	L.F	Amount ₹		Date	Payments	L.F.	Amount ₹	
			Discount	Cash				Discount	Cash
2017					2017				
Jan 1	To Balance b/d			11,500	Jan 5	By Ramanathan A/c		10	300
10	To Rajagopal A/c		20	980	8	By Purchases A/c			400
15	To Sales A/c			400	21	By Shanthi A/c		5	295
					25	By Wages A/c			50
					31	By Sanjeev A/c		10	390
					31	By Balance c/d			**11,445**
			20	12,880				25	12,880
Feb 1	To Balance b/d			**11,445**					

Note: Discount column is not to be balanced.

7.8.2 Posting from double column cash book

Following is the procedure for posting entries from double column cash book:

(a) Cash columns: Debit the accounts mentioned on the credit side and the credit is to Cash A/c with the amount mentioned in cash column; credit the accounts mentioned on the debit side and the debit is for Cash A/c with the amount mentioned in cash column.

(b) Discount columns: Debit the concerned personal account mentioned on the credit side and the credit is to Discount received A/c with the amount mentioned in the discount received column. Credit the concerned personal account mentioned on the debit side and the debit is for Discount allowed A/c with the amount entered in the discount allowed column.

7.9 Three column cash book (Cash book with cash, discount and bank column)

Student activity

Think: Is it safe and convenient to carry on the business transactions only in cash?

A three column cash book includes three amount columns on both sides, i.e., cash, bank and discount. This cash book is prepared in the same way as simple and double column cash books are prepared. The transactions which increase the cash and bank balance are recorded on the debit side of the cash and bank columns respectively. Opening balance of cash and favourable bank balance appear as the first item on the debit side of the three column cash book in case of existing business. If the business is a new one, capital contributed in cash and/or bank deposit appear as the first item on the debit side.

All the transactions which decrease the cash and bank balance are recorded in the cash and bank columns on the credit side. The balancing figures will be the closing balances of cash and bank. Cash will always have debit balance. Bank balance may be debit or credit depending on whether the balance is favourable or unfavourable respectively. If there is any discount allowed it is entered in the discount column on the debit side against the particular account. Similarly, if there is any discount received, it is entered in the discount column on the credit side.

7.9.1 Format

Format of three column cash book is as follows:

Dr. Cash book with cash, discount and bank columns or three column cash book Cr.

Date	Receipts	L.F	Amount ₹			Date	Payments	L.F.	Amount ₹		
			Discount	Cash	Bank				Discount	Cash	Bank

Tutorial note

(i) If a business entity has more than one bank account, columns may be provided in the cash book for each bank account separately.

(ii) Treatment of cheques: In addition to cash dealings every business may use cheques as a means of payment. For the purpose of accounting, cheques received are treated as cash received. When cheques received are banked on the same day the amount is to be directly debited to the bank account. When payments is made by cheque, the bank account is credited.

7.9.2 Contra entry

When the two accounts involved in a transaction are cash account and bank account, then both the aspects are entered in cash book itself. As both the debit and credit aspects of a transaction are recorded in the cash book, such entries are called contra entries.

Example

(i) When cash is paid into bank, it is recorded in the bank column on the debit side and in the cash column on the credit side of the cash book.

(ii) When cash is drawn from bank for office use, it is entered in cash column on the debit side and in the bank column on the credit side of the cash book.

To denote that there are contra entries, the alphabet 'C' is written in L.F. column on both sides. Contra means that particular entry is posted on the other side (contra) of the same book, because Cash account and Bank account are there in the cash book only and there are no separate ledger accounts needed for this purpose. The alphabet 'C' indicates that no further posting is required and the relevant account is posted on the opposite side.

Illustration 4

Prepare three column cash book in the books of Thiru Durairaj.

2017		₹
March 1	Cash in hand	12,000
	Cash at bank	15,000
2	Cash paid into bank	11,000
3	Goods sold ₹ 18,500. Half of it is received in cash and half of it is received by cheque which is immediately deposited in the bank	
4	Sold on credit to Jayaraj for	7,000
8	Jayaraj sent a cheque in full settlement	6,900
12	Jayaraj's cheque was sent to bank	
14	Bought goods from Iqbal and issued a cheque to him immediately	8,500
15	Bought goods from Murali on credit	4,000
19	Received a cheque from Kannappan in full settlement of his account of ₹ 2,000	1,975
20	Drew cash ₹ 3,000 and by cheque ₹ 5,000 for personal use	
25	Paid Vinod by cheque in full settlement of his account of ₹ 2,000	1,850

Solution

In the books of Durairaj

Three-column cash book

Dr. | Cr.

Date	Receipts	R.N	L.F	Amount ₹ Discount Allowed	Amount ₹ Cash	Amount ₹ Bank	Date	Payments	V.N	L.F.	Amount ₹ Discount Received	Amount ₹ Cash	Amount ₹ Bank
2017							2017						
Mar 1	To Balance b/d				12,000	15,000	Mar 2	By Bank A/c		C		11,000	
2	To Cash A/c		C			11,000	12	By Bank A/c		C		6,900	
3	To Sales				9,250	9,250	14	By Purchases A/c					8,500
8	To Jayaraj A/c			100	6,900		20	By Drawings A/c				3,000	5,000
12	To Cash A/c		C			6,900	25	By Vinod A/c			150		1,850
19	To Kannappan A/c			25	1,975		31	By Balance c/d				**9,225**	**26,800**
				125	30,125	42,150					150	30,125	42,150
Apr 1	To Balance b/d				9,225	26,800							

Illustration 5

Record the following transactions in three column cash book of Gunasekaran.

2017		
Jan		₹
1	Cash in hand	50,000
1	Cash at bank	90,000
2	Goods sold on credit to Rohini	15,000
5	Cheque received from Rohini in full settlement and deposited into bank	14,500
6	Cash deposited into bank through cash deposit machine	18,000
7	Goods sold to Sridhar for ₹ 12,000. He made the payment of ₹ 11,800 by debit card in full settlement by availing a cash discount of ₹ 200	
10	Money withdrawn from bank for office use	2,000
12	Purchased goods from Raja for ₹ 10,000 and paid through credit card in full settlement by availing a cash discount of ₹ 200	9,800
14	Nathiya who owed money made the payment through NEFT	18,000
27	Cheque of Rohini dishonoured	

(See the solution in the next page)

7.10 Petty cash book

Student activity

Think: A cashier finds it difficult to maintain record of large volume of cash payments, ranging from ₹ 5 to ₹ 10,00,000. Can you suggest a way to reduce his work burden?

Business entities have to pay various small expenses like taxi fare, bus fare, postage, carriage, stationery, refreshment and other sundry items. These are small payments and repetitive in nature. If all these small payments are recorded in the main cash book, it will be loaded with lot of entries. Hence, all petty payments of the business may be recorded in a separate book, which is called as petty cash book and the person who maintains the petty cash book is called the petty cashier. Thus business concerns may maintain main cash book and petty cash book separately.

All the small payments must be supported by vouchers, that is, documentary evidences. The vouchers must be numbered and filed in order. Petty cashier makes only cash payments. He must not be allowed to receive any cash except for reimbursement. Petty cashier has to make payments only within the specified limit. Payments involving large amounts must be made only by main cashier. At the end of the relevant period, petty cash book is balanced. Balancing of petty cash book is similar to the balancing of simple cash book.

Solution for illustration 5

In the books of Gunasekaran

Three column cash book

Dr. **C.r**

Date	Receipts	R.N.	L.F.	Amount ₹ Discount Allowed	Amount ₹ Cash	Amount ₹ Bank	Date	Payments	V.N.	L.F.	Amount ₹ Discount Received	Amount ₹ Cash	Amount ₹ Bank
2017							2017						
Jan. 1	To Balance b/d			-	50,000	90,000	Jan. 6	By Bank A/c		C	-	18,000	-
5	To Rohini A/c			500	-	14,500	10	By Cash A/c			-	-	2,000
6	To Cash A/c		C	-	-	18,000	12	By Purchases A/c			200	-	9,800
7	To Sales A/c			200	-	11,800	27	By Rohini A/c			-	-	14,500
10	To Bank A/c			-	2,000	-	31	By Balance c/d			-	34,000	1,26,000
14	To Nathiya A/c			-	-	18,000							
				700	52,000	1,52,300					200	52,000	1,52,300
Feb. 1	To Balance b/d				34,000	1,26,000							

Student activity

Think: The main cashier thinks that the petty cashier spends too much on everyday business activities. Is there any way to have a control on such expenses?

7.10.1 Impresst system of petty cash

Under this system, a fixed amount necessary or sufficient to meet petty payments determined on the basis of past experience is paid to the petty cashier on the first day of the period. (It may be a week or fortnight or month). The amount given to the petty cashier in advance is known as "Imprest Money". The word imprest means payment in advance. The petty cashier makes payments from this amount and records them in petty cash book. At the end of a particular period, the petty cashier submits the petty cash book to the head cashier. The head cashier scrutinises the petty payments and gives amount equal to the amount spent by petty cashier so that the total amount with the petty cashier is now equal to the amount he had received in the beginning as advance. Under the system, the total cash with the petty cashier never exceeds the imprest at any time during the period. This method thus provides an effective control over petty payments.

For example, On 1st June, 2017, ₹ 1,000 was given to the petty cashier. He had spent ₹ 940 during the month. He will be paid ₹ 940 on 30th June by the cashier so that he may again have ₹ 1,000 for the next month i.e., July, 2017.

7.10.2 Advantages of maintaining petty cash book

Following are the advantages of maintaining petty cash book:

(i) There can be better control over petty payments.
(ii) There is saving of time of the main cashier.
(iii) Cash book is not loaded with many petty payments.
(iv) Posting of entries from main cash book and petty cash book is comparatively easy.

7.10.3 Types of petty cash book

There are two types of petty cash books. They are:

(i) Simple petty cash book
(ii) Analytical petty cash book

(i) Simple petty cash book

A simple petty cash book resembles the single column cash book. But the columns are different. On the debit side, only the advance received from the head cashier is recorded. On the credit side, all payments are recorded in only one column. This is known as simple petty cash book.

(ii) Analytical petty cash book

In analytical petty cash book, a separate column is provided for different heads of payments and one column for total payments. When the petty expenses are recorded in the total payment column, same amount is also recorded in the appropriate expense column. This is known as analytical petty cash book.

Dr. **Format of analytical petty cash book** **Cr.**

Receipts ₹	C.B F.N	Date	Particulars	V.N.	Total payments ₹	Postage ₹	Stationery ₹	Carriage ₹	Travelling expenses ₹	Refreshments ₹	Sundries ₹	Personal accounts ₹	L.F.
			Total expenses		xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	
			Balance c/d		xxx								
xxx					xxx								
xxx			Balance b/d										
xxx			Cash a/c										

Details entered in the various columns of the petty cash book are as follows:

1) Receipts

This is the first column of the petty cash book. The amount received by the petty cashier for meeting petty expenses is recorded in this column. Generally, amount is received once on the first day of every week or month. The opening balance of petty cash is recorded in this column as the first item. This column shows the total amount available with the petty cashier.

2) Cash Book Folio Number (C.B.F.N.)

In this column, the page number of the cash book in which the entry is made is recorded.

3) Date

In this column, the date of receipt of petty cash and payment of every petty expense is recorded.

4) Particulars

The details of transactions are entered in this column. Cash received in the beginning is recorded as 'To Cash A/c' and all the petty expenses are recorded as 'By Concerned Expense A/c" (name of the expense).

5) Voucher Number (V.N.)

Every transaction in accounting must be supported by documentary evidence. All the payments must have vouchers which must be arranged in the chronological order of payment and serially numbered. Voucher number of every payment is written in this column.

6) Total

The amount of every petty expense is recorded in this column. At the end of the week or month expenses are totalled. The total expenses of the week or the month is compared with the total of the receipts column and balance is obtained.

7) Postage

Postal expenses incurred for post card, envelope, inland letter, postage stamps, registered letter, parcel, etc. are recorded in this column.

8) Stationery

It includes expenses incurred for purchasing materials such as paper, ink, pencil, eraser, carbon paper and other similar stationery items.

9) Carriage

It includes amount paid as wages, transport charges and other expenses.

10) Travelling or conveyance expenses

In this column fare for auto rickshaw, taxi, bus, train, etc., are recorded.

11) Refreshments

Amount spent for tea, coffee, snacks, etc., is recorded.

12) Sundries

There may be certain expenses which are infrequent for which specific columns are not provided. These are recorded in this column.

13) Personal accounts

Small amount of money paid to individuals are entered in this column.

14) Ledger Folio (L.F.)

This refers to the page number of the ledger where the respective account is recorded.

7.10.4 Balancing petty cash book

At the end of the period, i.e., week or month the total of the total column, individual expenses columns and sundries columns, is obtained. The total of the individual petty expenses column must be equal to the total in the total column. The sum of the total column is compared with the total of receipts column and the balance is obtained. The closing balance is shown as 'By Balance c/d'. The closing balance is carried forward to the next week or month. It is shown as 'To Balance b/d'. Cash received from the main cashier at the beginning of the next period is entered as 'To Cash A/c' and the amount is recorded in the Receipts column.

Illustration 6

Prepare a analytical petty cash book from the following information on the imprest system:

2017		₹
Jan. 1	Received for petty cash	500
Jan. 2	Paid rickshaw charges	5
	Paid cartage	12
Jan. 3	Paid for postage	15
	Paid wages to casual labourer	66
Jan. 4	Paid for stationery	134
	Paid for auto charges	18
Jan. 5	Paid for repairs	65
	Paid for bus fare	11
	Paid for cartage	24

Solution

Dr. **Analytical petty cash book (in ₹)** Cr.

Receipts ₹	C.B F.N	Date	Particulars	V.N.	Total Payments ₹	Conveyance ₹	Cartage ₹	Stationery ₹	Postage ₹	Wages ₹	Sundries ₹	L.F.
500		2017										
		Jan. 1	To Cash									
		2	By Conveyance		5	5						
			By Cartage		12		12					
		3	By Postage		15				15			
			By Wages		66					66		
		4	By Stationery		134			134				
			By Conveyance		18	18						
		5	By Repairs		65						65	
			By Conveyance		11	11						
			By Cartage		24		24					
			Total expenses		350	34	36	134	15	66	65	
		6	By Balance c/d		150							
500					500							
150		Jan. 6	To Balance b/d									
350		Jan. 6	To Cash									

7.10.5 Posting of entries from petty cash book to ledger

1. When petty cash is advanced at the beginning:

   A separate petty cash account is opened in the ledger. When advance is received by the petty cashier, petty cash account is debited and cash account is credited.

2. When individual expenses columns are periodically totalled:

   The total of various petty expenses are debited and the petty cash account is credited with the total of the payments made.

The petty cash account will show the balance of petty cash. This balance will be shown in the balance sheet as part of cash balance.

Tutorial note

Instead of debiting the total of each petty expense directly, a separate journal entry may also be made and then credited to petty cash account. The journal entries are:

(a) **For receiving petty cash:**

Petty cash A/c	Dr.	xxx	
To Cash A/c			xxx

(b) **For expenses paid:**

Respective expense A/c	Dr.	xxx	
To Petty cash A/c			xxx

Student activity

1) Interview a banker or invite a banker to your class to know the procedure for opening various types of bank accounts.

2) Imagine you have got a cash gift of ₹ 5,000. Come up with a small business plan. [Example: creating birthday cards on your own and selling them, buying and selling stationery items, etc.] Prepare cash book using imaginary transactions relevant to your chosen business.

Points to remember

- Three column cash book contains columns for discount, cash and bank on either side.
- Contra entry appears on both sides of a three column cash book. A contra entry occurs when cash is withdrawn from the bank or cash is deposited into the bank.
- A petty cash book is maintained to record small cash payments.

Self-examination questions

I Multiple choice questions

Choose the correct answer

AHN81C

1. Cash book is a
   (a) Subsidiary book (b) Principal book
   (c) Journal proper (d) Both subsidiary book and principal book

2. The cash book records
   (a) All cash receipts (b) All cash payments
   (c) Both (a) and(b) (d) All credit transactions

3. When a firm maintains a simple cash book, it need not maintain
   (a) Sales account in the ledger (b) Purchases account in the ledger
   (c) Capital account in the ledger (d) Cash account in the ledger

4. A cash book with discount, cash and bank column is called
   (a) Simple cash book (b) Double column cash book
   (c) Three column cash book (d) Petty cash book

5. In Triple column cash book, the balance of bank overdraft brought forward will appear in
   (a) Cash column debit side (b) Cash column credit side
   (c) Bank column debit side (d) Bank column credit side

6. Which of the following is recorded as contra entry?
   (a) Withdrew cash from bank for personal use
   (b) Withdrew cash from bank for office use
   (c) Direct payment by the customer in the bank account of the business
   (d) When bank charges interest

7. If the debit and credit aspects of a transaction are recorded in the cash book, it is
   (a) Contra entry (b) Compound entry
   (c) Single entry (d) Simple entry

8. The balance in the petty cash book is
   (a) An expense (b) A profit
   (c) An asset (d) A liability

9. Petty cash may be used to pay
   (a) The expenses relating to postage and conveyance
   (b) Salary to the Manager
   (c) Purchase of furniture and fixtures
   (d) Purchase of raw materials

10. Small payments are recorded in a book called
    (a) Cash book (b) Purchase book
    (c) Bills payable book (d) Petty cash book

Answer

1. (d)	2. (c)	3. (d)	4. (c)	5. (d)	6. (b)	7. (a)	8. (c)	9. (a)	10. (d)

II Very short answer questions

1. What is cash book?
2. What are the different types of cash book?
3. What is simple cash book?
4. Give the format of 'Single column cash book'.
5. What is double column cash book?
6. Give the format of 'Double column cash book'.
7. What is three column cash book?
8. What is cash discount?
9. What is trade discount?
10. What is a petty cash book?

III Short answer questions

1. Explain the meaning of imprest system of petty cash book.
2. Bring out the differences between cash discount and trade discount.
3. Write the advantages of maintaining petty cash book.
4. Write a brief note on accounting treatment of discount in cash book.
5. Brifly explain about contra entry with examples.

IV Exercises

Single Column Cash Book

1. Enter the following transactions in a single column cash book of Seshadri for May, 2017.

May		₹
1	Cash in hand	40,000
5	Cash received from Swathi	4,000
7	Paid wages in cash	2,000
10	Purchased goods from Sasikala for cash	6,000
15	Sold goods for cash	9,000
18	Purchased computer	15,000
22	Cash paid to Sabapathi	5,000
28	paid salary	2,500
30	Interest received	500

(**Answer**: Cash Balance ₹ 23,000)

2. Enter the following transactions in a single column cash book of Ramalingam for month of July, 2017.

July		₹
1	Cash in hand	32,000
5	Received from Keerthana	5,000
6	Paid packing charges in cash	300
7	Cash purchases	12,400
8	Sold goods for cash	2,600
10	Paid salary to manager in cash	7,000
11	Paid to Bala	3,000
12	Purchased goods from Bose	2,500
24	Cash deposited into bank through CDM	4,000
27	Withdraw cash from bank	2,000
31	Paid office rent in cash	6,000

(**Answer**: Cash Balance ₹ 8,900)

Double column cash book

3. Enter the following transactions in Ahamed's cash book with discount and cash columns.

2017 Oct		₹
1	Cash balance	37,500
3	Cash Sales	33,000
7	Paid to Velan Rs. 15,850 and Discount allowed by him	150
13	Sold goods to Perumal on credit	19,200
15	Cash withdrawn for personal expenses	4,800
16	Purchased goods from Subramanian	14,300
22	Paid to Bank	22,700
25	Cash received from Perumal in full settlement	19,000
26	Draw a cheque for office use	17,500
27	Paid cash to Gopalakrishnan	2,950
	Discount received from him	50
28	Paid cash to Subramanian and settled his account	14,200
29	Cash purchases	13,500
30	Cash paid for advertising	1,500

(**Answer**: Cash Balance ₹ 31,500)

4. Enter the following transactions in cash book with discount and cash column of Anand

2017 Dec.		₹
1	Cash in hand	19,500
4	Sold goods for cash	32,000
5	Credit purchases from Gandhi	20,000
9	Received from Gopu	11,800
	Discount allowed to him	200
15	Cash paid for Electricity charges	12,500
17	Bought computer and its accessories by cash	16,800
25	Paid cash to Gandhi ₹ 19,700 in full settlement of his account	
28	Received cash from Thiruvengadam	8,900
	Discount allowed to him	100
30	Paid trade expenses in cash	3,500

(**Answer**: Cash balance ₹ 19,700)

Three column cash book

5. Enter the following transactions in the three column cash book of Kalyana Sundaram

2017 Jan.		₹
1	Balance in hand	42,500
	Balance at bank	35,000
3	Received for cash sales	15,700
4	Cash paid into bank	11,500
6	Cash purchases	14,300
9	Received dividend directly by the bank through ECS	2,000
10	Pongal advance to staff paid through bank	17,000
12	Received cash from Nagarajan	11,850
	and allowed him discount	150
17	Paid Magesh in full settlement of his account ₹ 20,000	19,700
20	Cash withdrawn for personal expenses	20,000
30	Withdrawn cash from ATM for office use	1,500

(**Answer**: Cash Balance ₹ 6,050, Bank Balance ₹ 30,000)

6. Record the following transactions in the three column cash book of John.

2017 Dec.		₹
1	Cash balance brought forward	12,600
1	Bank overdraft brought forward	36,000
1	Advance paid to petty cashier by cheque	3,000
5	Goods sold for cash	12,000
7	Dividend on shares collected by the banker	1,000
13	Cash paid into Bank	10,000
14	Interest charged by the bank for bank overdraft	1,500
18	Cheque issued to Siddique	8,000
	Discount received from him	200
24	Insurance claim received by cheque and deposited into bank	17,000
28	Cash received from Baskar	15,000
	Discount allowed to him	150
31	Deposited into Bank all cash excess of ₹18,600	

(**Answer**: Cash Balance: ₹ 18,600, Bank Balance: ₹ 9,500 (Cr.),
Excess cash deposited into Bank (Cr.) 11,000)

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

2017 Feb.		₹
1	Cash in hand	25,000
	Cash at bank	10,000
5	Water purifier purchased for office use by cheque	8,000
6	Purchased goods for cash	9,000
8	Received cash from Daniel	9,900
	Discount allowed to him	100
10	Cheque received for goods sold and deposited in the bank	40,000
12	Paid to Amala by cheque	14,500
	Discount received from her	500
13	Paid transport charges by cash	5,000
14	Withdrawn cash from bank for office use	20,000
24	Cheque received from Kumar and deposited into the bank	15,000
28	Kumar's cheque dishonoured	

(**Answer**: Cash Balance: ₹ 40,900, Bank Balance: ₹ 7,500)

Petty cash book

8. Prepare analytical petty cash book from the following particulars under imprest system:

2017 July		₹
1	Received advance form cashier	2,000
7	Paid for writing pads and registers	100
8	Purchased white papers	50
10	Paid auto charges	200
15	Paid wages	300
18	Postal charges	100
21	Purchased stationery	450
23	Tea expenses	60
25	Paid for speed post	150
27	Refreshment expenses	250
31	Paid for carriage	150

(**Answer**: ₹ 190)

CASE STUDY

Vetri is a sole trader selling food products. He maintains a simple cash book. He sells and purchases goods both on cash and credit. He maintains the cash book by himself. He allows discount and receives discount. He has his personal bank account. He also has so many petty expenses. Now, he wants to establish his business. But he wants to maintain the cash book all by himself.

Now, discuss on the following points:

- What could be the reason that Vetri maintains the cash book by himself?
- Is it convenient for him to record all the cash transactions in the simple cash book?
- Will his personal bank account serve the purpose of his business transactions?
- Suggest him some better ways of maintaining the cash transactions.
- When his business becomes large, what other books will he be maintaining?

To explore further

When our country is moving towards cashless economy, will there be any change in the existing system of maintaining cash book?

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Unit 8

BANK RECONCILIATION STATEMENT

Contents

AHX42Z

Points to recall

The following points are to be recalled before learning bank reconciliation statement:

- When transactions are more in number, subsidiary books are used.
- Cash and bank transactions are recorded in the cash book.
- Deposit made into the bank is debited in the bank column of the cash book.
- Payment made by the bank is credited in the bank column of the cash book.
- Debit balance as per bank column of the cash book is favourable balance.
- Credit balance as per bank column of the cash book is overdraft.

Learning Objectives

To enable the students to

- Understand the meaning and purpose of preparing bank reconciliation statement
- Analyse the causes of disagreement between balance shown by bank column of the cash book and balance shown by bank statement
- Prepare bank reconciliation statement

Key terms to know

- Bank statement
- Bank overdraft
- Unpresented Cheques
- Uncleared Cheques
- Dishonoured cheques
- Standing instructions
- Bank reconciliation statement.

8.1 Introduction

Student activity

Imagine that you are the owner of a small shop. You maintain the three column cash book for your business. Now, think on the following points and discuss with the whole class:

- How often would you check your cash balance in hand? Everyday/once in a week?
- Why do you check your cash balance?
- How will you make sure that the bank column in cash book is correct and is the same as shown by the bank statement?

From the above activity, it is clear that physical cash in hand can be checked easily with the cash column of cash book. But, checking the accuracy of transactions in the bank column of the cash book cannot be done without bank statement (pass book).

8.1.1 Bank statement or bank pass book

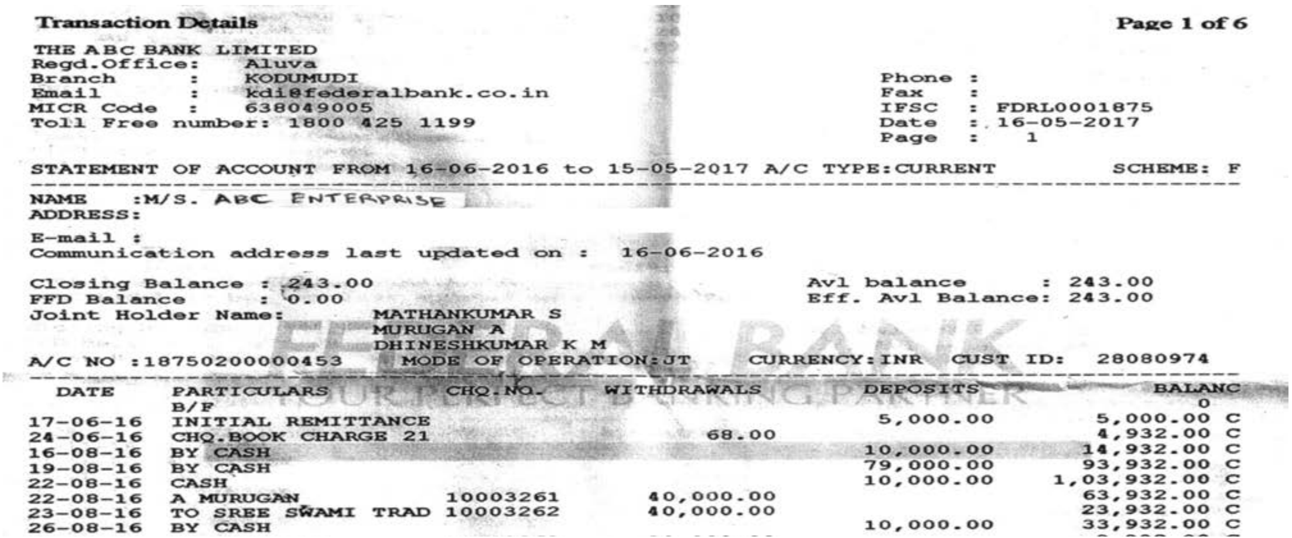
It is very common in business these days, to deposit cheques received and cash, with the bank. Payments can also be made through bank. Because, dealing cash through bank is always safe. Also, it is legally necessary to operate the transactions through bank beyond a certain limit.

When any bank transaction is undertaken, two records are kept of the transactions. One is kept by the business [customers to the bank], which is the cash book. The other one is kept by the bank, which is bank record [bank statement]. In other words, it can be said that the cash book maintained by the business [customer of a bank] and the ledger accounts maintained by the bank, record the same transactions. Bank statement or bank pass book is simply a copy of the customer's account in the books of a bank. A bank may send a statement at regular intervals to its customers. It shows all the deposits, withdrawals and the balance available in its customer's account, on a particular date. In recent times, the copy of the records can be obtained by the customer electronically, which is called E-statement.

Various types of accounts such as savings account, fixed deposit account, current account, etc., can be opened with the bank by different types of customers. But, current account is the most suitable for business concerns. The facility of bank overdraft is not available to any account other than current account.

तिथि Date	लेन–देन का विवरण Particular of transactions	जमा Credit	निकासी Debit	शेष Balance	मुहर/हस्ता. Stamp/ Sign.

Inside the pass book



Transaction Details **Page 1 of 6**

THE ABC BANK LIMITED
Regd.Office: Aluva
Branch : KODUMUDI
Email : kdi@federalbank.co.in
MICR Code : 638049005
Toll Free number: 1800 425 1199

Phone :
Fax :
IFSC : FDRL0001875
Date : 16-05-2017
Page : 1

STATEMENT OF ACCOUNT FROM 16-06-2016 to 15-05-2017 A/C TYPE:CURRENT SCHEME: F

NAME :M/S. ABC ENTERPRISE
ADDRESS:

E-mail :
Communication address last updated on : 16-06-2016

Closing Balance : 243.00
FFD Balance : 0.00
Joint Holder Name: MATHANKUMAR S
MURUGAN A
DHINESHKUMAR K M

Avl balance : 243.00
Eff. Avl Balance: 243.00

A/C NO :18750200000453 MODE OF OPERATION:JT CURRENCY:INR CUST ID: 28080974

DATE	PARTICULARS	CHQ.NO.	WITHDRAWALS	DEPOSITS	BALANC
	B/F				0
17-06-16	INITIAL REMITTANCE			5,000.00	5,000.00 C
24-06-16	CHQ.BOOK CHARGE 21		68.00		4,932.00 C
16-08-16	BY CASH			10,000.00	14,932.00 C
19-08-16	BY CASH			79,000.00	93,932.00 C
22-08-16	CASH			10,000.00	1,03,932.00 C
22-08-16	A MURUGAN	10003261	40,000.00		63,932.00 C
23-08-16	TO SREE SWAMI TRAD	10003262	40,000.00		23,932.00 C
26-08-16	BY CASH			10,000.00	33,932.00 C

Specimen of E-Statement

Student activity

Think: Observe the above format. Why the withdrawals are shown as debit and deposits are shown as credit in a bank statement? [Remember: in the cash book it is the reverse]

When the entries in the bank statement are compared with the cash book, it will be found that the accounting treatment is reverse in the cash book. This is because the cash book is prepared from the point of view of business, whereas the bank statement is prepared from the bank's point of view.

Following the double entry system, the credit balance in the bank pass book represents the debit balance as per the cash book and vice-versa. This is because, bank is a debtor for the business and business unit (customer to the bank) is a creditor for the bank when there is a favourable balance in the bank. When money is deposited by the business into the bank, customers account is credited in the bank's book, as this is the amount owed by the bank to its customer. Similarly, when the money is withdrawn or taken out of the bank by the business, customer's account is debited as this decreases the amount owed by the bank to the customer. As a result of this, favourable balance, as per bank statement (bank pass book), will appear as a credit balance and overdrawn balance as a debit balance.

8.1.2 Bank overdraft

It is not possible to have unfavourable cash balance in the cash book. But, it is possible to have unfavourable balance in the bank account. When the business is not having sufficient money in its bank account, it can borrow money from the bank. As a result of this, amount is overdrawn from bank.

Record	Debit balance	Credit balance
Bank statement	Overdraft (negative balance)	Favourable balance (positive balance)
Cash book	Favourable balance (positive balance)	Overdraft (negative balance)

8.1.3 Differences between bank column of cash book and bank statement

Following are the differences between bank column of cash book and bank statement:

S.No.	Bank column of cash book	Bank statement
1	It is prepared by business concern.	It is prepared by bank (banker).
2	Cash deposits are entered on the debit side.	Cash deposits are entered in the credit column.
3	Cash withdrawals are entered on the credit side.	Cash withdrawals are entered in the debit column.
4	Cheque deposits are debited on the day of deposit.	Cheque deposits are credited only at the time of realisation of cheque.
5	Cheques issued are credited on the day of issue of cheque.	Cheques issued by customers are debited by bank on the date on which the payment is made.
6	Collections and payments as per standing instructions of the business are entered only after checking with the bank statement.	Collections and payments as per standing instructions of the business are entered in the banker's book on the date of realisation or payment.
7	It is balanced at the end of a specific period.	It is balanced after each transaction.

8.2 Bank Reconciliation Statement

If every entry in the cash book matches with the bank statement, then bank balance will be the same in both the records. But, practically it may not be possible. When the balances do not agree with each other, the need for preparing a statement to explain the causes arises. This statement is called bank reconciliation statement (BRS). The bank reconciliation statement is a statement that reconciles the balance as per the bank column of cash book with the balance as per the bank statement by giving the reasons for such difference along with the amount. As a result of this, internal record of a business (bank column of cash) can be reconciled with external record (bank statement).

8.2.1 Need for bank reconciliation statement

It is important to compare the bank statement and bank column of cash book. If the two balances do not match, it is necessary to reconcile them to explain why the differences have occurred. It may be prepared every month, every week or even daily depending on the number of transactions and the needs of the business.

Balance as per cash book / bank statement **Balance as per cash book / bank statement**

The need for bank reconciliation statement is as follows:

(i) To identify the reasons for the difference between the bank balance as per the cash book and bank balance as per bank statement.

(ii) To identify the delay in the clearance of cheques.

(iii) To ascertain the correct balance of bank column of cash book.

(iv) To discourage the accountants of the business as well as bank from misusing funds.

8.3 Reasons why bank column of cash book and bank statement may differ

The need for reconciliation arises only when there are differences in entries recorded in the cash book and bank statement. Sometimes, the bank balance as per both the records may be the same, but the entries may not match. In such cases also, bank reconciliation statement is to be prepared. But, before preparing the bank reconciliation statement, it is necessary to find out the reasons for the disagreement.

Difference between the two records (bank column of cash book and bank statement) generally occur because of the following reasons:

(i) Timing differences – The different times at which the same items are entered

(ii) Errors in recording - Difference arising due to errors in recording the entries

(i) Timing differences

(a) cheques issued but not yet presented for payment

(b) cheques deposited into bank but not yet credited

(c) bank charges and interest on loan and overdraft

(d) interest and dividends collected by the bank

(e) dishonour of cheques and bills

(f) amount paid by parties directly into the bank

(g) payment made directly by the bank to others

(h) bills collected by the bank on behalf of its customer

(ii) Errors in recording

(a) errors committed in recording the transactions by the business in the cash book

(b) errors committed in recording the transactions by the bank.

8.3.1 Timing differences

(a) Cheques issued but not yet presented for payment

When the cheques are issued by the business, it is immediately entered on the credit side of the cash book by the business. But, this may not be entered in the bank statement on the same day. It will be entered in the bank statement only after it is presented with the bank.

For example, the balances as per cash book and bank statement are ₹ 20,000 for X & Co. X & Co. issued a cheque in favour of Y & Co for ₹ 10,000, on 27th March 2017. So, X & Co's cash book is credited with ₹ 10,000 on 27th March 2017. But, the cheque is presented to bank on 2nd April 2017. In case, bank sends a statement to X & Co, upto 31st March 2017, it will not contain this transaction. As a result, there will be a difference of ₹ 10,000, between balance shown as per cash book and balance as per bank statement. As a result of this,

Balance as per bank statement (₹ 20,000) is more than balance as per cash book

Balance as per cash book (₹ 10,000) is less than balance as per bank statement

(b) Cheques deposited into bank but not yet credited

When the cheques are deposited into bank, the amount is debited in the cash book on the same day. But, these may not be shown in the bank pass book on the same day because these will be entered in the bank statement only after the collection of the cheques.

For example, the balances as per cash book and bank statement are ₹ 20,000 for X & Co. X & Co. receives a cheque on 25th March 2016, from ABC Limited for ₹ 5,000. On the same day, X & Co, debits its cash book with ₹ 5,000. But bank credits X & Co's account only when the cheque is collected from ABC Limited's bank. This shows that is a time gap between depositing the cheque by the customer (X & Co) and collection of cheque by the bank. As a result of this,

Balance as per cash book (₹ 25,000) is more than balance as per bank statement

Balance as per bank statement (₹ 20,000) is less than balance as per cash book

(c) Bank charges and interest on loan and overdraft charged by the bank

The bank has to cover the cost of running the customer's account. So debit is given to the account of the business towards bank charges. Also, if the business had taken any loan or overdrawn, interest has to be paid by the business. These entries for bank charges and interest are made in the bank statement. But, the entry is made in the cash book only when the bank statement is received by the business. Till then, the cash book shows more balance than bank statement.

For example, the opening balance as per cash book and the bank statement as on 1st March 2017 is ₹ 7,000. Bank debits for bank charges ₹ 300 as on 27th March 2017. But there is no entry for the same in the cash book as on such date. As a result of this,

Balance as per cash book (₹ 7,000) is more than balance as per bank statement

Balance as per bank statement (₹ 6,700) is less than balance as per cash book

(d) Interest and dividends collected by the bank

The bank may collect dividends on its customer's investment in shares and also interest on any investment. The entry for this will be made in the bank statement on the date of collection. But the entry is made in the cash book only when the bank statement is received by the customer. Till then, the cash book shows less balance than the bank statement.

For example, the balances as per cash book and bank statement are ₹15,000. The bank has collected dividends of ₹1,000. As a result of this, the balance as per bank statement is increased to ₹16,000, whereas until the customer receives such information and records the same, balance as per cash book is lesser by ₹1000. As a result of this,

Balance as per bank statement (₹ 16,000) is more than balance as per cash book

Balance as per cash book (₹ 15,000) is less than balance as per bank statement

(e) Dishonour of cheques and bills

When the cheque is received from outside parties, it is deposited with the bank and debited in the cash book. If the cheque is dishonoured, the bank cannot collect the amount of such cheque from outside parties' bank. It is not credited in the bank statement. As a result of this, the two records would differ.

While discounting the bills receivables, in the cash book it is entered in the debit side and in the bank statement it is credited. When the bill is presented by the bank to the drawee of the bill and the payment is not received, the bank debits the same to cancel the credit. But, credit is made in the cash book only when the customer gets the entries made in the bank statement is received. The bank may also charge some amount for such dishonour.

For example, opening balance as per cash book and bank statement is ₹ 5,000 as on 1st January, 2017. A cheque for ₹ 1,000 deposited by the business into bank on 25th January, 2017 is dishonoured and no entry for such transaction is made in the cash book as on that date. As a result of this,

Balance as per cash book (₹ 6,000) is more than balance as per bank statement	**Balance as per bank statement (₹ 5,000) is less than balance as per cash book**

(f) Amount paid by parties directly into the bank

Sometimes, debtors or the customers of the business may directly deposit the money into bank account of the business. It may be done by directly visiting the branch of the bank by paying cash (including NEFT, RTGS) or swiping debit or credit or business card or depositing the money in cash deposit machine or transfer through online banking facility. This will be credited in the banker's book. But the entry is made in the cash book only when the bank statement is received by the customer. Until then, the cash book shows less balance than bank statement.

For example, as on 1st January, 2017, the balance as per cash book and the balance as per bank statement show the same balance of ₹ 10,000, but on 22nd January, a debtor directly deposits ₹ 5,000 into the bank account of the business. But no entry is made in the cash book as on that date. As a result of this,

Balance as per bank statement (₹ 15,000) is more than balance as per cash book	**Balance as per cash book (₹ 10,000) is less than balance as per bank statement**

(g) Amount paid directly by the bank to others

Sometimes the bank may be instructed to make payments such as, insurance premium, instalment of loan, etc., as an agent of the customer on behalf of its customer. In all such cases, debit is made in bank statement. But, the entry is made in the cash book only when the bank statement is received by the customer. Till then, the cash book shows more balance than bank statement.

For example, on 1st, March, 2017, balance as per cash book and balance as per bank statement show the same amount of ₹12,000. But, as per the standing instruction of its customer the bank pays ₹ 2,000 as insurance premium as on 28th March, 2017. But, no entry for such transaction is made in the cash book as on such date. As a result of this,

Balance as per cash book (₹ 12,000) is more than balance as per bank statement	**Balance as per bank statement (₹ 10,000) is less than balance as per cash book**

(h) Bills collected by the bank on behalf of its customers

When goods are sold by the business, the documents may be sent through the bank. When the bank collects the amount, it is credited in bank records. But, the entry is made in the cash book only when the bank statement is received by the business. Till then, the bank statement shows more balance than cash book.

Balance as per bank statement is more than balance as per cash book	Balance as per cash book is less than balance as per bank statement

8.3.2 Errors in recording

(a) Errors committed in recording the transactions by the business in the cash book

Sometimes, errors may be committed in the cash book. For example, omission or wrong recording of transaction relating to cheques deposited or issued, wrong balancing, etc. In these cases, obviously, there will be differences between bank balance as per bank statement and bank balance as per cash book.

For example, the cheque received for ₹ 10, 000 is not entered in the cash book, but has been deposited with the bank. As a result, on collecting the money the balance as per bank statement will be more by ₹ 10, 000.

(b) Errors committed in recording the transactions by the bank

Sometimes errors may be committed in the banker's book. For example, omission or wrong recording of transaction relating to cheques deposited and wrong balancing. In these cases, obviously, there will be differences between bank balance as per bank statement and bank balance as per cash book.

For example, the cheque deposited for ₹ 50000, wrongly entered by the bank as ₹ 15, 000. This will lead to a difference of ₹ 35, 000 between the cash book balance and the balance as per bank statement.

In a nutshell, based on the differences,

the cash book balance will be more than bank statement balance when:

1. Amounts deposited into bank but not yet credited
2. No entry made in cash book for
   a) Bank charges and bank interest
   b) Dishonoured cheques
   c) Amount paid directly by the bank to others
   d) Debit made in the pass book
3. Any error in addition to these in the cash book or bank statement which has the effect of high balance as per cash book

the cash book balance will be less than the bank statement balance when:

1. Cheques issued but not yet presented
2. No entry made in cash book for
   a) Interest and dividends collected by the bank
   b) Amount paid by customer of the business directly in to the bank
   c) Bills collected by the bank on behalf of the customer
3. Any error in addition to these in the cash book or bank statement which has the effect of low balance as per cash book

8.4 Preparation of bank reconciliation statement

After having identified the causes of differences, the reconciliation may be done in the following way:

Bank reconciliation statement can be prepared either from the balance as per cash book or bank statement. If it is prepared from the balance of cash book, the effect of the transaction will be studied on the balance as per bank statement. If it is prepared from the balance as per bank statement, the effect of the transaction will be studied on the balance as per cash book.

