Unit 1: Introduction to Accounting

Content

- Need for accounting and types of accounts. Accounting concepts and Conventions, GAAP, Accounting Standards, Accounting Equations, Preparation of Journal & Ledger accounts, Preparation of Trial Balance, Rectification of Errors and Types of Errors.

Introduction

- Profit to a business is like food to human body.
- Accounting is commonly referred to as the “language of the business” as it is effectively employed to communicate the financial performance of business to various interested parties.
- It is concerned with the measurement and communicating financial data.

Need for Accounting

- The basic aim of accounting in a business entity is to provide financial information for making decisions on its activities.
- This information can be provided only when business transactions are recorded, classified and summarized properly.
- Business transactions are numerous, that it is not possible to recall his memory as to how the money had been earned and spent.
- In all activities and in all organisations which require money and other economic resources, acounting is required to account for it.

Accountancy

- ***Accountancy*** refers to a systematic knowledge of accounting.
- It explains "why to do" and "how to do" of various aspects of accounting. It tells us why and how to prepare the books of accounts and how to summarize the accounting information and communicate it to the interested parties.

Accounting

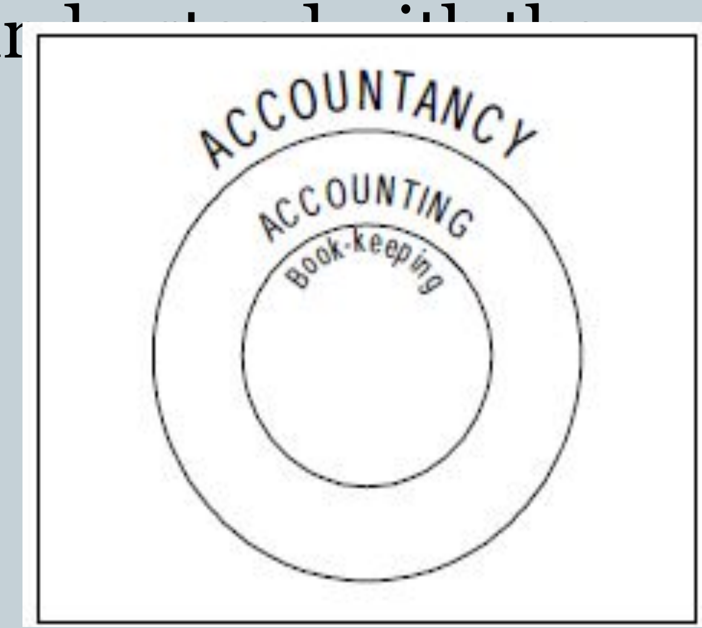
- The process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information. (American Accounting Association).
- The art of recording, classifying and summarising, in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character and interpreting the results thereof. (The American Institute of Certified Public Accountants)

Book Keeping

- **R.N. Carter says, "Book-keeping is the science and art of** correctly recording in the books of account all those business transactions that result in the transfer of money or money's worth".
- J. R. Batliboi is "Book-keeping is an art of recording business transactions in a set of books."

Relationship between Accountancy, Accounting and Book-Keeping

- Book-keeping provides the basis for accounting and it is complementary to accounting process.
- Accounting begins where book-keeping ends. Accountancy includes accounting and book-keeping.
- This relationship can be easily un help of the following diagram.



Difference between Book-Keeping and Accounting

Sl. No.	Basis of Distinction	Book-keeping	Accounting
1.	Scope	Recording and maintenance of books of accounts.	It is not only recording and maintenance of books of accounts but also includes analysis, interpreting and communicating the information.
2.	Stage	Primary stage.	Secondary stage.
3.	Objective	To maintain systematic records of business transactions.	To ascertain the net result of the business operation.
4.	Nature	Often routine and clerical in nature.	Analytical and executive in nature.
5.	Responsi--bility	A book-keeper is respon--sible for recording business transactions.	An accountant is also responsible for the work of a book-keeper.
6.	Supervision	The book-keeper does not supervise and check the work of an Accountant.	An accountant supervises and checks the work of the book-keeper.
7.	Staff involved	Work is done by the junior staff of the organisation.	Senior staff performs the accounting work.