DO YOU KNOW?

Adjusting the cash book before preparing the bank reconciliation statement is not compulsory, if reconciliation is done during different months. But if reconciliation is done at the end of the accounting year or financial year, the cash book must be updated so as to reflect the correct bank balance in the balance sheet.

Given the causes of disagreement, the balance of one record (cash book or bank statement) can be either more or less compared to the other record (cash book or bank statement).

Bank reconciliation statement can be prepared on the basis of

(a) 'Balance' presentation, or

(b) 'Plus & Minus' presentation

8.4.1 Balance presentation method

When balance of cash book or bank statement is given:

Format

Bank Reconciliation Statement as on --------------------

Particulars	Amount ₹	Amount ₹
Balance as per cash book (favourable balance)		xxx
Add:		
1. Cheques issued but not presented	xxx	
2. Credits in the pass book only		
(a) Interest credited in bank statement	xxx	
(b) Dividend and other income	xxx	
(c) Direct deposit by a party	xxx	
3. Any error in cash book/ bank statement which has the effect of increasing the balance as per bank statement	xxx	xxx
		xxx
Less:		
1. Cheques deposited but not credited	xxx	
2. Cheques dishonoured but not entered in cash book	xxx	
3. Debits in bank statement only		
(a) Interest debited	xxx	
(b) Insurance premium, loan instalment, etc., paid as per standing instructions	xxx	
(c) Direct payment by banker	xxx	
4. Any error in cash book/ bank statement which has the effect of decreasing the balance as per bank statement	xxx	xxx
Balance as per bank statement		xxx

The abridged version of the above statement is given below:

Bank Reconciliation Statement as on _______________

Particulars	Amount ₹	Amount ₹
Balance as per cash book		
Add: The transactions which increase the balance as per bank statement	---------	---------
Less: The transactions which decrease the balance as per bank statement	---------	---------
Balance as per bank statement		---------

If unfavourable balance as per cash book is the starting point, then reverse is the procedure for preparing bank reconciliation statement. This means that, items that are added are to be subtracted and items that are subtracted are to be added.

Based on the earlier explanation the following table has been prepared for ready reference when reconciliation is done on the basis of 'balance presentation'. The final balance, which is obtained after addition and subtraction, will be the balance as per the other book.

Sl. No	Causes of differences	Favourable balance (Dr.) as per cash book	Unfavourable balance (Cr.) as per cash book	Favourable balance (Cr.) as per bank statement	Unfavourable balance (Dr.) as per bank statement
1	Cheque issued but not presented to bank	Add	Subtract	Subtract	Add
2	Cheque directly deposited in bank by a customer	Add	Subtract	Subtract	Add
3	Income directly received by bank	Add	Subtract	Subtract	Add
4	Wrong credit in the cash book	Add	Subtract	Subtract	Add
5	Under casting of debit side of bank column of the cash book	Add	Subtract	Subtract	Add
6	Over casting of credit side of bank column of the cash book	Add	Subtract	Subtract	Add
7	Bill receivable collected directly by bank	Add	Subtract	Subtract	Add
8	Cheque deposited but not cleared	Subtract	Add	Add	Subtract

9	Expenses directly paid by bank on standing instructions	Subtract	Add	Add	Subtract
10	Bank charges levied by bank	Subtract	Add	Add	Subtract
11	Locker rent levied by bank	Subtract	Add	Add	Subtract
12	Wrong debit in the cash book	Subtract	Add	Add	Subtract
13	Wrong debit in the bank statement	Subtract	Add	Add	Subtract
14	Over casting of debit side of bank column of the cash book	Subtract	Add	Add	Subtract
15	Under casting of credit side of bank column of the cash book	Subtract	Add	Add	Subtract
16	Interest on bank overdraft charged	Subtract	Add	Add	Subtract
17	Final balance	If answer is positive, then favourable balance (Cr.) as per bank statement and If, negative then unfavorable balance (Dr.) as per bank statement	If answer is positive, then unfavouravbe balance (Dr.) as per bank statement and If, negative then favorable balance (Cr.) as per bank statement	If answer is positive, then favourable balance (Dr.) as per cash book and If, negative then unfavorable balance (Cr.) as per cash book	If answer is positive, then unfavourabe balance (Cr.) as per cash book and If, negative then favorable balance (Dr.) as per cash book

Student activity

Think: Remember, an item entered on the debit side of cash book is entered on the credit side of bank statement and vice-versa. Now, keep this in mind, think on the following:

Is it possible to prepare bank reconciliation statement with bank statement as starting point and ascertain the cash book balance? Prepare a specimen of bank reconciliation statement with balance as per bank statement as the starting point.

When balances of cash book and/or bank statement is given:

Illustration 1 (When balance as per cash book is favourable)

From the following information, prepare bank reconciliation statement to find out balance as per bank statement on 31st March, 2017.

Particulars	₹
(i) Cheques deposited but not yet collected by the bank	500
(ii) Cheque issued but not yet presented for payment	1,000
(iii) Bank interest charged	100
(iv) Rent paid by bank as per standing instruction	200
(v) Cash book balance	300

Solution

Bank reconciliation statement as on 31st March, 2017

Particulars	Amount ₹	Amount ₹
Balance as per cash book		300
Add: Cheque issued but not yet presented for payment		1,000
		1,300
Less: Cheques deposited but not yet collected by the bank	500	
Bank interest charged	100	
Rent paid by bank as per standing instruction	200	800
Balance as per bank statement		500

Student activity

Think: In the above illustration, what will be the bank statement balance if the cash book balance is unfavourable?

Illustration 2

On 31st March, 2018, the bank column of the cash book of Senthamarai Traders showed a debit balance of ₹ 40,200. On examining the cash book and the bank statement, it was found that:

(a) A cheque for ₹ 2,240 deposited on 29th March, 2018 was credited by the bank only on 4th April, 2018.

(b) A payment made through net banking for ₹ 180 has been entered twice in the cash book.

(c) Cheques amounting to ₹ 500 which were issued to trade payables and entered in the cash book before 31st March, 2018 were not presented for payment until that date.

(d) Cheque amounting to ₹ 2,000 had been recorded in the cash book as having been deposited into the bank on 30th March, 2018, but was entered in the bank statement on 3rd April, 2018.

(e) Transport subsidy amounting to ₹ 3,000 received from the Government of Tamilnadu directly by the bank, but not advised to the Senthamarai Traders.

(f) A sum of ₹ 1,500 was wrongly debited to Senthamarai Traders by the bank, for which no details are available.

Solution

Bank reconciliation statement of Senthamarai traders as on 31st March, 2018

Particulars	Amount ₹	Amount ₹
Balance as per cash book		40,200
Add:		
Net payment entered twice in the cash book	180	
Cheques issued to trade payables not yet presented	500	
Transport subsidy collected by bank	3,000	3,680
Less:		43,880
Cheques deposited but not yet credited by bank	2,240	
Cheques deposited but not yet credited by bank	2,000	
Wrong debit by bank	1,500	5,740
Balance as per bank statement		38,140

Illustration 3 (When balance as per cash book shows overdraft)

From the following information, prepare bank reconciliation statement as on 31st December, 2017 to find out the balance as per bank statement.

Particulars	₹
(i) Overdraft as per cash book	10,000
(ii) Cheques deposited but not yet credited	5,000
(iii) Cheque issued but not yet presented for payment	1,000
(iv) Payment received from the customer directly by the bank	500
(v) Interest on overdraft debited by bank	1,000
(vi) Amount wrongly debited by bank	300

Solution

Bank reconciliation statement as on 31st December, 2017

Particulars	Amount ₹	Amount ₹
Overdraft as per cash book		10,000
Add: Cheques deposited but not yet credited	5,000	
Interest on overdraft debited by bank	1,000	
Amount wrongly debited by bank	300	6,300
		16,300
Less: Cheque issued but not yet presented for payment	1,000	
Payment received from the customer directly by the bank	500	1,500
Overdraft balance as per bank statement		**14,800**

Illustration 4

Rony is the proprietor of Veena photos. The bank column of cash account of his business was balanced on 31st March 2018. It showed an overdraft of ₹ 12,000. The bank statement of Veena photos showed a credit balance of ₹ 5,000. Prepare a bank reconciliation statement taking the following into account.

(a) The bank had directly collected dividend ₹ 11,200 but was not entered in the cash book.

(b) Cheques amounting to ₹ 9,000 were issued on 27th March, 2018, of which, cheques amounting to ₹ 7,000 were not presented for payment before 31st March 2018.

(c) Cheque book charges of ₹ 200 debited by the bank but not recorded in cash book.

(d) Bank locker rent of ₹ 1,000 debited by the bank but not recorded in cash book.

Solution

Bank reconciliation statement of Veena photos as on 31st March, 2018

Particulars	Amount ₹	Amount ₹
Overdraft as per cash book		12,000
Add: Cheque book charges not recorded in cash book	200	
Bank locker charges debited by bank	1,000	1,200
		13,200
Less: Dividend directly collected by the bank	11,200	
Cheque issued but not yet presented for payment	7,000	18,200
Favourable balance as per bank statement*		**−5,000**

****Note:*** Since the balance obtained is negative, it is favourable balance.

Illustration 5 (When balance as per bank statement is favourable)

Prepare bank reconciliation statement as on 31st December, 2017 from the following information:

(a) Balance as per bank statement (pass book) is ₹ 25,000

(b) No record has been made in the cash book for a dishonour of a cheque for ₹ 250

(c) Cheques deposited into bank amounting to ₹ 3,500 were not yet collected

(d) Bank charges of ₹ 300 have not been entered in the cash book.

(e) Cheques issued amounting to ₹ 9,000 have not been presented for payment

Solution

Bank reconciliation statement as on 31st December, 2017

Particulars	Amount ₹	Amount ₹
Balance as per bank statement		25,000
Add: Dishonour of a cheque	250	
Cheques deposited into bank , but not yet collected	3,500	
Bank charges not entered in the cash book	300	4,050
		29,050
Less: Cheques issued, but not presented for payment		9,000
Balance as per cash book		20,050

Illustration 6

From the following information, prepare bank reconciliation statement as on 31st December, 2017 to find out the balance as per bank statement.

Particulars	₹
(i) Balance as per bank statement	6,000
(ii) Cheques deposited on 28th December, 2017 but not yet credited	2,000
(iii) Cheques issued for 10,000 on 20th December, 2017 but not yet presented for payment	3,000
(iv) Interest on debentures directly collected by the bank not recorded in cash book	4,000
(v) Insurance premium on building directly paid by the bank	1,000
(vi) Amount wrongly credited by bank	500

Solution

Bank reconciliation statement as on 31st December, 2017

Particulars	Amount ₹	Amount ₹
Balance as per bank statement		6,000
Add:		
Cheque deposited but not yet credited	2,000	
Insurance premium on building directly paid by the bank	1,000	3,000
Less:		9,000
Cheque issued but not yet presented for payment	3,000	
Interest on debentures directly collected by the bank not entered in cash book	4,000	
Amount wrongly credited by bank	500	7,500
Balance as per cash book		**1,500**

Illustration 7 (When balance as per bank statement is an overdraft)

From the following data, ascertain the cash book balance as on 31st December, 2017.

Particulars	₹
1) Overdraft balance as per bank statement	6,500
2) Cheques deposited into the bank but not yet credited	10,500
3) Cheques issued, but not yet presented for payment	3,000
4) Wrong debit by the bank	500
5) Interest and bank charges debited by bank	180
6) Insurance premium on goods directly paid by the bank as per standing instructions	100

Solution

Bank reconciliation statement as on 31st December, 2017

Particulars	Amount ₹	Amount ₹
Overdraft balance as per bank statement		6,500
Add: Cheques issued, but not yet presented for payment	3,000	3,000
		9,500
Less: Cheques deposited into the bank but not credited	10,500	
Wrong debit by the bank	500	
Interest and bank charges debited by bank	180	
Insurance premium directly paid by the bank as per standing order	100	11,280
Balance as per cash book*		**–1,780**

* ***Note:*** Since the balance obtained is negative, it is favourable balance.

Student activity

Think: In the above illustration, what will be the cash book balance, if the balance as per bank statement is favourable?

Illustration 8

The bank statement of Sudha and Company showed an overdraft of ₹ 10,000 on 31st December, 2017, prepare a bank reconciliation statement.

(a) A cheque deposited on 30th December 2017 for ₹ 15,000 was not credited by the bank.

(b) Interest on term loan ₹ 500 was debited by bank on 31st December, 2017 but not accounted in the books of Sudha and Company.

(c) A cheque issued for ₹ 550 on 24th December, 2017 was paid by the bank. It was recorded as ₹ 505 in the bank column of the cash book.

(d) One outgoing cheque on 27th December, 2017 of ₹ 200 was recorded twice in the cash book.

(e) Bank recorded a cash deposit of ₹ 2,598 as ₹ 2,589.

(f) A sum of ₹ 2,000 deposited in cash deposit machine by a customer of the business on 31st December, 2017 was not recorded in the books of Sudha and Company.

(g) Interest on overdraft of ₹ 600 was not recorded in the books of Sudha and Company.

(h) Two cheques issued on 29th December, 2017 for ₹ 500 and ₹ 700, but only the first cheque was presented for payment before 31st December, 2017.

Solution

Bank reconciliation statement of Sudha and Company as on 31st December, 2017

Particulars	Amount ₹	Amount ₹
Overdraft as per bank statement (debit balance)		10,000
Add:		
Cheque issued recorded twice in cash book	200	
Direct cash deposit not entered in cash book	2,000	
Unpresented cheque	700	2,900
		12,900
Less:		
Cheque deposited but not credited by bank	15,000	
Interest on term loan not entered in cash book	500	
Cheque issued amount entered lesser in cash book (550-505)	45	
Cash deposit recorded lesser in bank statement (2,598-2,589)	9	
Interest on overdraft not entered in cash book	600	16,154
Favourable balance as per cash book*		–3,254

* ***Note:*** Since the balance obtained is negative, it is favourable balance.

When an extract of cash book and bank statement is given

When an extract of the cash book and bank statement is given, the following points are to be remembered:

Compare the items in the bank column of the cash book with that of the bank statement

Tick the items in the cash book that match with bank statement. Items not matched will be the causes for disagreement

Use those causes to prepare bank reconciliation statement

Remember, the starting balance in the bank reconciliation statement can be either cash book balance or balance as per bank statement.

Illustration 9 (When an extract of cash book and bank statement is given)

Given below are the entries in the bank column of the cash book and the bank statement. Prepare a bank reconciliation statement as on 31st October, 2017.

Cash book

(Bank column)

Dr. **Cr.**

Date	Receipts	Amount ₹	Date	Payments	Amount ₹
2017			2017		
Oct. 1	To Balance b/d	**20,525**	Oct. 8	By Kamala A/c	**12,000**
18	To Ram A/c	**6,943**	26	By Magesh A/c	**9,740**
19	To Sales A/c (Ravi)	**450**	28	By Mala A/c	11,780
20	To Commission A/c (Kala)	**200**	30	By Salaries A/c	**720**
20	To Nirmala A/c	7,810	31	By Balance c/d	1,688
		35,928			35,928
Nov. 1	To Balance b/d	1,688			

Bank statement

Date	Particulars	Dr. Withdrawals ₹	Cr. Deposits ₹	Balance Dr./Cr. ₹
1.10.17	By Balance b/d			**20525 Cr**
9.10.17	To Kamala	**12,000**		8525 Cr
19.10.17	By Ram		**6,943**	15468 Cr
25.10.17	By Ravi		**450**	15918 Cr
26.10.17	To Magesh	**9,740**		6178 Cr
27.10.17	By Kala		**200**	6378 Cr
28.10.17	To Rajan (salaries)	**720**		5658 Cr
30.10.17	By Bills receivable		20,000	25658 Cr
	By Interest on Investment		1,820	27478 Cr
31.10.17	To Bills payable	4,000		23478 Cr

Solution

Bank reconciliation statement as on 31st October 2017

Particulars	Amount ₹	Amount ₹
Balance as per cash book		1,688
Add: Bills receivable collected, not entered in cash book	20,000	
Interest on investment collected, not entered in cash book	1,820	
Cheques issued but not presented – Mala	11,780	33,600
		35,288
Less: Cheques deposited into bank, but not yet collected –Nirmala	7,810	
Bills payable paid, not entered in cash book	4,000	11,810
Balance as per bank statement		23,478

8.4.2 Plus or Minus presentation

Bank reconciliation statement can also be presented in an alternative method. In such presentation, two columns are given, one to record items that increase the balance (plus items) and the other one to record items that decrease the balance (minus items). Balances as per the cash book or bank statement are written as the starting balance.

**Note:* Students will be tested on balance presentation method only.

DO YOU KNOW?

Banks provide facility to maintain savings bank account for individuals and trusts. Banks allow interest for such accounts. In such cases, adjustments need to be made in bank reconciliation statement for interest allowed by the bank on savings bank account.

Points to remember

- Debit balance as per cash book is favourable
- Credit balance as per bank column of the cash book is an overdraft
- Debit balance as per bank statement is unfavourable
- Credit balance as per bank statement is favourable
- Bank reconciliation statement is prepared by the business entity
- The purpose of preparing bank reconciliation statement is to explain the causes of disagreement between balance as per bank column of cash book and bank statement
- Most of the differences are caused by differences in the time at which items are recorded.
- Some items cannot be recorded in the bank column of the cash book until the bank statement is received.

Self-examination questions

I Multiple choice questions

Choose the correct answer

1. A bank reconciliation statement is prepared by
   (a) Bank (b) Business
   (c) Debtor to the business (d) Creditor to the business

2. A bank reconciliation statement is prepared with the help of
   (a) Bank statement (b) Cash book
   (c) Bank statement and bank column of the cash book (d) Petty cash book

3. Debit balance in the bank column of the cash book means
   (a) Credit balance as per bank statement (b) Debit balance as per bank statement
   (c) Overdraft as per cash book (d) None of the above

4. A bank statement is a copy of
   (a) Cash column of the cash book (b) Bank column of the cash book
   (c) A customer's account in the bank's book (d) Cheques issued by the business

5. A bank reconciliation statement is prepared to know the causes for the difference between:
   (a) The balance as per the cash column of the cash book and bank column of the cash book
   (b) The balance as per the cash column of the cash book and bank statement
   (c) The balance as per the bank column of the cash book and the bank statement
   (d) The balance as per petty cash book and the cash book

6. When money is withdrawn from bank, the bank
   (a) Credits customer's account (b) Debits customer's account
   (c) Debits and credits customer's account (d) None of these

7. Which of the following is not the salient feature of bank reconciliation statement?
   a) Any undue delay in the clearance of cheques will be shown up by the reconciliation
   b) Reconciliation statement will discourage the accountant of the bank from embezzlement
   c) It helps in finding the actual position of the bank balance
   d) Reconciliation statement is prepared only at the end of the accounting period

8. Balance as per cash book is ₹ 2, 000. Bank charge of ₹ 50 debited by the bank is not yet shown in the cash book. What is the bank statement balance now?
   (a) ₹ 1,950 credit balance (b) ₹ 1,950 debit balance
   (c) ₹ 2,050 debit balance (d) ₹ 2,050 credit balance

9. Balance as per bank statement is ₹ 1, 000. Cheque deposited, but not yet credited by the bank is ₹ 2, 000. What is the balance as per bank column of the cash book?
   (a) ₹ 3,000 overdraft (b) ₹ 3,000 favourable
   (c) ₹ 1,000 overdraft (d) ₹ 1,000 favourable

10. Which one of the following is not a timing difference?
   (a) Cheque deposited but not yet credited
   (b) Cheque issued but not yet presented for payment
   (c) Amount directly paid into the bank
   (d) Wrong debit in the cash book

Answer

1. (b)	2. (c)	3. (a)	4. (c)	5. (c)	6. (b)	7. (d)	8. (a)	9. (b)	10. (d)

II Very short answer questions

1. What is meant by bank overdraft?

2. What is bank reconciliation statement?

3. State any two causes of disagreement between the balance as per bank column of cash book and bank statement.

4. Give any two expenses which may be paid by the banker as per standing instruction.

5. Substitute the following statements with one word/phrase

   (a) A copy of customer's account issued by the bank

   (b) Debit balance as per bank statement

   (c) Statement showing the causes of disagreement between the balance as per cash book and balance as per bank statement

6. Do you agree on the following statements? Write "yes" if you agree, and write "no" if you disagree.
   (a) Bank reconciliation statement is prepared by the banker.
   (b) Adjusting the cash book before preparing the bank reconciliation statement is compulsory.
   (c) Credit balance as per bank statement is an overdraft.
   (d) Bank charges debited by the bank increases the balance as per bank statement.
   (e) Bank reconciliation statement is prepared to identify the causes of differences between balance as per bank column of the cash book and balance as per cash column of the cash book.

III Short answer questions

1. Give any three reasons for preparing bank reconciliation statement.
2. What is meant by the term "cheque not yet presented?"
3. Explain why does money deposited into bank appear on the debit side of the cash book, but on the credit side of the bank statement?
4. What will be the effect of interest charged by the bank, if the balance is an overdraft?
5. State the timing differences in BRS with examples.

IV Exercises

1. From the following particulars prepare a bank reconciliation statement of Jayakumar as on 31st December, 2016.
   (a) Balance as per cash book ₹ 7,130
   (b) Cheque deposited but not cleared ₹ 1,000
   (c) A customer has deposited ₹ 800 into the bank directly

   (**Answer:** Balance as per bank statement ₹ 6,930)

2. From the following particulars of Kamakshi traders, prepare a bank reconciliation statement as on 31st March, 2018.
   (a) Debit balance as per cash book ₹ 10,500
   (b) Cheque deposited into bank amounting to ₹5,500 credited by bank, but entered twice in the cash book
   (c) Cheques issued and presented for payment amounting to ₹ 7,000 omitted in the cash book
   (d) Cheque book charges debited by the bank ₹ 200 not recorded in the cash book.
   (e) Cash of ₹ 1,000 deposited by a customer of the business in cash deposit machine not recorded in the cash book.

   (**Answer:** Overdraft as per bank statement ₹ 1,200)

3. From the following information, prepare bank reconciliation statement to find out the bank statement balance as on 31st December, 2017.

Particulars	₹
1. Balance as per cash book	15,000
2. Cheques deposited but not yet credited	1,000
3. Cheques issued and entered in the cash book before 31st December 2017 but not presented for payment until that date	1,500
4. Dividend directly received by bank	200
5. Direct payment made by bank for rent	1,000
6. Locker rent charged by the bank not recorded in cash book	1,200
7. Wrong debit given by the bank on 30th December 2017	500
8. A payment made through net banking has been entered twice in the cash book	300

(**Answer:** Balance as per bank statement ₹ 13,300)

4. From the following particulars of Raheem traders, prepare a bank reconciliation statement as on 31st March, 2018.

(a) Overdraft as per cash book ₹ 2,500. On the same day the balance as per bank statement is ₹ 1,99,000.

(b) Interest on debentures of ₹ 700 was received by the bank directly.

(c) Amount received by bank through RTGS amounting to ₹ 2,00,000, omitted in the cash book.

(d) Two cheques issued for ₹ 1,800 and ₹ 2,000 on 29th March 2018. Only the second cheque is presented for payment.

(e) Insurance premium on car for ₹ 1,000 paid by the bank as per standing instruction not recorded in the cash book.

5. From the following information, prepare bank reconciliation statement as on 31st December, 2017 to find out the balance as per bank statement.

Particulars	₹
(i) Bank overdraft as per cash book	20,000
(ii) Cheques deposited but not yet credited	4,000
(iii) Cheque issued but not yet presented for payment	1,000
(iv) Rent collected by the bank as per standing instruction	500
(v) Interest on overdraft debited by bank	2,000
(vi) Amount wrongly debited by bank	300
(vii) Cheque issued on 30th December 2017 dishonoured by the bank	5,000
(viii) A customer's cheque deposited in the bank dishonoured by bank not recorded in the cash book	2,000

(**Answer:** Overdraft as per bank statement ₹ 21,800)

6. Prepare bank reconciliation statement from the following data and find out the balance as per cash book as on 31st March, 2018.

Particulars		₹
(i)	Bank balance as per bank statement	15,000
(ii)	Cheques issued but not yet presented for payment	2,500
(iii)	Bank charges not recorded in the cash book	250
(iv)	Interest charged by bank not recorded in the cash book	500
(v)	Bank paid insurance premium as per standing instruction but not recorded in the cash book	300
(vi)	Cheques deposited but not yet credited	900

(**Answer:** Balance as per cash book ₹ 14,450)

7. From the following particulars of Raja traders, prepare a bank reconciliation statement as on 31st January, 2018.

(a) Balance as per bank statement ₹ 5,000

(b) Cheques amounting to ₹ 800 had been recorded in the cash book as having been deposited into the bank on 25th January 2018, but were entered in the bank statement on 2nd February 2018.

(c) Amount received by bank through NEFT amounting to ₹ 3,000, omitted in the cash book.

(d) Two cheques issued for ₹ 3,000 and ₹ 2,000 on 29th March 2018. Only the first cheque is presented for payment.

(e) Insurance premium on motor vehicles for ₹1,000 paid by the bank as per standing instruction not recorded in the cash book.

(f) Credit side of cash book was undercast by ₹ 700

(g) Subsidy received directly by the bank from the state government amounting to ₹ 10,000, not entered in cash book.

(**Answer:** Overdraft as per cash book ₹ 7,500)

8. From the following particulars of Simon traders, prepare a bank reconciliation statement as on 31st March, 2018.

(a) Debit balance as per bank statement ₹2,500

(b) Cheques deposited amounting to ₹ 10,000, not yet credited by bank.

(c) Payment through net banking for ₹2,000, omitted in the cash book

(**Answer:** Balance as per cash book ₹ 9,500)

9. From the following particulars, ascertain the cash book balance as on 31st December, 2016.
   (i) Overdraft balance as per bank statement ₹1,26,640
   (ii) Interest on overdraft entered in the bank statement, but not yet recorded in cash book ₹ 3,200
   (iii) Bank charges entered in bank statement, but not found in cash book ₹600
   (iv) Cheques issued, but not yet presented for payment ₹ 23,360
   (v) Cheques deposited into the bank but not yet credited ₹ 43,400
   (vi) Interest on investment collected by the bank ₹ 24,000

(**Answer:** Overdraft as per cash book ₹ 1,26,800)

10. Prepare bank reconciliation statement as on 31st March, 2017 from the following extracts of cash book and bank statement.

Dr. **Cash book (Bank column only)** **Cr.**

Date	Receipts	Amount ₹	Date	Payments	Amount ₹
2017 March 1	To Balance b/d	9,000	2017 Mar 4	By Drawings	1,700
3	To Ram	2,200	8	By Sumi	3,300
9	To Prem	1,500	12	By Salary	2,800
16	To Pavithra	3,400	16	By Kayal	1,700
23	To Devi	2,600	18	By Pooja	4,200
27	To Mani	1,100	26	By Sam	2,000
30	To Shankar	350	28	By Raheem	1,100
			30	By Rent	1,100
			30	By Balance c/d	2,250
		20,150			20,150

Bank statement

Date	Particulars	Dr. Withdrawals ₹	Cr. Deposits ₹	Balance Dr./Cr.
2017 March 1	By balance b/d			9000 Cr.
4	To cheque- drawings			8,300 Cr.
5	By cheque- Ram	700	2,200	10,500 Cr.
9	To cheque – Sumi			7,200 Cr.
11	By cheque- Prem	3,300	1,500	8,700 Cr.
12	To cheque – Salary			5,900 Cr.
17	To cheque – Kayal	2,800		4,200 Cr.
20	By cheque- Devi	1,700	2,600	6,800 Cr.
30	By interest received		900	7,700 Cr.
30	To bank charges	15		7,685 Cr.

Student activity

Think: Ram enterprises received a bank statement on 31st March, 2018, which showed a credit balance of ₹ 13,500. On the same date, the balance as per cash book was ₹ 11,000.

Think of minimum five possible causes of difference [with amount] between these two balances.

CASE STUDY

Magesh, an enthusiastic young entrepreneur, started a business on 1st December, 2017. He opened a current account with a nationalised bank for his business transaction. In the same bank, he maintains his personal savings bank account too. He did not find time to maintain his cash book. So he appointed a person called Dinesh to take care of bank transactions. But that person was inexperienced.

On 1st December, 2017, the opening balance as per cash book and bank record was the same. On 2nd December, Magesh issued a cheque for ₹ 2,000 to a supplier, but the same was entered in the credit side of the cash book as ₹ 200.

On 3rd, December, Magesh issued his savings bank account cheque for his personal expenses amounting to ₹ 2,500, but Dinesh assumed this as current account cheque and the same was entered in the cash book as drawings.

Dinesh was asked to deposit cash of ₹1,000 in cash deposit machine in order to make a payment to one of the business' supplier. He credited the same in the bank column of the cash book.

On 15th December, one of his customers made online payment to Magesh's current account, amounting to ₹ 1,000. There was no entry in the cash book for this.

Dinesh received his salary in cash for ₹ 5,000. He credited this amount in the bank column of cash book.

Bank made payment on 23rd December, amounting to ₹ 2,500, as per standing instruction. But, there is no entry in the cash book for the same.

On 31st, December 2017, Magesh received a bank statement from his bank, which showed a credit balance of ₹19,700. He instructed Dinesh to check the statement with the cash book. On comparing both, Dinesh found that the cash book showed a balance of ₹14,500. He was puzzled. He needs your help to reconcile the balances.

To explore further

- Are there ways to reduce the number of entries in the bank reconciliation statement? If so, what is to be done?
- "Ten years from now, there will not be any need to prepare bank reconciliation statement" - Do you agree? Why?
- Can the concept of reconciliation be used other than banking transactions?

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Unit 9

RECTIFICATION OF ERRORS

Contents

AIFV6A

Points to recall

The following points are to be recalled before learning rectification of errors:

- The golden rules of accounting used in journalising
- Journalising of transactions
- Posting of entries from journal to ledger
- Preparation of cash book
- Preparation of other subsidiary books
- Procedure for posting from subsidiary books to ledger
- Procedure for balancing of ledger accounts
- Various accounts that normally show debit and credit balances
- Preparation of trial balance

Learning Objectives

To enable the students to

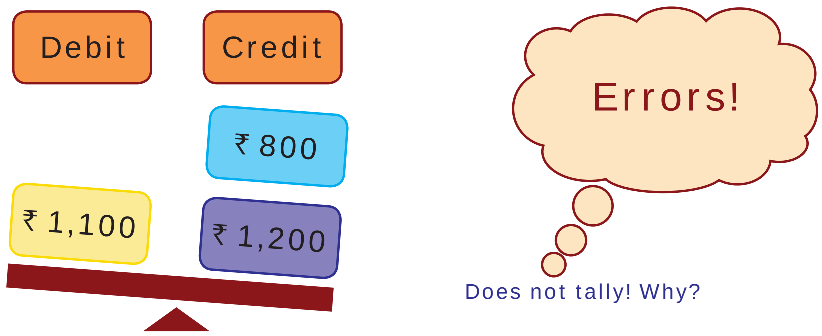
- Understand the meaning and types of errors
- Analyse the steps involved in locating the errors
- Analyse the errors and rectify the errors at different stages

Key terms to know

- Errors of commission
- Errors of omission
- Errors of principle
- Compensating errors
- Suspense account
- Rectification

9.1 Introduction

The very purpose of maintaining accounting records is to know the profit made or the loss incurred by a business entity and its financial position at the end of every accounting year. Accuracy is assured only when there are no errors in the books of accounts. To ensure accuracy, errors are identified and rectified. Many business enterprises have shifted from manual accounting to computerised accounting. Yet, errors in accounting are unavoidable. Hence, errors are to be located and rectified to find out the real profit or loss and financial position i.e., assets and liabilities at different periods, usually at the end of each financial year.



9.2 Meaning of errors

Error means recording or classifying or summarising the accounting transactions wrongly or omissions to record them by a clerk or an accountant unintentionally.

9.3 Errors at different stages of accounting

In the accounting process, errors may occur in any of the following stages:

A) At the stage of journalising

At this stage, the following types of errors may occur:

(i) Error of omission (ii) Error of commission (iii) Error of principle

B) At the stage of posting

At this stage, the following types of errors may occur:

(i) Errors of omission

(a) Error of complete omission (b) Error of partial omission

(ii) Error of commission

(a) Posting to wrong account (b) Posting of wrong amount

(c) Posting to the wrong side

C) At the stage of balancing

At this stage, the following types of errors may occur:

(i) Wrong totalling of accounts (ii) Wrong balancing of accounts

D) At the stage of preparing trial balance

At this stage, following types of errors may occur:

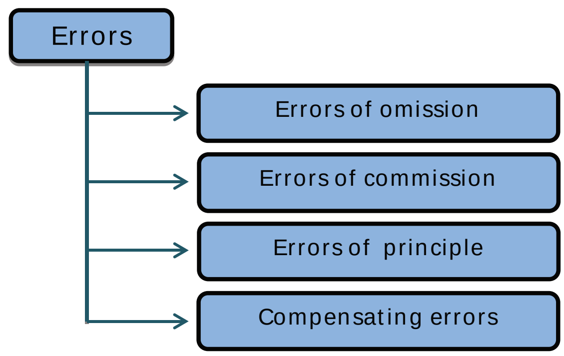
(i) Error of omission

(ii) Error of commission

(a) Entering to wrong account (b) Entering wrong amount

(c) Entering to the wrong side of trial balance, etc.

9.4 Classification of errors



The errors can be classified into four types as follows:

9.4.1 Error of omission

The failure of the accountant to record a transaction or an item in the books of accounts is known as an error of omission. It can be complete omission or partial omission.

(i) Error of complete omission

It means the failure to record a transaction in the journal or subsidiary book or failure to post both the aspects in ledger. This error affects two or more accounts.

Examples

a	Purchase of a machine from Aadhavan & Co. on credit is not recorded in the journal.
b	Sale of goods to Arivuchelvan on credit not recorded in the sales book.

(ii) Error of partial omission

When the accountant has failed to record a part of the transaction, it is known as error of partial omission. This error usually occurs in posting. This error affects only one account.

Examples

a	Cash received from Ponnarasan recorded in the cash book but not posted to Ponnarasan's account in the ledger.
b	Goods sold to Cheran on credit recorded in the sales book but not posted to Cheran's account in the ledger.

Student activity

Think: Is there any way to avoid the error of partial omission?

9.4.2 Error of commission

When a transaction is incorrectly recorded, it is known as error of commission. It usually occurs due to lack of concentration or carelessness of the accountant.

The following are the possibilities of error of commission:

(i) Entering a wrong amount in a correct subsidiary book

Example

Goods sold to Kumanan on credit for ₹ 234 entered in the sales book as ₹ 243.

(ii) Entering a correct amount in a wrong subsidiary book

Example

Goods sold to Athiyamaan on credit for ₹ 500 entered in the purchases book.

(iii) Entering a wrong amount in a wrong subsidiary book

Example

Goods sold to Palanisamy for ₹ 2,450 entered in the purchases book as ₹ 2,540.

(iv) Over-casting or under-casting in a subsidiary book

Example

Purchases book was undercast by ₹ 500, i.e., ₹ 500 less than the correct total.

(v) Posting a correct amount to the wrong side of an account in the Ledger

Example

The total of purchases returns book ₹ 10,500 were posted to the debit side of purchases returns account.

(vi) Posting a wrong amount to the correct side of an account

Example

The total of sales returns book ₹ 7,200 were posted to the debit side of the sales returns account as ₹ 2,700.

(vii) Posting a wrong amount to the wrong side of an account

Example

The total of sales book ₹ 9,240 was debited in the sales account as ₹ 9,420.

(viii) Posting a correct amount to a wrong account

Example

The total of purchases book ₹ 5,500 was credited to the purchases returns account.

(ix) Posting a wrong amount to a wrong account

Example

Goods sold to Naveen on credit for ₹ 545 was entered in the sales book and posted to Praveen's account as ₹ 554.

(x) Double posting in an account

Example

Goods sold to Parimalam on credit for ₹ 500 entered in the sales book and posted twice to Parimalam's account.

(xi) Entering a transaction twice in the journal

Example

Goods sold to Mohanambal for ₹ 2,000 was entered twice in the sales book.

(xii) Errors arising in carrying forward from one page to the next page of an account

While carrying forward the total of one page of a ledger account to the next page, the wrong amount may be recorded.

Example

The total of page No.15 of the sales account of ₹ 5,765 is carried forward to page No.16 as ₹ 5,675.

(xiii) Error arising in the balancing of an account

Sometimes, at the time of balancing a ledger account, the wrong balance may be written.

9.4.3 Error of principle

It means the mistake committed in the application of fundamental accounting principles in recording a transaction in the books of accounts.

The following are the possibilities of error of principle:

(i) Entering the purchase of an asset in the purchases book

Example

Machinery purchased on credit for ₹ 10,000 by M/s. Anbarasi garments manufacturing company entered in the purchases book.

(ii) Entering the sale of an asset in the sales book

Example

Sale of old furniture on credit for ₹ 500 was entered in the sales book.

(iii) Treating a capital expenditure as a revenue expenditure

Example

An amount of ₹ 3,000 spent on the construction of an additional room is debited to repairs account.

(iv) Treating a revenue expenditure as a capital expenditure

Example

An amount of ₹ 2,000 paid for repairs to a machine is debited to machinery account.

9.4.4 Compensating errors

The errors that make up for each other or neutralise each other are known as compensating errors. These errors may occur in related or unrelated accounts. Thus, excess debit or credit in one account may be compensated by excess credit or debit in some other account. These are also known as offsetting errors.

Example

Purchases book and sales book are overcast by ₹ 1,000 each.

Student activity

Think: Do you think that all the errors can be revealed by trial balance?

9.5 Errors disclosed by the trial balance and errors not disclosed by the trial balance

Generally, one-sided errors are revealed by trial balance. They will cause disagreement of totals of debit balances and credit balances. Two-sided errors are not revealed by trial balance. Thus, the errors can be classified on the basis of their effect on the trial balance as follows:

9.5.1 Errors disclosed by the trial balance

Certain errors affect the agreement of trial balance. If such errors have occurred in the books of accounts, the total of debit and credit balances will not be the same. The trial balance will not tally. Error of partial omission and error of commission affect the agreement of trial balance.

Examples of such errors are follows:

(i) Entered in the journal but posted to one account and omitted to be posted to the other.
(ii) Posting an amount to the wrong side of a ledger account.
(iii) Posting twice in a ledger account
(iv) Over-casting or Under-casting in a subsidiary book
(v) Posting a wrong amount to the correct side of an account
(vi) Posting a wrong amount to the wrong side of an account
(vii) Errors arising in carrying forward the page total from one page to the next page of an account or subsidiary book.
(viii) Errors arising in the balancing of an account.
(ix) Omission to post an entry from a subsidiary book.

9.5.2 Errors not disclosed by the trial balance

Certain errors will not affect the agreement of trial balance. Though such errors occur in the books of accounts, the total of debit and credit balance will be the same. The trial balance will tally. Errors of complete omission, error of principle, compensating error, wrong entry in the subsidiary books are not disclosed by the trial balance. Examples of such errors are as follows:

(i) Treating revenue expenditure as capital expenditure
(ii) Omitting a transaction completely
(iii) Entering a transaction in a wrong subsidiary book
(iv) Entering a transaction twice in a subsidiary book or journal
(v) Entering the amount of a transaction wrongly in the journal
(vi) Entering the amount of a transaction wrongly in a subsidiary book
(vii) Compensating error

9.6 Steps to locate errors

Errors can be located by going through various steps. Such steps are as follows:

9.6.1 Location of errors before preparation of trial balance

Errors may be located before preparing the trial balance either spontaneously or by intentional scrutiny of books of accounts.

The following are the steps to be followed to locate errors before preparing trial balance:

(i) Scrutiny of entries made in the journal proper
(ii) Scrutiny of entries made in the subsidiary books
(iii) Checking the totals of the subsidiary books
(iv) Scrutiny of postings made to the ledger accounts
(v) Scrutiny of balancing of ledger accounts

The errors located at this stage are rectified by debiting or crediting the relevant accounts in the books.

9.6.2 Location of errors after the preparation of trial balance

While preparing trial balance, if it does not tally, it is an indication of presence of errors in the books of accounts. The difference in trial balance is transferred to suspense account and then errors are to be located and rectified.

The following are the steps to be followed to locate errors after preparing trial balance:

(i) The totals of debit and credit columns of trial balance are to be checked.

(ii) The balances of various ledger accounts shown in the trial balance are to be checked to ensure whether they are shown in the respective columns (debit or credit).

(iii) The difference in the trial balance must be halved and compared with balances of ledger to verify whether any ledger balance is recorded on the wrong side of the trial balance.

(iv) The totals of all the subsidiary books are to be checked, especially if the difference is ₹ 1, ₹ 100 etc.

(v) If the difference is divisible by '9', the difference may be due to transposition of figures in the books. (Writing ₹ 127 as ₹ 172). Hence, the possibilities of transposition of figures shall be checked.

(vi) The accounts of all the creditors and debtors are to be verified.

(vii) Postings from the subsidiary books to different accounts in the ledger are to be checked.

(viii) The correctness of the balances of various ledger accounts is to be ensured.

(ix) All the amounts carried forward from one page to the next are to be verified.

(x) If the difference still exists, as a final step all the entries in the journals should be verified.

Student activity

Think: Is it possible to prepare final accounts, even when the trial balance does not tally?

9.7 Suspense account

9.7.1 Meaning of suspense account

When the trial balance does not tally, the amount of difference is placed to the debit (when the total of the credit column is higher than the debit column) or credit (when the total of the debit column is higher than the credit column) to a temporary account known as 'suspense account'.

Student activity

Think: If the suspense account is not balanced, what does it indicate?

9.7.2 Preparation of suspense account

Suspense account will remain in the books until the location and rectification of errors. After rectifying the errors and posting the rectification entries to the respective ledger accounts, the suspense account appearing in the ledger is to be balanced. If all the errors are located and rectified, the suspense account gets closed.

9.8 Rectification of errors

ERRORS → Can be Rectified

Depending on the stage at which errors are located, they are subsequently rectified at the respective stage itself.

9.8.1 Stages of rectification of errors

The following are the various stages of rectification of errors:

Stage 1: Before preparing trial balance

↓

Stage 2: While preparing trial balance

↓

Stage 3:After preparing trial balance but before preparing final accounts

↓

Stage 4: After preparing final accounts

(i) Rectification of errors before preparing trial balance

If the accountant finds time before preparing trial balance to recheck the entries made in the journal, postings in the ledger accounts, amounts carried forward and balancing of ledger accounts with the intention of ensuring their correctness, he/she will be able to locate and rectify the errors at that stage itself.

(a) Rectification of one-sided errors before preparing trial balance

When one-sided error is detected before preparing the trial balance, no journal entry is required to be passed in the books. In such cases, the error can be rectified by giving an explanatory note in the account affected as to whether the concerned account is to be debited or credited.

Student activity

Think: How many times in a year and at what intervals, the trial balance needs to be prepared?

Illustration 1 (Errors in casting)

The following errors were detected before the preparation of trial balance. Rectify them.

(a) Sales book is undercast by ₹ 100

(b) Sales book is overcast by ₹ 200

(c) Purchases book is undercast by ₹ 300

(d) Purchases book is overcast by ₹ 400

Solution

(a) Sales account should be credited with ₹ 100

(b) Sales account should be debited with ₹ 200

(c) Purchases account should be debited with ₹ 300

(d) Purchases account should be credited with ₹ 400

Tutorial Note:

(a) In this case, the sales book is undercast by ₹ 100. The total of sales book is posted to the credit side of sales account in the ledger. The undercasting has resulted in under-crediting of sales account by ₹ 100. This is an error of commission. The error is only in sales account. There is short credit in sales account by ₹ 100. Hence, it is rectified by crediting sales account by ₹ 100.

Illustration 2 (Errors in casting)

The following errors were detected before preparation of trial balance. Rectify them.

(a) Purchases returns book is undercast by ₹ 500.
(b) Purchases returns book is overcast by ₹ 600.
(c) Sales returns book is undercast by ₹ 700.
(d) Sales returns book is overcast by ₹ 800.

Solution

(a) Purchases returns account should be credited with ₹ 500
(b) Purchases returns account should be debited with ₹ 600
(c) Sales returns account should be debited with ₹ 700
(d) Sales returns account should be credited with ₹ 800

Illustration 3 (Errors in carry forward)

The following errors were detected before preparation of trial balance. Rectify them.

(a) The total of purchases book is carried forward to the next page ₹ 100 short.
(b) The total of purchases returns book is carried forward to the next page ₹ 200 excess.
(c) The total of sales book is carried forward to the next page ₹ 300 excess.
(d) The total of sales returns book is carried forward to the next page ₹ 400 short.

Solution

(a) Purchases account should be debited with ₹ 100.
(b) Purchases returns account should be debited with ₹ 200.
(c) Sales account should be debited with ₹ 300.
(d) Sales returns account should be debited with ₹ 400.

Illustration 4 (Errors in carry forward)

The following errors were detected before preparation of trial balance. Rectify them.

(a) The total of rent received account is carried forward ₹ 900 short.
(b) The total of rent received account is carried forward ₹ 1,000 excess.
(c) The total of salary account is carried forward ₹ 1,100 short.
(d) The total of salary account is carried forward ₹ 1,200 excess.

Solution

(a) Rent received account is to be credited with ₹ 900
(b) Rent received account is to be debited with ₹ 1,000
(c) Salary account is to be debited with ₹ 1,100
(d) Salary account is to be credited with ₹ 1,200

Illustration 5 (Errors in posting)

The following errors were detected before preparation of the trial balance. Rectify them.

(a) A sum of ₹ 5,000 written off as depreciation on buildings has not been posted to depreciation account.

(b) Payment of wages ₹ 2,000 to Venkat was posted twice to wages account.

(c) An amount of ₹ 250 for a credit sale of goods to Nila, although correctly entered in the sales book, has been posted as ₹ 200.

Solution

(a) Depreciation account should be debited with ₹ 5,000.
(b) Wages account should be credited with ₹ 2,000.
(c) Nila account should be debited with ₹ 50.

(b) Rectification of two-sided errors before preparing the trial balance

When a two-sided error is detected before preparing the trial balance, it must be rectified by passing a rectifying journal entry in the journal proper after analysing the error.

Practical steps to be followed in rectifying two-sided errors

Step 1	Write the wrong entry (the entry which has already been passed in the books)	Wrongly done
Step 2	Write the correct entry (the entry that should have been passed in the books)	Not done
Step 3	Make the rectifying entry [the net effect by cancelling the wrong account (debit or credit) in the wrong entry by reversing it and recording the correct account in its place (debit or credit)]	To be done

Illustration 6

The following errors were located before the preparation of the trial balance. Rectify them.

(a) Goods sold to Anand for ₹ 1,000 on credit was not entered in the sales book.

(b) An amount of ₹ 400 paid for repairs to the machinery stands wrongly posted to machinery account.

(c) Salaries ₹ 2,000 paid to Gandhiraj was wrongly debited to his personal account in the ledger.

Solution

Rectifying entries

	Particulars		L.F.	Dr. ₹	Cr. ₹
a	Anand A/c	Dr.		1,000	
	To Sales A/c				1,000
	(Sale of goods to Anand not entered in sales book, now rectified)				
b	Repairs A/c	Dr.		400	
	To Machinery A/c				400
	(Repairs wrongly debited to machinery account, now rectified)				
c	Salaries A/c	Dr.		2,000	
	To Gandhiraj A/c				2,000
	(Salaries paid to Gandhiraj wrongly debited to his account, now rectified)				

Note: Method of deriving the rectifying entries

	Wrong Entry	Correct Entry	Rectifying Entry
a	Nil (Complete Omission)	Anand A/c Dr. 1,000 To Sales A/c 1,000	Anand A/c Dr. 1,000 To Sales A/c 1,000
b	Machinery A/c Dr. 400 To Cash A/c 400	Repairs A/c Dr. 400 To Cash A/c 400	Repairs A/c Dr. 400 To Machinery A/c 400
c	Gandhiraj A/c Dr. 2,000 To Cash A/c 2,000	Salary A/c Dr. 2,000 To Cash A/c 2,000	Salary A/c Dr. 2,000 To Gandhiraj A/c 2,000

Illustration 7

The following errors were located before the preparation of the trial balance. Rectify them.

(a) Paid ₹ 500 to Angappan were wrongly debited to Angannan's account.

(b) Sale of furniture for ₹ 750 was credited to sales account.

(c) Purchase of goods from Bagya for ₹ 2,100 was wrongly passed through sales book.

(d) Wages ₹ 1,000 paid on erection of machinery were debited to wages account.

Solution

Rectifying entries

	Particulars		L.F.	Dr. ₹	Cr. ₹
a	Angappan A/c	Dr.		500	
	To Angannan A/c				500
	(Amount paid to Angappan wrongly debited to Angannan's account, now rectified)				
b	Sales A/c	Dr.		750	
	To Furniture A/c				750
	(Sale of furniture wrongly credited to sales account, now rectified)				
c	Purchases A/c	Dr.		2,100	
	Sales A/c	Dr.		2,100	
	To Bagya A/c				4,200
	(Purchases from Bagya wrongly passed through sales book, now rectified)				
d	Machinery A/c	Dr.		1,000	
	To Wages A/c				1,000
	(Wages paid for erection of machinery wrongly debited to wages account, now rectified)				

Note: Method of deriving the rectifying entries

	Wrong Entry	Correct Entry	Rectifying Entry
a	Angannan A/c Dr. 500 To Cash A/c 500	Angappan A/c Dr. 500 To Cash A/c 500	Angappan A/c Dr. 500 To Angannan A/c 500
b	Cash A/c Dr. 750 To Sales A/c 750	Cash A/c Dr. 750 To Furniture A/c 750	Sales A/c Dr. 750 To Furniture A/c 750
c	Bagya A/c Dr. 2,100 To Sales A/c 2,100	Purchases A/c Dr. 2,100 To Bagya A/c 2,100	Purchases A/c Dr. 2,100 Sales A/c Dr. 2,100 To Bagya A/c 4,200
d	Wages A/c Dr. 1,000 To Cash A/c 1,000	Machinery A/c Dr. 1,000 To Cash A/c 1,000	Machinery A/c Dr. 1,000 To Wages A/c 1,000

(ii) Rectification of errors while preparing the trial balance

Errors can be rectified at the time of preparing the trial balance as follows:

(a) Rectification of one-sided errors while preparing the trial balance

While preparing the trial balance, if the total of debit balances and credit balances are not the same, there is disagreement of trial balance. It shows that there are errors in the books of accounts. As a consequence, the accountant may start locating errors before closing the trial balance. In such cases, the errors are rectified at that stage itself. At this stage, the rectification of one-sided errors is made in the same manner as in the case of rectification before preparing trial balance. Rectifying journal entries are not required to be passed in the books. In such cases, errors can be rectified by giving an explanatory note in the account affected.

Illustration 8

The following errors were located at the time of preparation of the trial balance. Rectify them.

(a) Sale of goods to Akila on credit for ₹ 1,520 posted to her account as ₹ 1,250.

(b) Bought goods from Narendran on credit for ₹ 5,500, credited to his account as ₹ 5,050.

(c) Purchase of furniture from Ravivarman for ₹ 404 on credit were debited to furniture account as ₹ 440.

(d) Purchased machinery for cash ₹ 2,000 was not posted to machinery account.

(e) The total of purchases book ₹ 899 was carried forward as ₹ 989.

Solution

(a) Akila account should be debited with ₹ 270

(b) Narendran account should be credited with ₹ 450

(c) Furniture account should be credited with ₹ 36

(d) Machinery account should be debited with ₹ 2,000

(e) Purchases account should be credited with ₹ 90

(b) Rectification of two-sided errors while preparing the trial balance

Rectification of two-sided errors at the time of preparing the trial balance is just similar to that of their rectification before preparation of trial balance.

Illustration 9

The following errors were located at the time of preparation of the trial balance. Pass rectifying entries.

(a) Goods of the value of ₹ 100 returned by Bhuvana were included in stock, but no entry was made in the books.

(b) Sale of goods to Mani on credit for ₹ 475 has been wrongly entered in the sales book as ₹ 745.

(c) A cheque of ₹ 500 received from Sandhiya was dishonoured and debited to allowances account.

(d) A sum of ₹ 300 drawn by the proprietor for personal use was debited to wages account.

Solution

Rectifying entries

	Particulars		L.F.	Dr. ₹	Cr. ₹
a	Sales Returns A/c	Dr.		100	
	To Bhuvana A/c				100
	(Goods returned by Bhuvana not entered in the books, now rectified)				
b	Sales A/c	Dr.		270	
	To Mani A/c				270
	(Goods sold to Mani for ₹ 475 wrongly entered in the sales book as ₹ 745, now rectified)				
c	Sandhiya A/c	Dr.		500	
	To Allowances A/c	Dr.			500
	(Dishonour of cheque received from Sandhiya wrongly debited to allowances A/c , now rectified)				
d	Drawings A/c	Dr.		300	
	To Wages A/c				300
	(Cash drawn by the proprietor for his personal use wrongly debited to wages account, now rectified)				

Note: Method of deriving the rectifying entries

	Wrong Entry	Correct Entry	Rectifying Entry
a	- - -	Sales Returns A/c Dr. 100 To Bhuvana A/c 100	Sales Returns A/c Dr. 100 To Bhuvana A/c 100

b	Mani A/c Dr. 745 To Sales A/c 745	Mani A/c Dr. 475 To Sales A/c 475	Sales A/c Dr. 270 To Mani A/c 270
c	Allowances A/c Dr. 500 To Bank A/c 500	Sandhiya A/c Dr. 500 To Bank A/c 500	Sandhiya A/c Dr. 500 To Allowances A/c 500
d	Wages A/c Dr. 300 To Cash A/c 300	Drawings A/c Dr. 300 To Cash A/c 300	Drawings A/c Dr. 300 To Wages A/c 300

(iii) Rectification of errors after preparing the trial balance but before preparing the final accounts

(a) Rectification of one-sided errors after preparing the trial balance

If there is disagreement of trial balance and if it is not possible immediately to locate errors, the accountant may place the difference to 'suspense account'. After that, before the preparation of final accounts, the entries, postings, castings, balancing of accounts and amounts carried forward are scrutinised to locate the errors.

At this stage, every one-sided error is rectified by passing a rectifying journal entry with the respective account (debited or credited) and suspense account (credited or debited). The suspense account is used to rectify such errors so that the difference in trial balance placed to that account gets adjusted. Once all the one-sided errors are completely rectified, the balance in the suspense account gets eliminated.

Illustration 10

The following errors were located after the preparation of the trial balance. Assume that there exists a suspense account. Rectify them.

(a) Sale of goods on credit to Arun for ₹ 152 posted to his account as ₹ 125.

(b) Bought goods from Lakshmi on credit for ₹ 550, credited to her account as ₹ 505.

(c) Purchase of furniture from Abirupa for ₹ 404 on credit was debited to furniture account as ₹ 440.

(d) Purchased machinery for cash ₹ 200 was not posted to machinery account.

(e) The total of purchases book ₹ 89 was carried forward as ₹ 98.

Solution

Rectifying entries

	Particulars	L.F.	Dr. ₹	Cr. ₹
a	Arun A/c Dr. To Suspense A/c (Wrong amount posted to Arun account rectified)		27	27
b	Suspense A/c Dr. To Lakshmi A/c (Short credit to Lakshmi account rectified)		45	45

c	Suspense A/c To Furniture A/c (Excess debit to furniture account rectified)	Dr.		36	36
d	Machinery A/c To Suspense A/c (Omission to debit machinery account rectified)	Dr.		200	200
e	Suspense A/c To Purchases A/c (Excess amount carried forward to purchases account rectified)	Dr.		9	9

Illustration 11

The following errors were located after the preparation of the trial balance. Assume that there exists a suspense account. Pass journal entries to rectify them.

(a) The total of purchases book was undercast by ₹ 100.

(b) The total of the discount column on the debit side of cash book ₹ 575 were not posted.

(c) The total of one page of the sales book for ₹ 5,975 were carried forward to the next page as ₹ 5,795.

(d) Salaries ₹ 1,800 were posted as ₹ 18,000.

(e) Purchase of goods on credit from Mukilan for ₹ 150 have been posted to his account as ₹ 1,500.

Solution

Rectifying entries

	Particulars		L.F.	Dr. ₹	Cr. ₹
a	Purchases A/c To Suspense A/c (Under casting of purchases book rectified)	Dr.		100	100
b	Discount allowed A/c To Suspense A/c (Omission to post the total of discount allowed, now rectified)	Dr.		575	575
c	Suspense A/c To Sales A/c (Lesser amount carried forward in the sales book rectified)	Dr.		180	180
d	Suspense A/c (18,000 –1,800) To Salaries A/c (Excess amount posted to the salaries account rectified)	Dr.		16,200	16,200

e	Mukilan A/c (1,500 –150) Dr. To Suspense A/c (Excess amount posted to Mukilan account rectified)		1,350	 1,350

(b) Rectification of two-sided errors after preparing the trial balance

At this stage, every two-sided error is rectified by passing a rectifying journal entry by debiting one of the accounts affected and crediting the other account. As these errors do not cause difference in trial balance, the suspense account is not used in the rectifying journal entries. Therefore, the rectifying entries passed for rectifying two-sided errors before preparation of trial balance and after preparation of trial balance are the same.

Illustration 12

The following errors were located after the preparation of the trial balance. Rectify them.

(a) Paid ₹ 50 to Anitha was wrongly debited to Vanitha account.

(b) Sale of furniture for ₹ 500 was credited to sales account.

(c) Purchased goods from Natarajan on credit for ₹ 750 were wrongly passed through sales book.

(d) Wages ₹ 1,000 paid on erection of machinery was debited to wages account.

Solution

Rectifying entries

	Particulars	L.F.	Dr. ₹	Cr. ₹
a	Anitha A/c Dr. To Vanitha A/c (Amount paid to Anitha wrongly debited to Vanitha account, now rectified)		50	 50
b	SalesA/c Dr. To Furniture A/c (Sale of furniture wrongly credited to sales account, now rectified)		500	 500
c	Purchases A/c Dr. Sales A/c Dr. To Natarajan A/c (Purchases from Natarajan wrongly passed through sales book, now rectified)		750 750	 1,500
d	Machinery A/c Dr. To Wages A/c (Wages paid for erection of machinery wrongly debited to wages account, now rectified)		1,000	 1,000

Illustration 13

Rectify the following journal entries.

	Particulars		L.F.	Dr. ₹	Cr. ₹
a	Purchases A/c	Dr.		5,000	
	To Cash A/c				5,000
	(Furniture purchased for cash)				
b	Nila A/c	Dr.		8,000	
	To Cash A/c				8,000
	(Salary paid to Nila)				
c	Kuralamudhu A/c	Dr.		2,000	
	To Cash A/c				2,000
	(Rent paid to Kuralamudhu)				
d	Cash A/c	Dr.		9,000	
	To Sales A/c				9,000
	(Furniture sold for cash)				
e	Cash A/c	Dr.		6,000	
	To Kothaimalar A/c				6,000
	(Goods sold to Kothaimalar for cash)				

Solution

Rectifying entries

	Particulars		L.F.	Dr. ₹	Cr. ₹
a	Furniture A/c	Dr.		5,000	
	To Purchases A/c				5,000
	(Purchase of furniture wrongly debited to purchases account rectified)				
b	Salaries A/c	Dr.		8,000	
	To Nila A/c				8,000
	(Salary paid to Nila wrongly debited to her account rectified)				
c	Rent A/c	Dr.		2,000	
	To Kuralamudhu A/c				2,000
	(Rent paid to Kuralamudhu wrongly debited to her account rectified)				
d	Sales A/c	Dr.		9,000	
	To Furniture A/c				9,000
	(Furniture sold for cash wrongly credited to sales account rectified)				
e	Kothaimalar A/c	Dr.		6,000	
	To Sales A/c				6,000
	(Goods sold to Kothaimalar for cash wrongly credited to her account rectified)				

Illustration 14 (One-sided errors and two-sided errors)

Pass journal entries to rectify the following errors located after the preparation of the trial balance. Assume that there exists a suspense account.

(a) The total of sales book was undercast by ₹ 2,000.

(b) The purchase of machinery for ₹ 3,000 was entered in the purchases book.

(c) A credit sale of goods for ₹ 45 to Mathi was posted in his account as ₹ 54.

(d) The purchases returns book was overcast by ₹ 200.

(e) The total of sales book ₹ 1,122 were wrongly posted in the ledger as ₹ 1,222.

Solution

Rectifying entries

	Particulars	L.F.	Dr. ₹	Cr. ₹
a	Suspense A/c Dr.		2,000	
	To Sales A/c			2,000
	(Under casting in the sales book rectified)			
b	Machinery A/c Dr.		3,000	
	To Purchases A/c			3,000
	(Purchase of machinery wrongly entered in the purchases book rectified)			
c	Suspsense A/c Dr.		9	
	To Mathi A/c			9
	(Excess amount posted to the debit of Mathi rectified)			
d	Purchase returns A/c Dr.		200	
	To Suspense A/c			200
	(Overcasting in the purchase returns book rectified)			
e	SalesA/c Dr.		100	
	To Suspense A/c			100
	(Excess amount carried forward in the sales book rectified)			

Illustration 15 (One-sided errors and two-sided errors with preparation of suspense account)

A book-keeper finds that the debit column of the trial balance is short by ₹ 308 and the difference is put to a suspense account. Subsequently, the following errors were located.

(a) An entry for sale of goods on credit for ₹ 102 to Mekala was posted to her account as ₹ 120.

(b) ₹ 100 being the monthly total of discount allowed to customers was credited to discount received account in the ledger.

(c) ₹ 275 paid by Mannan was credited to Kannan account.

(d) ₹ 26 appearing in the cash book as paid for the purchase of stationery for office use has not been posted to ledger.

(e) The purchases book was undercast by ₹ 100.

Rectify the errors and prepare suspense account.

Solution

Rectifying entries

	Particulars	L.F.	Dr. ₹	Cr. ₹
a	Suspense A/c Dr.		18	
	To Mekala A/c			18
	(Excess amount posted to Mekala account rectified)			
b	Discount allowed A/c Dr.		100	
	Discount received A/c Dr.		100	
	To Suspense A/c			200
	(Discount allowed wrongly posted to discount received account rectified)			
c	Kannan A/c Dr.		275	
	To Mannan A/c			275
	(Wrong credit to Kannan account instead of Mannan account rectified)			
d	Stationery A/c Dr.		26	
	To Suspense A/c			26
	(Purchase of stationery not posted to stationery account rectified)			
e	Purchases A/c Dr.		100	
	To Suspense A/c			100
	(Undercasting in the purchases book rectified)			

Dr. **Suspense Account** **Cr.**

Particulars	₹	Particulars	₹
To Balance b/d	308	By Discount allowed A/c	100
To Mekala A/c	18	By Discount received A/c	100
		By Stationery A/c	26
		By Purchases A/c	100
	326		**326**

(iv) Location and rectification of errors after preparing the final accounts

Sometimes, though there is disagreement of trial balance, due to lack of time and urgency in the completion of final accounts, the accountant may not locate and rectify the errors. Under such circumstances, the difference in trial balance is placed to the suspense account, which may show either debit balance or credit balance. If it shows a debit balance, it is shown on the assets side. If it shows a credit balance, it is shown on the liabilities side. The errors will be located and rectified by the accountant during the next accounting period. If the error to be rectified is in a nominal account, it affects the profit or loss of the business. Hence, instead of debiting or crediting them for rectification, profit and loss adjustment account is debited or credited. If the error to be rectified is in a real account or personal account, the respective real account or personal account itself is debited or credited for rectification. After all the errors are rectified, the net effect on profit is calculated by preparing profit and loss adjustment account and the balance is transferred to capital account.

9.9 Errors in computerised accounting

In the recent years, because of the technological developments, many firms have computerised their accounting. It is done to save time and to have accuracy. Though certain errors of commission such as casting errors, errors in carrying forward, etc. and errors of partial omissions can be avoided, the following errors become unavoidable:

- Errors of complete omission
- Errors of principle
- Errors of making wrong entry in the books of original entry
- Errors of entering wrong amounts in the books of original entry
- Errors of entering wrong accounts in the books of original entry
- Errors of duplication

DO YOU KNOW?

The duality concept is applied in locating and rectifying errors.

Student activity

Think: Prepare 10 transactions with errors and ask your friend to solve.

Points to remember

- Error means recording or classifying or summarising the accounting transactions wrongly or omissions to record them by a clerk or accountant unintentionally.
- In the accounting process, errors may occur at the stage of journalising, posting, balancing or preparing trial balance.
- The failure of an accountant to record a transaction or an item in the books of accounts is known as error of omission. It may be complete omission or partial omission.
- Error of principle means the mistake committed in the application of fundamental accounting principles in recording a transaction in the books of accounts.
- The errors that make up for each other or neutralise each other are known as compensating errors.
- Certain errors are disclosed by the trial balance and certain errors are not disclosed by the trial balance.
- When the trial balance does not tally, the amount of difference is placed to a temporary account known as 'suspense account'.
- Errors can be rectified before preparing the trial balance or while preparing the trial balance or after preparing the trial balance but before preparing the final accounts or after preparing the final accounts.

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Self-examination questions

I Multiple choice questions

Choose the correct answer

1. Error of principle arises when
   (a) There is complete omission of a transaction
   (b) There is partial omission of a transaction
   (c) Distinction is not made between capital and revenue items
   (d) There are wrong postings and wrong castings

2. Errors not affecting the agreement of trial balance are
   (a) Errors of principle (b) Errors of overcasting
   (c) Errors of undercasting (d) Errors of partial omission

3. The difference in trial balance is taken to
   (a) The capital account (b) The trading account
   (c) The suspense account (d) The profit and loss account

4. A transaction not recorded at all is known as an error of
   (a) Principle (b) Complete omission
   (c) Partial omission (d) Duplication

5. Wages paid for installation of machinery wrongly debited to wages account is an error of
   (a) Partial omission (b) Principle
   (c) Complete omission (d) Duplication

6. Which of the following errors will not affect the trial balance?
   (a) Wrong balancing of an account
   (b) Posting an amount in the wrong account but on the correct side
   (c) Wrong totalling of an account
   (d) Carried forward wrong amount in a ledger account

7. Goods returned by Senguttuvan were taken into stock, but no entry was passed in the books. While rectifying this error, which of the following accounts should be debited?
   (a) Senguttuvan account (b) Sales returns account
   (c) Returns outward account (d) Purchases returns account

8. A credit purchase of furniture from Athiyaman was debited to purchases account. Which of the following accounts should be debited while rectifying this error?
   (a) Purchases account (b) Athiyaman account
   (c) Furniture account (d) None of these

9. The total of purchases book was overcast. Which of the following accounts should be debited in the rectifying journal entry?
   (a) Purchases account (b) Suspense account
   (c) Creditor account (d) None of the above

10. Which of the following errors will be rectified using suspense account?
    (a) Purchases returns book was undercast by ₹ 100
    (b) Goods returned by Narendran was not recorded in the books
    (c) Goods returned by Akila ₹ 900 was recorded in the sales returns book as ₹ 90
    (d) A credit sale of goods to Ravivarman was not entered in the sales book.

Answer

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

II Very short answer questions

1. What is meant by rectification of errors?
2. What is meant by error of principle?
3. What is meant by error of partial omission?
4. What is meant by error of complete omission?
5. What are compensating errors?

III Short answer questions

1. Write a note on error of principle by giving an example.
2. Write a note on suspense account.
3. What are the errors not disclosed by a trial balance?
4. What are the errors disclosed by a trial balance?
5. Write a note on one-sided errors and two sided errors.

IV Exercises

1. State the account/s affected in each of the following errors:
   (a) Goods purchased on credit from Saranya for ₹ 150 was posted to the debit side of her account.
   (b) The total of purchases book ₹ 4,500 was posted twice.

2. Rectify the following errors discovered before the preparation of the trial balance:
   (a) Sales book was undercast by ₹ 100
   (b) Purchases returns book was overcast by ₹ 200

3. Rectify the following errors assuming that the trial balance is yet to be prepared:
   (a) Sales book was undercast by ₹ 400
   (b) Sales returns book was overcast by ₹ 500
   (c) Purchases book was undercast by ₹ 600
   (d) Purchases returns book was overcast by ₹ 700
   (e) Bills receivable book was undercast by ₹ 800

4. Rectify the following errors before preparing trial balance:
   (a) The total of purchases book was carried forward ₹ 90 less.
   (b) The total of purchases book was carried forward ₹ 180 more.
   (c) The total of sales book was carried forward ₹ 270 less.
   (d) The total of sales returns book was carried forward ₹ 360 more.
   (e) The total of purchase returns book was carried forward ₹ 450 less.

5. The following errors were located by the accountant before preparation of trial balance. Rectify them.
   (a) The total of the discount column of ₹ 1,100 on the debit side of the cash book was not yet posted.
   (b) The total of the discount column on the credit side of the cash book was undercast by ₹ 500.
   (c) Purchased goods from Anbuchelvan on credit for ₹ 700 was posted to the debit side of his account.
   (d) Sale of goods to Ponmukil on credit for ₹ 78 was posted to her account as ₹ 87.
   (e) The total of sales returns book of ₹ 550 was posted twice.

6. Rectify the following errors which were located before preparing the trial balance.
   (a) Wages paid ₹ 2,000 for the erection of machinery was debited to wages account.
   (b) Sales returns book was short totalled by ₹ 1,000.
   (c) Goods purchased for ₹ 200 was posted as ₹ 2,000 to purchases account.
   (d) The sales book was overcast by ₹ 1,500.
   (e) Cash paid to Mukil ₹ 2,800 which was debited to Akhil's account as ₹ 2,000.

7. The following errors were located at the time of preparing trial balance. Rectify them.
   (a) A personal expense of the proprietor ₹ 200 was debited to travelling expenses account.
   (b) Goods of ₹ 400 purchased from Ramesh on credit was wrongly credited to Ganesh's account.
   (c) An amount of ₹ 500 paid as salaries to Mathi was debited to his personal account.
   (d) An amount of ₹ 2,700 paid for extension of the building was debited to repairs account.
   (e) A credit sale of goods of ₹ 700 on credit to Mekala was posted to Krishnan's account.

8. Rectify the following errors discovered after the preparation of the trial balance:
   (a) Rent paid was carried forward to the next page ₹ 500 short.
   (b) Wages paid was carried forward ₹ 250 excess.

9. Give journal entries to rectify the following errors discovered after the preparation of trial balance:
   (a) Purchases book was overcast by ₹ 10,000.
   (b) Repairs to furniture of ₹ 500 was debited to furniture account.
   (c) A credit sale of goods to Akilnilavan for ₹ 456 was credited to his account as ₹ 654.

10. The following errors were located after the preparation of trial balance. Pass journal entries to rectify them. Assume that there exists a suspense account.

(a) The total of sales book was undercast by ₹ 350.

(b) The total of the discount column on the debit side of cash book ₹ 420 was not posted.

(c) The total of one page of the purchases book of ₹ 5,353 was carried forward to the next page as ₹ 5,533.

(d) Salaries ₹ 2,400 was posted as ₹ 24,000.

(e) Purchase of goods from Sembiyanmadevi on credit for ₹ 180 was posted to her account as ₹ 1,800

11. Rectify the following journal entries.

	Particulars	L.F.	Dr. ₹	Cr. ₹
a	Kumanan A/c Dr. To Cash A/c (Salary paid to Kumanan)		10,000	 10,000
b	Senguttuvan A/c Dr. To Cash A/c (Rent paid to Senguttuvan)		6,000	 6,000
c	Cash A/c Dr. To Sales A/c (Furniture sold for cash)		2,000	 2,000
d	Cash A/c Dr. To Kumararaja A/c (Goods sold to Kumararaja for cash)		10,000	 10,000
e	Manimaran A/c Dr. To Purchases A/c (Goods taken by the proprietor Mr. Manimaran for his personal use)		1,000	 1,000

12. The accountant of a firm located the following errors after preparing the trial balance. Rectify them assuming that there is a suspense account.

(a) Machinery purchased for ₹ 3,500 was debited to purchases account.

(b) ₹ 1,800 paid to Raina as salary was debited to his personal account.

(c) Interest received ₹ 200 was credited to commission account.

(d) Goods worth ₹ 1,800 purchased from Amudhanila on credit was not recorded in the books of accounts.

(e) Used furniture sold for ₹ 350 was credited to sales account.

13. The book-keeper of a firm found that the trial balance was out by ₹ 922 (excess credit). He placed the amount in the suspense account and subsequently found the following errors:

(a) The total of discount column on the credit side of the cash book ₹ 78 was not posted in the ledger.

(b) The total of purchases book was short by ₹ 1,000.

(c) A credit sale of goods to Natarajan for ₹ 375 was entered in the sales book as ₹ 735.

(d) A credit sale of goods to Mekala for ₹ 700 was entered in the purchases book.

You are required to give rectification entries and prepare suspense account.

(**Answer**: Total of suspense account: ₹ 1,000)

CASE STUDY

Rameela, a class 11 student, visited one of her relative's furniture shop. She met the accountant of the shop. He was busy with preparing final accounts. At that time, one of the staff approached the accountant with a list of errors found in ledger postings.

Rameela asked the accountant, in a surprised tone, "Is it possible to rectify the errors before preparing the final accounts?"

The accountant replied, "Yes, it is!".

Rameela was curious to analyse the errors. She found the following:

- Furniture sold on credit to Siva and company for ₹ 12,000 was debited to Sam and company.
- Rent paid ₹ 2,500, was debited to rent account as ₹ 250.
- The total of purchase journal was undercast by ₹ 1,000.
- A sales invoice for ₹ 2,000, completely omitted from the books.
- Stationery bought for ₹ 250, was posted to purchases account.

Can you help Rameela to identify and rectify the errors?

To explore further

Is there any possible way to reduce the errors in trial balance?

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Unit 10

DEPRECIATION ACCOUNTING

Contents

Points to recall

The following points are to be recalled before learning the depreciation accounting:

- The going concern concept
- The matching concept
- Meaning of fixed assets
- Tangible assets and intangible assets

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Learning Objectives

To enable the students to

- Understand the meaning and causes of depreciation
- Understand the various methods of providing depreciation
- Apply the different methods of depreciation and prepare asset account

Key terms to know

- Depreciation
- Provision for depreciation
- Scrap value/residual value
- Book value
- Straight line method
- Diminishing balance method

10.1 Introduction

Student activity

Think: Mr. Nihal bought a car for ₹ 4, 00,000. After four years he wanted to sell it for more than ₹ 4, 00,000. Is it possible? Why do you think that it is possible/it is not possible?

Business enterprises use certain fixed assets for the conduct of business operations. Such assets are building, plant and machinery, motor vehicles, furniture, office equipment, etc. These assets have a long span of life. After some years, the assets will lose their usefulness for the business operations. Purchase of such fixed assets or construction of these is a capital expenditure. Hence the amount cannot be transferred to profit and loss account of the year of purchase. But every year, a part of the capital expenditure attributable to the use during the year is charged to profit and loss account and is reduced from the cost of the asset. The portion of cost of asset attributable to the use and expiry of time is to be measured and accounted which is called depreciation. Depreciation is treated as a charge against profit and is debited to profit and loss account.

10.2 Depreciation - Meaning and definition

The process of allocation of the relevant cost of a fixed asset over its useful life is known as depreciation. It is an allocation of cost against the benefit derived from a fixed asset during an accounting period.

According to **Spicer and Pegler**, "Depreciation is the measure of exhaustion of the effective life of an asset from any cause during a given period".

According to **R.N. Carter**, "Depreciation is the gradual and permanent decrease in the value of an asset from any cause".

10.2.1 Useful life of the asset

Useful life is (a) the period over which an asset is expected to be available for use by an enterprise; or (b) the number of production or similar units expected to be obtained from the asset by an enterprise.

DO YOU KNOW?

According to Indian Accounting Standards, (AS 10) depreciation is the systematic allocation of the depreciable amount of an asset over its useful life. The depreciable amount of an asset is the cost of an asset or other amount substituted for cost, less its residual value.

10.2.2 Depreciable assets

Fixed assets which are meant for use in the business for more than one accounting period, the cost of which can be written off over their useful life are known as depreciable assets. Buildings, machinery, vehicles, furniture, computers and equipment are examples of depreciable fixed assets. These assets have limited useful life. They are meant for use in the business for production or supply of goods or for administrative purposes. These are not meant for resale.

10.3 Objectives of providing depreciation

Following are the objectives of providing depreciation:

(i) To find out the true profit or loss

According to matching principle, the expenses incurred during a period must be matched with revenue earned during that period. Hence, when an asset is used for generating income for a business, the cost of the asset attributable to the use, i.e., the reduction in the book value of the asset proportionate to the benefit derived from it, should be charged against the revenue. This is to be done to find out the true cost of production and profit or loss of the business for every accounting period.

(ii) To present the true and fair view of financial position

When the depreciation is charged on fixed assets, the book value of fixed assets are reduced to that extent and the remaining value is shown in the balance sheet. The balance represents the value of benefit that is yet to be derived from them. The written down value is the true value of fixed assets which represent cost not yet written off. The balance sheet must represent a true and fair view of financial status. Hence, fixed assets must be shown at their at written down value.

(iii) To facilitate replacement of fixed assets

When the depreciation is debited to profit and loss account, an equal amount is either retained in the business or invested outside the business. When the useful life of an asset comes to an end, a new asset can be purchased by using the resources available in the business.

(iv) To avail tax benefits

As per the Indian Income Tax Act, while computing tax on business income, depreciation is deductible from income. Hence, depreciation is computed and charged to profit and loss account to reduce tax liability.

(v) To comply with legal requirements

Depreciation is provided on fixed assets to comply with the provisions of law apart from Income Tax Act. For example, Section 123(1) of the Indian Companies Act, 2013, requires every company to provide depreciation on fixed assets before declaring dividend to its shareholders.

10.4 Causes of depreciation

There are different reasons causing the reduction in the book value of the fixed assets. Such causes are as follows:

(i) Wear and tear

The normal use of a tangible asset results in physical deterioration which is called wear and tear. When there is wear and tear, the value of the asset decreases proportionately.

(ii) Efflux of time

Certain assets whether used or not become potentially less useful with the passage of time.

(iii) Obsolescence

It is a reduction in the value of assets as a result of the availability of updated alternative assets. This happens due to new inventions and innovations. Though the original asset is in a usable condition, it is not preferred by the users and it loses its value. For example, preference of latest computers by the users.

(iv) Inadequacy for the purpose

Sometimes, the use of assets may be stopped due to their inadequacy for the purpose. These may become inadequate due to expansion in the capacity of a firm.

(v) Lack of maintenance

A good maintenance will naturally increase the life of the asset. When there is no proper maintenance, there is a possibility of more depreciation.

(vi) Abnormal factors

Decline in the usefulness of fixed asset may be caused by abnormal factors like damage due to fire accidents, natural calamities, etc. These may even lead to the state of an asset being discarded.

10.5 Characteristics of depreciation

Following are the characteristics of depreciation:

i. Depreciation is the process of allocation of cost of depreciable asset (capital expenditure) to revenue expenditure or to profit and loss account over the useful life of the asset.
ii. It is the process of allocation of cost and not the process of valuation.
iii. It is a decrease in the book value of the asset and not the market value of the asset.
iv. It is a gradual and continuous decrease in the book value of asset over its useful life.
v. It is calculated only for tangible depreciable fixed assets. Depreciation is not provided on intangible and wasting assets.

DO YOU KNOW?

Allocation of acquisition cost of natural resources such as mineral deposits, oil well, coal, timber is called depletion. Allocation of acquisition cost of intangible fixed assets such as goodwill, patents, copyrights, trademarks, and intellectual property rights is called amortization.

10.6 Factors determining the amount of depreciation

There are different factors that determine the amount of depreciation to be provided on a fixed asset. They are as follows:

(i) Actual cost of the asset

Actual cost means the amount incurred in acquiring or constructing the asset. It is the acquisition or construction cost or historical cost. It includes all the expenses incurred on the asset to bring the asset to present condition and location, that is, all incidental expenses incurred till it is put into use. Purchase price of the asset, freight, loading charges, unloading charges, erection cost, setting up cost and expenses of trial run are included in the cost of the asset. If the asset is a second-hand one, the initial repair to make the asset useable is also to be taken as part of actual cost of the asset.

(ii) Estimated useful life of the asset

The period for which an asset can be used in the enterprise is known as estimated useful life of an asset. It can be calculated in terms of period for which the asset is expected to be used by the entity or units of output to be obtained by the use of the asset. etc. In the case of intellectual properties like patents and copyrights, their legal life is taken as their estimated useful life. The Indian Companies Act, 2013 has prescribed useful lives of fixed assets for the purpose of computation of depreciation. For example, the useful lives prescribed in Part C of Section 123 for general plant and machinery and general furniture and fittings are 15 years and 10 years respectively.

(iii) Scrap value of an asset

The amount which is expected to be realised at the end of the estimated useful life of an asset is known as scrap value of the asset. It is also known as residual value. In determining the scrap value, costs to be incurred for removal and sale of the asset should be deducted from the estimated gross realisable value.

(iv) Other factors

Besides the above mentioned factors, legal provisions, technological factors, etc., also determine the amount of depreciation.

10.7 Methods of providing depreciation

There are various methods used for providing depreciation on fixed assets. The management of a business enterprise has to select the most appropriate method based on the consideration of various factors such as nature of the asset, use of the asset and circumstances that prevail in the business. The following are the different methods of providing depreciation:

i) Straight line method or Fixed instalment method or Original cost method
ii) Written down value method or Diminishing balance method
iii) Sum of years of digits method
iv) Machine hour rate method
v) Depletion method
vi) Annuity method
vii) Revaluation method
viii) Sinking fund method
ix) Insurance policy method

10.7.1 Straight line method/ Fixed instalment method / Original cost method

Under this method, a fixed percentage on the original cost of the asset is charged every year by way of depreciation. Hence it is called original cost method. As the amount of depreciation remains equal in all years over the useful life of an asset it is also called as fixed instalment method. When the amount of depreciation charged over its life is plotted on a graph and the points are joined together, the graph will show a horizontal straight line. Hence, it is called straight line method.

This method is suitable for those assets the useful life of which can be estimated accurately and which do not require much expense on repairs and renewals.

Under this method, the following formulae are used for calculating the amount of depreciation and the rate of depreciation respectively:

$$\text{Amount of depreciation per year} = \frac{\text{Original cost of the asset} - \text{Estimated scrap value}}{\text{Estimated useful life of the asset in years}}$$

$$\text{Rate of depreciation} = \frac{\text{Amount of depreciation per year}}{\text{Original cost}} \times 100$$

Tutorial note

a) In the year of purchase, if the period of use is less than a year, the amount of depreciation will be charged proportionately for the period for which the asset has been used in the business.

b) If depreciation is deducted from the cost of the asset at the end of useful life of the asset the amount left in the asset account will be equal to the scrap value if there is any scrap value or it will be zero if there is no scrap value.

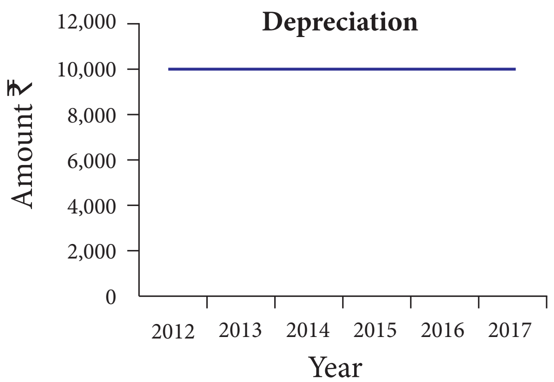
Example

On 1.1.2012, a firm purchased a machine at a cost of ₹ 1,10,000. Its life was estimated to be 10 years with a scrap value of ₹ 10,000. The amount of depreciation to be charged at the end of each year is:

$$\text{Amount of depreciation per year} = \frac{\text{Original cost of the asset} - \text{Estimated scrap value}}{\text{Estimated useful life of the asset in years}}$$

$$= \frac{1,10,000 - 10,000}{10} = \frac{1,00,000}{10} = ₹\ 10,000 \text{ per year}$$

When it is plotted on a graph for 5 years, it appears as follows:



Merits

Following are the merits of straight line method of depreciation:

(a) Simple and easy to understand

Computation of depreciation under this method is very simple and is easy to understand.