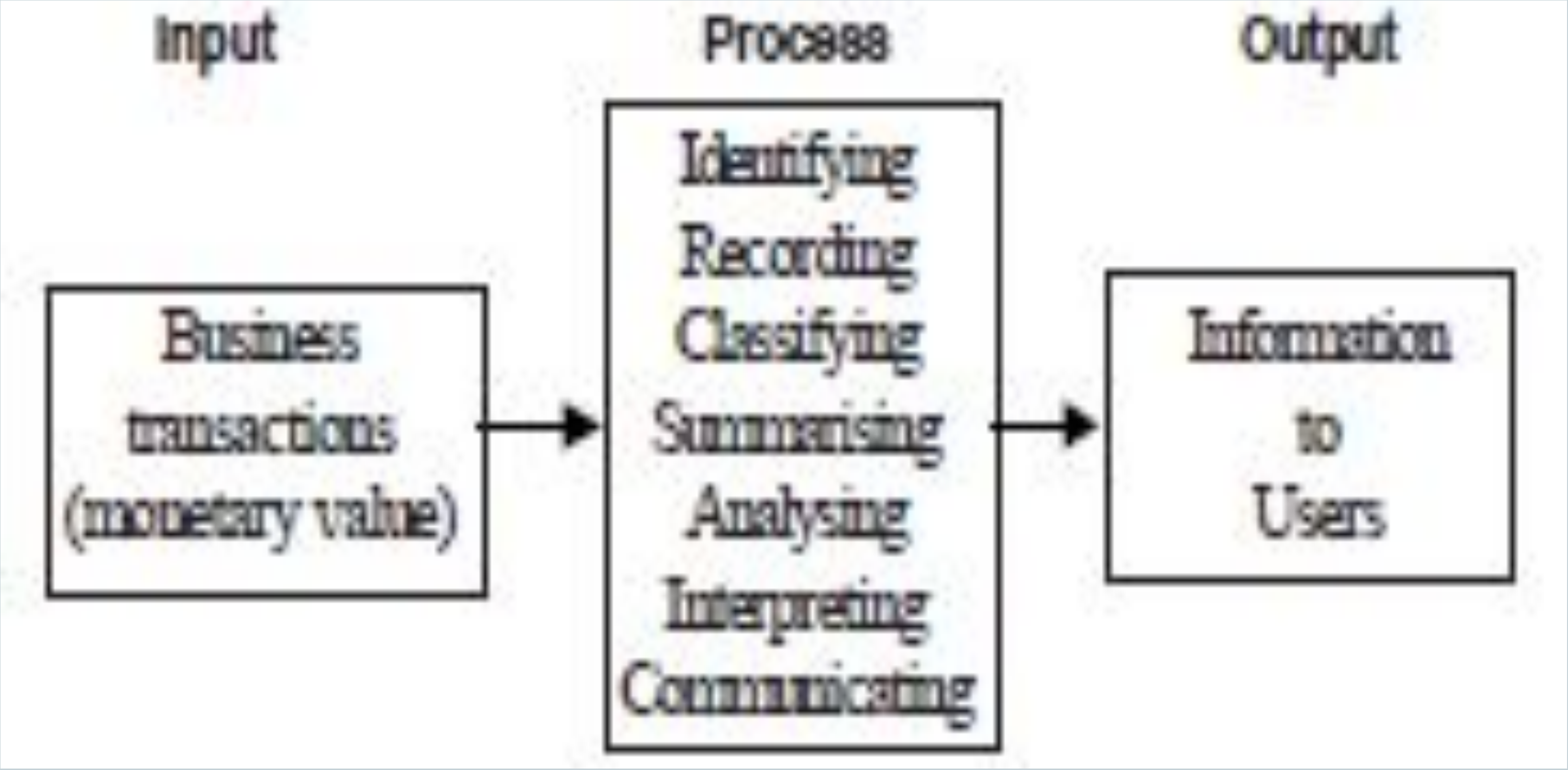
Objectives of Accounting

- Maintenance of records of Business Transactions.
- Calculation of Profit and Loss.
- Depiction of financial position.
- Providing accounting information to users.
- To facilitate proper management of cash.

Features of Accounting or Process of Accounting

- Identifying.
- Measuring.
- Recording.
- Classifying.
- Summarising.
- Analysing and Interpreting.
- Communicating.