(b) Equality of depreciation burden

Under this method, equal amount of depreciation is debited to the profit and loss account each year. Hence, the burden of depreciation on the profit of each year is equal.

(c) Assets can be completely written off

Under this method, the book value of an asset can be reduced to zero if there is no scrap value or to the scrap value at the end of its useful life. Thus the asset account can be completely written off.

(d) Suitable for the assets having fixed working life

This method is appropriate for the fixed assets having certain fixed period of working life. In such cases, the estimation of useful life is easy and in turn it helps in easy determination of rate of depreciation.

Limitations

Following are the limitations of straight line method of depreciation:

(a) Ignores the actual use of the asset

Under this method, a fixed amount of depreciation is provided on each asset by applying the predetermined rate of depreciation on its original cost. But, the actual use of the asset is not considered in computation of depreciation.

(b) Ignores the interest factor

This method does not take into account the loss of interest on the amount invested in the asset. That is, the amount would have earned interest, had it been invested outside the business is not considered.

(c) Total charge on the assets will be more when the asset becomes older

With the passage of time, the cost of maintenance of an asset goes up. Hence, the amount of depreciation and cost of maintenance put together is less in the initial period and goes up year after year. But, this method does not consider this.

(d) Difficulty in the determination of scrap value

It may be quite difficult to assess the true scrap value of the asset after a long period say 10 or 15 years after the date of its installation.

Suitability

Straight line method of depreciation is suitable in case of fixed assets in respect of which useful life can be determined and maintenance and repair cost is the same throughout the life of the asset.

Illustration 1

On 1.1.2017 a firm purchased a machine at a cost of ₹ 1,00,000. Its life was estimated to be 10 years with a scrap value of ₹ 10,000. Compute the amount of depreciation to be charged at the end of each year.

Solution

$$\text{Amount of depreciation per year} = \frac{\text{Original cost of the asset} - \text{Estimated scrap value}}{\text{Estimated useful life of the asset in years}}$$

$$= \frac{1{,}00{,}000 - 10{,}000}{10} = \frac{90{,}000}{10} = ₹\ 9{,}000 \text{ per year}$$

Illustration 2

From the following information, calculate the amount of depreciation and rate of depreciation under straight line method.

Purchase price of machine	₹ 80,000
Expenses to be capitalised	₹ 20,000
Estimated residual value	₹ 35,000
Expected useful life	5 years

Solution

$$\text{Amount of depreciation per year} = \frac{\text{Original cost of the asset} - \text{Estimated scrap value}}{\text{Estimated useful life of the asset in years}}$$

$$= \frac{1{,}00{,}000 - 35{,}000}{5} = \frac{65{,}000}{5} = ₹\ 13{,}000 \text{ per year}$$

$$\text{Rate of depreciation} = \frac{\text{Amount of depreciation per year}}{\text{Original cost}} \text{ x } 100$$

$$= \frac{13{,}000}{1{,}00{,}000} \text{ x } 100 = 13\%$$

Note:

Original cost = Purchase price + Expenses to be capitalised

= 80,000 + 20,000 = ₹ 1,00,000

Illustration 3

Find out the rate of depreciation under straight line method from the following details:

Original cost of the asset	= ₹ 10,000
Estimated life of the asset	= 10 years
Estimated scrap value at the end	= ₹ 2,000

Solution

$$\text{Amount of depreciation per year} = \frac{\text{Original cost of the asset} - \text{Estimated scrap value}}{\text{Estimated useful life of the asset in years}}$$

$$= \frac{10{,}000 - 2{,}000}{10} = \frac{8{,}000}{10} = ₹\ 800 \text{ per year}$$

$$\text{Rate of depreciation} = \frac{\text{Amount of depreciation per year}}{\text{Original cost}} \times 100$$

$$= \frac{800}{10{,}000} \times 100 = 8\%$$

10.7.2 Written down value / Diminishing balance method

Under this method, depreciation is charged at a fixed percentage on the written down value of the asset every year. Hence, it is called written down value method. Written down value is the book value of the asset, i.e., original cost of the asset minus depreciation upto the previous accounting period. As the amount of depreciation goes on decreasing year after year, it is called diminishing balance method or reducing installment method.

DO YOU KNOW?

The following formula is used to compute the rate of depreciation under written down value method:

$$\left[1 - \sqrt[n]{\frac{\text{Scrap value}}{\text{Original cost}}}\right] \times 100$$

Example: Original cost ₹ 1,00,000; Scrap value ₹ 1,000; Useful life 5 years

$$\left[1 - \sqrt[5]{\frac{1{,}000}{1{,}00{,}000}}\right] \times 100 = [1-(0.01)^{1/5}] \times 100$$

$$= (1 - 0.3981) \times 100$$

$$= 0.6019 \times 100 = 60.19\%$$

Rate of depreciation = 60.19%

If the scrap value is 10,000; rate of depreciation is 36.90%

If there is no scrap value, rate of depreciation will be 100%. Hence, to calculate depreciation the scrap value is taken as 1.

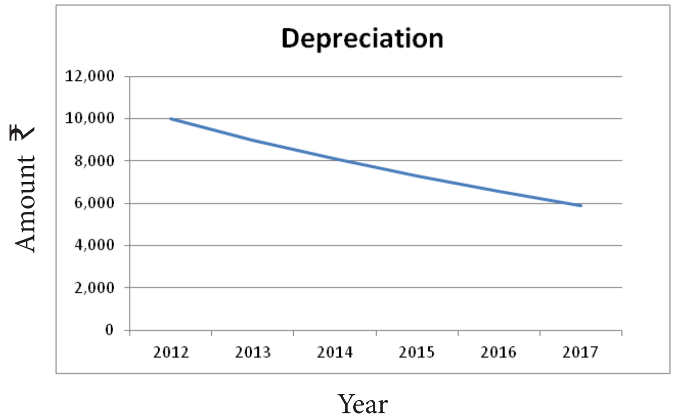
If the scrap value is less, rate of depreciation will be high.

Example

On 1.1.2012, a firm purchased a machine at a cost of ₹ 1,00,000. Depreciation charged at 10% p.a. on written down value method for the five years is as follows:

Cost of the asset on 1.1.2012	₹ 1,00,000
Less: Depreciation for 2012 at 10% on 1,00,000	₹ 10,000
Written down value on 1.1.2013	₹ 90,000
Less: Depreciation for 2013 at 10% on 90,000	₹ 9,000
Written down value on 1.1.2014	₹ 81,000
Less: Depreciation for 2014 at 10% on 81,000	₹ 8,100
Written down value on 1.1.2015	₹ 72,900
Less: Depreciation for 2015 at 10% on 72,900	₹ 7,290
Written down value on 1.1.2016	₹ 65,610
Less: Depreciation for 2016 at 10% on 65,610	₹ 6,561
Written down value on 1.1.2017	₹ 59,049
Less: Depreciation for 2017 at 10% on 59,049	₹ 5,905

When depreciation is plotted on a graph for 5 years, it appears as follows:



Merits

Following are the merits of written down value method.

(a) Equal charge against income

In the initial years depreciation is high and repair charges are low. When the asset becomes older, the amount of depreciation charged is less but repair charges are high. Hence, the total burden on profit in respect of depreciation and repairs put together remains almost similar year after year.

(b) Logical method

In the earlier years, when the asset is more productive, high depreciation is charged. In the later years when the asset becomes less productive, the depreciation charge is less.

Limitations

Following are the limitations of written down value method.

(a) Assets cannot be completely written off

Under this method, the value of an asset even if it becomes obsolete and useless, cannot be reduced to zero and some balance would continue in the asset account.

(b) Ignores the interest factor

This method does not take into account the loss of interest on the amount invested in the asset. The amount would have earned interest, had it been invested outside the business is not considered.

(c) Difficulty in determining the rate of depreciation

Under this method, the rate of providing depreciation cannot be easily determined. The rate is generally kept higher because it takes very long time to write off an asset down to its scrap value.

(d) Ignores the actual use of the asset

Under this method, a fixed rate of depreciation is provided on the written down value of the asset by applying the predetermined rate of depreciation on its original cost. But, the actual use of the asset is not considered in the computation of depreciation.

Suitability

This method is suitable in case of assets having a comparatively long life and which require considerable repairs in the later years when they become older. Examples are building and plant and machinery.

Illustration 4

A firm purchased a plant on 1.1.2018 for ₹ 9,000 and spent ₹ 1,000 as erection charges. Calculate the amount of depreciation for the year 2018 @ 15% per annum under the written down value method. Accounts are closed on 31st March every year.

Solution

Original cost = 9,000 + 1,000 = 10,000
Rate of depreciation = 15%
Date of purchase = 1.1.2018
Number of months used = 1.1.2018 to 31.03.2018 = 3 months
Amount of depreciation = 15% on 10,000 for 3 months
= 10,000 ×15% × 3/12 = ₹ 375

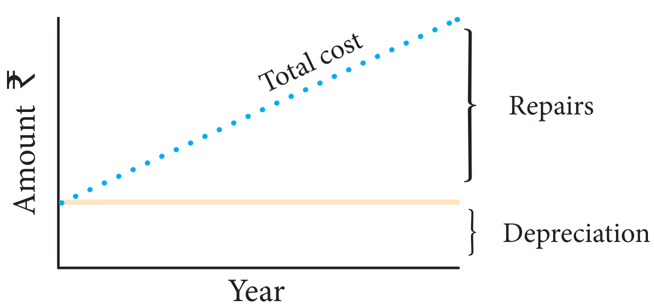
In Microsoft Excel, there are inbuilt finance functions available for calculating depreciation. For example: SLM for calculating depreciation under Straight Line Method (SLM) and DB for Diminishing Balance method (DB).

10.7.2.1 Differences between straight line method and written down value method

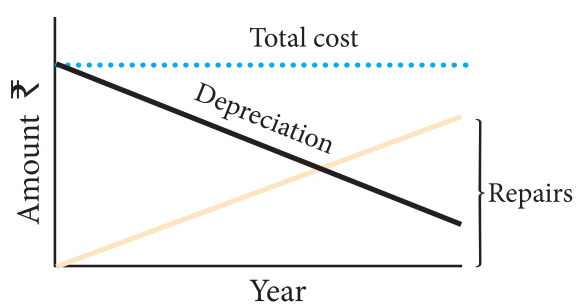
Following are the differences between straight line method and written down value method

Point of difference	Straight line method	Written down value method
1. Basis of calculation	Depreciation is calculated on the original cost of the asset for all the years.	Depreciation is calculated on the written down value of the asset year after year.
2. Amount of depreciation	The amount of depreciation is the same for all the years.	The amount of depreciation goes on decreasing year after year.
3. Book value of the asset at the end of its life	The book value of the asset becomes zero when there is no scrap value or is equal to its scrap value at the end of its life.	The book value of the asset never becomes zero.

4. Computation of rate of depreciation	It is easy to calculate the rate of depreciation.	It is very difficult to calculate the rate of depreciation.
5. Order of calculation of depreciation amount	Amount of depreciation is calculated first, followed by the rate of depreciation.	Rate of depreciation is calculated first, followed by the amount of depreciation.
6. Total charge	As the cost of repair goes on increasing with the passage of time, the total charge, i.e., the total of depreciation amount and repair amount keeps on increasing from year to year.	As the cost of repair increases and depreciation decreases with the passage of time, total of depreciation amount and repair amount charged to profit and loss account remains almost the same from year to year.
7. Suitability	It is suitable for assets for which the repair charges are less and the possibility of obsolescence is less and expiration of cost of asset depends upon time period involved.	It is suitable for assets which are affected by technological changes and assets which require more repairs with the passage of time.



Straight line method



Written down value method

10.7.3 Sum of years of digits method

This method is similar to the diminishing balance method. The amount of depreciation goes on decreasing year after year in proportion to the unexpired life of the asset. This method is suitable for those assets having more probability of obsolescence and increased repair charges as the assets grow older. Under this method, amount of depreciation per year is calculated by multiplying the cost of the asset and the number of remaining years of life and dividing it by the sum of the digits of all years of life of the asset. The following formula is used to compute the amount of depreciation under this method:

$$\text{Amount of depreciation} = \frac{\left[\begin{array}{c}\text{Total number of years of remaining} \\ \text{life of the asset} \\ \text{(including the current year)}\end{array}\right] \left[\text{Original cost - Scrap value}\right]}{\text{Sum of all the digits of all years from 1 to the life of the asset in years}}$$

Student activity

Think: Why does a business use different rates of depreciation for different types of assets?

10.7.4 Machine hour rate method

Under this method, depreciation per machine hour is calculated. The cost of the machinery after deducting the residual value, if any, is divided by the estimated working hours of the machine to find the depreciation per hour. The actual depreciation for any given period depends upon the working hours during that year. The special feature of this method is that depreciation is found directly in proportion to the actual use of the asset. Under this method life of the asset is estimated in hours and not in years. The following formula is used to determine the rate of depreciation:

$$\text{Rate of depreciation per machine hour} = \frac{\text{Original cost} - \text{Estimated scrap value}}{\text{Life of the asset in hours}}$$

Amount of depreciation = Number of machine hours used × Rate of depreciation per hour

10.7.5 Depletion method

Depletion means exhaustion of natural resources. That is, depletion means quantitative reduction in the content of assets. This is applicable to those assets that get exhausted due to extraction and exploitation. Examples: mines, oil fields, etc. Under this method, depreciation rate is calculated on the basis of the estimated quantities of the output during the whole life of the asset.

$$\text{Rate of depreciation per unit} = \frac{\text{Original cost}}{\text{Life of the asset in quantities of output}}$$

Amount of depreciation = Units of output during the year × Rate of depreciation per unit

Note: Even though it is not depreciated, it is used to write off the cost of the asset as per matching principle.

10.7.6 Annuity method

Under this method, not only the original cost of the asset but also the amount of interest on the investment is taken into account while computing depreciation. The idea of considering interest is that if the investment is made in any other asset instead of the relevant fixed asset, it would have earned a certain rate of interest. To calculate the amount of depreciation, annuity factor is used. Annuity factor can be found out from the annuity table or by using formula.

Amount of depreciation is computed as follows:
Amount of depreciation = Annuity factor × Original cost of the asset

DO YOU KNOW?

The following formula is used to compute annuity factor:

$$\text{Annuity factor} = \frac{i(1+i)^n}{(1+i)^n - 1}$$

where, i = interest rate;
n = estimated life of the asset in number of years

10.7.7 Revaluation method

Under this method, the amount of annual depreciation is calculated by comparing the value of the assets at the end of the year and their value at the beginning of the year. The value of the asset at the end of the year is determined with the consultation of relevant experts. The excess of opening value over the closing value of the asset is the amount of depreciation for that year. This method is used for live stock, loose tools, etc.

10.7.8 Sinking fund method

This method is adopted especially when it is desired not merely to write off an asset but also to provide enough funds to replace an asset at the end of its working life. Under this method, the amount charged as depreciation is transferred to depreciation fund and invested outside the business. The investment is made in safe securities which offer a certain rate of interest. Interest is received annually and reinvested every year along with the amount of annual depreciation. On the expiry of the life of the asset, the investments are sold and the sale proceeds are used for replacement of the asset. This method of depreciation is suitable for assets of higher value. This method is also known as depreciation fund method. Thus, this method not only takes into account depreciation but also makes provision for the replacement of the asset.

10.7.9 Insurance policy method

Under this method, an insurance policy is taken for an amount equal to the cost of replacement of the asset. The amount of depreciation is paid by way of insurance premium every year to the insurance company. On maturity of the policy, the policy amount is received from the insurance company and it is used for the purchase of new asset.

DO YOU KNOW?

The process of allocating the cost of an intangible asset over a period of time is called amortisation.

10.8 Methods of recording depreciation

There are two methods followed to record depreciation.

(i) Charging depreciation to asset account

(ii) Charging depreciation to provision for depreciation account.

10.8.1 Charging depreciation to asset account

Under this method at the end of every accounting period, the amount of depreciation charged is debited to depreciation account and the amount of depreciation is credited to asset account. Hence the asset appears in the balance sheet at its depreciated value. Depreciation being revenue charge is transferred to profit and loss account.

The following journal entries are to be passed in the books for depreciation and related transactions:

(a) For purchase of asset

Asset A/c Dr.	xxx	
To Bank A/c		xxx

(b) For providing depreciation at the end of the accounting year

Depreciation A/c Dr.	xxx	
To Asset A/c		xxx

(c) For closing the depreciation account

Profit and loss A/c Dr.	xxx	
To Depreciation A/c		xxx

(d) For sale of asset

Bank A/c Dr.	xxx	
Profit and loss* A/c Dr.	xxx	
To Asset A/c		xxx

***Note**: Profit and loss A/c will be credited if there is profit on sale.

Creating provision for depreciation account

In this method, a provision for depreciation account is created. The amount of depreciation charged every year is transferred to provision for depreciation account and not to asset account. Hence, asset account appears in the balance sheet at its original cost. Amount in the provision for depreciation account is shown on the liabilities side of the balance sheet under the head current liabilities and provisions. Depreciation for every year being nominal item is closed by debiting to profit and loss account of the respective year.

Example: Original cost of plant and machinery ₹ 10,000 Depreciation ₹ 1,000

Method 1: When provision for depreciation account is not created

Balance sheet (extract)			
Liabilities	**₹**	**Assets**	**₹**
		Plant and machinery 10,000 Less: Depreciation 1,000	9,000

Method 2: When provision for depreciation account is created

Balance sheet (extract)			
Liabilities	**₹**	**Assets**	**₹**
Provision for depreciation	1,000	Plant and machinery	10,000

The following journal entries are made under provision for depreciation account method:

a) For purchase of asset

Asset A/c To Bank A/c	Dr.	xxx	 xxx

b) For providing depreciation at the end of the accounting year

Depreciation A/c To Provision for depreciation A/c	Dr.	xxx	 xxx

c) For closing the depreciation account

Profit and loss A/c To Depreciation A/c	Dr.	xxx	 xxx

On sale of asset

d) For transferring accumulated depreciation on asset sold to asset account

Provision for depreciation A/c To Asset A/c	Dr.	xxx	 xxx

*__Note__: After making this entry, the asset account gets reduced by the amount of accumulated depreciation upto the date of sale. In other words the asset appears at book value.

e) For sale of asset

Bank A/c Profit and loss A/c To Asset A/c	Dr. Dr.	xxx xxx	 xxx

* Note: Profit and loss A/c will be credited if there is profit on sale.

Tutorial note

Transactions relating to sale of asset may also be transferred to a temporary account called asset disposal account and completed. Each time an asset is sold, a separate asset disposal account is opened and the balance in the asset account is transferred to asset disposal account. All transactions relating to sale are entered in the asset disposal account. The asset disposal account is closed immediately after the sale.

Illustration 5

Calculate the amount of depreciation and depreciation rate from the following by using 'straight line method'. Also give journal entries for the first two years. The books are closed on 31st December every year.

January 1, 2016 Payment to vendor for purchase of machinery	₹ 1,40,000
January 1, 2016 Transportation cost	₹1,000
January 1, 2016 Installation cost	₹ 9,000
Estimated scrap value at the end of the life	₹ 45,000
Estimated life	7 years

Solution

$$\text{Amount of depreciation per year} = \frac{\text{Original cost of the asset} - \text{Estimated scrap value}}{\text{Estimated useful life of the asset in years}}$$

$$= \frac{1{,}50{,}000 - 45{,}000}{7} = \frac{1{,}05{,}000}{7} = ₹\ 15{,}000 \text{ per year}$$

$$\text{Rate of depreciation per year} = \frac{\text{Amount of depreciation}}{\text{Original cost}} \times 100$$

$$= \frac{15{,}000}{1{,}50{,}000} \times 100 = 10\%$$

Note:

Cost of the asset = Purchase price + Transportation cost + Installation cost

= 1,40,000 + 1,000 + 9,000 = ₹ 1,50,000

Journal entries

Date	Particulars	Debit ₹	Credit ₹
2016 January 1	Machinery A/c Dr. To Bank A/c (Machinery bought)	1,40,000	1,40,000
January 1	Machinery A/c Dr. To Bank A/c (Transportation and installation cost incurred on purchase of machinery)	10,000	10,000
December 31	Depreciation A/c Dr. To Machinery A/c (Depreciation provided)	15,000	15,000
December 31	Profit and Loss A/c Dr. Dr. To Depreciation A/c (Depreciation transferred to profit and loss account)	15,000	15,000

Date	Particulars	Debit ₹	Credit ₹
2017 December 31	Depreciation A/c Dr. To Machinery A/c (Depreciation provided)	15,000	 15,000
 December 31	Profit and Loss A/c Dr. To Depreciation A/c (Depreciation transferred to profit and loss account)	15,000	 15,000

Illustration 6

Ramu Brothers purchased a machine on 1st July 2016 at a cost of ₹ 14,000 and spent ₹ 1,000 on its installation. The firm writes off depreciation at 10% of original cost every year. The books are closed on 31st December every year. Give journal entries and prepare machinery account and depreciation account for 2 years.

Solution

Note: Cost of the asset = Purchase price + Installation cost
= 14,000 + 1,000 = ₹ 15,000

Journal entries

Date	Particulars	Debit ₹	Credit ₹
2016 July 1	Machinery A/c Dr. To Bank A/c (Machinery bought)	14,000	 14,000
July 1	Machinery A/c Dr. To Bank A/c (Installation expenses on machinery incurred)	1,000	 1,000
December 31	Depreciation A/c Dr. To Machinery A/c (15,000 × 10/100 × 6/12) (Depreciation provided)	750	 750
December 31	Profit and Loss A/c Dr. Dr. To Depreciation A/c (Depreciation transferred to profit and loss account)	750	 750
2017 December 31	Depreciation A/c (15,000 × 10/100) Dr. To Machinery A/c (Depreciation provided)	1,500	 1,500
December 31	Profit and Loss A/c Dr. To Depreciation A/c (Depreciation transferred to profit and loss account)	1,500	 1,500

Ledgers

Dr. **Machinery Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016			2016		
July 1	To Cash A/c	15,000	Dec 31	By Depreciation A/c	750
				By Balance c/d	14,250
		15,000			15,000
2017	To Balance b/d	14,250	2017		
Jan 1			Dec 31	By Depreciation A/c	1,500
				By Balance c/d	12,750
		14,250			14,250
2018 Jan1	To Balance b/d	12, 750			

Dr. **Depreciation Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016			2016		
Dec 31	To Machinery A/c	750	Dec 31	By Profit and Loss A/c	750
		750			750
2017			2017		
Dec 31	To Machinery A/c	1,500	Dec 31	By Profit and Loss A/c	1,500
		1,500			1,500

Illustration 7

Anand bought a machinery for ₹ 1,00,000 on 1-1-2015. On 1-6-2016, he bought another machine for ₹ 50,000. On 1-10-2017, he purchased another machine for ₹ 20,000. Provide depreciation at 10% p.a. on straight line method. Prepare machinery account for the years 2015 to 2017 by using accounts by assuming accounts are closed on 31st December every year.

Solution

Dr. **Machinery Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2015			2015		
Jan 1	To Bank A/c	1,00,000	Dec 31	By Depreciation A/c	10,000
			Dec 31	By Balance c/d	90,000
		1,00,000			1,00,000
2016			2016		
Jan 1	To Balance b/d	90,000	Dec 31	By Depreciation A/c	12,500
June 1	To Bank A/c	50,000	Dec 31	By Balance c/d	1,27,500
		1,40,000			1,40,000
2017			2017		
Jan 1	To Balance b/d	1,27,500	Dec 31	By Depreciation A/c	15,500
Oct 1	To Bank A/c	20,000	Dec 31	By Balance c/d	1,32,000
		1,47,500			1,47,500
2018 Jan1	To Balance b/d	1,32,000			

Note:

Depreciation for 2015:	1,00,000 × 10%	= 10,000	
2016:	1,00,000 × 10%	= 10,000	
	(+) 50,000 x 10% x 6/12	= 2,500	12,500
2017:	1,00,000 x 10%	= 10,000	
	(+) 50,000 x 10%	= 5,000	
	(+) 20,000 x 10% x 3/12	= 500	15,500

10.9 Calculation of profit or loss on sale of asset

Sometimes, a business may sell an asset. In that case, the profit or loss on sale is to be calculated and accounted in the books. To find the profit or loss on sale of asset, the book value of the asset on the date of sale and the sale price are to be compared. Book value of the asset on the date of sale is calculated by subtracting the total depreciation provided on the asset from the date of its purchase or construction to the date of sale from the original cost of the asset. If the sale price is more than the book value of the asset, the difference is profit. On the other hand, if the book value of the asset is more than the sale price, the difference is loss.

Book value = Cost of the asset – Total depreciation provided upto the date of sale

Profit on sale = Sale price – Book value (Sale Price > Book Value)

Loss on sale = Book Value – Sale price (Sale Price < Book Value)

Illustration 8

Joy and Co. purchased machinery on 1st April 2016 for ₹ 75,000. On 31st March 2018, it sold the machinery for ₹ 62,000. Depreciation is to be provided every year at 10% per annum on the fixed instalment method. Accounts are closed on 31st March every year. Find out the profit or loss on sale of machinery.

Solution

Calculation of profit or loss on sale of machinery

Particulars		₹
Cost price		75,000
Less: Depreciation for 2016-17	(75,000 x 10%)	7,500
		67,500
Less: Depreciation for 2017-18	(75,000 x 10%)	7,500
Book value on the date of sale		60,000
Less: Selling price		62,000
Profit on sale		- 2,000

The selling price is more than the book value on the date of sale of machinery. Hence, the difference ₹ 2,000 is profit on sale of machinery.

Student activity

Think: Will the method of depreciation affect the profit or loss made on the sale of an asset?

Illustration 9

On 1st April 2015, Kumar purchased a machine for ₹ 80,000 and spent ₹ 20,000 on its installation. The residual value at the end of its expected useful life of 8 years is estimated at ₹ 4,000. On 30th September 2017, the machine is sold for ₹ 50,000. Depreciation is to be provided according to straight line method. Prepare Machinery Account. Accounts are closed on 31st December every year.

Solution

$$\text{Amount of depreciation} = \frac{\text{Original cost of the asset} - \text{Estimated scrap value}}{\text{Estimated life of the asset in years}}$$

$$= \frac{1,00,000 - 4,000}{8}$$

$= ₹$ 12,000 per year

$$\text{Rate of depreciation per year} = \frac{\text{Amount of depreciation per year}}{\text{Original cost}} \times 100$$

$$= \frac{12,000}{1,00,000} \text{x}\, 100 \;= 12\%$$

Note:

Cost of the asset = Purchase price + Installation cost

= 80,000 + 20,000 = ₹ 1,00,000

Ledger accounts

Dr. **Machinery Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2015			2015		
April 1	To Bank A/c	80,000	Dec 31	By Depreciation A/c	9,000
April 1	To Bank A/c	20,000		(1,00,000 ×12/100 × 9/12)	
			Dec 31	By Balance c/d	91,000
		1,00,000			1,00,000
2016			2016		
Jan 1	To Balance b/d	91,000	Dec 31	By Depreciation A/c	12,000
				(1,00,000 ×12/100)	
			Dec 31	By Balance c/d	79,000
		91,000			91,000
2017			2017		
Jan 1	To Balance b/d	79,000	Sep 30	By Depreciation A/c	9,000
				(1,00,000 ×12/100 × 9/12)	
			Sep 30	By Bank A/c	50,000
			Sep 30	By Profit and Loss A/c	20,000
				(Loss on sale)	
		79,000			79,000

Illustration 10

M/s Ramco textile mills purchased machinery on 1st April 2014 for ₹ 2,00,000 on credit from M/s. Nila & Co. and spent ₹ 10,000 on its installation. Depreciation is provided at 10% per annum on the written down value method. Prepare machinery account and depreciation account for the first three years. Books are closed on 31st March every year.

Solution

Ledger accounts

Dr. Machinery Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2014			2015		
April 1	To Nila & Co. A/c	2.00,000	March 31	By Depreciation A/c	21,000
April 1	To Bank A/c	10,000		(2,10,000 ×10%)	
			March 31	By Balance c/d	1,89,000
		2,10,000			2,10,000
2015			2016		
April 1	To Balance b/d	1,89,000	March 31	By Depreciation A/c	18,900
				(1,89,000 ×10%)	
			March 31	By Balance c/d	1,70,100
		1,89,000			1,89,000
2016			2017		
April 1	To Balance b/d	1,70,100	March 31	By Depreciation A/c	17,010
				(1,70,100 ×10%)	
			March 31	By Balance c/d	1,53,090
		1,70,100			1,70,100
2017					
April 1	To Balance b/d	1,53,090			

Dr. Depreciation Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2015			2015		
March 31	To MachineryA/c	21,000	March 31	By Profit & Loss A/c	21,000
		21,000			21,000
2016			2016		
March 31	To MachineryA/c	18,900	March 31	By Profit & Loss A/c	18,,900
		18,900			18,900
2017			2017		
March 31	To MachineryA/c	17,010	March 31	By Profit & Loss A/c	17,010
		17,010			17,010

Illustration 11

A Ltd., purchased a machine on 1st January 2014 for ₹ 60,000. On 1st July 2014, it purchased another machine for ₹ 50,000. On 1st July 2015, the company sold the machine purchased on 1st January 2014 for ₹ 40,000. It was decided that the machine be depreciated at 10% per annum on diminishing balance method. Show the machinery account for the years 2014 to 2016. The accounts are closed on December 31st, every year.

Solution

Ledger accounts

Dr. **Machinery Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2014			2014		
Jan 1	To Bank A/c	60,000	Dec 31	By Depreciation* A/c	8,500
July 1	To Bank A/c	50,000	Dec 31	By Balance c/d	1,01,500
		1,10,000			1,10,000
2015			2015		
Jan 1	To Balance b/d	1,01,500	July 1	By Depreciation A/c	2,700
			July 1	By Bank A/c	40,000
			July 1	By Profit and Loss A/c	11,300
			Dec 31	By Depreciation A/c*	4,750
			Dec 31	By Balance c/d	42,750
		1,01,500			1,01,500
2016			2016		
Jan 1	To Balance b/d	42,750	Dec 31	By Depreciation A/c (42,750 ×10%)	4,275
			Dec 31	By Balance c/d	38,475
		42,750			42,750
2017					
Jan 1	To Balance b/d	38,475			

* Note:

1. Computation of depreciation for the year 2014

Asset purchased on 1.1.14:	60,000 x 10%	= 6,000	
Asset purchased on 1.7.14:	50,000 x 10%x6/12	= 2,500	₹ 8,500

2. Computation of depreciation on the asset sold on 1.7.2015

Original cost on 1.1.2014	= 60,000
Less: Depreciation for 2014 (60,000 x 10%)	= 6,000
Written down value on 1.1.2015	54,000
Less: Depreciation for 2015 upto 1.7.2015 (54,000 x 10%x6/12)	= 2,700
Book value	51,300
Sale price	40,000
Loss on sale of asset	11,300

3. **Depreciation for 2015 for the asset purchased on 1.7.2014**

Original cost on 1.7.2014	= 50,000
Less: Depreciation for 2014 (50,000 x 10%x6/12)	= 2,500
Written down value on 1.1.2015	47,500
Less: Depreciation for 2015 (47,500 x 10%)	= 4,750

Points to remember

- The process of allocation of the relevant cost of a fixed asset over its useful life is known as depreciation.
- Cost of an asset is not merely the purchase price but also the expenses incurred on the asset till it is put into use including cost of trial run.
- Cost of a second-hand asset includes the initial repairs charges also.
- Under the straight line method, the book value of the asset at the end of its useful life is reduced to zero or its scrap value.
- The book value of the asset on any date is calculated by subtracting the depreciation provided to date from its original cost.
- The excess of sale proceeds of an asset over its book value represents profit on sale.
- The excess of book value of an asset over its sale price represents loss on sale.

Self-examination questions

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I Multiple choice questions

Choose the correct answer

1. Under straight line method, the amount of depreciation is
   (a) Increasing every year (b) Decreasing every year
   (c) Constant for all the years (d) Fluctuating every year
2. If the total charge of depreciation and maintenance cost are considered, the method that provides a uniform charge is
   (a) Straight line method (b) Diminishing balance method
   (c) Annuity method (d) Insurance policy method
3. Under the written down value method of depreciation, the amount of depreciation is
   (a) Uniform in all the years (b) Decreasing every year
   (c) Increasing every year (d) None of the above
4. Depreciation is caused by
   (a) Lapse of time (b) Usage
   (c) Obsolescence (d) a, b and c
5. For which of the following assets, the depletion method is adopted for writing off cost of the asset?
   (a) Plant and machinery (b) Mines and quarries
   (c) Buildings (d) Trademark
6. A depreciable asset may suffer obsolescence due to____
   (a) Passage of time (b) Wear and tear
   (c) Technological changes (d) None of the above.
7. Which method shall be efficient, if repairs and maintenance cost of an asset increases as it grows older.
   (a) Straight line method (b) Reducing balance method
   (c) Sinking fund method (d) Annuity method

8. Residual value of an asset means the amount that it can fetch on sale at the _____ of its useful life.

   (a) Beginning (b) End (c) Middle (d) None

9. Depreciation is to be calculated from the date when

   (a) Asset is put to use (b) Purchase order is made

   (c) Asset is received at business premises (d) Invoice of assets is received

10. If the rate of depreciation is same, then the amount of depreciation under straight line method vis-à-vis written down value method will be

    (a) Equal in all years

    (b) Equal in the first year but higher in subsequent years

    (c) Equal in the first year but lower in subsequent years

    (d) Lower in the first year but equal in subsequent years.

Answer

1 (c)	2 (b)	3 (b)	4 (d)	5 (b)	6 (c)	7 (b)	8 (b)	9 (a)	10 (b)

II Very short answer questions

1. What is meant by depreciation?
2. List out the various methods of depreciation.
3. Give the formula to find out the amount and rate of depreciation under straight line method of depreciation.
4. What is annuity method?
5. What is sinking fund method?

III Short answer questions

1. What are the objectives of providing depreciation?
2. What are the causes for depreciation?
3. State the advantages and limitations of straight line method of depreciation.
4. State the advantages and limitations of written down value method of depreciation.
5. Distinguish between straight line method and written down value method of providing depreciation.

IV Exercises

Straight line method

1. A firm purchased a plant for ₹ 40,000. Erection charges amounted to ₹ 2,000. Effective life of the plant is 5 years. Calculate the amount of depreciation per year under straight line method.

   (**Answer**: ₹ 8,400)

2. A company purchased a building for ₹ 50,000. The useful life of the building is 10 years and the residual value is ₹ 5,000. Find out the amount and rate of depreciation under straight line method.

   (**Answer**: Amount of depreciation: ₹ 4,500; Rate of depreciation 9%)

3. Furniture was purchased for ₹ 1,00,000 on 1.7.2016. It is expected to last for 5 years. Estimated scrap at the end of five years is ₹ 10,000. Find out the rate of depreciation under straight line method.

(**Answer**: Amount of depreciation ₹ 18,000; Rate of depreciation 18%)

4. Calculate the rate of depreciation under straight line method from the following information:
   Purchased a second hand machinery on 1.1.2018 for ₹ 38,000
   On 1.1.2018 spent ₹12,000 on its repairs
   Expected useful life of machine is 4 years
   Estimated residual value ₹6,000

(**Answer**: Amount of depreciation ₹ 11,000; Rate of depreciation 22%)

5. Machinery was purchased on 1st January 2015 for ₹ 4,00,000. ₹ 15,000 was spent on its erection and ₹ 10,000 on its freight charges. Depreciation is charged at 10% per annum on straight line method. The books are closed on 31st March each year. Calculate the amount of depreciation on machinery for the first two years.

(**Answer**: Amount of depreciation on 31.03.2015: ₹ 10,625; on 31.03.2016: ₹ 42,500)

6. An asset is purchased on 1.1.2016 for ₹50,000. Depreciation is to be provided annually according to straight line method. The useful life of the asset is 10 years and its residual value is ₹ 10,000. Accounts are closed on 31st December every year. You are required to find out the rate of depreciation and give journal entries for first two years.

(**Answer**: Amount of depreciation ₹ 4,000, Rate of depreciation 8%)

7. From the following particulars, give journal entries for 2 years and prepare machinery account under straight line method of providing depreciation:
   Machinery was purchased on 1.1.2016

Price of the machine	₹ 36,000
Freight charges	₹ 2,500
Installation charges	₹ 1,500

Life of the machine 5 years

(**Answer**: Amount of depreciation: ₹ 8,000; Balance in machinery A/c: ₹ 24,000)

8. A manufacturing company purchased on 1 April, 2010, a plant and machinery for ₹4,50,000 and spent ₹ 50,000 on its installation. After having used it for three years, it was sold for ₹ 3,85,000. Depreciation is to be provided every year at the rate of 15% per annum on the fixed instalment method. Accounts are closed on 31st March every year. Calculate profit or loss on sale of machinery.

(**Answer**: Profit on sale ₹ 1,10,000)

9. On 1st April 2008, Sudha and Company purchased machinery for ₹ 64,000. To instal the machinery expenses incurred was ₹ 28,000. Depreciate machinery 10% p.a. under straight line method. On 30th June, 2010 the worn out machinery was sold for ₹ 52,000. The books are closed on 31st December every year. Show machinery account.

(**Answer**: Loss on sale ₹ 19,300)

10. Ragul purchased machinery on April 1, 2014 for ₹ 2,00,000. On 1st October 2015, a new machine costing ₹ 1,20,000 was purchased. On 30th September 2016, the machinery purchased on April 1, 2014 was sold for ₹ 1,20,000. Books of accounts are closed on 31st March and depreciation is to be provided at 10% p.a. on straight line method. Prepare machinery account and depreciation account for the years 2014-15 to 2016-17.

(**Answer**: Amount of depreciation: 2014-15: ₹ 20,000; 2015-16: ₹ 26,000; 2016-17: ₹ 22,000; Loss on sale of 1st machine: ₹ 30,000; Balance in machinery a/c: ₹ 1,02,000).

Written down value method

11. An asset is purchased for ₹ 50,000. The rate of depreciation is 15% p.a. Calculate the annual depreciation for the first two years under diminishing balance method.

(**Answer**: Amount of depreciation I year ₹ 7,500; II year ₹ 6,375)

12. A boiler was purchased on 1st January 2015 from abroad for ₹10,000. Shipping and forwarding charges amounted to ₹2,000. Import duty ₹ 7,000 and expenses of installation amounted to ₹ 1,000. Calculate depreciation for the first 3 years @10% p.a. on diminishing balance method assuming that the accounts are closed 31st December each year.

(**Answer**: Amount of depreciation: 2015: ₹ 2,000; 2016: ₹ 1,800; 2017: ₹ 1,620)

13. A furniture costing ₹ 5,000 was purchased on 1.1.2016, the installation charges being ₹1,000. The furniture is to be depreciated @10% p.a. on the diminishing balance method. Pass journal entries for the first two years.

(**Answer**: Amount of depreciation I year ₹ 600; II year ₹ 540)

14. A firm acquired a machine on 1st April 2015 at a cost of ₹ 50,000. Its life is 6 years. The firm writes off depreciation @ 30% p.a. on the diminishing balance method. The firm closes its books on 31st December every year. Show the machinery account and depreciation account for three years starting from 1st April 2015.

(**Answer**: Amount of depreciation: 2015: ₹ 11,250; 2016: ₹ 11,625; 2017: ₹ 8,138; Balance in machinery a/c on 31-12-17 ₹ 18,987)

15. On 1st October 2014, a truck was purchased for ₹ 8,00,000 by Laxmi Transports Ltd. Depreciation was provided @ 15% p.a. under diminishing balance method. On 31st March 2017, the above truck was sold for ₹5,00,000. Accounts are closed on 31st March every year. Find out the profit or loss made on the sale of the truck.

(**Answer**: Amount of depreciation: 2014-15: ₹ 60,000; 2015-16: ₹ 1,11,000; 2017: ₹ 94,350; Loss on sale ₹ 34,650)

16. Raj & Co purchased a machine on 1st January 2014 for ₹ 90,000. On 1st July 2014, they purchased another machine for ₹ 60,000. On 1st January 2015, they sold the machine purchased on 1st January 2014 for ₹ 40,000. It was decided that the machine be depreciated at 10% per annum on diminishing balance method. Accounts are closed on 31st December every year. Show the machinery account for the years 2014 and 2015.

(**Answer**: Amount of depreciation: 2014: ₹12,000; 2015: ₹ 5,700; Loss on sale ₹ 41,000; Balance in machine a/c on 31.12.14 ₹1,38,000; on 31.12.15 ₹ 51,300).

CASE STUDY

Lucky & Co's income statement shows a loss of ₹ 3,000. The owner thinks that there is no need to provide for depreciation as the company has made a loss. He also suggests his accountant to change the method of depreciation for the next year so as to avoid the loss. But, the accountant is hesitant to make the necessary changes suggested by his owner.

Now, discuss on the following points:

- Do you agree on the point that there is no need to charge depreciation when the company has made a loss?
- Why does the accountant hesitate to make the changes suggested by his owner?
- What are the accounting principles not followed if the accountant agrees to his owner's suggestion?
- Do you think charging depreciation could be the only reason for the company's loss?

To explore further

Is it possible to exchange the old fixed asset with a new one? In such a case, what do you think will be the adjustment in terms of payment and accounting treatment?

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Unit 11

CAPITAL AND REVENUE TRANSACTIONS

Contents

Points to recall

The following points are to be recalled before learning capital and revenue transactions:

- Matching concept
- Periodicity concept
- Income and expenditure

AJHECV

Learning Objectives

To enable the students to

- Understand the meaning of capital and revenue expenditure and capital and revenue receipts
- Understand the meaning of deferred revenue expenditure
- Analyse the transactions to classify into capital and revenue items

Key terms to know

- Capital expenditure
- Revenue expenditure
- Deferred revenue expenditure
- Capital receipts
- Revenue receipts

11.1 Introduction

Student activity

Think: How often the business entities buy stationery items? How often they buy machinery? Is it fair if the business entity treats both these type of expenditure the same?

The main objective of accounting of business transactions is to ascertain the results of operations and the financial position of the business concern. The transactions carried on may yield benefit only for the current accounting period or they may yield benefit for more than one accounting period. According to matching principle, the expenses incurred in the current accounting period must be matched with the revenues earned during that period.

In case of certain expences, the benefit accrues only in the relevant accounting period. They are called revenue expenditrues. For example, salaries, rent, etc. But in case of certain expenditrues benefit extends beyond one accounting period. They are called capital expenditrues.

To exhibit a true and fair view of profitability and state of affairs, proper allocation of capital and revenue items is required. The revenue items are to be shown in the trading and profit and loss account and capital items are to be shown in the balance sheet.

11.2 Considerations in determining capital and revenue expenditures

The basic considerations to differentiate between capital and revenue expenditures are:

(i) Nature of business

Expenditure on purchase of goods is revenue expenditure. Expenditure on purchase of asset is capital expenditure. Whether an item of expenditure is goods or asset depends on the nature of business. Goods include articles or commodities in which the business is dealing with. For example, for a trader dealing in furniture, purchase of furniture is revenue expenditure but for any other trade, the purchase of furniture should be treated as capital expenditure and shown in the balance sheet as asset. Therefore, the nature of business is very important criteria in classifying expenditure between capital and revenue.

(ii) Effect on revenue generating capacity of business

If expenditure helps to generate income or revenue in the current accounting period, it is revenue expenditure. On the other hand, if expenditure helps to generate revenue for more than one accounting period, it is capital expenditure.

(iii) Purpose of expenditure

If expenditure is incurred in the normal course of maintenance of an asset, it is revenue expenditure. On the other hand, if expenditure is incurred for major repair of an asset which increases its productive capacity, it is capital expenditure.

(iv) Materiality of the amount involved

Relative proportion of the amount involved is considered in distinguishing between revenue expenditure and capital expenditure. If the amount of expenditure is material, it is treated as capital expenditure even if the expenditure does not increase the productive capacity of the asset. On the other hand, when the amount of expenditure is immaterial, it is treated as revenue even if the benefit of the expenditure extends beyond one accounting period. For example cost of waste basket is treated as revenue expenditure.

11.3 Classification of expenditure

Expenditures may be classified into the following three categories:

(i) Capital expenditure

(ii) Revenue expenditure

(iii) Deferred revenue expenditure.

Expenditure

- **Capital Expenditure**
- **Revenue Expenditure**
- **Deferred Revenue Expenditure**

11.4 Capital expenditure

It is an expenditure incurred during an accounting period, the benefits of which will be available for more than one accounting period. It includes any expenditure resulting in the acquisition of any fixed asset or contributes to the revenue earning capacity of the business. It is non- recurring in nature.

11.4.1 Features of capital expenditure

Following are the features of capital expenditure:

(i) It gives benefit for more than one accounting period.

(ii) It includes acquisition of fixed assets and all expenditure incurred upto the point an asset is ready for use.

(iii) It contributes to the revenue earning capacity of the business.

(iv) It is non-recurring in nature.

(v) It is shown on the assets side of the balance sheet.

Examples

- Cost of acquisition of land and building.
- Cost of acquisition of office equipment, computer and air-conditioner.
- Cost of acquisition of plant and machinery including installation charges and trial run.

11.5 Revenue expenditure

The expenditure incurred for day to day running of the business or for maintaining the earning capacity of the business is known as revenue expenditure. It is recurring in nature. It is incurred to generate revenue for a particular accounting period. The revenue expenditure may be incurred in relation with revenue or in relation with a particular accounting period. For example, cost of purchases is a revenue expenditure related to sales revenue. Rent and salaries are related to a particular accounting period.

11.5.1 Features of revenue expenditure

Following are the features of revenue expenditure:

(i) It is recurring in nature.

(ii) It is incurred for maintaining the earning capacity of the business.
(iii) Its benefit expires in the same accounting period.
(iv) It is shown on the debit side of the trading and profit and loss account.

Examples

- Purchase of goods for resale.
- Administrative, selling and distribution expenses.
- Manufacturing expenses.

Student activity

Think: Identify and list down capital and revenue expenditures at home and at school.

11.6 Deferred revenue expenditure

An expenditure, which is revenue expenditure in nature, the benefit of which is to be derived over a subsequent period or periods is known as deferred revenue expenditure. The benefit usually accrues for a period of two or more years. It is for the time being, deferred from being charged against income. It is charged against income over a period of certain years.

11.6.1 Features of deferred revenue expenditure

Following are the features of deferred revenue expenditure:

(a) It is a revenue expenditure, the benefit of which is to be derived over a subsequent period or periods.
(b) It is not fully written off in the year of actual expenditure. It is written off over a period of certain years.
(c) The balance available after writing off (i.e., Actual expenditure - Amount written off) is shown on the assets side balance sheet.

Examples

- Considerable amount spent on advertising
- Major repairs to plant and machinery

11.7 Comparison of capital, revenue and deferred revenue expenditure

Following are the points of comparison among capital, revenue and deferred revenue expenditure:

Basis	Capital expenditure	Revenue expenditure	Deferred revenue expenditure
i) Nature	It is non – recurring in nature.	It is recurring in nature.	It is non- recurring in nature.
ii) Purpose	To contribute to the revenue earning capacity of the business.	To carry on the day to day activities of the business.	To get benefit for certain years.
iii) Period of benefits	Its benefit is available for a longer period.	Its benefit is obtained within one accounting period.	Its benefit is available for more than one accounting period.

iv) Effect on profit earning capacity	It increases the profit earning capacity of the business.	It maintains the profit earning capacity of the business.	It is of benefit to the business for certain years.
v) Accounting treatment	It will appear on the assets side of the balance sheet.	It will be shown on the debit side of the trading and profit and loss account depending on whether direct or indirect in nature.	The amount written off during the year is shown on the debit side of profit and loss account and the unwritten off portion is shown on the asset side.

11.8 Capital and revenue receipts

Student activity

Think: A textile business sells some part of its unused land and receives the amount. Can it be considered as normal sale? Can it be shown in the trading account?

11.8.1 Capital receipt

Receipt which is not revenue in nature is called capital receipt. It is non-recurring in nature. The amount received is normally substantial. It is shown on the liabilities side of the balance sheet.

Examples

- Proceeds from issue of shares and debentures
- Long term loan raised from bank and other financial institutions
- Proceeds of sale of fixed assets
- Proceeds of sale of long-term investments
- Receipt of special donations

11.8.2 Revenue receipt

Receipts which are obtained in the normal course of business are called revenue receipts. It is recurring in nature. The amount received is generally small.

Examples

- Proceeds from sale of goods
- Interest on investments received
- Rent received
- Dividend from investment in shares.

11.9 Distinction between capital and revenue receipts

Following are the main differences between capital and revenue receipts:

Basis	Capital receipts	Revenue receipts
i) Nature	Non-recurring in nature.	Recurring in nature.
ii) Size	Amount is generally substantial.	Amount is generally smaller.
iii) Distribution	These amounts are not available for distribution as profits.	The excess of revenue receipts over the revenue expenses can be used for distribution as profits.

Examples of capital and revenue items

Capital expenditure	Revenue expenditure	Deferred revenue expenditure	Capital receipts	Revenue receipts
i) Purchase cost of fixed assets ii) Purchase cost of long term investments iii) Expenses to increase the earning capacity of fixed assets iv) Loan given to outsiders v) Cost of acquisition of goodwill, copyright, trademark, etc. vi) Installation expenditure of fixed assets vii) Expenses incurred for trial run of a machinery	i) Maintenance expenses of fixed assets ii) Insurance premium iii) Postage and stationery iv) Administrative, selling and distribution expenditure v)Advertisement expenditure, the benefit of which will accrue for one accounting period vi) Payment of honorarium vii) Annual subscription vii) Entertainment expenses	i) Heavy amount on advertisement. ii) Cost of major repairs on fixed assets	i) Life membership fees ii) Special donations received iii) Loan borrowed iv) Sale of fixed assets v) Contribution towards capital fund vi) Long term investment sold vii) Government grants. (specific purpose) viii) Amount received not in normal course of business	i) Sale proceeds of goods ii) Commission received iii) Sale of old news paper iv) Rent received v) Interest on investments vi) Government grants (general purpose) vii) Bad debts recovered

Illustration 1

State with reasons whether the following are capital or revenue expenditure:

(i) Expenses incurred in connection with obtaining a licence for starting the factory for ₹ 25,000.

(ii) A factory shed was constructed at a cost of ₹ 2,00,000. A sum of ₹ 10,000 had been incurred in the construction of temporary huts for storing building material.

(iii) Overhaul expenses of second-hand machinery purchased amounted to₹ 5,000.

Solution

(i) It is a capital expenditure since it is incurred to acquire the right to carry on business.

(ii) Cost of construction of building including cost of temporary huts is capital expenditure.

(iii) It is a capital expenditure because overhaul expenses are incurred to put second-hand machinery in working condition to get long-term advantage.

Illustration 2

State with reasons whether the following are capital or revenue or deferred revenue expenditure:

(i) Advertisement expenses amounted to ₹ 10 crores to introduce a new product.

(ii) Expenses on freight for purchasing new machinery.

(iii) Freight and insurance on the new machinery and cartage paid to bring the new machinery to the factory.

Solution

(i) The effect of heavy advertisement expenses will extend to more than one accounting period, but it does not create any property of tangible or intangible nature and hence it is deferred revenue expenditure.

(ii) It is a capital expenditure since it is incurred up to the point the machine is ready for use.

(iii) These are capital expenditures since they are incurred up to the point the machine is ready for use.

Illustration 3

State whether the following are capital, revenue or deferred revenue expenditure.

(i) Carriage of ₹ 1,000 spent on machinery purchased and installed.

(ii) Office rent paid ₹ 2,000.

(iii) Wages of ₹ 5,000 paid to machine operators.

(iv) Hire charges for the use of motor vehicle, hired for five years, but paid yearly.

Solution

(i) Carriage of ₹ 1,000 spent on machinery purchased and installed is capital expenditure.

(ii) Office rent paid ₹ 2,000 is revenue expenditure.

(iii) Wages of ₹ 5,000 paid to machine operators is revenue expenditure.

(iv) Hire charges for the use of motor vehicle, hired for five years, but paid yearly is revenue expenditure.

Illustration 4

State whether the following are capital or revenue items.

(i) ₹ 5,000 spent towards additions to buildings.

(ii) Second-hand motor car purchased for ₹30,000 and paid ₹2,000 as repairs immediately.

(iii) ₹ 10,000 was spent on painting the new factory.

(iv) Freight and cartage on the new machine ₹ 150, erection charges ₹ 200.

(v) ₹ 150 spent on repairs before using a second hand car purchased recently.

Solution

(i) ₹ 5,000 spent towards additions to buildings is capital expenditure.

(ii) The entire amount of ₹ 32,000 should be treated as capital expenditure.

(iii) ₹ 10,000 spent on painting the new factory should be treated as capital expenditure.

(iv) Freight, cartage and erection charges are capital expenditures.

(v) ₹ 150 being expense to bring the asset in usable condition, is a capital expenditure.

Illustration 5

Classify the following expenses as capital or revenue.

(i) The sum of ₹ 3,200 has been spent on a machine as follows:

a) ₹ 2,000 for additions to double the output.

b) ₹ 1,200 for repairs necessitated by negligence.

(ii) Overhauling expenses of ₹ 25,000 for the engine of a motor car to get better fuel efficiency.

Solution

(i) a) ₹ 2,000 spent on additions should be treated as capital expenditure

b) ₹ 1200 spent on repairs should be treated as revenue expenditure.

(ii) Overhauling expenses are incurred for the engine of a motor car to get better fuel efficiency. So this expenditure should be treated as capital expenditure.

Illustration 6

Classify the following expenditures and receipts as capital or revenue:

(i) ₹ 10,000 spent as travelling expenses of the directors on trips abroad for the purchase of fixed assets.

(ii) Amount received from trade receivables during the year.

(iii) Amount spent on demolition of building to construct a large building on the same site.

(iv) Insurance claim received on account of a machinery damaged by fire.

Solution

(i) Capital expenditure

(ii) Revenue receipt

(iii) Capital expenditure

(iv) Capital receipt.

Points to remember

- Expenditures of a business can be classified into capital, revenue and differred revenue expenditure.
- Capital expenditure is an expenditure incurred during an accounting period, the benefits of which will be available for more than one accounting period.
- Revenue expenditure is the expenditure incurred for day today running of the business or for maintaining the earning capacity of the business.
- Deferred revenue expenditure is expenditure of revenue nature incurred for getting benefits which extends to two or more years.
- Revenue receipts are incomes derived from the normal activities of the business. Capital receipts are derived from transactions that are not the usual activities of the business.

Self–examination questions

AJRAEI

I Multiple choice questions

Choose the correct answer

1. Amount spent on increasing the seating capacity in a cinema hall is
   (a) Capital expenditure (b) Revenue expenditure
   (c) Deferred revenue expenditure (d) None of the above.

2. Expenditure incurred ₹ 20,000 for trial run of a newly installed machinery will be
   (a) Preliminary expense (b) Revenue expenditure
   (c) Capital expenditure (d) Deferred revenue expenditure

3. Interest on bank deposits is
   (a) Capital receipt (b) Revenue receipt
   (c) Capital expenditures (d) Revenue expenditures

4. Amount received from IDBI as a medium term loan for augmenting working capital
   (a) Capital expenditures (b) Revenue expenditures
   (c) Revenue receipts (d) Capital receipt

5. Revenue expenditure is intended to benefit
   (a) Past period (b) Future period
   (c) Current period (d) Any period

6. Pre-operative expenses are
   (a) Revenue expenditure (b) Prepaid revenue expenditure
   (c) Deferred revenue expenditure (d) Capital expenditure

Answer

1 (a)	2 (c)	3 (b)	4 (d)	5 (c)	6 (d)

II Very short answer questions

1. What is meant by revenue expenditure?
2. What is capital expenditure?
3. What is capital profit?
4. Write a short note on revenue receipt.
5. What is meant by deferred revenue expenditure?

III Short answer questions

1. Distinguish between capital expenditure and revenue expenditure.
2. Distinguish between capital receipt and revenue receipt.
3. What is deferred revenue expenditure? Give two examples.

IV Exercises

1. State whether the following expenditures are capital, revenue or deferred revenue.
   (i) Advertising expenditure, the benefits of which will last for three years.
   (ii) Registration fees paid at the time of registration of a building.
   (iii) Expenditure incurred on repairs and whitewashing at the time of purchase of an old building in order to make it usable.

(**Answer**: Capital Expenditure: ii , iii Deferred revenue expenditure: i)

2. Classify the following items into capital and revenue.
   (i) Registration expenses incurred for the purchase of land.
   (ii) Repairing charges paid for remodelling the old building purchased.
   (iii) Carriage paid on goods purchased.
   (iv) Legal expenses paid for raising of loans

(**Answer**: Capital : i, ii, iv Revenue: iii)

3. State whether they are capital and revenue.
   (i) Construction of building ₹ 10,00,000.
   (ii) Repairs to furniture ₹ 50,000.
   (iii) White-washing the building ₹ 80,000
   (iv) Pulling down the old building and rebuilding ₹ 4,00,000

(**Answer**: Capital: i, iv. Revenue: ii, iii)

4. Classify the following items into capital and revenue.
   (i) ₹ 50,000 spent for railway siding.
   (ii) Loss on sale of old furniture
   (iii) Carriage paid on goods sold.

(**Answer**: Capital: i, Revenue: ii, iii)

5. State whether the following are capital, revenue and deferred revenue.
   (i) Legal fees paid to the lawyer for acquiring a land ₹ 20,000.
   (ii) Heavy advertising cost of ₹ 12,00,000 spent on introducing a new product.
   (iii) Renewal of factory licence ₹ 12,000.
   (iv) A sum of ₹ 4,000 was spent on painting the factory.

(**Answer**: Capital: i, Revenue: iii, iv Deferred revenue: ii)

6. Classify the following receipts into capital and revenue.
   (i) Sale proceeds of goods ₹ 75,000.
   (ii) Loan borrowed from bank ₹ 2,50,000
   (iii) Sale of investment ₹ 1,20,000.
   (iv) Commission received ₹ 30,000.
   (v) ₹ 1,400 wages paid in connection with the erection of new machinery.

(**Answer**: Capital: ii, iii, v Revenue: i, iv)

7. Identify the following items into capital or revenue.

   (i) Audit fees paid ₹ 10,000.
   (ii) Labour welfare expenses ₹ 5,000.
   (iii) ₹ 2,000 paid for servicing the company vehicle.
   (iv) Repair to furniture purchased second hand ₹ 3,000.
   (v) Rent paid for the factory ₹ 12,000

(**Answer**: Capital: iv Revenue: i, ii, iii, v)

CASE STUDY

Sadhana decides to start a business of selling air-conditioners. She buys different brands of air-conditioners. She also buys a delivery van, some furniture and some tools to fix air-conditioners. She buys some stationery items and cleaning liquid. She spends some amount on advertising her shop. She records the entire amount spent in the trading account.

Now, discuss on the following points:

- Is it correct to record the entire amount spent in the first year of trading in the trading account? What impact will it have on the profit for the year?
- What are her fixed assets?
- Does she apply accounting concepts? If not which is the concept she does not apply?
- Can you help Sadhana to classify the expenditure?
- What other capital, revenue and deferred revenue expenditure her business may incur in the future?

To explore further

Do you think that the amount of the expenditure determines whether it is capital or revenue in nature? Justify.

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Unit 12

FINAL ACCOUNTS OF SOLE PROPRIETORS - I

Contents

AK16G6

Learning Objectives

To enable the students to

- Understand the meaning of final accounts and the purpose they serve
- Prepare trading and profit and loss account and balance sheet

Points to recall

Following points are to be recalled before learning final accounts of sole proprietors - I:

- Accounting process
- Trial balance
- Dual aspect concept, Historical cost concept, Periodicity concept and Matching concept
- Differences between capital expenditure and revenue expenditure
- Differences between capital receipts and revenue receipts

Key terms to know

- Final accounts
- Financial statements
- Income statement
- Trading account
- Profit and loss account
- Cost of goods sold
- Gross profit
- Net profit
- Financial position
- Balance sheet

12.1 Introduction to final accounts

Student activity

Think: A trader wants to know the profit earned by him, at the end of his first year of trading. Do you think the trial balance shows the profit earned? How will he find the profit?

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.

Final Accounts

- Trading and Profit and Loss Account
- Balance Sheet

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.

12.2 Closing entries and Opening entry

12.2.1 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:

1. For closing purchases returns account

Particulars	Debit ₹	Credit ₹
Purchases returns A/c Dr.	xxx	
To Purchases A/c		xxx
(Closing of purchase returns account by transferring to purchases account)		

2. For closing sales returns account

Particulars	Debit ₹	Credit ₹
Sales A/c Dr.	xxx	
To Sales returns A/c		xxx
(Closing of sales returns account by transferring to sales account)		

3. For closing opening stock and direct expenses, i.e., items that appear on the debit side of trading account

Particulars	Debit ₹	Credit ₹
Trading A/c Dr.	xxx	
To Opening stock A/c		xxx
To Purchases A/c		xxx
To Carriage inwards A/c		xxx
To Wages A/c		xxx
To All other direct expenses A/c (individually)		xxx
(Closing of various items by transferring them to trading account)		

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.	xxx	
To Trading A/c			xxx
(Closing of various iteams 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.	xxx	
To Profit and loss A/c			xxx
(Transfer of gross profit to the profit and loss account)			

(b) For gross loss

Particulars		Debit ₹	Credit ₹
Profit and loss A/c	Dr.	xxx	
To Trading A/c			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)		

12.2.2 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 becomes 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)		

12.3 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

12.3.1 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.

12.3.2 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 go down 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).

Student activity

Think: 'Closing stock need to be valued at cost price or market price whichever is less'. Which is the accounting principle applied here?

12.3.3 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.

12.3.4 Format of trading account

Dr. Trading account for the year ended . . . Cr.

Particulars	₹	₹	Particulars	₹	₹
To Opening stock		xxx	By Sales	xxx	
To Purchases	xxx		Less: Sales returns	xxx	xxx
Less: Purchases returns	xxx	xxx	By Closing stock		xxx
To Direct expenses:			By **Gross loss c/d***		xxx
Carriage/Freight inwards		xxx			
Wages		xxx			
Dock charges		xxx			
Octroi		xxx			
Royalty		xxx			
Import duty		xxx			
To Cost of goods manufactured		xxx			
To **Gross profit c/d***		xxx			
		xxx			xxx

* 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

Student activity

Think: Do you think a business that provides service such as a travel agency, insurance and an auditing firm needs to prepare a trading account?

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		**18,300**			
		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			Cash	85,000	
manufactured		12,000	Credit	60,000	
To Purchases:				1,45,000	
Cash	60,000		Less: Sales returns	3,000	1,42,000
Credit	35,000		By Gross loss c/d		**45,000**
	95,000				
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		7,000			
		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

Cost of goods sold = Opening stock + Net purchases + Direct expenses – Closing stock
= 8,000 + 60,000 + 5,000 – 9,000
= ₹ 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

Cost of goods sold = Opening stock + Net purchases + Direct expenses – Closing stock
= 20,000 + 70,000 + 10,000–30,000
= ₹ 70,000

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

Therefore, percentage of Gross profit on Cost of goods sold is $\frac{20}{80}$ x 100 = 25 %

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

Sales = Cost of goods sold + Gross profit
= 70,000 + 17,500 = ₹ 87,500

DO YOU KNOW?

When gross profit is 25% on cost, it is 20% on sales
When gross profit is 33 $\frac{1}{3}$ % on cost, it is 25% on sales

12.4 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".

Student activity

Think: What will be the effect on the profit, if purchase of fixed asset is shown as expense in profit and loss account?

12.4.1 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.

12.4.2 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.

12.4.4 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
		(transferred to capital account)	
To Selling and distribution expenses:			
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

* The balance will be either net profit or net loss.

Tutorial note

The expenses which are not related to the business are not shown in the profit and loss account. Examples are personal expenses of the proprietor such as domestic and household expenses of the proprietor, income-tax and life insurance premium of the proprietor, etc. These expenses are classified as drawings by the proprietor and are deducted from capital on the liabilities side of the balance sheet if they are paid out of business funds

Only revenue receipts and revenue expenses are shown in the trading and profit and loss account. Capital receipts, capital gains, capital expenditure and capital losses are not shown in trading and profit and loss account. That part of capital items that relate to that accounting period only are shown. For example, depreciation on fixed assets. Purchase of fixed asset is a capital expenditure. But depreciation is a revenue item which relates to the use of the fixed asset in the current accounting period.

Student activity

Think: A furniture trader takes some furniture from his business, for his domestic use. How do you treat this transaction?

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	9,000		
	84,900		84,900

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

Student activity

Think: From the income statement, is it possible to know how much the business owns or owes?

12.5 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."

12.5.1 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 it the external liabilities exceed the assets.

12.5.2 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., Assets = Capital + 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.

12.5.3 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.

12.5.4 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
Reserves		xxx	Copy rights		xxx
Long term loans		xxx	Trade marks		xxx
Current liabilities:			Computer software		xxx
Bank overdraft, Cash credit	xxx		**ii) Tangible assets**		
Outstanding expenses	xxx		Land		xxx
Unearned income	xxx		Buildings	xxx	
Short term loans from banks	xxx		Less: Depreciation	xxx	xxx
Sundry creditors	xxx		Plant and machinery	xxx	
Bills payable	xxx	xxx	Less: Depreciation	xxx	xxx
Provisions			Vehicles	xxx	
Provision for employee benefits		xxx	Less: Depreciation	xxx	xxx
Provision for tax		xxx	Furniture and Fittings	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	
Cash in hand	xxx	
Total Current assets		xxx
Less: Current liabilities:		
Sundry creditors	xxx	
Bills payable	xxx	
Bank overdraft	xxx	
Short term loans	xxx	
Outstanding expenses	xxx	
Total current liabilities		xxx
Net working capital		xxx
Add: Long term investments		xxx
Add: Fixed Assets:		
Goodwill	xxx	
Land and building	xxx	
Plant and machinery	xxx	
Furniture	xxx	
Total fixed assets		xxx
Capital Employed (both owner's funds and outsiders' funds)		xxx
Less: Long term liabilities:		
Loans	xxx	
Total long term liabilities		xxx
Net Assets		**xxx**
Represented by:		
Owners' Capital	xxx	
Reserves and surplus	xxx	xxx
Proprietor's fund		**xxx**

12.5.5 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.

12.5.6 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 classifed 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.

DO YOU KNOW?

Cash in hand and stock are tangible assets.

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.

Tutorial note

Prepaid expenses are treated as current assets. Though cash cannot be realised from prepaid expenses, the service will be available against these without further payment.

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.

Tutorial note

i) Contingent liabilities are not shown in the balance sheet. They are, however, shown as a foot note just below the balance sheet so that the existence of such liabilities may be revealed.

ii) Capital: Capital is money or money's worth contributed by the owner to the business for the purpose of carrying on business. The difference between assets and liabilities is owner's equity = capital contributed + accumulated profits.

12.6 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.

Tutorial note

If a trial balance is not given in the question, trial balance has to be prepared first. If there is a difference in the trial balance, the difference is placed to 'suspense account' and shown in the balance sheet.

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		20,000
		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		2,80,000			
		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		12,000			
		26,97,000			26,97,000

Tutorial note

Trading account and profit and loss account are prepared together. The first part is trading account, whereas the second part is profit and loss account.

Points to remember

- Trading and profit and loss account is a nominal account in nature. It means that while preparing this account, the rule of nominal account is followed.
- On the debit side of trading account, direct expenses and opening stock are shown.
- Direct expenses include 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.
- On the credit side of trading account direct income, i.e. sales and closing stock are shown.
- On the debit side of profit and loss account, indirect expenses and losses are shown.
- On the credit side of this account, indirect incomes and gains are shown.
- Indirect expenses are those expenses incurred for office, administration and selling and distribution.
- Indirect incomes and gains are the incomes or gains which are not directly related to the operation of business enterprise. For example, interest received on the deposits in the bank.
- Balance sheet is a statement and not an account. On the left side liabilities including capital and on the right side the assets are shown in the balance sheet.
- Assets are the resources owned by a business entity. Liabilities are claims against the business or the amounts owed by business to outsiders and owners.

Self-examination questions

AKA2HT

I Multiple choice questions

Choose the correct answer

1. Closing stock is an item of __________.
   (a) Fixed asset (b) Current asset
   (c) Fictitious asset (d) Intangible asset
2. Balance sheet is __________
   (a) An account (b) A statement
   (c) Neither a statement nor an account (d) None of the above
3. Net profit of the business increases the __________
   (a) Drawings (b) Receivables
   (c) Debts (d) Capital
4. Carriage inwards will be shown
   (a) In the trading account (b) In the profit and loss account
   (c) On the liabilities side (d) On the assets side
5. Bank overdraft should be shown
   (a) In the trading account (b) Profit and loss account
   (c) On the liabilities side (d) On the assets side

6. Balance sheet shows the __________ of the business.
   (a) Profitability (b) Financial position
   (c) Sales (d) Purchases
7. Drawings appearing in the trial balance is
   (a) Added to the purchases (b) Subtracted from the purchases
   (c) Added to the capital (d) Subtracted from the capital
8. Salaries appearing in the trial balance is shown on the
   (a) Debit side of trading account (b) Debit side of profit and loss account
   (c) Liabilities side of the balance sheet (d) Assets side of the balance sheet
9. Current assets does not include
   (a) Cash (b) Stock
   (c) Furniture (d) Prepaid expenses
10. Goodwill is classified as
   (a) A current asset (b) A liquid asset
   (c) A tangible asset (d) An intangible asset

Answer

1 (b)	2 (b)	3 (d)	4 (a)	5 (c)	6 (b)	7 (d)	8 (b)	9 (c)	10 (d)

II Very short answer questions

1. Write a note on trading account.
2. What are wasting assets?
3. What are fixed assets?
4. What is meant by purchases returns?
5. Name any two direct expenses and indirect expenses.
6. Mention any two differences between trial balance and balance sheet.
7. What are the objectives of preparing trading account?
8. What is the need for preparing profit and loss account?

III Short answer questions

1. What are final accounts? What are its constituents?
2. What is meant by closing entries? Why are they passed?
3. What is meant by gross profit and net profit?
4. "Balance sheet is not an account"- Explain.
5. What are the advantages of preparing a balance sheet?
6. What is meant by grouping and marshalling of assets and liabilities?

IV Exercises

1. Prepare trading account in the books of Mr.Sanjay for the year ended 31st December 2017:

Particulars	₹	Particulars	₹
Opening stock	570	Purchases	15,800
Sales	26,200	Purchases returns	90
Sales returns	60	Closing stock	860

(**Answer**: Gross profit: ₹ 10,720)

2. From the following balances taken from the books of Saravanan, calculate gross profit for the year ended December 31, 2017

Particulars	₹	Particulars	₹
Opening stock	1,50,000	Net sales during the year	4,00,000
Direct expenses	8,000	Net purchases during the year	1,50,000
Closing Stock	25,000		

(**Answer**: Gross profit: ₹ 1,17,000)

3. From the following details for the year ended 31st March, 2018, prepare trading account.

Particulars	₹	Particulars	₹
Opening stock	2,500	Returns inwards	7,000
Purchases	27,000	Coal and gas	3,300
Sales	40,000	Carriage inwards	2,600
Wages	2,500	Closing stock	5,200
Returns outwards	5,200		

(**Answer**: Gross profit: ₹ 5,500)

4. From the following balances taken from the books of Victor, prepare trading account for the year ended December 31, 2017:

Particulars	₹	Particulars	₹
Adjusted purchases	80,000	Closing stock	7,000
Sales	90,000	Carriage inwards	3,000
Royalty on purchases of goods	4,000	Import duty on purchases of goods	6,000
Octroi on purchase of goods	2,000	Dock charges on purchases	5,000
Cost of goods manufactured	5,000		

(**Answer**: Gross loss: ₹ 15,000)

(**Hint**: Closing stock will not appear in trading account)

5. Compute cost of goods sold from the following information:

Particulars	₹	Particulars	₹
Opening stock	10,000	Indirect expenses	5,000
Purchases	80,000	Closing stock	15,000
Direct expenses	7,000		

(**Answer**: Cost of goods sold: ₹ 82,000)

(**Hint**: Indirect expenses do not form part of cost of goods sold)

6. Find out the amount of sales from the following information:

Particulars	₹	Particulars	₹
Opening stock	30,000	Closing stock	20,000
Purchases less returns	2,00,000	Gross profit margin (on sales)	30%

(**Answer**: Sales ₹ 3,00,000)

7. From the following details, prepare profit and loss account.

Particulars	₹	Particulars	₹
Gross profit	50,000	Interest received	2,000
Office rent	10,000	Discount received	3,000
Depreciation on office assets	8,000	Carriage outwards	2,500
Discount allowed	12,000	Insurance on office building	3,500
Advertisement	4,000	General expenses	3,000
Audit fees	1,000	Freight inwards	1,000

(**Answer**: Net profit ₹ 11,000)

(**Hint**: Freight inwards will not appear in profit and loss account as it is a direct expense)

8. From the following information, prepare profit and loss account for the year ending 31st December, 2016.

Particulars	₹	Particulars	₹
Gross loss	60,000	Printing and stationery (office)	2,000
Promotional expenses	5,000	Legal charges	5,000
Distribution expenses	15,000	Bad debts	1,000
Commission paid	7,000	Depreciation	2,000
Interest on loan paid	5,000	Rent received	4,000
Packing charges (on sales)	4,000	Loss by fire not covered by insurance	3,000
Dividend received	3,000		

(**Answer**: Net loss: ₹ 1,02,000)

9. From the following balances obtained from the books of Mr. Ganesh, prepare trading and profit and loss account.

Particulars	₹	Particulars	₹
Stock on 01.01.2017	8,000	Bad debts	1,200
Purchases for the year	22,000	Trade expenses	1,200
Sales for the year	42,000	Discount allowed	600
Expenses on purchases	2,500	Commission allowed	1,100
Financial charges paid	3,500	Selling expenses	600
Expenses on sale	1,000	Repairs on office vehicles	600

Closing stock on December 31.12.2017 was ₹ 4,500

(**Answer**: Gross profit: ₹ 14,000; Net profit: ₹ 4,200)

10. From the following particulars, prepare balance sheet in the books of Bragathish as on 31st December, 2017:

Particulars	₹	Particulars	₹
Capital	80,000	Cash in hand	20,000
Debtors	12,800	Net profit	4,800
Drawings	8,800	Plant	43,200

(**Answer**: Balance sheet total: ₹ 76,000)

11. Prepare trading and profit and loss account in the books of Ramasundari for the year ended 31st December, 2017 and balance sheet as on that date from the following information:

Particulars	₹	Particulars	₹
Opening stock	2,500	Sales	7,000
Wages	2,700	Purchases	3,300
Closing Stock	4,000	Salary	2,600
Discount received	2,500	Capital	52,000
Machinery	52,000	Cash at Bank	6,400
Creditors	8,000		

(**Answer**: Gross profit: ₹ 2,500; Net profit: ₹ 2,400; Balance sheet total: ₹ 62,400)

12. Prepare trading and profit and loss account and balance sheet in the books of Deri, a trader, from the following balances as on March 31, 2018.

Debit Balances	₹	Credit Balances	₹
Stock	10,000	Sales	1,22,500
Cash	2,500	Creditors	5,000
Bank	5,000	Bills payable	2,000
Freight inwards	750	Capital	1,00,000
Purchases	95,000		
Drawings	4,500		
Wages	27,500		
Machinery	50,000		
Debtors	13,500		
Postage (office)	150		
Sundry expenses	850		
Rent paid	2,500		
Furniture	17,250		
	2,29,500		**2,29,500**

Closing stock (31st March, 2018) ₹ 8,000

(**Answer**: Gross loss: ₹ 2,750; Net loss: ₹ 6,250; Balance sheet total: ₹ 96,250)

DO YOU KNOW?

Operating profit is the profit earned from the normal operating activities of a business entity. Operating profit is the difference between operating revenue and operating cost.

Operating profit = Operating revenue – Operating Cost

= Net sales – (Cost of goods sold + other operating expenses)

= Net sales – (Cost of goods sold + office and administration expenses + selling and distribution expenses)

Operating profit is also called Earning Before Interest and Tax, ie., EBIT

Operating activities mean the activities relating to normal or main business of an enterprise. Operating revenues are the revenues earned in the normal course of business and operating cost is the cost incurred in the normal course of business of an enterprise.

Operating cost includes cost of goods sold and other indirect operating expenses such as office and administration and selling and distribution expenses. Purely financial expenses interest on loan and incomes such as dividend received are not included in operating expenses.

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CASE STUDY

Mr. Abhinav started a small shop of selling dairy products. He wanted to maintain proper books of accounts. But, he had very little knowledge of accounting. He maintained only three books – purchases, sales and cash book by himself. He bought some dairy products and a refrigerator to store the milk products for which the payment was made by cheque but recorded the same in the purchases book. He also spent for the transportation charges and paid some money to the person who unloaded the stock. He recorded the same in the cash book.

He made both cash and credit sale for the next few weeks. He entered the entire sales in the sales book. In the middle of the month, he was in need of some money for his personal use. So he took some money, but did not record in the books.

Now, discuss on the following points:

- Do you think Mr. Abhinav needs an accountant? Why do you think so?
- Does he maintain enough books of accounts?
- What other books do you think that he needs to maintain?
- What will be the impact on the profit, if he records the purchase of refrigerator in the purchases book?
- Is it important to record the money taken for personal use? Will it affect the final accounts?
- Identify some of the accounting principles relevant to this situation.

To explore further

Do you think the presentation of final accounts is the same for all forms of business?

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Unit 13

FINAL ACCOUNTS OF SOLE PROPRIETORS-II

Contents

Points to recall

The following points are to be recalled before learning final accounts of sole proprietors-II

- Final accounts
- Revenue recognition principle
- Matching principle
- Accrual principle
- Periodicity principle

AKIXJG

Learning Objectives

To enable the students to

- Understand the accounting treatment for adjustments
- Pass adjusting entries
- Prepare final accounts when adjustments are given

Key terms to know

- Adjustment entries
- Outstanding expenses
- Prepaid expenses
- Accrued income
- Income received in advance
- Bad debts
- Provision for bad and doubtful debts
- Provision for discount on debtors

13.1 Introduction

Student activity

Think: A trader has to pay rent of ₹5,000 per month, for the building occupied for is business. His accounting period ends on 31st December, every year. He has paid totally ₹40,000 for the period from 1st January, 2017 to 31st December, 2017. How much do you think that he should show as his expense for rent in the income statement?

The principal function of final accounts is to exhibit a true and fair view of the profitability and the financial position of the business to which they relate. Final accounts are prepared based on the ledger account balances as shown by the trial balance for an accounting period as a whole. The expenses and incomes for the whole accounting period must be taken into account while preparing the final accounts.

Sometimes, it is possible that certain expenses have been incurred but not paid and certain incomes have been earned but not received during the accounting period. Similarly, there may be expense or income which have been paid or received in the accounting period but they may pertain to another accounting period. These items are to be adjusted to include correct amounts of them in the final accounts at the end of the accounting period. Certain items like value of stock at the end might have been ascertained after closing the ledger accounts for the accounting period. Such items might also be included in the financial statements so that they represent a true and fair view of profitability and financial status. It becomes necessary to make adjustments for such items after the preparation of trial balance by passing journal entries, called adjustment entries. Both debit as well as credit aspects of these adjustments are to be recorded at the time of preparation of final accounts.

13.1.1 Rationale of making adjustments at the time of preparing final accounts

The important consideration in the preparation of final accounts with adjustments are as under:

Matching principle

Revenues earned during the period must be compared with the expenses incurred during that period.

13.2 Adjustment entries and accounting treatment of adjustments

13.2.1 Meaning of adjustment entries

Adjustment entries are the journal entries made at the end of the accounting period to account for items which are omitted in trial balance and to make adjustments for outstanding and prepaid expenses and revenues accrued and received in advance.

13.2.2 Purpose of adjustment entries

The main purpose of adjustment entries are to match current year revenue with the expenses incurred to earn these revenues. Other purposes are:

(i) To exhibit true and fair view of profitability

(ii) To exhibit true and fair view of financial status.

13.2.3 Need for adjustment entries

The need arises to pass adjusting entries for the following reasons:

(i) To record omissions in trial balance such as closing stock, interest on capital, interest on drawings, etc.
(ii) To bring into account outstanding and prepaid expenses.
(iii) To bring into account income accrued and received in advance.
(iv) To create reserves and provisions.

13.2.4 Adjustments and adjustment entries

The following are the common adjustments and adjustment entries which are made while preparing the final accounts.

(i) Closing stock (ii) Outstanding expenses (iii) Prepaid expenses
(iv) Accrued income (v) Income received in advance (vi) Interest on capital
(vii) Interest on drawings (viii) Interest on loan (ix) Interest on investment
(x) Depreciation (xi) Bad debts (xii) Provision for bad and doubtful debts
(xiii) Provision for discount on debtors (xiv) Income tax paid
(xv) Manager's commission

(i) Closing stock

The unsold goods in the business at the end of the accounting period are termed as closing stock. As per AS-2 (Revised), the stock is valued at cost price or net realisable value, whichever is lower.

DO YOU KNOW? According to Indian Accounting Standards, AS-2 (Revised), "Net realisable value is the estimated selling price in the ordinary course of business less the estimated cost of completion and the estimated cost necessary to make the sale."

DO YOU KNOW? The principle of valuation of stock is based on the convention of conservatism.

Adjusting entry

Particulars	L.F.	Debit ₹	Credit ₹
Stock (closing) A/c Dr. To Trading A/c (Closing stock brought into account)		xxx	 xxx

Presentation in final accounts

In the Trading Account	Shown on the credit side.
In the Balance Sheet	Shown on the assets side under current assets.

Tutorial note

Closing stock is the opening stock for the next accounting period. At the beginning of the next accounting period this entry is reversed to bring into account the opening stock.

Example

The value of closing stock shown as adjustment on 31st March, 2016 is ₹10,000. The adjusting entry is:

Adjusting entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
2016 March 31	Stock - in trade (closing) A/c To Trading A/c (Closing stock brought into account)	Dr.		10,000	 10,000

In final accounts, it is presented as follows:

Dr. Trading Account for the year ended 31st March, 2016 Cr.

Particulars	₹	₹	Particulars	₹	₹
			By Closing stock		10,000

Balance Sheet as on 31st March, 2016

Liabilities	₹	₹	Assets	₹	₹
			Stock-in-trade		10,000

Tutorial note

If closing stock is already adjusted, adjusted purchases account and closing stock will appear in trial balance. Adjusted purchases account will be shown on the debit side of the trading account and closing stock will be shown on the assets side of the balance sheet.

(ii) Outstanding expenses

Expenses which have been incurred in the accounting period but not paid till the end of the accounting period are called outstanding expenses. In other words, if certain benefits or services are received during the year but payment is not made for the services received and utilised, these are termed as outstanding expenses. Outstanding expense account is a representative personal account and expense account is a nominal account.

Adjusting entry

Particulars		L.F.	Debit ₹	Credit ₹
Concerned expense A/c To Outstanding expense A/c (Expense outstanding adjusted)	Dr.		xxx	 xxx

Presentation in final accounts

In the Trading A/c or Profit and loss A/c	Amount outstanding is added to particular expense account in the trading account if it is direct expense and in the profit and loss account if it is an indirect expense.
In the Balance Sheet	Amount of outstanding expense is a current liability and is shown on the liabilities side of the balance sheet.

Tutorial note

1. If outstanding expenses account appears in the trial balance with credit balance, it means that journal entry has been made already for outstanding expenses. Hence, the outstanding expenses account will be shown only in the liabilities side of balance sheet. No adjustment is therefore necessary in expenses account as already expenses would have been adjusted.

2. At the beginning of the next accounting period the above entry is reversed to bring into account outstanding expenses at the beginning so that it is reduced from amount of expense of next year.

Example

For the year 2017, rent is payable @ ₹2,000 p.m. and during the year ₹20,000 is paid on account of rent.

Total rent for the year 2017 is ₹24,000 i.e., 2,000 p.m. x 12 months. The difference between total rent payable and actual rent paid ₹4,000 (i.e. ₹24,000 - ₹20,000) is outstanding rent. The adjusting entry is:

Adjusting entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
2017 Dec 31	Rent A/c	Dr.		4,000	
	To Outstanding rent A/c				4,000
	(Rent outstanding adjusted)				

In final accounts, it is presented as follows:

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

Particulars	₹	₹	Particulars	₹	₹
To Rent	20,000				
Add: Outstanding	4,000	24,000			

Balance Sheet as on 31st December, 2017

Liabilities	₹	₹	Assets	₹	₹
Rent outstanding		4,000			

(iii) Prepaid Expenses

Prepaid expenses refer to any expense or portion of expense paid in the current accounting year but the benefit or services of which will be received in the next accounting period. They are also called as unexpired expenses. Though these expenses are paid in the accounting period, they are not incurred during the accounting period. Prepaid expense account is a representative personal account. Expense account is a nominal account.

Adjusting entry

Particulars		L.F.	Debit ₹	Credit ₹
Prepaid expense A/c	Dr.		xxx	
To Concerned expense A/c				xxx
(Expense paid in advance adjusted)				

Presentation in final accounts

In Trading A/c or Profit and loss A/c	Amount prepaid is deducted from particular expense in the trading account or profit and loss account depending upon whether it is direct or indirect respectively.
In Balance Sheet	Amount of prepaid expense is shown on the assets side under current assets.

Deferred revenue expenses Vs. Prepaid expenses

Deferred revenue expenditure is that expenditure which yields benefits which extend beyond the current accounting period, but relatively a short period as compared to a capital expenditure. Prepaid expenses refer to amount paid in the current accounting period benefit of which will be received in the next accounting period.

Tutorial note

1. If prepaid expense already appears in trial balance it means that it is already adjusted and journal entry has already been made. Hence, prepaid expense is shown only in balance sheet.
2. At the beginning of the next accounting period, the above entry is reversed to bring into account prepaid expenses at the beginning so that it is added to amount of expense of next year.

Example

Insurance premium of ₹6,000 for one year is paid on 1st January, 2016 and the accounting year closes on 31st March, 2016.

In this example, insurance premium has been paid in advance or prepaid for nine months, i.e. from 1st April to 31st December amounting to ₹4,500 (i.e., ₹ 6000 × 9/12). The adjusting entry is:

Adjusting entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
2016 March 31	Prepaid insurance premium A/c To Insurance premium A/c (Insurance premium paid in advance adjusted)	Dr.		4,500	4,500

In final accounts, it is presented as follows:

Dr. Profit and loss account for the year ended 31st March, 2016 Cr.

Particulars	₹	₹	Particulars	₹	₹
To Insurance premium	6,000				
Less: Prepaid insurance	4,500	1,500			

Balance Sheet as on 31st March, 2016

Liabilities	₹	Assets	₹
		Insurance premium prepaid	4,500

(iv) Accrued income

Accrued income is income or portion of income which has been earned during the current accounting year but not received till the end of that accounting year. It generally happens in case of amount to be received on account of commission, interest, dividend, etc.

Adjusting entry

Particulars	L.F.	Debit ₹	Credit ₹
Accrued income A/c Dr. To Concerned income A/c (Income accrued adjusted)		xxx	xxx

Presentation in final accounts

In Profit and loss A/c	Amount accrued is added to particular income.
In Balance Sheet	Amount of accrued income is shown on the assets side under current assets.

Tutorial note

1. If accrued income account appears in the trial balance with debit balance, it means that journal entry has been made already for accrued income. Hence, the accrued income account will be shown only in the assets side of balance sheet. No adjustment is necessary in income account as already it would have been adjusted.
2. At the beginning of the next accounting period, the above entry is reversed to bring into account accrued income at the beginning, so that it is reduced from amount of income in the next year.

Example

A business has a fixed deposit of ₹1,00,000 with a bank for 12 months in the accounting period ending 31st March, 2018 @ 9% interest p.a. Interest received during the year was ₹6,750.

In this example, income earned is ₹9,000 (i.e., 1,00,000 × 9%). Income received is ₹6,750. Hence, the income earned but not received, is the accrued interest ie., ₹2,250 (9,000 - 6,750). The adjusting entry is:

Adjusting entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
2018 March 31	Accrued interest on fixed deposit A/c Dr. To Interest on fixed deposit A/c (Interest accrued but not received adjusted)		2,250	2,250

In final accounts, it is presented as follows:

Dr. Profit and loss account for the year ended 31st March, 2018 Cr.

Particulars	₹	₹	Particulars	₹	₹
			By Interest on fixed deposit	6,750	
			Add: Accrued interest	2,250	9,000

Balance Sheet as on 31st March, 2018

Liabilities	₹	Assets	₹
		Accrued interest on fixed deposit	2,250

(v) Income received in advance

Income received in advance refers to income or portion of income received in an accounting year which is not earned in the accounting period. It is also known as unearned income or unexpired income. Though the amount is received in the current accounting year, the benefit is yet to be offered to the concerned person in the next accounting year.

Adjusting entry

Particulars		L.F.	Debit ₹	Credit ₹
Concerned income A/c To Income received in advance A/c (Income received in advance adjusted)	Dr.		xxx	 xxx

Presentation in final accounts

In Profit and loss A/c	Amount received in advance is deducted from particular income.
In Balance Sheet	Amount of income received in advance being current liability is shown on the liabilities side of the balance sheet.

Tutorial note

1. If income received in advance account appears in the trial balance with credit balance, it means that journal entry has been made already for income received in advance. Hence, the income received in advance account will be shown only in the liabilities side of balance sheet. No adjustment is necessary in income account as already it would have been adjusted.
2. At the beginning of the next accounting period, the above entry is reversed to bring into account income received in advance at the beginning, so that it is added to the amount of income in the next year.

Example

The trial balance as on 31st March, 2017 shows commission received as ₹7,500.

Adjustment: One-third of the commission received is in respect of work to be done in the next accounting year.

Commission received includes one-third of the commission for the next accounting period. ₹7,500 × 1/3, that is ₹2,500 is received in advance. The adjusting entry is:

Adjusting entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
2017 March 31	Commission received A/c To Commission received in advance A/c (Commission received in advance adjusted)	Dr.		2,500	 2,500

In final accounts, it is presented as follows:

Dr. Profit and loss account for the year ended 31st March, 2017 Cr.

Particulars	₹	₹	Particulars	₹	₹
			By Commission received	7,500	
			Less: Received in advance	2,500	5,000

Balance Sheet as on 31st March, 2017

Liabilities	₹	Assets	₹
Commission received in advance	2,500		

(vi) Interest on capital

According to separate entity concept business and proprietor are two separate entities. Capital contributed by proprietor is a liability to the business. Hence, interest may be provided on capital contributed by proprietor. It is treated as a business expense. The purpose is to know the true profit of the business.

Adjusting entry

Particulars		L.F.	Debit ₹	Credit ₹
Interest on capital A/c	Dr.		xxx	
To Capital A/c				xxx
(Interest on capital provided)				

Transfer entry

Particulars		L.F.	Debit ₹	Credit ₹
Profit and Loss A/c	Dr.		xxx	
To Interest on capital A/c				xxx
(Interest on capital transferred)				

Presentation in final accounts

In Profit and loss A/c	Amount of interest on capital is shown on the debit side.
In Balance Sheet	Amount of interest on capital is added to capital on the liabilities side of the balance sheet.

Tutorial note

Interest on capital is calculated on the opening balance of capital if there is no change in the capital account during the accounting year. If there is any additional capital introduced or capital withdrawn, then interest on capital is to be calculated proportionately on the balance outstanding.

Example

The trial balance prepared on 31st December, 2016 shows Capital of ₹5,00,000.
Adjustment: Provide interest on capital @ 4% p.a.

Interest on capital = ₹5,00,000 × 4/100 = ₹20,000. The adjusting entry is:

Adjusting entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
2016	Interest on capital A/c	Dr.		20,000	
Dec. 31	To Capital A/c				20'000
	(Interest on capital provided)				

Transfer entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
2016	Profit and Loss A/c	Dr.		20,000	
Dec. 31	To Interest on capital A/c				20,000
	(Interest on capital transferred)				

In final accounts, it is presented as follows:

Dr. Profit and loss account for the year ended 31st December, 2016 Cr.

Particulars	₹	₹	Particulars	₹	₹
To Interest on capital		20,000			

Balance Sheet as on 31st December, 2016

Liabilities	₹	₹	Assets	Debit ₹	Credit ₹
Capital	5,00,000				
Add: Interest on Capital	20,000	5,20,000			

(vii) Interest on drawings

Drawings represent the amount or goods withdrawn by the proprietor from the business for his personal use. As business is separate from owner, interest charged on drawings, if any, is to be treated as business income.

Adjusting entry

Particulars	L.F.	Debit ₹	Credit ₹
Capital A/c Dr.		xxx	
To Interest on drawings A/c			xxx
(Interest on drawings provided)			

Transfer entry

Particulars	L.F.	Debit ₹	Credit ₹
Interest on drawings A/c Dr.		xxx	
To Profit and loss A/c			xxx
(Interest on drawings transferred)			

Presentation in final accounts

In Profit and loss A/c	Amount of interest on drawings is shown on the credit side as it is an income / gain.
In Balance Sheet	Amount of interest on drawings is deducted from the capital on the liabilities side of the balance sheet.

Example

The trial balance on 31st March, 2016 shows capital as ₹1,50,000 and drawings as ₹10,000. Adjustment: Charge interest on drawings at 4%.

Interest on drawings = ₹10,000 × 4/100 = ₹400. The adjusting entry is:

Adjusting entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
2016	Capital A/c Dr.		400	
March 31	To Interest on drawings A/c			400
	(Interest on drawings provided)			

Transfer entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
2016	Interest on drawings A/c Dr.		400	
Marh 31	To Profit and loss A/c			400
	(Interest on drawings transferred)			

In final accounts, it is presented as follows:

Dr. Profit and loss account for the year ended 31st March, 2016 Cr.

Particulars	₹	₹	Particulars	₹	₹
			By Interest on drawings		400

Balance Sheet as on 31st March, 2016

Liabilities	₹	₹	Assets	₹	₹
Capital	1,50,000				
Less: Drawings	10,000				
	1,40,000				
Less: Interest on drawings	400	1,39,600			

(viii) Interest on loan

Business entities may have loans borrowed from banks and other financial institutions, private money lenders, etc. If any interest is payable on loan and not yet provided at the time of preparation of trial balance, it is necessary to provide for outstanding interest on loan. It is an outstanding expense.

Adjusting entry

Particulars		L.F.	Debit ₹	Credit ₹
Interest on loan A/c	Dr.		xxx	
To Outstanding interest on loan A/c				xxx
(Interest on loan outstanding)				

Presentation in final accounts

In Profit and loss A/c	Amount outstanding is added to interest on loan on the debit side.
In Balance Sheet	Amount of interest outstanding is added to loan on the liabilities side as it is payable along with the loan.

Tutorial note

1. If the trial balance contains loan account specifying the percentage of interest and date of borrowing and interest paid appears in the trial balance, it is to be checked whether interest for the whole year is paid. If it is not paid, outstanding interest must be adjusted.
2. Similar to any other expenses outstanding, this entry also will be reversed at the beginning of the next accounting period.

Example

Extracts from the trial balance as on 31st December, 2017 is given below:

Particulars	Debit ₹	Credit ₹
Loan @ 12% p.a.		5,00,000
Interest paid on loan	45,000	

Adjustment: Interest on loan is unpaid for three months.
Interest unpaid = ₹5,00,000 × 12/100 × 3/12 = ₹15,000. The adjusting entry is:

Adjusting entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
2017	Interest on loan A/c	Dr.		15,000	
Dec. 31	To Outstanding interest on loan A/c				15,000
	(Interest on loan outstanding provided)				

In final accounts, it is presented as follows:

Dr. **Profit and loss account for the year ended 31st December, 2017** **Cr.**

Particulars	₹	₹	Particulars	₹	₹
To Interest on loan	45,000				
Add: Outstanding	15,000	60,000			

Balance Sheet as on 31st December, 2017

Liabilities	₹	₹	Assets	₹	₹
Loan @12%	5,00,000				
Add: Interest outstanding	15,000	5,15,000			

(ix) Interest on investment

Business entities may have investments in outside securities carrying specified rate of interest. If interest is due but not yet received, adjustment is to be made for the same in the accounting records before preparation of final accounts. Interest receivable on any investments in the form of shares, deposits, etc. made outside the business is called accrued interest. It is an accrued income.

Adjusting entry

Particulars		L.F.	Debit ₹	Credit ₹
Accrued interest on investment A/c	Dr.		xxx	
To Interest on investment A/c				xxx
(Interest on investment due adjusted)				

Presentation in final accounts

In Profit and loss A/c	Amount accrued is added to interest on investment on the credit side.
In Balance Sheet	Amount of accrued interest being current asset is shown on the assets side of the balance sheet.

Example

Extracts from the trial balance as on 31st December, 2017 is given below:

Particulars	Debit ₹	Credit ₹
Investment @ 12%	1,00,000	
Interest received on investment		9,000

Adjustment: Provide for accrued interest on investment ₹3,000. The adjusting entry is:

Adjusting entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
2017 Dec. 31	Accrued Interest on investment A/c	Dr.		3,000	
	To Interest on investment A/c				3,000
	(Interest on investments accrued)				

In final accounts, it is presented as follows:

Dr. Profit and loss account for the year ended 31st December, 2017 Cr.

Particulars	₹	₹	Particulars	₹	₹
			By Interest on investment	9,000	
			Add: Accrued interest	3,000	12,000

Balance Sheet as on 31st December, 2017

Liabilities	₹	₹	Assets	₹	₹
			Investment @ 12%		1,00,000
			Accrued interest		3,000

(x) Depreciation

The decrease in book value of fixed assets due to usage or passage of time is called depreciation. It is a loss to the business. Therefore, it must be written off from the value of asset. Generally, a certain percentage on the value of the asset is calculated as the amount of depreciation.

Adjusting entry

Particulars	L.F.	Debit ₹	Credit ₹
Depreciation A/c Dr.		xxx	
To Concerned fixed asset A/c			xxx
(Depreciation provided)			

Transfer entry

Particulars	L.F.	Debit ₹	Credit ₹
Profit and loss A/c Dr.		xxx	
To Depreciation A/c			xxx
(Depreciation transferred)			

Presentation in final accounts

In Profit and loss A/c	Depreciation is shown on the debit side.
In Balance Sheet	Amount of depreciation is deducted from concerned fixed asset on the assets side.

Tutorial note

When depreciation already appears in trial balance, it means journal entry is already made and asset account has been already reduced to the extent of depreciation. Hence, depreciation will be shown only in profit and loss account.

Example

The trial balance prepared on 31st March, 2016 shows the value of buildings as ₹50,000. Adjustment: Depreciate buildings @ 10% p.a.

Amount of depreciation = ₹50,000 x 10/100 = ₹5,000. The adjusting entry is:

Adjusting entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
2016	Depreciation A/c Dr.		5,000	
Mar. 31	To Buildings A/c			5,000
	(Depreciation on buildings provided)			

Transfer entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
2016	Profit and Loss A/c	Dr.		5,000	
Mar. 31	To Depreciation A/c				5,000
	(Depreciation transferred)				

In final accounts, it is presented as follows:

Dr. Profit and loss account for the year ended 31st March, 2016 Cr.

Particulars	₹	₹	Particulars	₹	₹
To Depreciation on buildings	5,000				

Balance Sheet as on 31st March, 2016

Liabilities	₹	₹	Assets	₹	₹
			Buildings	50,000	
			Less: Depreciation	5,000	45,000

DO YOU KNOW?

When a provision for depreciation account is created, the entry is

Profit and Loss A/c Dr. xxx

To Provision for depreciation A/c xxx

Here the asset account is not reduced with depreciation. It will appear in the balance sheet at its original cost. Provision for depreciation accumulated up to date will appear on the liabilities side of balance sheet.

(xi) Bad debts

When it is definitely known that amount due from a customer (debtor) to whom goods were sold on credit, cannot be realised at all, it is treated as bad debts. In other words, debts which cannot be recovered or irrecoverable debts are called bad debts. It is a loss for the business and should be charged against profit.

Student activity **Think:** Why do business entities sell goods on credit?

Adjusting entry

Particulars		L.F.	Debit ₹	Credit ₹
Bad debts A/c	Dr.		xxx	
To Sundry debtors A/c				xxx
(Bad debts written off)				

Transfer entry

(if provision for bad and doubtful debts account is not maintained)

Particulars		L.F.	Debit ₹	Credit ₹
Profit and Loss A/c	Dr.		xxx	
To Bad debts A/c				xxx
(For transfer of bad debts)				

Transfer entry

(if provision for bad and doubtful debts account is maintained)

Particulars	L.F.	Debit ₹	Credit ₹
Provision for bad and doubtful debts A/c Dr. To Bad debts A/c (Bad debts transferred)		xxx	 xxx

Presentation in final accounts

In Profit and loss A/c	Amount of bad debt is shown on the debit side.
In Balance Sheet	Amount of bad debts is deducted from sundry debtors on the assets side.

Tutorial note

1. When bad debts already appears in the trial balance it means journal entry is already made, i.e., debtors is already reduced. Hence, bad debt is taken only to debit side of profit and loss account.
2. If there is bad debt in trial balance as well as in adjustments, total bad debt is debited in profit and loss account. Additional bad debt only is deducted from debtors in the balance sheet.

Example

The trial balance as on 31st December, 2016 shows sundry debtors as ₹1,02,000.

Adjustment: Write off ₹2,000 as bad debts. The adjusting entry is:

Adjusting entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
2016 Dec. 31	Bad debts A/c Dr. To Sundry debtors A/c (Bad debts written off)		2,000	 2,000

Transfer entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
2016 Mar. 31	Profit and Loss A/c Dr. To bad debts A/c (Bad debts transferred to profit and loss A/c)		2,000	 2,000

In final accounts, it is presented as follows:

Dr. Profit and loss account for the year ended 31st December, 2016 Cr.

Particulars	₹	₹	Particulars	₹	₹
To Bad debts	2,000				

Balance Sheet as on 31st December, 2016

Liabilities	₹	₹	Assets	₹	₹
			Sundry debtors Less: Bad debts	1,02,000 2,000	 1,00,000

(xii) Provision for bad and doubtful debts

Provision for bad and doubtful debts refers to amount set aside as a charge against profit to meet any loss arising due to bad debt in future. At the end of the accounting period, there may be certain debts which are doubtful, i.e., the amount to be received from debtors may or may not be received. The reason may be incapacity to pay the amount or deceit.

In general, based on past experience, the amount of doubtful debts is calculated on the basis of some percentage on debtors at the end of the accounting period after deducting further bad debts (if any). Since the amount of loss is impossible to ascertain until it is proved bad, doubtful debts are charged against profit and loss account in the form of provision. A provision for doubtful debts is created and is charged to profit and loss account. When bad debts occur, it is transferred to provision for doubtful debts account and not to profit and loss account.

This is according to the convention of conservatism. Moreover, according to matching principle, all costs related to earning revenue in a period must be charged in the relevant period itself. Hence, it is appropriate that provision is created in the current year against debtors of current year.

Adjusting entry

Particulars	L.F.	Debit ₹	Credit ₹
Profit and loss A/c Dr.		xxx	
To Provision for bad and doubtful debts A/c			xxx
(Provision for bad and doubtful debts created)			

Presentation in final accounts

In Profit and loss A/c	Amount of provision for bad and doubtful debts is shown on the debit side.
In Balance Sheet	Amount of provision for bad and doubtful debts is deducted from sundry debtors on the assets side.

Example

The trial balance prepared on 31st December, 2016 shows sundry debtors as ₹1,50,000.

Adjustment: Provide 5% for bad and doubtful debts on sundry debtors.

Provision for bad and doubtful debts = ₹1,50,000 x 5/100 = ₹7,500. The adjusting entry is:

Adjusting entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
2016	Profit and loss A/c Dr.		7,500	
Dec. 31	To Provision for bad and doubtful debts A/c			7,500
	(Provision for bad and doubtful debts made)			

In final accounts, it is presented as follows:

Dr. Profit and loss account for the year ended 31st December, 2016 Cr.

Particulars	₹	₹	Particulars	₹	₹
To Provision for bad and doubtful debts	7,500				

Balance Sheet as on 31st December, 2016

Liabilities	₹	₹	Assets	₹	₹
			Sundry debtors	1,50,000	
			Less: Provision for bad and doubtful debts	7,500	1,42,500

Tutorial note

When provision already exists and appears in trial balance, the accounting treatment is as below:

1. If the provision required at the end plus the bad debts written off, is higher than the existing provision, the difference amount will be created as provision in the current year and will appear on the debit side of profit and loss account.
2. If the provision required at the end plus bad debts written off, is lesser than the existing provision, the excess is written back and will appear on the credit side of profit and loss account.

The journal entries are:

(a) For bad debts written off			
Bad debts A/c	Dr.	xxx	
To Debtors A/c			xxx
(b) For transferring bad debts			
Provision for doubtful debts A/c	Dr.	xxx	
To Bad debts A/c			xxx
(c) For creating provision to the extent of difference			
Profit and Loss A/c	Dr.	xxx	
To Provision for doubtful debts A/c			xxx
(d) For writing back provision to the extent of difference			
Provision for doubtful debts A/c	Dr.	xxx	
To Profit and Loss A/c			xxx

(xiii) Provision for discount on debtors

Cash discount is allowed by the suppliers to customers for prompt payment of amount due either on or before the due date. A provision created on sundry debtors for allowing such discount is called provision for discount on debtors. This provision is a charge against profit and hence profit and loss account is debited.

Provision for discount on debtors is made on the basis of past experience at an estimated rate on sundry debtors. Discount should be calculated on sundry debtors after deducting bad debts and provision for bad debts.

Adjusting entry

Particulars		L.F.	Debit ₹	Credit ₹
Profit and loss A/c	Dr.		xxx	
To Provision for discount on debtors A/c				xxx
(Provision for discount on debtors created)				

Presentation in final accounts

In Profit and loss A/c	Amount of provision for discount on debtors is shown on the debit side.
In Balance Sheet	Amount of provision for discount on debtors is deducted from sundry debtors on the assets side.

Tutorial note

1 Provision for discount on debtors is calculated on the balance of debtors after deducting bad debts and provision for doubtful debts. This is because provision for discount is to be expected only on good book debts. When the amount realisable itself is doubtful, provision for discount is not to be made. Similar to bad debts and provision for doubtful debts, here also discount allowed to debtors must be transferred to provision for discount on debtors account if a provision exists.

2. When provision already exists and appears in trial balance, the accounting treatment is as below:

a. If the provision required at the end plus the discount allowed, is higher than the existing provision, the difference amount will be created as provision in the current year and will appear on the debit side of profit and loss account.

b. If the provision required at the end plus discount allowed, is lesser than the existing provision, the excess is written back and will appear on the credit side of profit and loss account.

The presentation in the balance sheet is as below:

Debtors	xxx
Less Bad debts (in adjustments)	xxx
	xxx
Less Provision for doubtful debts (end) (adjustment)	xxx
	xxx
Less Provision for discount on debtors (end) (adjustment)	xxx
Balance to be shown in balance sheet	xxx

Example

The trial balance for the year ended 31st March, 2016 shows sundry debtors as ₹ 50,000. Adjustment: Create a provision for discount on debtors @ 1%.

Provision for discount on debtors = ₹ 50,000 x 1/100 = ₹ 500. The adjusting entry is:

Adjusting entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
2016 March 31	Profit and loss A/c Dr.		500	
	To Provision for discount on debtors A/c			500
	(Provision for discount on debtors made)			

In final accounts, it is presented as follows:

Dr. Profit and loss account for the year ended 31st March, 2016 Cr.

Particulars	₹	₹	Particulars	₹	₹
To Provision for discount on debtors		500			

Balance Sheet as on 31st March, 2016

Liabilities	₹	₹	Assets	₹	₹
			Sundry debtors	50,000	
			Less: Provision for discount on debtors	500	49,500

Student activity

Think: Is it possible to change the rate of provision for bad and doubtful debts? Under what circumstances will the trader decide this?

(xiv) Income tax paid

As per the Indian Income Tax Act, 1961, business income of the sole proprietor is not assessed and taxed separately. It is the sole proprietor who is assessed to tax for his total income including the business income. Hence, income tax paid by the business is not a business expenditure and is treated as drawings.

Adjusting entry

Particulars		L.F.	Debit ₹	Credit ₹
Drawings A/c	Dr.		xxx	
To Bank A/c				xxx
(Income tax of the proprietor paid)				

Presentation in final accounts

Trading / Profit and loss account	Not shown.
In Balance Sheet	Shown as deduction from capital on the liabilities side. Shown as a deduction from bank balance on the assets side.

Example

Trial balance of Sibi as on 31st December, 2017 shows the capital as ₹ 1,05,000 and cash at bank as ₹ 80,000.

Adjustment: Income tax paid ₹ 15,000. The adjusting entry is:

Adjusting entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
2017 Dec. 31	Drawings A/c	Dr.		15,000	
	To Bank A/c				15,000
	(Income tax paid)				

In final accounts, it is presented as follows:

Balance Sheet as on 31st December, 2017

Liabilities	₹	₹	Assets	₹	₹
Capital	1,05,000		Cash at bank	80,000	
Less: Drawings (income tax)	15,000	90,000	Less: Income tax	15,000	65,000

(xv) Manager's commission

Sometimes the manager is given commission as a percentage on profit of the business. It may be given at a certain percentage on the net profit before charging such commission or after charging such commission. Calculation procedure is explained below:x

a) Commission on net profit before charging such commission:

$$\text{Commission} = \text{Net profit before charging commission} \times \frac{\text{Rate of commission}}{100}$$

b) Commission on net profit after charging such commission:

$$\text{Commission} = \text{Net profit before charging commission} \times \frac{\text{Rate of commission}}{(100+\text{ Rate of commission})}$$

The purpose of giving such commission may be to motivate the managers to work with their full potential, to reward the managers for their efficiency and to retain the efficient managers by rewarding them sufficiently. Such commission can be calculated only at the end of the accounting period after calculating net profit. Hence, it remains outstanding at the end of the accounting period.

Student activity

Think: Do you think only money can motivate managers? What other factors can effect motivation?

Adjusting entry

Particulars	L.F.	Debit ₹	Credit ₹
Manager's Commission A/c Dr.		xxx	
To Outstanding Manager's commission A/c			xxx
(Manager's commission on profit provided)			

Transfer entry

Particulars	L.F.	Debit ₹	Credit ₹
Profit and loss A/c Dr.		xxx	
To Manager's commission A/c			xxx
(Commission on profit transferred)			

Presentation in final accounts

In Profit and loss account	Commission being an indirect expense is shown on the debit side of profit and loss account.

In Balance Sheet	Commission outstanding being a current liability is shown on the liabilities side of the balance sheet.

Example

On 31st March, 2017, Net profit before charging commission is ₹11,000.

The manager is entitled to receive 10% as commission on the profit before charging such a commission.

Commission = 11,000 x 10/100 = ₹1,100. The adjusting entry is:

Adjusting entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
2017	Manager's Commission A/c	Dr.		1,100	
March 31	To Outstanding Manager's commission A/c				1,100
	(Manager's commission on profit provided)				

Transfer entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
2016	Profit and Loss A/c	Dr.		1,100	
Mar. 31	To Manager's commission A/c				1,100
	(Manager's commission transferred to profit and loss A/c)				

In final accounts, it is presented as follows:

Dr. Profit and loss account for the year ended 31st March, 2017 Cr.

Particulars	₹	₹	Particulars	₹	₹
To Manager's commission		1,100			
To Net profit (transferred to capital a/c)		9,900			

Balance Sheet as on 31st March, 2017

Liabilities	₹	₹	Assets	₹	₹
Manager's commission outstanding		1,100			

Example

On 31st March, 2017, Net profit before charging commission is ₹11,000.

Adjustment: Provide Manager's commission at 10% on the profit after charging such Manager's commission.

Manager's commission = $11,000 \times \frac{10}{(100+10)}$ = ₹ 1,000. The adjusting entry is.

Adjusting entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
2017	Manager's commission A/c	Dr.		1,000	
March 31	To Outstanding Manager's commission A/c				1,000
	(Commission on profit provided)				

Transfer entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
2016 Mar. 31	Profit and Loss A/c Dr. To Manager's commission A/c (Manager's commission A/c transferred to profit and loss A/c)		1,000	 1,000

In final accounts, it is presented as follows:

Dr. Profit and loss account for the year ended 31st March, 2017 Cr.

Particulars	₹	₹	Particulars	₹	₹
To Manager's commission		1,000			
To Net profit (transferred to capital a/c)		10,000			

Balance Sheet as on 31st March, 2017

Liabilities	₹	₹	Assets	₹	₹
Manager's commission outstanding		1,000			

Illustration 1

Show necessary entries to adjust the following on 31st December, 2017.

(i) Outstanding salaries ₹ 1,200 (ii) Outstanding rent ₹ 300

(iii) Prepaid insurance premium ₹ 450 (iv) Interest on investments accrued ₹ 400

(v) Bad debts written off ₹ 200

Solution

Adjusting entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
2017 Dec. 31	Salaries A/c Dr. To Outstanding salaries A/c (Salaries outstanding provided)		1,200	 1,200
Dec. 31	Rent A/c Dr. To Outstanding rent A/c (Provided for rent outstanding)		300	 300
Dec. 31	Prepaid insurance premium A/c Dr. To Insurance premium A/c (Insurance prepaid)		450	 450
Dec. 31	Accrued Interest on investment A/c Dr. To Interest on investment A/c (Provided for interest accrued)		400	 400
Dec. 31	Bad debts A/c Dr. To Sundry debtors A/c (Bad debts written off)		200	 200

Illustration 2

Pass adjusting entries for the following on 31st March, 2018.

(i) Charge interest on drawings at ₹ 50

(ii) Write off bad debts by ₹ 500

(iii) Depreciate furniture by ₹ 1,000

Solution

Adjusting entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
2018 March 31	Capital A/c	Dr.		50	
	To Interest on drawings A/c				50
	(Interest on drawings provided)				
March 31	Bad debts A/c	Dr.		500	
	To Sundry debtors A/c				500
	(Bad debts written off)				
March 31	Depreciation A/c	Dr.		1,000	
	To Furniture A/c				1,000
	(Depreciation provided on furniture)				

Illustration 3

Sundry debtors as per trial balance as on 31st March, 2016 is ₹ 10,000.

Adjustment: Write off bad debts amounting to ₹ 300.

Give adjusting entry and show how these appear in the final accounts as on 31st March, 2016.

Solution

Adjusting entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
2016 March 31	Bad debts A/c	Dr.		300	
	To Sundry debtors A/c				300
	(Bad debts written off)				

Dr. Profit and loss account for the year ended 31st March, 2016 Cr.

Particulars	₹	₹	Particulars	₹	₹
To Bad debts		300			

Balance Sheet as on 31st March, 2016

Liabilities	₹	₹	Assets	₹	₹
			Sundry debtors	10,000	
			Less: Bad debts	300	9,700

Illustration 4

Sundry debtors as per trial balance ₹ 26,000

Bad debts as per trial balance ₹ 1,000

Adjustment: Additional bad debts amounted to ₹ 2,500

Give adjusting entry and show how these appear in the final accounts on 31st March, 2016.

Solution

Adjusting entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
2016	Bad debts A/c	Dr.		2,500	
March 31	To Sundry debtors A/c				2,500
	(Bad debts written off)				

Dr. Profit and loss account for the year ended 31st March, 2016 Cr.

Particulars	₹	₹	Particulars	₹	₹
To Bad debts	1,000				
Add: Additional bad debts	2,500	3,500			

Balance Sheet as on 31st March, 2016

Liabilities	₹	₹	Assets	₹	₹
			Sundry debtors	26,000	
			Less: Additional Bad debts	2,500	23,500

Illustration 5

An abstract of the trial balance as on 31st December, 2016 is as follows:

Particulars	₹
Sundry Debtors	20,000
Bad debts	500

Adjustment: Create a provision for bad and doubtful debts @ 5% on sundry debtors. Pass the adjusting entry and show how these items will appear in final accounts.

Solution

Provision for bad and doubtful debts = ₹ 20,000 x 5/100 = ₹ 1,000

Adjusting entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
2016	Profit and loss A/c	Dr.		1,000	
Dec. 31	To Provision for bad and doubtful debts A/c				1,000
	(Provision for bad and doubtful debts created)				

Dr. Profit and loss account for the year ended 31st December, 2016 Cr.

Particulars	₹	₹	Particulars	₹	₹
To Bad debts		500			
Add: Provision for bad and doubtful debts		1,000			

Balance Sheet as on 31st December, 2016

Liabilities	₹	₹	Assets	₹	₹
			Sundry debtors Less: Provision for bad and doubtful debts	20,000 1,000	19,000

Illustration 6

Abstracts from the trial balance as on 31st March, 2016:

Particulars	Debit ₹
Sundry debtors	52,000
Bad debts	1,000

Adjustments:

(i) Additional bad debts ₹ 2,000

(ii) Create 5% provision for bad and doubtful debts

You are required to pass necessary adjusting entries and show how these items will appear in final accounts.

Solution

Working note:

Particulars	₹
Sundry debtors	52,000
Less: Additional Bad debts	2,000
	50,000

Provision for bad and doubtful debts = ₹ 50,000 x 5/100 = ₹ 2,500

Adjusting entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
2016 March 31	Bad debts A/c Dr. To Sundry debtors A/c (Bad debts written off)		2,000	2,000
March 31	Profit and Loss A/c Dr. To Provision for bad and doubtful debts A/c (Provision for bad and doubtful debts created)		2,500	2,500

Dr. Profit and loss account for the year ended 31st March, 2016 Cr.

Particulars	₹	₹	Particulars	₹	₹
To Bad debts	1,000				
Add: Additional bad debts	2,000	3,000			
To Provision for bad and doubtful debts		2,500			

Balance Sheet as on 31st March, 2016

Liabilities	₹	₹	Assets	₹	₹
			Sundry debtors	52,000	
			Less: Additional bad debts	2,000	
				50,000	
			Less: Provision for bad and doubtful debts	2,500	47,500

Illustration 7

Abstracts from the trial balance as on 31st December, 2016:

Particulars	Debit ₹	Credit ₹
Sundry debtors	1,04,000	
Bad debts	5,000	
Provision for bad and doubtful debts		2,000

Adjustments:

(i) Additional bad debts amounted to ₹4,000.

(ii) Create a provision for bad and doubtful debts @ 5% on sundry debtors.

Pass necessary adjusting entries and show how the different items appear in final accounts.

Solution

Working note:

Particulars	Debit ₹
Sundry debtors	1,04,000
Less: Additional bad debts	4,000
	1,00,000

Provision for bad and doubtful debts = ₹1,00,000 x 5/100 = ₹5,000

Adjusting entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
2016 Dec. 31	Bad debts A/c Dr.		4,000	
	To Sundry debtors A/c			4,000
	(Bad debts written off)			
Dec. 31	Provision for bad and doubtful debts A/c Dr.		9,000	
	To Bad debts A/c			9,000
	(Bad debts transferred to provision for bad and doubtful debts account (5000 + 4000))			
Dec. 31	Profit and Loss A/c Dr.		12,000	
	To Provision for bad and doubtful debts A/c			12,000
	(Provision for bad and doubtful debts created) (9,000 + 5,000 - 2,000 = 12,000)			

Dr. Profit and loss account for the year ended 31st December, 2016 Cr.

Particulars	₹	₹	Particulars	₹	₹
To Provision for bad and doubtful debts (closing)	5,000				
Add: Bad debts	5,000				
Add: Additional bad debts	4,000				
	14,000				
Less: Provision for bad and doubtful debts (Opening)	2,000	12,000			

Balance Sheet as on 31st December, 2016

Liabilities	₹	₹	Assets	₹	₹
			Sundry debtors	1,04,000	
			Less: Additional bad debts	4,000	
				1,00,000	
			Less: Provision for bad and doubtful debts (closing)	5,000	95,000

13.3 Summary of adjusting entries and accounting treatment of adjustments

Sl. No.	Adjustment	Journal entry	Treatment in Trading A/c or P & L A/c	Treatment in Balance Sheet
1	Closing stock	Stock in trade A/c Dr. To Trading A/c	Shown on the credit side of the trading A/c.	Shown on the assets side as a current asset.
2	Outstanding expenses	Concerned expense A/c Dr. To Outstanding expense A/c	Added to the concerned expense on the debit side of trading account if direct expense and profit and loss account if indirect expense.	Shown on the liabilities side as a current liability.
3	Prepaid expenses	Prepaid expense A/c Dr. To Concerned expense A/c	Deducted from the concerned expense on the debit side. of trading account if direct expense and profit and loss account if indirect expense.	Shown on the assets side as a current asset.
4	Accrued income	Accrued income A/c Dr. To Income A/c	Added to the concerned income on the credit side of profit and loss A/c.	Shown on the assets side as a current asset.
5	Income received in advance	Concerned income A/c Dr. To Income received in advance A/c	Deducted from the concerned income on the credit side of profit and loss account.	Shown on the liabilities side as a current liability.

6	Interest on capital	Interest on capital A/c Dr. To Capital A/c	Shown on the debit side of profit and loss A/c.	Shown on the liabilities side as an addition to capital.
7	Interest on drawings	Capital A/c Dr. To Interest on drawings A/c	Shown on the credit side of profit and loss A/c.	Shown on the liabilities side as a deduction from capital.
8	Interest on loan outstanding	Interest on loan A/c Dr. To Outstanding interest on loan A/c	Shown on the debit side of profit and loss A/c.	Shown on the liabilities side as a current liability.
9	Interest on investments accrued	Accrued interest on investments A/c Dr. To Interest on investment A/c	Shown on the credit side of profit and loss A/c.	Shown on the assets side as a current asset.
10	Deprecia-tion	Depreciation A/c Dr. To Concerned fixed asset A/c	Shown on the debit side of profit and loss A/c.	Shown on the assets side as a deduction from the value of concerned fixed asset.
11	Bad debts	Bad debts A/c Dr. To Sundry debtors A/c	Shown on the debit side of profit and loss A/c when there is no provision for bad and doubtful debts. (If there is a provision for bad and doubtful debts account existing, bad debts is to be transferred to provision for bad debts A/c).	Shown on the assets side by way of deduction from the amount of sundry debtors.
12	Provision for bad and doubtful debts	Profit & Loss A/c Dr. To Provision for bad and doubtful debts A/c	Shown on the debit side of profit and loss A/c	Shown on the assets side as a deduction from sundry debtors.
13	Provision for discount on debtors	Profit & Loss A/c Dr. To Provision for discount on debtors A/c	Shown on the debit side of profit and loss A/c.	Shown on the assets side as a deduction from sundry debtors.
14	Income tax paid	Drawings A/c Dr. To Bank A/c	Shown on the liabilities side as a deduction from capital.	Shown on the assets side as a deduction from bank balance.
15	Manager's commission	Manager's commission A/c Dr. To Outstanding manager's commission A/c	Shown on the debit side of profit and loss A/c.	Shown on the liabilities side as a current liability.

13.4 Final accounts with adjustments

Illustration 8

Prepare trading account from the following ledger balances presented by P. Sen as on 31st March, 2016.

Particulars	₹	Particulars	₹
Stock (1-4-2015)	10,000	Sales	3,00,000
Purchases	1,60,000	Returns inward	16,000
Wages	30,000	Returns outward	10,000
Carriage inwards	10,000	Gas and Fuel	8,000
Freight inwards	8,000		

Additional information:

(a) Stock on 31st March, 2016 ₹ 20,000

(b) Outstanding wages amounted to ₹ 4,000

(c) Gas and fuel was paid in advance for ₹ 1,000

Solution

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

Particulars	₹	₹	Particulars	₹	₹
To Opening Stock		10,000	By Sales	3,00,000	
To Purchases	1,60,000		Less: Returns inward	16,000	2,84,000
Less: Returns outward	10,000	1,50,000	By Closing Stock		20,000
To Wages	30,000				
Add: Outstanding	4,000	34,000			
To Carriage inwards		10,000			
To Freight inwards		8,000			
To Gas and fuel	8,000				
Less: Prepaid	1,000	7,000			
To Gross profit c/d		**85,000**			
		3,04,000			3,04,000

Illustration 9

From the following particulars presented by Thilak for the year ended 31st March, 2017, prepare profit and loss account.

Particulars	₹	Particulars	₹
Gross profit	1,00,000	Interest received	6,000
Rent paid	22,000	Bad debts	2,000
Salaries	10,000	Provision for bad debts (1-4-2016)	4,000
Commission (Cr.)	12,000	Sundry debtors	40,000
Discount received	2,000	Buildings	80,000
Insurance premium paid	8,000		

Adjustments:

(a) Outstanding salaries amounted to ₹4,000

(b) Rent paid for 11 months

(c) Interest due but not received amounted to ₹2,000

(d) Prepaid insurance amounted to ₹2,000

(e) Depreciate buildings by 10%

(f) Further bad debts amounted to ₹3,000 and make a provision for bad debts @ 5% on sundry debtors

(g) Commission received in advance amounted to ₹2,000

Solution

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

Particulars	₹	₹	Particulars	₹	₹
To Rent	22,000		By Gross profit b/d	-	1,00,000
Add: Outstanding	2,000	24,000	By Commission	12,000	
(22,000x1/11)			Less: Received in		
To Salaries	10,000		advance	2,000	10,000
Add: Outstanding	4,000	14,000	By Discount received		2,000
To Insurance premium	8,000		By Interest received	6,000	
Less: Prepaid insurance	2,000	6,000	Add: Accrued	2,000	8,000
To Provision for bad and					
doubtful debts (closing)	1,900				
Add: Bad debts	2,000				
Add: Further bad debts	3,000				
	6,900				
Less: Opening provision for					
bad and doubtful debts	4,000	2,900			
To Depreciation on building		8,000			
(80,000x10%)					
To Net profit (transferred to					
capital A/c)		**65,100**			
		1,20,000			1,20,000

Working Note:

Debtors	: 40,000
Less: Further bad debts	: 2,000
	38,000

Provision for bad and doubtful debts at 5% : 38,000 x 5% = ₹1,900

Illustration 10

From the following balances as on 31st December, 2017, prepare profit and loss account.

Particulars	₹	Particulars	₹
Gross profit	50,000	Rent received	2,000
Salaries	18,000	Discount received	3,000
Office rent paid	12,000	Carriage outwards	2,500
Advertisement	8,000	Fire insurance premium	6,500

Adjustments:

(a) Rent accrued but not yet received ₹ 500

(b) Fire insurance premium prepaid to the extent of ₹ 1,500

(c) Provide manager's commission at 10% on profits before charging such commission.

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

Particulars	₹	₹	Particulars	₹	₹
To Salaries		18,000	By Gross profit b/d		50,000
To Office rent		12,000	By Rent received	2,000	
To Advertisement		8,000	Add: Rent accrued	500	2,500
To Carriage outwards		2,500	By Discount received		3,000
To Fire insurance premium	6,500				
Less: Prepaid	1,500	5,000			
To Manager's commission		1,000			
To Net profit (transferred to capital account)	-	**9,000**			
		55,500			55,500

Working note:

$$\text{Manager's Commission} = \text{Net profit before charging commission} \times \frac{\text{Rate of commission}}{100}$$

Net profit = 55,500 – (18,000 + 12,000 + 8,000 + 2,500 + 5,000) = ₹ 10,000

$$\text{Manager's commission} = 10,000 \times \frac{10}{100} = 1,000$$

Illustration 11

From the following balances obtained from the books of Siva, prepare trading and profit and loss account.

Particulars	₹	Particulars	₹
Stock on 01.01.2016	9,000	Bad debts	1,200
Purchases	22,000	Sundry expenses	1,800
Sales	42,000	Discount allowed	1,700
Expenses on purchases	1,500	Expenses on sale	1,000
Bank charges paid	3,500	Repairs on office furniture	600

Adjustments:

a) Closing stock on, 31st December, 2016 was ₹ 4,500

b) Manager is entitled to receive commission @ 5% of net profit after providing such commission.

Solution

Dr. Trading and Profit and Loss Account for the year ended 31st December, 2016 Cr.

Particulars	₹	Particulars	₹
To Opening stock	9,000	By Sales	42,000
To Purchases	22,000	By Closing stock	4,500
To Expenses on purchases	1,500		
To Gross profit c/d	**14,000**		
	46,500		46,500
To Bank charges	3,500	By Gross profit b/d	14,000
To Bad debts	1,200		
To Sundry expenses	1,800		
To Discount allowed	1,700		
To Expenses on sale	1,000		
To Repairs on office furniture	600		
To Manager's commission	200		
To Net profit (transferred to capital A/c)	**4,000**		
	14,000		14,000

Working note:

$$\text{Commission} = \text{Net profit before charging commission} \times \frac{\text{Rate of commission}}{(100+\text{ Rate of commission})} \times 100$$

Net profit = 14,000 – (3,500 + 1,000+1,200+1,800+1,700+600) = ₹ 4,200

$$\text{Manager's commission} = 4{,}200 \times \frac{5}{105} = ₹\ 200$$

Illustration 12

Given below are the balances extracted from the books of Nagarajan as on 31st March, 2016.

Particulars	₹	Particulars	₹
Purchases	10,000	Sales	15,100
Wages	600	Commission received	1,900
Freight inwards	750	Rent received	600
Advertisement	500	Creditors	2,400
Carriage outwards	400	Capital	5,000
Cash	1,200		
Machinery	8,000		
Debtors	2,250		
Bills receivable	300		
Stock on 1st January, 2016	1,000		
	25,000		25,000

Prepare the trading and profit and loss account for the year ended 31st March, 2016 and the balance sheet as on that date after adjusting the following:

(a) Commission received in advance ₹ 400 (b) Advertisement paid in advance ₹ 150

(c) Wages outstanding ₹ 200 (d) Closing stock on 31st March 2016, ₹ 2,100

Solution

In the books of Nagarajan

Dr. Trading and Profit and Loss Account for the year ended 31st March, 2016 Cr.

Particulars	₹	₹	Particulars	₹	₹
To Opening stock		1,000	By Sales		15,100
To Purchases		10,000	By Closing stock		2,100
To Wages	600				
Add: Outstanding	200	800			
To Freight inwards		750			
To Gross profit c/d		**4,650**			
		17,200			17,200
To Advertisement	500		By Gross profit b/d		4,650
Less: Prepaid advertisement	150	350	By Commission received	1,900	
To Carriage outwards		400	Less: Received in advance	400	1,500
To Net profit (transferred to capital a/c)		**6,000**	By Rent received		600
		6,750			6,750

Balance Sheet as on 31st March, 2016

Particulars	₹	₹	Particulars	₹	₹
Capital	5,000		Machinery		8,000
Add: Net profit	6,000	11,000	Stock in trade		2,100
Creditors		2,400	Debtors		300
Commission received in			Bills receivable		2,250
advance		400	Advertisement prepaid		150
Outstanding wages		200	Cash		1,200
		14,000			14,000

Illustration 13

Consider the following balances extracted from the books of Jain as on 31st December, 2016. Prepare the final accounts.

Particulars	₹	Particulars	₹
Capital	20,000	Office Salaries	6,600
Debtors	8,000	Establishment expenses	4,500
Creditors	10,500	Selling expenses	2,300
Purchases	60,000	Furniture	10,000
Sales	80,000	Cash at bank	2,400
Income tax of Jain paid	500	Miscellaneous receipts	600
Opening stock	12,000	Drawings	4,800

Adjustments

(a) Salaries outstanding for December, 2016 amounted to ₹ 600

(b) Provide depreciation on furniture @ 10% p.a.

(c) Provide interest on capital for the year @ 5% p.a.

(d) Stock on 31st December, 2016 ₹ 14,000

Solution

In the books of Jain

Dr. Trading and Profit and Loss Account for the year ended 31st December, 2016 Cr.

Particulars	₹	₹	Particulars	₹	₹
To Opening Stock		12,000	By Sales		80,000
To Purchases		60,000	By Closing Stock		14,000
To Gross Profit c/d		**22,000**			
		94,000			94,000
To Office salaries	6,600		By Gross Profit b/d		22,000
Add: Outstanding	600	7,200	By Miscellaneous receipts		600
To Establishment expenses		4,500			
To Selling expenses		2,300			
To Depreciation on furniture (10,000 x 10%)		1,000			
To Interest on capital (20,000 x 5%)		1,000			
To Net profit (transferred to capital A/c)		**6,600**			
		22,600			22,600

Balance Sheet as on 31st December, 2016

Liabilities	₹	₹	Assets	₹	₹
Capital	20,000		Furniture	10,000	
Add: Net profit	6,600		Less: Depreciation	1,000	9,000
Add: Interest on capital	1,000		Stock in trade		14,000
	27,600		Debtors		8,000
Less: Drawings 4,800			Cash at bank		2,400
Income tax 500	5,300	22,300			
Creditors		10,500			
Office salaries outstanding		600			
		33,400			33,400

Illustration 14

Edward's books show the following balances. Prepare his trading and profit and loss A/c for the year ended 31st December, 2016 and a balance sheet on at that date.

Debit balances	₹	Credit balances	₹
Drawings	5,000	Capital	1,31,500
Sundry debtors	60,000	Loan at 6% p.a.	20,000
Coal, gas and water	10,500	Sales	3,56,500
Returns inward	2,500	Interest on investments	2,550
Purchases	2,56,500	Sundry creditors	40,000
Stock on 1-1-2016	89,700		
Travelling expenses	51,250		
Interest on loan paid	300		
Petty cash	710		
Repairs	4,090		
Investments	70,000		
	5,50,550		5,50,550

Adjustments:

(a) Closing stock was ₹ 1,30,000 on 31st December, 2016.

(b) Create 5% provision for bad and doubtful debts on sundry debtors

(c) Create provision at 2% for discount on debtors

(d) Interest on loan due for 9 months.

Solution

In the books of Edward

Dr. Trading and Profit and Loss Account for the year ended 31st December, 2016 Cr.

Particulars	₹	₹	Particulars	₹	₹
To Opening Stock		89,700	By Sales	3,56,500	
To Purchases		2,56,500	Less: Returns inward	2,500	3,54,000
To Coal, gas and water		10,500	By Closing stock		1,30,000
To Gross profit c/d		**1,27,300**			
		4,84,000			4,84,000
To Travelling expenses		51,250	By Gross Profit b/d		1,27,300
To Interest on loan paid	300		By Interest on		
Add: Interest outstanding	900	1,200	investments		2,550
(20,000 x 6/100 x 9/12)					
To Repairs		4,090			
To Provision for bad and doubtful debts		3,000			
To Provision for discount on debtors		1,140			
To Net profit (transferred to capital A/c)		**69,170**			
		1,29,850			1,29,850

Balance Sheet as on 31st December, 2016

Liabilities	₹	₹	Assets	₹	₹
Capital	1,31,500		Investments		70,000
Add: Net profit	69,170		Stock in trade		1,30,000
	2,00,670		Sundry debtors	60,000	
Less: Drawings	5,000	1,95,670	Less: Provision for bad and doubtful debts (60,000 x 5/100)	3,000	
6% Loan	20,000			57,000	
Add: Interest outstanding	900	20,900	Less: Provision for discount on debtors (57,000 x 2/100)	1,140	55,860
Sundry creditors		40,000	Petty cash		710
		2,56,570			2,56,570

Illustration 15

Given below are the balances of Pandian as on 31st March, 2016.

Particulars	Debit ₹	Credit ₹
Capital		1,20,000
Sundry debtors and creditors	22,000	22,500
Sales		59,700
Drawings	2,000	
Cash in hand	8,200	
Cash at bank	30,000	
Wages	2,500	
Purchases	10,000	
Opening stock	30,000	
Business premises	60,000	
Bills receivable	14,500	
Office telephone expenses	3,500	
General expenses	9,000	
Goodwill	10,500	
	2,02,200	2,02,200

Adjustments:

(a) The stock value at the end of the accounting period was ₹ 5,000

(b) Interest on capital at 6% is to be provided

(c) Interest on drawing at 5% is to be provided

(d) Write off bad debts amounting to ₹ 2,000

(e) Create provision for bad and doubtful debts on sundry debtors @ 10%

Prepare final accounts for the year ended 31st March, 2016.

Solution

In the books of Pandian

Dr. Trading and Profit and Loss Account for the year ended 31st March, 2016 Cr.

Particulars	₹	₹	Particulars	₹	₹
To Opening stock		30,000	By Sales		59,700
To Purchases		10,000	By Closing Stock		5,000
To Wages		2,500			
To Gross Profit c/d		**22,200**			
		64,700			64,700
To Office telephone expenses		3,500	By Gross profit b/d		22,200
To General expenses		9,000	By Interest on drawings		100
To Interest on capital		7,200	(2000 x5/100)		
(1,20,000 x 6/100)			By Net loss		**1,400**
To Bad debts		2,000	(transferred to capital account)		
To Provision for bad and doubtful debts		2,000			
		23,700			23,700

Balance Sheet as on 31st March, 2016

Liabilities	₹	₹	Assets	₹	₹
Capital	1,20,000		Goodwill		10,500
Less: Net loss	1,400		Business premises		60,000
	1,18,600		Stock in trade		5,000
Add: Interest on capital	7,200		Sundry debtors	22,000	
	1,25,800		Less: Bad debts	2,000	
				20,000	
Less: Drawings and Interest on drawings (2000+100)	2,100	1,23,700	Less: Provision for bad and doubtful debts (20,000 x 10/100)	2,000	18,000
Sundry creditors		22,500	Bills receivable		14,500
			Cash at bank		30,000
			Cash in hand		8,200
		1,46,200			1,46,200

Illustration 16

From the trial balance of Ajith and the adjustments given below, prepare trading and profit and loss A/c for the year ended 31st March, 2016 and the balance sheet as on that date.

Particulars	Debit ₹	Particulars	Credit ₹
Opening stock	15,000	Capital	25,000
Furniture and fixtures	30,000	Returns outward	1,000
Purchases	40,000	Bills payable	10,000
Sales returns	2,000	Sales	1,24,000
Carriage inwards	10,000	Provision for doubtful debts	500
Office rent	23,000	Provision for discount on debtors	100
Sundry debtors	20,100		
Bank balance	19,600		
Bad debts	900		
	1,60,600		1,60,600

Adjustments:

(a) Stock at the end of the year was ₹ 8,000

(b) Further bad debts amounted to ₹ 100

(c) Create 2% provision for doubtful debts on sundry debtors

(d) Create 1% provision for discount on sundry debtors

In the books of Ajith

Dr. Trading and Profit and Loss Account for the year ended 31st March, 2016 Cr.

Particulars	₹	₹	Particulars	₹	₹
To Opening Stock		15,000	By Sales	1,24,000	
To Purchases	40,000		Less: Sales returns	2,000	1,22,000
Less: Returns outward	1,000	39,000	By Closing stock		8,000
To Carriage inwards		10,000			
To Gross profit c/d		**66,000**			
		1,30,000			1,30,000
To Office rent		23,000	By Gross profit b/d		66,000
To Provision for bad and doubtful debts (closing)	400				
Add: Bad debts	900				
Add: Further bad debts	100				
	1,400				
Less: Provision for bad and doubtful debts (opening)	500	900			
To Provision for discount on debtors (closing)	196				
Less: Provision for discount on debtors (opening)	100	96			
To Net profit (transferred to capital A/c)		**42,004**			
		66,000			66,000

Balance Sheet as on 31st March, 2016

Liabilities	₹	₹	Assets	₹	₹
Capital	25,000		Furniture and fixtures		30,000
Add: Net profit	42,004	67,004	Sundry debtors	20,100	
Bills payable		10,000	Less: Further bad debts	100	
				20,000	
			Less: Provision for bad and doubtful debts (20,000 × 2%)	400	
				19,600	
			Less: Provision for discount (19,600 × 1%)	196	19,404
			Stock-in-trade		8,000
			Cash at bank		19,600
		77,004			**77,004**

Illustration 17

The following trial balance has been extracted from the books of Rajesh on 31st December, 2016.

Debit balance	₹	Credit balance	₹
Drawings	44,000	Capital	1,76,000
Plant and machinery	1,00,000	Cash sales	1,72,000
Opening stock	20,000	Provision for bad and doubtful debts	
Purchases	2,70,000		2,000
Wages	62,000	Bank overdraft	20,000
Salaries	70,000	Discount received	6,000
Insurance	45,000	Credit sales	3,00,000
Rent and taxes	17,000	Sundry creditors	24,000
Sundry debtors	50,000		
Suspense A/c	22,000		
	7,00,000		7,00,000

The following adjustments are to be made:

(a) Stock on 31st December, 2016 was ₹28,000

(b) Unexpired insurance was ₹15,000

(c) Provision for doubtful debts is to be maintained at 5% on sundry debtors.

(d) Depreciate plant and machinery at 20%.

You are required to prepare trading and profit and loss account for the year ended 31st December, 2016 and a balance sheet as on that date.

Solution

In the books of Rajesh

Dr. Trading and Profit and Loss Account for the year ended 31st December, 2016 Cr.

Particulars	₹	₹	Particulars	₹	₹
To Opening stock		20,000	By Sales: Cash	1,72,000	
To Purchases		2,70,000	Credit	3,00,000	4,72,000
To Wages		62,000	By Closing stock		28,000
To Gross profit c/d		**1,48,000**			
		5,00,000			5,00,000
To Salaries		70,000	By Gross profit b/d		1,48,000
To Insurance	45,000		By Discount received		6,000
Less: Unexpired	15,000	30,000	By Provision for bad and doubtful debts (opening)	2,000	
To Rent and taxes		17,000	Less: Closing provision	1,000	1,000
To Depreciation on plant and machinery (1,00,000 × 20%)		20,000			
To Net profit (transferred to capital A/c)		**18,000**			
		1,55,000			**1,55,000**

Balance Sheet as on 31st December, 2016

Liabilities	₹	₹	Assets	₹	₹
Capital	1,76,000		Plant & Machinery	1,00,000	
Add: Net profit	18,000		Less: Depreciation	20,000	80,000
	1,94,000		Stock-in-trade		28,000
Less: Drawings	44,000	1,50,000	Sundry debtors	50,000	
Sundry creditors		24,000	Less: Provision for bad and doubtful debts (2%)	1,000	49,000
Bank overdraft		20,000	Unexpired insurance		15,000
			Suspense A/c		22,000
		1,94,000			**1,94,000**

Points to remember

- Adjustment entries are the journal entries made at the end of the accounting period to bring into account items which are omitted in trial balance but which relate to the relevant accounting period.
- Adjustment entries are made so that the financial statements represent a true and fair view of profitability and financial position.
- Closing stock is valued at cost price or net realisable value whichever is lower.
- Outstanding expense and income received in advance are current liabilities.
- Prepaid expense and accrued income are current assets.
- Provision is created for bad and doubtful debts and discount on debtors in the current accounting period against debtors of current accounting period.

Self-examination questions

AKSTL4

I Multiple choice questions

Choose the correct answer

1. A prepayment of insurance premium will appear in
   (a) The trading account on the debit side
   (b) The profit and loss account on the credit side
   (c) The balance sheet on the assets side
   (d) The balance sheet on the liabilities side

2. Net profit is
   (a) Debited to capital account (b) Credited to capital account
   (c) Debited to drawings account (d) Credited to drawings account

3. Closing stock is valued at
   (a) Cost price (b) Market price
   (c) Cost price or market price whichever is higher
   (d) Cost price or net realisable value whichever is lower

4. Accrued interest on investment will be shown
   (a) On the credit side of profit and loss account (b) On the assets side of balance sheet
   (c) Both (a) and (b) (d) None of these

5. If there is no existing provision for doubtful debts, provision created for doubtful debts is
   (a) Debited to bad debts account (b) Debited to sundry debtors account
   (c) Credited to bad debts account (d) Debited to profit and loss account

Answer

1 (c)	2 (b)	3 (d)	4 (c)	5 (d)

II Very short answer questions

1. What are adjusting entries?
2. What is outstanding expense?
3. What is prepaid expense?
4. What are accrued incomes?
5. What is provision for discount on debtors?

III Short answer questions

1. What is the need for preparing final accounts?
2. What is meant by provision for doubtful debts? Why is it created?
3. Explain how closing stock is treated in final accounts.
4. Give the adjusting entries for interest on capital and interest on drawings.
5. Explain the accounting treatment of bad debts, provision for doubtful debts and provision for discount on debtors.

IV Exercises

1. Pass adjusting entries for the following:
   (a) The closing stock was valued at ₹ 5,000
   (b) Outstanding salaries ₹ 150
   (c) Insurance prepaid ₹ 450
   (d) ₹20,000 was received in advance for commission.
   (e) Accrued interest on investments is ₹ 1,000.

2. For the following adjustments, pass adjusting entries:
   (a) Outstanding wages ₹ 5,000.
   (b) Depreciate machinery by ₹ 1,000.
   (c) Interest on capital @ 5% (Capital: ₹ 20,000)
   (d) Interest on drawings ₹ 50
   (e) Write off bad debts ₹ 500
3. On preparing final accounts of Suresh, bad debt account has a balance of ₹ 800 and sundry debtors account has a balance of ₹ 16,000 of which ₹ 1,200 is to be written off as further bad debts. Pass adjusting entry for bad debts. And also show how it would appear in profit and loss account and balance sheet.

(**Answer**: Profit and loss account: ₹ 2,000 (Dr.);
Balance of sundry debtors in balance sheet: ₹ 14,800)

4. The trial balance on March 31, 2016 shows the following:
   Sundry debtors ₹ 30,000;   Bad debts ₹ 1,200
   It is found that 3% of sundry debtors is doubtful of recovery and is to be provided for. Pass journal entry for the amount of provision and also show how it would appear in the profit and loss account and balance sheet.

(**Answer**: Profit and loss account: ₹ 900 (Dr.);
Balance of sundry debtors in balance sheet: ₹ 29,100)

5. The trial balance of a trader on 31st December, 2016 shows sundry debtors as ₹ 50,000.
   Adjustments:
   (a) Write off ₹ 1,000 as bad debts
   (b) Provide 5% for doubtful debts
   (c) Provide 2% for discount on debtors
   Show how these items will appear in the profit and loss A/c and balance sheet of the trader.

(**Answer**: Profit and loss account: ₹ 4,381 (Dr.),
Balance of sundry debtors in balance sheet: ₹ 45619)

6. The following are the extracts from the trial balance.
   Sundry debtors ₹ 30,000;   Bad debts ₹ 5,000
   Additional information:
   (a) Write off further bad debts ₹ 3,000.
   (b) Create 10% provision for bad and doubtful debts.
   You are required to pass necessary adjusting entries and show how these items will appear in profit and loss account and balance sheet.

(**Answer**: Profit and loss account: ₹ 10,700 (Dr.),
Balance of sundry debtors in balance sheet: ₹ 24,300)

7. The following are the extracts from the trial balance.

Particulars	Debit ₹	Credit ₹
Sundry debtors	50,000	
Provision for doubtful debts		5,000
Bad debts	3,000	

Additional information:
   (a) Additional bad debts ₹ 3,000.

(b) Keep a provision for bad and doubtful debts @ 10% on sundry debtors.

You are required to pass necessary adjusting entries and show how these items will appear in profit and loss account and balance sheet.

(**Answer**: Profit and loss account: ₹ 5,700 (Dr.),
Balance of sundry debtors in balance sheet: ₹ 42,300)

8. The following are the extracts from the trial balance.

Particulars	Debit ₹	Credit ₹
Sundry debtors	50,000	
Discount on debtors	2,000	
Bad debts	3,000	

Additional information:

(a) Create a provision for doubtful debts @ 10% on sundry debtors.

(b) Create a provision for discount on debtors @ 5% on sundry debtors.

You are required to pass necessary adjusting entries and show how these items will appear in the final accounts.

(**Answer**: Profit and loss account: Provision for bad and doubtful debts ₹ 8,000 (Dr.),
Provision for discount on debtors: ₹ 4,250 (Dr.);
Balance of sundry debtors in balance sheet: ₹ 42,750).

9. Prepare trading account of Archana for the year ending 31st December, 2016 from the following information.

Debit balance	₹	Credit balance	₹
Opening stock	80,000	Purchases returns	10,000
Purchases	8,60,000	Sales returns	3,16,000
Freight inwards	52,000	Import duty on purchases	30,000
Wages	24,000	Sales	14,40,000

Adjustments:

(a) Closing stock ₹ 1,00,000 (b) Wages outstanding ₹ 12,000

(c) Freight inwards paid in advance ₹ 5,000

(**Answer**: Gross Profit: ₹ 1,81,000)

10. Prepare profit and loss account of Manoj for the year ending on 31st March, 2016

Particulars	₹	Particulars	₹
Gross profit	25,000	Travelling expenses	500
Salaries	5,600	Stationery	75
Insurance	200	Rent	650
Discount allowed	400	Interest on loan	225
Discount received	300	Repairs	125
Commission received	100	Office expenses	55
Advertisement	450	General expenses	875
Printing charges	375	Postage	175

Adjustments:

(i) Salary outstanding ₹ 400 (ii) Rent paid in advance ₹ 50

(iii) Commission receivable ₹ 100

(**Answer**: Net profit: ₹ 15,445)

11. From the trial balance of Sumathi and the adjustments prepare the trading and profit and loss account for the year ended 31st March, 2016, and a balance sheet as on that date.

Particulars	Debit ₹	Credit ₹
Stock on April 1, 2015	900	
Purchases	2,000	
Sales		4,000
10% Loan		2,000
Carriage on purchases	200	
Rent from tenant		250
Interest on loan	100	
Machinery	400	
Postage	100	
Salary	650	
Commission received		200
Cash in hand	75	
Furniture	4,000	
Capital		1,975
	8,425	8,425

Adjustments

(a) Six months interest on loan is outstanding.

(b) Two months rent is due from tenant, the monthly rent being ₹ 25.

(c) Salary for the month of March 2016, ₹ 75 is unpaid.

(d) Stock in hand on March 31, 2016 was valued at ₹ 1,030.

(**Answer**: Gross profit: ₹ 1,930; Net profit ₹ 1,405, Balance sheet total ₹ 5,555)

12. The following trial balance was extracted from the books of Arun Traders as on 31st March, 2018.

Particulars	Debit ₹	Credit ₹
Buildings	17,500	
Plant and machinery	12,000	
Cash purchases	30,000	
Credit purchases	8,500	
Sales		63,250
Bills receivable	6,750	
Coal and water	1,625	
Office expenses	5,250	
Rent received		1,750
Carriage outwards	2,875	
Repairs and maintenance	500	
Wages	9,250	
Debtors and creditors	9,000	8,500
Cash	2,000	
Capital		44,750
Opening stock	13,000	
	1,18,250	1,18,250

Prepare trading and profit and loss account for the year ending 31st March, 2018 and balance sheet as on that date after considering the following:

(a) Depreciate Plant and machinery @ 20%

(b) Wages outstanding amounts to ₹ 750.

(c) Half of repairs and maintenance paid is for the next year.

(d) Closing stock was valued at ₹ 15,000.

(**Answer**: Gross profit: ₹ 15,125; Net profit ₹ 6,100, Balance sheet total ₹ 60,100)

13. From the following trial balance of Ramesh as on 31st March, 2017, prepare the trading and profit and loss account and the balance sheet as on that date.

Particulars	Debit ₹	Credit ₹
Stock (01.04.2016)	40,000	
Purchases	85,000	
Sales		1,90,000
Sundry creditors		48,000
Furniture and fixtures	65,000	
Debtors	45,000	
Cash at bank	21,000	
Wages	37,500	
Drawings	15,000	
Telephone charges	3,000	
Bad debts	2,000	
Provision for bad debts		2,500
Discount received		3,000
Capital		85,000
Advertising	15,000	
	3,28,500	3,28,500

Adjustments:

(a) Closing stock was valued at ₹ 35,000

(b) Unexpired advertising ₹ 250

(c) Provision for bad and doubtful debts is to be increased to ₹ 3,000

(d) Provide 2% for discount on debtors.

(e) Charge interest on drawings @ 10%.

(**Answer**: Gross profit ₹ 62,500; Net profit ₹ 45,910; Balance sheet total ₹ 1,62,410)

14. Following are the ledger balances of Devi as on 31st December, 2016.

Debit balance	₹	Credit balance	₹
Purchases	35,000	Goodwill	40,000
Salaries	11,750	Sundry debtors	20,500
Drawings	4,500	Furniture	31,000
Opening Stock	6,250	General expenses	3,250
Capital	50,000	Commission received	2,750
Sales	78,500	Loan	44,000
Carriage inwards	21,800	Cash at bank	3,100
Bad debts	600	Provision for bad debts	2,500

Prepare trading and profit and loss account for the year ended 31st December, 2016 and balance sheet as on that date.

(a) Stock on 31st December, 2016 ₹ 5,800.

(b) Write off bad debts ₹ 500.

(c) Make a provision for bad debts @ 5%.

(d) Provide for discount on debtors @ 2%.

(**Answer:** Gross profit: ₹21,250; Net profit ₹9,020, Balance sheet total ₹98,520)

15. Prepare trading and profit and loss account and balance sheet from the following trial balance of Madan as on 31st March, 2018

Debit balance	₹	Credit balance	₹
Sundry debtors	61,000	Capital	70,000
Plant and machinery	80,000	Purchases return	2,000
Bank charges	4,200	Sales	2,55,000
Wages	7,000	Bank overdraft	77,000
Sales return	5,000		
Purchases	1,52,000		
Opening stock	30,000		
Drawings	22,000		
Establishment expenses	20,000		
Bad debts	800		
Business premises	22,000		
	4,04,000		4,04,000

Adjustments:

(a) The closing stock was ₹ 80,000

(b) Provide depreciation on plant and machinery @ 20%

(c) Write off ₹ 800 as further bad debts

(d) Provide the doubtful debts @ 5% on sundry debtors

(**Answer**: Gross profit ₹ 1,43,000; Net profit ₹ 98,190; Balance sheet total ₹ 2,23,190)

16. From the following information prepare trading and profit and loss account and balance sheet of Kumar for the year ending 31st December, 2017.

Debit balance	₹	Credit balance	₹
Purchases	14,500	Sales	20,100
Coal and fuel	600	Bills payable	400
Carriage inwards	750	Rent received	2,500
Advertisement	500	Creditors	2,000
Carriage outwards	400	Capital	5,000
Bank	1,200		
Furniture	8,000		
Debtors	2,250		
Bills receivable	300		
Stock on 1st January, 2017	1,500		
	30,000		30,000

Adjustments:

a) The closing stock on 31st December, 2017 was valued at ₹ 3,900.

b) Carriage inwards prepaid ₹ 250

c) Rent received in advance ₹ 100

d) Manager is entitled to receive commission @ 5% of net profit after providing such commission.

(**Answer**: Gross profit ₹ 6,900; Manager's commission ₹ 400;
Net profit ₹ 8,000; Balance sheet total ₹ 15,900)

17. From the following information, prepare trading and profit and loss account and balance sheet in the books of Sangeetha for the year ending 31st March, 2018.

Particulars	₹	Particulars	₹
Capital	20,000	Salaries	6,600
Bills receivable	8,000	Establishment expenses	4,500
Bills payable	10,500	Advertisement	2,300
Purchases	75,000	Furniture	10,000
Sales	95,000	Cash at bank	3,200
Opening stock	12,000	Miscellaneous receipts	600
Drawings	4,500		

Adjustments:

(a) Stock on 31st March, 2018 ₹ 14,200

(b) Income tax of Sangeetha paid ₹ 800

(c) Provide interest on capital @ 10%

(d) Provide managerial remuneration @ 10% of net profit before charging such commission.

(**Answer**: Gross profit ₹ 22,200; Manager's commission ₹ 740; Net profit ₹ 6,660; Balance sheet total ₹ 34,600)

CASE STUDY

James is a trader who sells washing machines on credit. But, he does not remember the due date to collect the money from his debtors. Some of his customers do not pay on time. His cash inflow is becoming worse. As a result, he could not pay his telephone bill and rent at the end of the accounting period. Hence, he showed only the amount paid as expense. He has many washing machines unsold at the year end. He is worried about the performance of his business. So, he is planning to appoint a manager to take care of his business. The new manager insists James to apply the accounting principle of prudence and matching and also to allow cash discount.

Now, discuss on the following points:

- Why does James sell on credit?
- Are there any ways to encourage his debtors to make the payment on time?
- What might happen if the debtors do not pay?
- In what ways prudence and matching principles can be applied for the business of James?
- What will be the impact on income statement and the balance sheet, if the outstanding expenses are not adjusted?
- On what basis the unsold washing machines should be valued?
- What can be done to motivate the new manager to retain him in the business of James?

To explore further

'Profit does not necessarily mean cash inflow' – Do you agree?

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Unit 14

COMPUTERISED ACCOUNTING

Contents

Points to recall

The following points are to be recalled before learning computerised accounting:

- Accounting cycle
- Invoice
- Concept of depreciation

AL2PMR

Learning Objectives

To enable the students to:

- Understand the usage of computers in maintaining accounts
- Evaluate the advantages and limitations of Computerised Accounting System
- Apply MS Word and MS Excel in maintaining accounts

Key terms to know

- Computerised Accounting System (CAS)
- Input, CPU, output
- Accounting software
- Grouping and codification

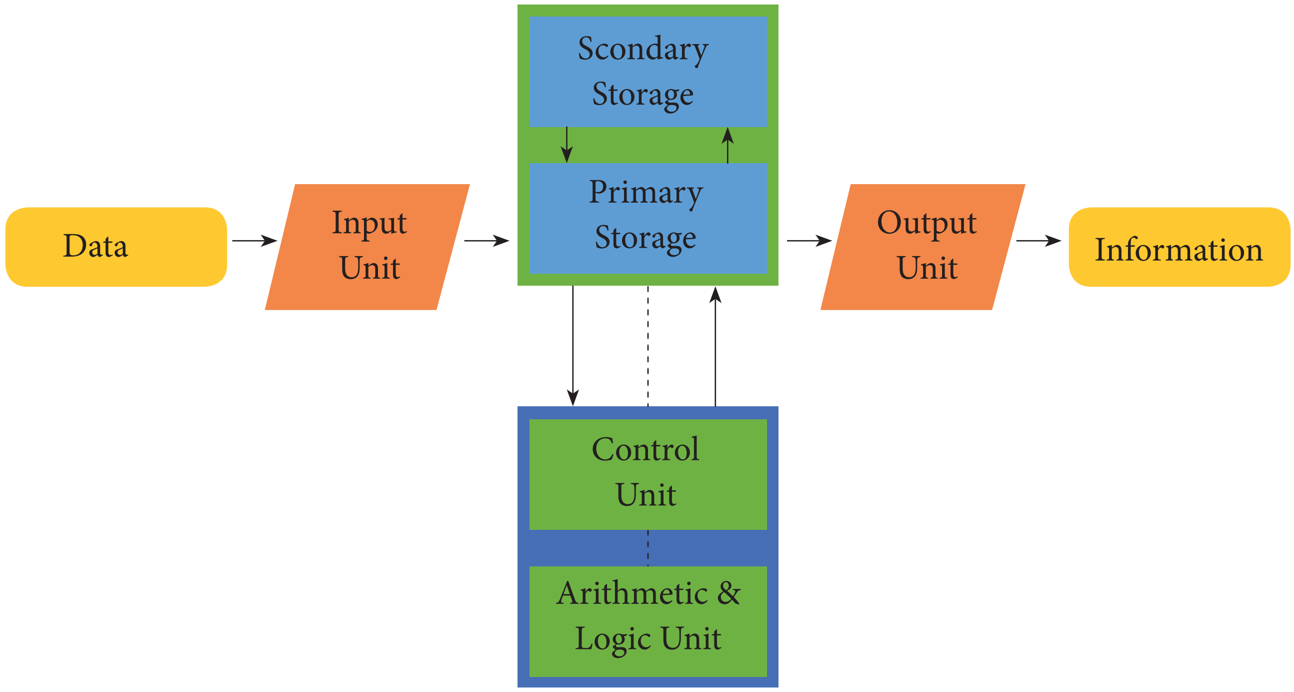
14.1 Introduction to computers

Student activity

Think: A trader has more than 10 years of accounting records. He finds it difficult to keep them all, because it requires a large store room. Is there any way to overcome this difficulty?

A computer can be described as an electronic device designed to accept raw data as input, processes them and produces meaningful information as output. It has the ability to perform arithmetic and logical operations as per given set of instructions called program. Today, computers are used all over the world in several areas for different purposes.

A computer system has mainly three components namely, input unit, central processing unit and output unit. These components are the building blocks of a computer and define its architecture. The relationship among these components is established by the following diagram:



CPU (Central Processing Unit)

Computers are nowadays widely used in scientific research, education, business, accounting, transportation, communication, banking, defence, etc. With the expansion of business, the number of transactions has increased tremendously and as a result in accounting the manual method of keeping and maintaining records have become unmanageable. The manual method of accounting is being gradually replaced with the introduction of computers in business.

14.2 Computerised Accounting System (CAS)

Computerised accounting system refers to the system of maintaining accounts using computers. It involves the processing of accounting transactions through the use of hardware and software in order to keep and produce accounting records and reports. Computerised accounting system takes accounting transactions as inputs that are processed through accounting software to generate the following reports:

- Day books /Journals
- Ledger
- Trial balance
- Trading account
- Profit and loss account
- Balance sheet, etc.

In accounting, computer is commonly used in the following areas:

a) Recording of business transactions b) Payroll accounting
c) Stores accounting and d) Generation of accounting reports

It is to be noted that the fundamentals of accounting do not change whether books of accounts are maintained manually or computerised. The same principles of debit and credit are equally applicable in a computerised environment.

14.2.1 Features of computerised accounting system

Computerised Accounting System (CAS) facilitates the management and other users to maintain accounts and prepare financial statements using computers. The reports generated through CAS are used to analyse financial status of a business and take necessary decisions to strengthen the financial soundness of the business. The CAS possesses the following features:

i) Simple and integrated: CAS is designed to automate and integrate all the business operations such as purchase, sales, finance, inventory and manufacturing. The CAS may be integrated with enhanced Management Information System (MIS), multi-lingual and data organisation capabilities to simplify all the business processes of the organisation easily and cost-effectively.

ii) Speed: It can perform functions at much higher speed than doing the same manually.

iii) Accuracy: Computers perform functions with high degree of accuracy. If hardware, software and input by people are proper, the computerised accounting system can assure of accurate outcome.

iv) Reliability: Computers are used to process large volumes of data and hence, data provided by it are reliable.

v) Versatility: Computer and accounting software have the ability to perform diverse tasks. For example, by simply recording accounting entries through accounting software, one can get trial balance, trading account, profit and loss account, balance sheet and diverse reports.

vi) Transparency: With computerised accounting, the organisation will have greater transparency of day-to-day business operations and access to the vital information.

vii) Scalability: CAS enables processing of any volume of data in tune with the change in the size of the business.

viii) On-line facility: CAS offers online facility to store and process transaction and data so as to retrieve information to generate and view financial reports in any part of the world.

ix) Security: In CAS, only the authorised users are permitted to have access to accounting data. Under manual accounting system, it is very difficult to secure such information as it is open to inspection by any person dealing with the books of accounts.

14.2.2 Components of Computerised Accounting System

Components of CAS can be classified into six categories, namely, i) Hardware ii) Software iii) People iv) Procedure v) Data and vi) Connectivity.

i) Hardware: The physical components of a computer constitute its hardware. Hardware consists of input devices and output devices that make a complete computer system. Examples of input devices are keyboard, optical scanner, mouse, joystick, touch screen and slylus which are used to feed data into the computer. Output devices such as monitor and printer are media to get the output from the computer.

ii) Software: A set of programs that form an interface between the hardware and the user of a computer system are referred to as software. The following are the various types of software:

a) System software: A set of programs to control the internal operations such as reading data from input devices, giving results to output devices and ensuring proper functioning of components is called system software. The system software includes the following:

   (1) Operating system: A set of tools and programs to manage the overall working of a computer using a defined set of hardware components is called an operating system. It is the interface between the user and the computer system. Example: DOS, Windows, UBUNTU, imac, etc.

   (2) Programming software: Special software to accept data and interpret them in the form of machine/assembly language understandable by a computer. Example: C, PASCAL, COBOL, etc.

   (3) Utility software: These are designed specifically for managing the computer device and its resources. Example: File manager, Anti-virus software, etc.

b) Application software: Programs designed to perform a specific function for a user. An application software can be classified as follows:

   (i) General purpose software: This type of application can be used for a variety of tasks and not limited to one particular function. Example: MS-Office.

   (ii) Specific purpose software: This software is created to execute one specific task and they are customised to the needs of user. Example: Accounting software, payroll software, etc.]

DO YOU KNOW?

Finacle is a banking software.

iii) People: The most important element of a computer system is its users. They are also called live-ware of the computer system. The following types of people interact with a computer system.

a) System analysts: People who design the operation and processing of the system.

b) System programmers: People who write codes and programs to implement the working of the system.

c) System operators: People who operate the system and use it for different purposes. They are also called as end users.

iv) Procedure: Procedure is a step by step series of instructions to perform a specific function and achieve desired output. In a computer system there are three types of procedures.

a) Hardware oriented procedure: It defines the working of a hardware component.

b) Software oriented procedure: It is a set of detailed instructions for using the software.

c) Internal procedure: It maintains the overall working of each part of a computer system by directing the flow of information.

v) Data: The facts and figures that are fed into a computer for further processing are called data. Data are raw input until the computer system interprets them using machine language, stores them in memory, classifies them for processing and produces results in conformance with the instructions given to it. Processed and useful data are called information which is used for decision making.

vi) Connectivity: When two or more computers are connected to each other, they can share information and resources such as sharing of files (data/music, etc), sharing of printer, sharing of facilities like the internet. This sharing is possible using wires, cables, satellite, infra-red, bluetooth, microwave transmission, etc.

14.3 Advantages of Computerised Accounting System

The main advantages of computerised accounting system are as follows:

(i) Faster processing: Computers require far less time than human beings in performing a particular task. Therefore, accounting data are processed faster using a computerised accounting system.

(ii) Accurate information: There is less space for error because only one account entry is needed for each transaction unlike repeated posting of the same accounting data in manual system.

(iii) Reliability: Computer systems are immune to boredom, tiredness or fatigue. Therefore, these can perform repetitive functions effectively and are highly reliable.

(iv) Easy availability of information: The data are easily available and can be communicated to different users at the same time.

(v) Up-to-date information: Account balances will always be up to date since the records are automatically updated as and when accounting data are entered or stored.

(vi) Efficiency: The computer based accounting system ensures better use of time and resources.

(vii) Storage and retrieval: Computer based systems require a fractional amount of physical space as compared to the books of accounts in the form of journals, ledgers and accounting registers.

(viii) Works as a motivator to employees: Employees using computer systems feel more valued as they are trained and specialised for the job.

(ix) Automated document production: Accounting reports like trial balance and financial statements are generated automatically and are easily accessible just by a click of the mouse.

(x) MIS Reports: It is easier to monitor and control the business using the real time management reports generated by the computerised information systems.

Student activity

Think: Businesses can benefit by introducing computerised accounting system. But, how would employees feel about this change?

14.4 Limitations of Computerised Accounting System

The main limitations of CAS are being dependent upon the operating environment they work in. Some of them are listed as follows:

(i) Heavy cost of installation: Computer hardware needs replacement and software needs to be updated from time to time with the availability of newer versions.

(ii) Cost of training: To ensure effective and efficient use of computerised system of accounting, newer versions of hardware and software are to be introduced. These require special training and hence, cost is incurred to train the staff personnel.

(iii) Fear of unemployment: On account of the introduction of computerised accounting system, the employees feel insecure that they may lose employment and show less interest in computer related work.

(iv) Disruption of work: When computerised system is introduced, the existing process of accounting and other works are interrupted. This results in certain changes in the working environment.

(v) System failure: The danger of a system crashing due to some failure in hardware can lead to subsequent interruption of work. This is more when no back-up is made.

(vi) Time consuming: When there is system failure, an alternative arrangement needs to be made to avoid loss of work. This consumes some time to bring the regular processes back.

(vii) Unanticipated errors not known: Unlike human beings, computers do not have the capability to judge or detect unanticipated errors in the system.

(viii) Breaches of security: The danger of viruses and hacking into the system from outside creates a strong need for security of the system. Similarly, the person who has created the specific programme can easily defraud by tampering with the original records.

(ix) Health dangers: Extensive use of computers may lead to many health problems such as eye strain, muscular complaints, back ache, etc. resulting in reducing work efficiency as well as increased medical expenditure.

Student activity

Think: "People even without accounting knowledge can work on computerised accounting system" – Do you agree?

DO YOU KNOW? It is possible to track the origins of figures in the accounting system, from the original source document through to figures in the end-of-year final accounts. This is called audit trail.

14.5 Differences between manual and computerised accounting system

The differences between manual accounting and computerised accounting are given below:

Basis	Manual accounting	Computerised accounting
i) Recording of transactions	Transactions are recorded manually.	Transactions are recorded using computers.
ii) Storage	Transactions are stored in volumes of books.	Transactions are stored in well-designed databases.
iii) Preparation of ledger accounts, trial balance and financial statements	Ledger accounts, trial balance and financial statements are prepared manually.	Once journal entries are passed or subsidiary books are entered, data are processed automatically and ledger accounts, trial balance and balance sheet are automatically prepared.
iv) Preparation of report	Analysis of financial statements and preparation of report are to be done manually.	Financial statement analysis such as ratio analysis, preparation of cash flow statement, etc. is automatically done.
v) Time involved	It takes lot of time as everything from journalising to report generation is done manually.	It saves lot of time. Time is taken only for passing journal entries or entering data in subsidiary books. Once date are entered, preparation of ledger, trial balance, financial statements or report generation is done within seconds.
vi) Cost involved	The cost is high in manual accounting as several books of account are to be maintained.	The cost is less compared to manual accounting as all the records are kept in soft copy.
vii) Retrieval of data	It becomes difficult and time consuming to retrieve data as several books have to be gone through.	Retrieval of data is easier as the records are kept in soft copy in data base. By giving instructions, data can be retrieved quickly.
viii) Accuracy	Certain clerical errors such as arithmetical, error in carrying forward, etc. can happen.	If the input given is correct, the output will also be correct. Arithmetical error, error in carrying forward will not happen provided the programming is correct.
ix) Communication of report	Communication of report takes time and it is difficult as it has to be done manually to the users of information.	It is easier and takes lesser time. The report is in soft copy and if online facility is available, it can be communicated to the users very easily at any time and at any place.

14.6 Accounting software

The main function of CAS is to perform the accounting activities in an organisation and generate reports as per the requirements of the users. To obtain the desired results optimally, need based software or packages are to be installed in the organisation. Depending upon the suitability of business requirements there are three types of software, namely, (i) Readymade software, (ii) Customised software and (iii) Tailormade software.

(i) Readymade software

These packages are standardised or readymade packages which can be used by the business enterprises immediately on procurement. These packages are used by small and conventional business enterprises. Cost of installation and maintenance is very low. Training cost is negligible and sometimes the vendor provides free of cost training. These softwares are used by those enterprises where financial transactions are simple, uniform and routine in nature. Few examples of such type of software are Tally, Busy, Marg, Profitbooks.

(ii) Customised software

Many a time, it is not possible that ready-to-use packages suit the requirements of the business enterprise. In such circumstances, customised packages may help the business enterprise for fulfilling their requirements. Customised packages can be modified according to the need of the enterprise. For example, software can record attendance of the employees and on the requirement of the customer it can also count the absence of employees in a month, etc.

These packages are used by medium or large business enterprises. Cost of installation, maintenance and training is relatively higher than that of ready-to-use packages. These softwares are used by those enterprises where financial transactions are somewhat peculiar in nature.

(iii) Tailormade software

Large enterprises have their own way of functioning. For effective management information system, varied and specific information is frequently required by many users which may not be needed in case of small or medium scale enterprises. In such enterprises, depending upon their functioning, need based softwares known as tailored packages are installed. The cost of these packages is very high and specific training for using these packages is also required.

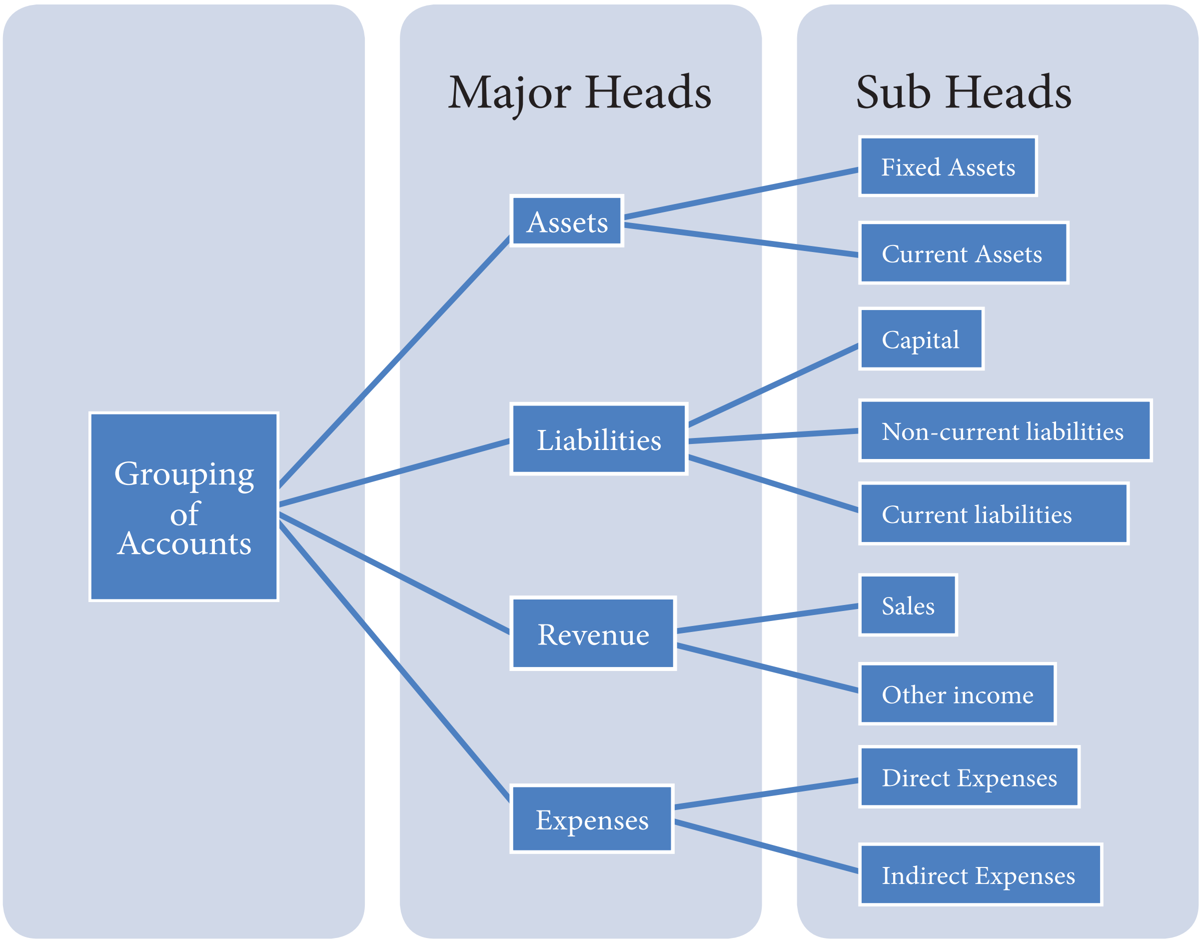
The following are the differences among the three types of software:

Basis	Ready to use software	Customised software	Tailor made software
(i) Nature of business	Small, conventional business	Large, medium business	Large
(ii) Cost of installation and maintenance	Low	Relatively high	High
(iii) Expected level of secrecy (software and data)	Low	Relatively high	Relatively high
(iv) Number of users and their interface	Limited	As per specifications	Unlimited
(v) Linkage to other information system	Restricted	Not restricted	Not restricted

(vi) Adaptability	High	Relatively high	Specific
(vii) Training Requirements	Low	Medium	High

14.7 Grouping and codification of accounts

When the volume and size of the business increase, the number of transaction increases. Therefore, it becomes necessary to have proper classification of data.



14.7.1 Grouping of accounts

In any organisation, the main unit of classification is the major head which is further divided into minor heads. Each minor head may have number of sub-heads. After classification of accounts into various groups namely, major, minor and sub-heads and allotting codes to each account these are programmed into the computer system.

A proper codification requires a systematic grouping of accounts. The major groups or heads could be Assets, Liabilities, Revenues and Expenses. The sub-groups or minor heads could be capital, non-current liabilities, current assets, sales and so on.

In general, the basic classifications of different accounts embodied in a transaction are resorted through accounting equation.

Assets = Liabilities + Capital + (Revenues – Expenses)

Each component of the above equation can be divided into groups of accounts as follows:

A. Liabilities and capital

Capital

- Capital
- Reserves and surplus

Non-Current Liabilities

- Long-term borrowings
- Other long-term liabilities

Current liabilities

- Short term borrowings
- Trade payables
- Other current liabilities

B. Assets

Fixed tangible assets

- Land and building
- Plant and machinery
- Furniture and fixtures

Intangible assets

- Goodwill
- Copyright
- Patents

Current Assets

- Short term investments
- Inventories
- Trade receivables
- Cash and cash equivalents
- Short term loans and advances
- Other current assets

C. Revenues

- Sales
- Other income

D. Expenses

- Material consumed
- Wages
- Manufacturing expenses
- Depreciation
- Administrative expenses
- Interest
- Selling and distribution expenses, etc.

14.7.2 Codification of accounts

Code is an identification mark. Generally, computerised accounting involves codification of accounts. Codification of accounts is needed where there are numerous accounts heads in an organisation. There is a hierarchical relationship between the groups and its components. In order to maintain the hierarchical relationships between a group and its sub-groups, proper codification is required.

The coding scheme of account heads should be such that it leads to grouping of accounts at various levels so as to generate various reports. For example, the codes for various accounts may be allotted as follows:

1 Liabilities and Capital   2 Assets   3 Revenues   4 Expenses

Under Liabilities and Capital

11 Capital   12 Non-current liabilities   13 Current liabilities

Under Assets

21 Non-current assets   22 Current assets

The above codification scheme utilises the hierarchy present in grouping of accounts. Major advantage of such coding is that if the account codes are listed in ascending order, these will be automatically listed as per the desired hierarchy.

14.7.3 Methods of codification

Following are the three methods of codification.

a. Sequential codes

In sequential code, numbers and/or letters are assigned in consecutive order. These codes are applied primarily to source documents such as cheques, invoices, etc. A sequential code can facilitate document search. For example:

Code	Accounts
CL001	ABC LTD
CL002	XYZ LTD
CL003	SCERT

b. Block codes

In a block code, a range of numbers is partitioned into a desired number of sub-ranges and each sub-range is allotted to a specific group. In most of the cases of block codes, numbers within a sub-range follow sequential coding scheme, i.e., the numbers increase consecutively. For example:

Code	Dealer type
100 – 199	Small pumps
200 – 299	Medium pumps
300 – 399	Pipes
400 – 499	Motors

c. Mnemonic codes

A mnemonic code consists of alphabets or abbreviations as symbols to codify a piece of information. For example:

Code	Information
SJ	Sales Journals
HQ	Head Quarters

14.8 Microsoft Office - MS Word and MS Excel Practical

14.8.1 MS-Word

(i) Creation of a word file : Start – All Programs – Microsoft Office – Microsoft Word – File Save As – File name – Save

(ii) Opening of a word file : File – Open – File name – Open

(iii) Saving an existing file : File Save (Short cut key: Control+S)

(iv) For closing a file : File Close

(v) Table creation: Insert – Table – Choose number of rows and columns

(vi) Formatting the text :
- To bold : Control+B;
- To italicise : Control+I
- To underline : Control+U

(vii) Paragraph alignment :
- To align text left : Control+L
- To align text right : Control+R
- To align text centre : Control+E
- To align text justify : Control+J

(viii) Line spacing :
- Single line spacing : Control+1
- Double line spacing : Control+2
- 1.5 line spacing : Control+5

(ix) Page lay out :
- Margin (normal, narrow, wide, etc.)
- Orientation (Portrait, Landscape)
- Size (A4, A5, etc)
- Columns (1,2,3, etc.)

(x) Page number : Insert Page Number (top of the page, bottom of the page, etc.)

14.8.1(a) MS Word Practical

Illustration 1

Type the given below passage in MS-Word and format as directed.

Fra Luca Bartolomeo de Pacioli was an Italian mathematician (1447 – 1517). He is referred to as The Father of Accounting and Book keeping in Europe and he was the first person to publish a work on the double-entry system of book keeping.

Solution

Procedure

(i) Select and bold the name Fra Luca Bartolomeo de Pacioli.

(ii) Add single quote before The Father and after Book keeping.
'The Father of Accounting and Bookkeeping'

(iii) Select and italicise the word Europe.
Europe

(iv) Select and underline the word double-entry.
double-entry

(v) Select the full text and change the font style to Arial and font size to 10

Output:

Fra Luca Bartolomeo de Pacioli was an Italian mathematician (1447 – 1517). He is referred to as 'The Father of Accounting and Book keeping' in *Europe* and he was the first person to publish a work on the <u>double-entry</u> system of book keeping.

14.8.2 MS-Excel

i) Functions

a. Statistical functions

There are several statistical functions such that are inbuilt in MS Excel. The following are explained.

AVERAGE	Returns the average	=AVERAGE(cell1, cell2…)
MAX	Returns the largest value	=MAX(number1,number2)
MIN	Returns the lowest value	=MIN(number1,number2…)
COUNT	Counts the number of cells that contain numbers	=COUNT(value1,value2…)
COUNTA	Counts the number of cells that are not empty.	=COUNTA(range)
COUNTIF	Counts the number of cells that meet the given condition.	=COUNTIF(range,criteria)

b. Text functions

There are several text functions such that are inbuilt in MS Excel. The following are explained.

CONCATENATE	Joins several text strings into one text string	=CONCATENATE(text1, text2…)
UPPER	Converts all letters into Uppercase letters	=UPPER(text)
LOWER	Converts all letters into Lowercase letters	=LOWER(text)

c. Logical functions

There are several logical functions such that are inbuilt in MS Excel. The following are explained.

AND	Returns TRUE if all arguments are TRUE	=AND(logical1,logical2…)

OR	Returns TRUE if any one argument is TRUE else returns FALSE	=OR(logical1,logical2…)
IF	Returns one value if condition is true, and another value if false.	=IF(logical_test,value_if_true,value_if_false)

d. Financial functions

There are several financial functions such that are inbuilt in MS Excel. The following are explained.

SLN	Returns the depreciation of an asset for a specified period using the Straight Line method.	=SLN(cost,salvage,life)
PMT	Calculates the payment for a loan.	=PMT(rate,nper,pv,fv,type)
RATE	Returns interest rate per period of loan.	=RATE(nper,pmt,pv,fv,type)

14.8.2(a) MS-Excel practical

Illustration 2

The following are the scores obtained by some students in a competitive examination. Find out the average, the highest and the lowest score using appropriate function in spreadsheet.

	A	B	C	D	E	F	G	H
1	NAME	Anbu	Balu	Gobu	Ramu	Somu	Raju	Anu
2	SCORES	60	80	164	192	104	64	204

Solution

Procedure

(i) Open a new spreadsheet in MS-Excel

(ii) Enter all given values as given in the question.

(iii) To find the Average mark in cell B5 give the formula

=AVERAGE(B2:H2)

(iv) To calculate the highest score, in cell B3 give the formula

=MAX(B2:H2)

(v) To find the lowest rank in cell B4 give the formula

=MIN(B2:H2)

Answer:

The average score is 124, the highest score is 204 and the lowest score is 60.

Illustration 3

The following table is given to you. Find solution for the following questions.

	A	B	C	D	E	F	G	H	I	J
1	550	156			852	584	TAX	573	GST	1234
2	340	1285	468	584	268	222	CASH	BRS	STOCK	DEBT

A) How many cells contain numbers only?

B) Count the number of cells that contain any value.

C) Count the number of cells containing the value exceeding 1000.

Solution

Procedure

i) Open a new spread sheet in MS-Excel.

ii) Enter the data in cells from A1 to J2 as in the question

iii) To get the Number of cells containing numbers only, write the formula in B3

=COUNT(A1:J2)

iv) To get Number of cells that contain any value, write the formula in B4

=COUNTA(A1:J2)

v) To get the Number of cells which have values exceeding 1000, write the formula in B5

=COUNTIF(A1:J2,">1000")

Answer

A) 12 B) 18 C) 2

Illustration 4 (AND function)

There are three salesmen. Two days of sales achievement is given. You are required to find out the salesmen who have achieved a minimum sale of ₹ 400 on each day.

Salesman	Day 1 ₹	Day 2 ₹
Anand	500	250
Balu	600	500
Cibi	250	300

Solution

Procedure

1. Open new excel sheet.
2. Input the table as given in the question.
3. Enter the data "Achieved" in Cell D1.
4. Type the following in Cell D2:

   =AND(B2>=400,C2>=400)
5. Copy the formula in D2 into D3 and D4

Output

Salesman	Day 1 ₹	Day 2 ₹	Achieved
Anand	500	250	FALSE
Balu	600	500	TRUE
Cibi	250	300	FALSE

Illustration 5 (OR function)

Find out from the following data, minimum collection of ₹ 500 on any one day achieved by the sales counters.

Counter	Day 1 sales ₹	Day 2 sales ₹
Ground floor	600	600
First floor	850	300
Second floor	350	400

Solution

Procedure

1. Open new excel sheet.
2. Input the table as given in the question.
3. Enter the data "Achieved" in Cell D1.
4. Type the following in Cell D2:

   =OR(B2>=500,C2>=500)
5. Copy the formula from D2 into D3 and D4

Output

Counter	Day 1 sales ₹	Day 2 sales ₹	Achieved
Ground Floor	600	600	TRUE
First Floor	850	300	TRUE
Second Floor	350	400	FALSE

Illustration 6 (IF function)

Following is the list of students and percentage of marks obtained by them. If a student has secured a minimum of 50%, he is declared pass, else fail.

Student	Percentage of marks
1	59
2	60
3	65
4	45
5	35

Solution

Procedure

1. Open new excel sheet.
2. Input the table as given in the question.
3. Enter the data "Result" in Cell A3.
4. Type the following in Cell B3

   B3=IF(B1>=50,"Pass","Fail")
5. Copy the formula from B3 to C3, D3 and E3

Output

Student	% of marks	Result
1	59	Pass
2	60	Pass
3	65	Pass
4	45	Fail
5	35	Fail

Illustration 7 (Depreciation – SLN method)

Calculate depreciation under Straight Line Method using Spreadsheet based on the details given below.

A	B	C	D	E	F
Asset	Cost of purchase ₹	Installation charge ₹	Transportation charge ₹	Salvage value ₹	Life in years
1. Machinery	200000	20000	5000	25000	10
2. Furniture	50000	4000	2000	5000	8

Solution

Procedure and answer

(i) Open a new spreadsheet in MS-EXCEL

(ii) Enter labels and values in the cells as given above

(iii) Write total cost in G1 and annual depreciation in H1

(iv) Calculate total cost in the cell G2 by the formula

=Sum(B2:D2) and copy formula to cell G3

(v) Calculate annual depreciation in the cell H2 by the formula

=SLN(G2,E2,F2) and copy formula to cell H3

Output

	A	B	C	D	E	F	G	H
1	**Asset**	**Cost of purchase ₹**	**Installation charge ₹**	**Transportation charge ₹**	**Salvage value ₹**	**Life in years**	**Total cost ₹**	**Annual depreciation ₹**
2	Machinery	200000	20000	5000	25000	10	225000	20,000
3	Furniture	50000	4000	2000	5000	8	56000	6,375

Illustration 8 (PMT)

Consider the following information:

Loan amount ₹ 3,00,000

Number of payment periods 48 months

Annual rate of interest 10%

Calculate periodic payment using PMT function.

Solution

Procedure

i) Open a new spreadsheet in MS-Excel

ii) Enter values in the cells as given below

	A	B
1	Rate of interest (p.a.)	10%
2	Number of instalments (nper)	48
3	Loan amount (pv)	-300000
4	FV	0
5	Type	0

iii) Compute PMT in the cell B6 by the formula

=PMT(B1/12,B2,B3,B4,B5)

Answer ₹ 7,608.78

Illustration 9 (RATE)

Mr. Vivek took a loan of ₹ 2,00,000 from State Bank of India, Chennai and number of installments is 84 months. Calculate the rate assuming payments ₹ 3,300 per month using appropriate function.

Solution

Procedure

(i) Open a new spreadsheet in MS-Excel

ii). Enter values in the cells as given below

	A	B
1	Number of instalments (nper)	84
2	Periodic payment (pmt)	3300
3	Loan amount (pv)	-200000
4	FV	0
5	Type	0

iii) Compute RATE in the cell B6 by the formula

=RATE(B1,B2,B3,B4,B5)*12

Answer 10%

Illustration 10 (Column chart and Line chart)

The total sales volume (Product wise) of TECH Ltd for the year 2016-2017 is given below:

Product	Sales ₹
Toothpaste	22000
Toothbrush	11000
Hair Oil	9000
Shampoo	13000
Toilet Soap	9500

a) Present the data in a column chart

b) Change the chart type to line chart.

Procedure

(a) **Column chart**

(i) Enter the data given in the table in a new spreadsheet.

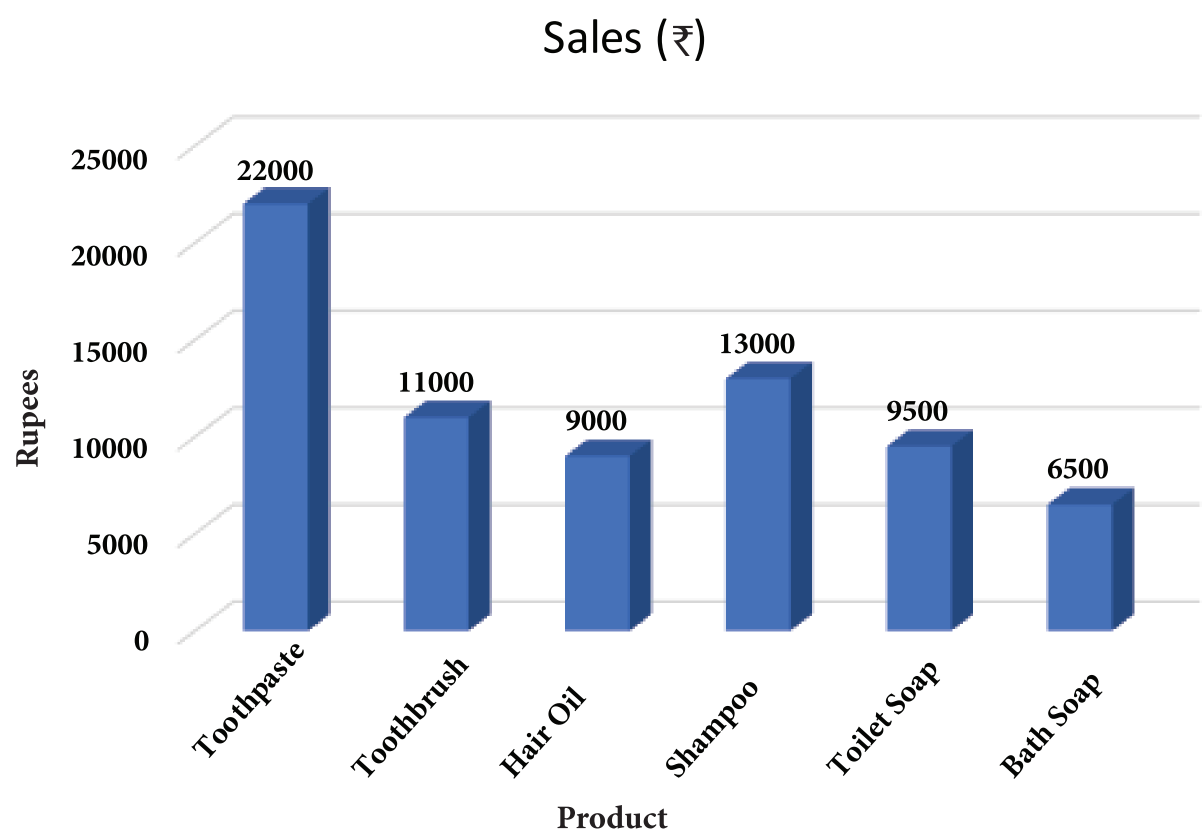
(ii) Select the data range from A1 to B7.

(iii) Go to Insert menu and select Column Chart (3D)

(iv) Right click column chart and select 'Add Data Labels'

(v) Choose layout tab under Chart tools.

(vi) Select Axis title and name them.



(b) Line Chart

(i) Select the data range from A1 to B7.

(ii) Go to Insert menu and select Line Chart (2D)

(iii) Right click chart and select 'Add Data Labels'

(iv) Choose layout tab under Chart tools.

(v) Select Axis title and name them.

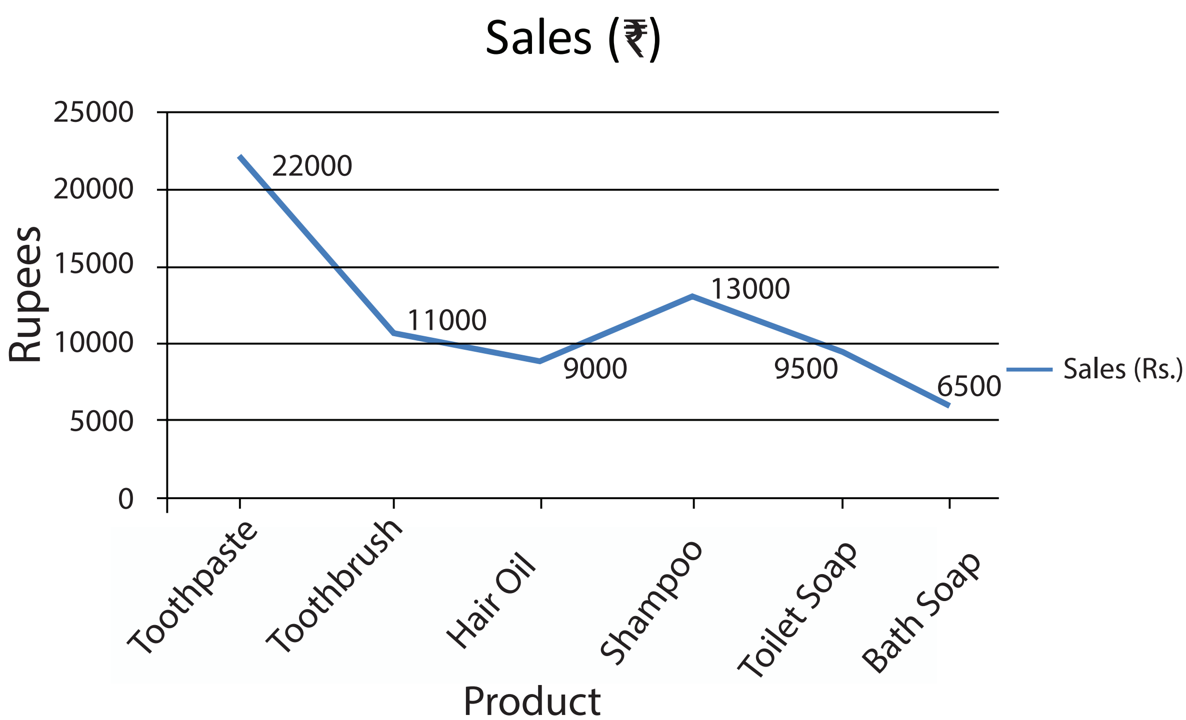


Illustration 11 (Pie Chart)

Sales volume of Moon Ltd during 2017 is given below.
Draw Pie chart.

	A	B	C	D	E	F	G
1	**CITY**	Chennai	Coimbatore	Madurai	Trichy	Tanjore	Tirunelveli
2	**SALES** (₹ in lakhs)	500	350	250	250	200	150

Procedure

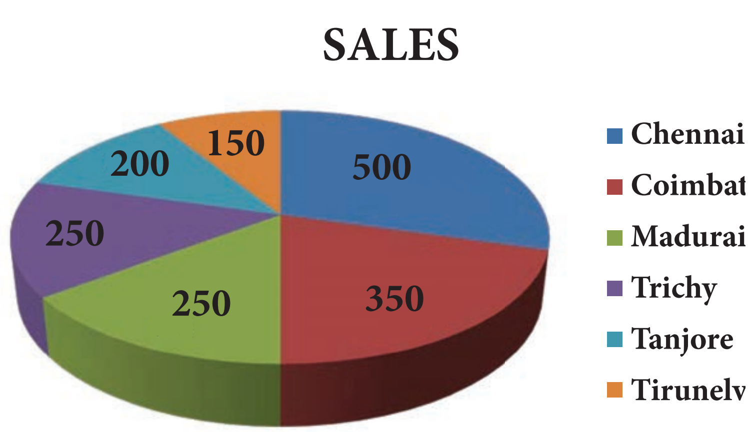
Pie chart

(i) Enter the data given in the table in a new spreadsheet.

(ii) Select the data range from A1 to G2.

(iii) Go to Insert menu and select Pie Chart (3D Type)

(iv) Right click pie chart and select 'Add Data Labels'



Output (Pie chart)

Points to remember

- Computers play a major role in various business activities.
- In accounting computer is commonly used in many areas such as, recording business transactions, payroll accounting etc.
- Accounting softwares are classified as (i) Readymade software, (ii) Customised software and (iii) Tailormade software.
- Few of the software commonly used in business include, MS-office, (Word, Excel etc.), Tally, SAP, Finacle.

Self - examination questions

AU2GGH

I Multiple Choice Questions

Choose the correct answer

1. In accounting, computer is commonly used in the following areas:
   (a) Recording of business transactions
   (b) Payroll accounting
   (c) Stores accounting
   (d) All the above

2. Customised accounting software is suitable for
   (a) Small, conventional business
   (b) Large, medium business
   (c) Large, typical business
   (d) None of the above

3. Which one is not a component of computer system?
   (a) Input unit
   (b) Output unit
   (c) Data
   (d) Central Processing Unit

4. An example of output device is
   (a) Mouse
   (b) Printer
   (c) Scanner
   (d) Keyboard

5. One of the limitations of computerised accounting system is
   (a) System failure
   (b) Accuracy
   (c) Versatility
   (d) Storage

6. Which one of the following is not a method of codification of accounts?
   (a) Access codes
   (b) Sequential codes
   (c) Block codes
   (d) Mnemonic codes
7. TALLY is an example of
   (a) Tailor-made accounting software
   (b) Ready-made accounting software
   (c) In-built accounting software
   (d) Customised accounting software
8. People who write codes and programes are called as
   (a) System analysts
   (b) System designers
   (c) System operators
   (d) System programmers
9. Accounting software is an example of
   (a) System software
   (b) Application software
   (c) Utility software
   (d) Operating software

Answer

1 (d)	2 (b)	3 (c)	4 (b)	5 (a)	6 (a)	7 (b)	8 (d)	9 (b)

II Very short answer questions

1. What is a computer?
2. What is CAS?
3. What is hardware?
4. What is meant by software?
5. What is accounting software?
6. Name any two accounting packages.
7. Give any two examples of readymade software.
8. What is coding?
9. What is grouping of accounts?
10. What are mnemonic codes?

III Short answer questions

1. What are the various types of accounting software?
2. Mention any three limitations of computerised accounting system.
3. State the various types of coding methods.
4. List out the various reports generated by computerised accounting system.
5. State the input and output devices of a computer system.

CASE STUDY

The manager of a medium- sized business is considering the introduction of computerised accounting system. Some staff feels that it is an opportunity to learn new skill. The manager has promised free training for their staff. So, the staff realise that their own skill can be enhanced. Also, there is a demand for highly skilled staff. But, some staff feels threatened by these changes. They feel that they may not be able to learn new skill. Moreover, some of them are nearing their retiring age. So they think that it is not needed for them. But the manager expects the cooperation from all the staff.

Now, discuss on the following points:

- Will it be expensive for the business to introduce computerised accounting system?
- Will everyone get the access to use the computers? In such a case, how to protect data?
- "People at the retirement age are not required to learn new skill" – Do you think so?
- What are the factors to be considered by the managers before introducing CAS?

To explore further

Is it possible to maintain the confidentiality in computerised accounting system? How is it possible?

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GLOSSARY

Account (A/c)	கணக்கு (க/கு)
Accountancy	கணக்குப் பதிவியல்
Accountant	கணக்காளர்
Accounting	கணக்கியல்
Accounting concepts	கணக்கியல் கருத்துகள்
Accounting conventions	கணக்கியல் மரபுகள்
Accounting cycle	கணக்கியல் சுழல்
Accounting equation	கணக்கியல் சமன்பாடு
Accounting principles	கணக்கியல் கோட்பாடுகள்
Accounting standard	கணக்கியல் தரம்
Accounting Standards Board	கணக்கியல் தரக்குழு
Accounting terminologies	கணக்கியல் கலைச்சொற்கள்
Accrued income	பெறவேண்டிய வருமானம்
Adjusted purchases	சரிக்கட்டப்பட்ட கொள்முதல்
Adjusting entries	சரிக்கட்டுப் பதிவுகள்
Amortisation	போக்கெழுதுதல்
Analytical petty cash book	பாகுபடுத்தப்பட்ட சில்லறை ரொக்க ஏடு
Annuity method	ஆண்டுத் தொகை முறை
Artificial person	சட்டமுறை அமைப்புகள்
Assets	சொத்துகள்
Bad debts	வாராக் கடன்
Balance	இருப்பு
Balance b/d	இருப்பு கீ/கொ (கீழ் கொண்டு வரப்பட்டது)
Balance c/d	இருப்பு கீ/இ (கீழ் இறக்கப்பட்டது)
Balance method	இருப்பு முறை
Balance Sheet	இருப்பு நிலைக் குறிப்பு
Balancing	இருப்புக் கட்டுதல்
Bank	வங்கி
Bank overdraft	வங்கி மேல்வரைப் பற்று
Bank pass book	வங்கிச் செல்லேடு
Bank reconciliation statement	வங்கிச் சரிகட்டும் பட்டியல்
Bank statement	வங்கி அறிக்கை
Bank transactions	வங்கி நடவடிக்கைகள்
Barter system	பண்டமாற்று முறை
Bill of exchange	மாற்றுச்சீட்டு
Bills payable	செலுத்தற்குரிய மாற்றுச்சீட்டு
Bills receivable	பெறுதற்குரிய மாற்றுச்சீட்டு
Book keeping	கணக்கேடுகள் பராமரிப்பு
Books of prime entry	முதன்மைப் பதிவு ஏடுகள்

Branches of accounting	கணக்கியல் பிரிவுகள்
Capital	முதல்
Capital expenditure	முதலினச் செலவினம்
Capital receipts	முதலின வரவுகள்
Capital transaction	முதலின நடவடிக்கை
Carriage	தூக்குக் கூலி
Carriage inwards	உள் தூக்குக் கூலி
Carriage outwards	வெளி தூக்குக் கூலி
Cash	ரொக்கம்
Cash book	ரொக்க ஏடு
Cash discount	ரொக்கத் தள்ளுபடி
Cash receipt	ரொக்கச் சீட்டு
Cash transaction	ரொக்க நடவடிக்கை
Cheque	காசோலை
Closing balance	இறுதி இருப்பு
Closing entries	இறுதிப் பதிவுகள்
Closing stock	இறுதிச் சரக்கிருப்பு
Columnar petty cash book	பல பத்திகளுடையச் சில்லறை ரொக்க ஏடு
Company	நிறுமம்
Compensating errors or Offsetting errors	ஈடுசெய் பிழைகள்
Compound journal entry	கூட்டுக் குறிப்பேட்டுப் பதிவு
Computer	கணினி
Computerised accounting	கணினிமயமாக்கப்பட்ட கணக்கியல்
Contra entry	எதிர்ப் பதிவு
Cost accounting	அடக்கவிலைக் கணக்கியல்
Credit	வரவு
Credit balance	வரவு இருப்பு
Credit card	கடன் அட்டை
Credit note	வரவுக் குறிப்பு
Credit side	வரவுப் பக்கம்
Credit transaction	கடன் நடவடிக்கை
Creditor	கடனீந்தோர்
Current account	நடப்புக் கணக்கு
Current asset	நடப்புச் சொத்து
Current liability	நடப்புப் பொறுப்பு
Days of Grace	சலுகை நாட்கள்
Debit	பற்று
Debit balance	பற்று இருப்பு
Debit card	எடுப்பு அட்டை
Debit note	பற்றுக் குறிப்பு
Debit side	பற்றுப் பக்கம்
Debtor	கடனாளி
Deferred revenue expenditure	நீள்பயன் வருவாயினச் செலவு
Depreciation	தேய்மானம்

Discount	தள்ளுபடி
Discounting	தள்ளுபடி செய்தல்
Dishonour	மறுக்கப்படுதல்
Dividend	பங்காதாயம்
Double column cash book	இருபத்தி ரொக்க ஏடு
Double entry system	இரட்டைப் பதிவுமுறை
Drawings	எடுப்புகள்
Error	பிழை
Error of complete omission	முழு விடு பிழை
Error of partial omission	பகுதி விடு பிழை
Errors in accounting	கணக்கியல் பிழைகள்
Errors of recording	பதிவு செய்தல் பிழைகள்
Errors of balancing	இருப்புக் கட்டல் பிழைகள்
Errors of carrying forward	முன் எடுத்து எழுதுதல் பிழைகள்
Errors of casting	கூட்டல் பிழைகள்
Errors of commission	செய் பிழைகள்
Errors of omission	விடு பிழைகள்
Errors of posting	எடுத்தெழுதுதல் பிழைகள்
Errors of principle	விதிப்பிழைகள்
Expenses	செலவுகள்
Fictitious assets	கற்பனைச் சொத்துகள்
Final Accounts	இறுதிக் கணக்குகள்
Financial accounting	நிதிநிலைக் கணக்கியல்
Financial statement	நிதிநிலை அறிக்கை
Fixed assets	நிலைச் சொத்துகள்
Freight	வண்டிக் கட்டணம்
Furniture	அறைகலன்
General reserve	பொதுக் காப்பு
Goods	சரக்கு
Goodwill	நற்பெயர்
Gross profit	மொத்த இலாபம்
Hardware	வன்பொருள்
Human resources accounting	மனிதவளக் கணக்கியல்
Impersonal accounts	ஆள்சாராக் கணக்குகள்
Imprest system	முன்பண மீட்பு முறை
Income	வருமானம்
Income received in advance	முன்கூட்டிப் பெற்ற வருமானம்
Insolvency	நொடிப்பு நிலை
Institute of Chartered Accountants of India	இந்தியப் பட்டயக் கணக்காளர் நிறுவனம்
Insurance	காப்பீடு
Intangible asset	புலனாகாச் சொத்துகள்
Interest	வட்டி
Interest on capital	முதல் மீது வட்டி
Interest on drawings	எடுப்புகள் மீது வட்டி

Interest on investments	முதலீடுகள் மீதான வட்டி
Interest on loan	கடன் மீதான வட்டி
International Accounting Standards Committee	பன்னாட்டு கணக்கியல் தரக்குழு
International Financial Reporting Standards	பன்னாட்டு நிதி அறிக்கை தரநிலைகள்
Investments	முதலீடுகள்
Invoice	இடாப்பு
Journal	குறிப்பேடு
Journal entry	குறிப்பேட்டுப் பதிவு
Journal proper	உரிய குறிப்பேடு
Journalising	குறிப்பேட்டில் பதிவு செய்தல்
Ledger	பேரேடு
Ledger posting	பேரேட்டில் எடுத்தெழுதுதல்
Liabilities	பொறுப்புகள்
Liquidity	நீர்மைத் தன்மை
Long term liabilities	நீண்டகாலப் பொறுப்புகள்
Loss	நட்டம்
Machinery	இயந்திரம்
Management accounting	மேலாண்மைக் கணக்கியல்
Merger	இணைப்பு
Narration	விளக்கக் குறிப்பு
Net profit	நிகர இலாபம்
Nominal Accounts	பெயரளவுக் கணக்குகள்
Opening balance	தொடக்க இருப்பு
Opening entry	தொடக்கப் பதிவு
Opening Stock	தொடக்கச் சரக்கிருப்பு
Outstanding	கொடுபட வேண்டியது
Pay-in-slip	செலுத்துச்சீட்டு
Personal A/c	ஆள்சார் கணக்கு
Petty cash book	சில்லறை ரொக்க ஏடு
Posting	எடுத்தெழுதுதல்
Preliminary expenses	தொடக்கச் செலவுகள்
Premium	முனைமம்
Prepaid	முன் கூட்டிச் செலுத்தியவை
Profit	இலாபம்
Profit and Loss A/c	இலாபநட்டக் கணக்கு
Provision	ஒதுக்கு
Provision for bad and doubtful debts	வாரா ஐயக்கடன் ஒதுக்கு
Provision for discount on debtors	கடனாளிகள் மீதான தள்ளுபடி ஒதுக்கு
Purchase returns / Return outwards	கொள்முதல் திருப்பம் / வெளித் திருப்பம்
Purchases	கொள்முதல்
Purchases book	கொள்முதல் ஏடு
Purchases returns book	கொள்முதல் திருப்ப ஏடு
Real accounts	சொத்துக் கணக்குகள்

Rectification of errors	பிழைகளைத் திருத்துதல்
Rectifying entries	திருத்தப் பதிவுகள்
Rent	வாடகை
Representative personal account	பிரதிநிதித்துவ ஆள்சார் கணக்கு
Reserve	காப்பு
Revenue	வருவாய்
Revenue expenditure	வருவாய்சார் செலவுகள்
Revenue receipts	வருவாய்சார் வரவுகள்
Revenue transactions	வருவாயின நடவடிக்கைகள்
Salary	ஊதியம்
Sale	விற்பனை
Sales book	விற்பனை ஏடு
Sales returns / Returns inwards	விற்பனைத் திருப்பம் / உள்திருப்பம்
Sales returns book	விற்பனைத் திருப்ப ஏடு
Savings account	சேமிப்புக் கணக்கு
Scrap	எறி மதிப்பு
Share	பங்கு
Single column cash book	தனிப்பத்தி ரொக்க ஏடு
Social Responsibility Accounting	சமூகப் பொறுப்புக் கணக்கியல்
Software	மென்பொருள்
Sole proprietor	தனியாள் உரிமையாளர்
Solvency	கடன் தீர்க்கும் திறன்
Source documents	ஆதார ஆவணங்கள்
Stock	சரக்கிருப்பு
Straight line method	நேர்கோட்டு முறை
Subsidiary books	துணை ஏடுகள்
Sundry creditors	பற்பல கடனீந்தோர்
Sundry debtors	பற்பல கடனாளிகள்
Sundry expenses	பற்பல செலவுகள்
Suspense account	அனாமத்துக் கணக்கு
Tangible assets	புலனாகும் சொத்துகள்
Three column cash book	முப்பத்தி ரொக்க ஏடு
Total method	மொத்தத் தொகை முறை
Trade discount	வியாபாரத் தள்ளுபடி
Trading account	வியாபாரக் கணக்கு
Transaction	நடவடிக்கை
Transfer entries	மாற்றுப் பதிவுகள்
Travel expenses	பயணச் செலவுகள்
Trial Balance	இருப்பாய்வு
Voucher	சான்றாவணம்
Wage	கூலி
Written down value	குறைந்து செல் மதிப்பு

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