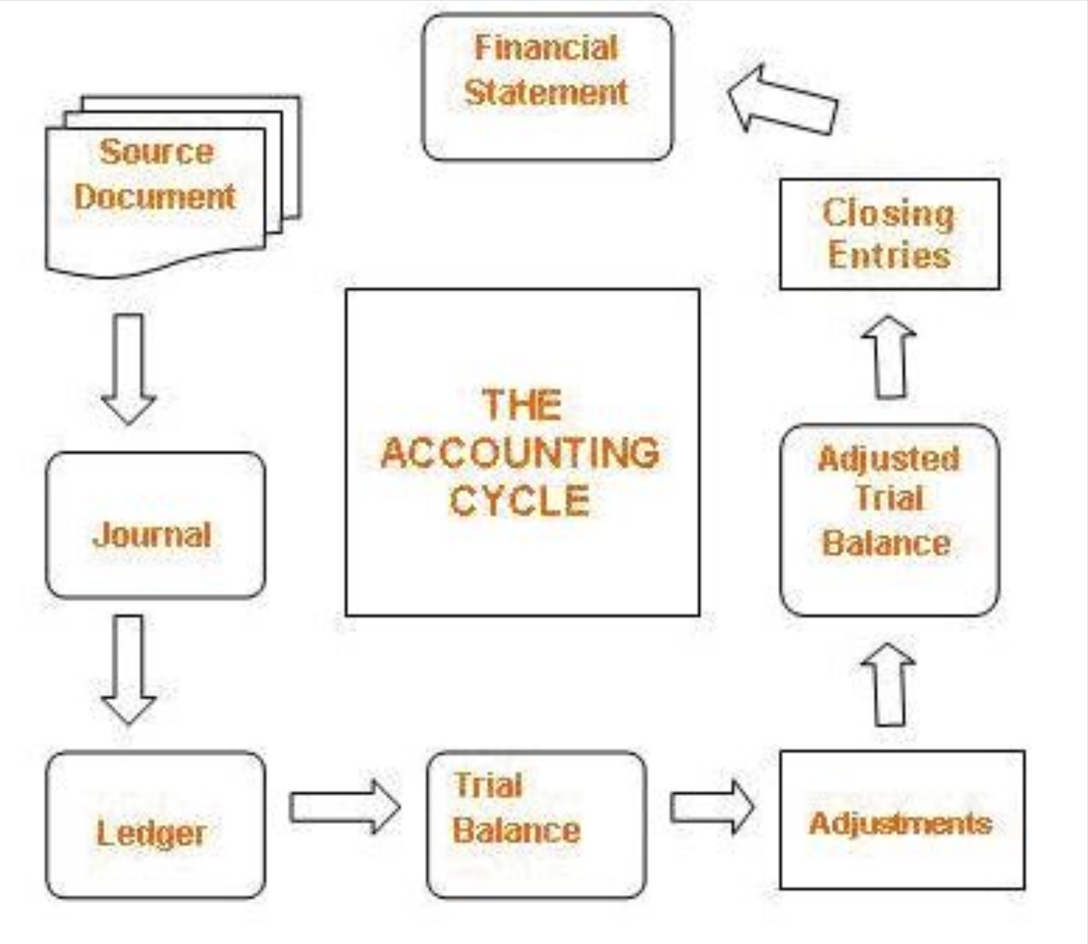
Features of Accounting or Process of Accounting



Accounting Cycle

Accounting Cycle is a series of accounting process which begins with the identification of an economic activity or transaction, recording of the economic activity and ends with the preparation of the financial statements.

Accounting Cycle



Importance of Accounting

- Facilitates to comply with legal requirements.
- It shows the mode of investment for shareholders.
- It provides business trade credit for suppliers.
- It notifies the risks of loan in business for banks and lenders.
- Facilitates to replace memory.
- Facilitates to ascertain net result of operations.
- Facilitates to ascertain financial position.
- Facilitates the users to take decisions.
- Facilitates a comparative study.

Importance of Accounting

- Assists the management in planning and controlling business activities and in taking decisions.
- Facilitates control over assets.
- Facilitates the settlement of tax liability.
- Facilitates the ascertainment of value of business.
- Facilitates raising of loans.
- Acts as legal evidence.

Scope of Accounting

- As accounting derives its usefulness from the social value of the environment in which it is developed, its scope and definition change with the passage of time.
- In general, it is argued that accounting is concerned with the provision of information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of potential users in making economic decisions.

Scope of Accounting

- The apparently divergent needs of internal and external users of accounting information have resulted in the development of sub-disciplines within the accounting discipline namely,

1) Financial Accounting: It is concerned with recording of business transactions in the books of accounts in such a way that operating result of a particular period and financial position on a particular date can be known.
2) Cost Accounting: It relates to collection, classification and ascertainment of the cost of production or job undertaken by the firm.

Scope of Accounting

3) Management Accounting: It relates to the use of accounting data collected with the help of financial accounting and cost accounting for the purpose of policy formulation, planning, control and decision making by the management.

4) Social Responsibility accounting: It is the accounting for social responsibility aspects of a business. Management is held responsible for what it contributes to the social well being and progress.

Users of Accounting Information

Basic Accounting Terminologies

- Transactions: Transactions are those activities of a business, which involve transfer of money or goods or services between two persons or two accounts. *For example, purchase of goods, sale of goods, etc*. Transactions are of two types, namely, cash and credit transactions.
- Proprietor: A person who owns a business is called its proprietor.
- Capital: It is the amount invested by the proprietor/s in the business. *For example, if Mr.Anand* starts business with Rs.5,00,000, his capital would be Rs.5,00,000.

Basic Accounting Terminologies

- Assets: Any physical thing or right owned that has a money value is an asset. In other words, an asset is that expenditure which results in acquiring of some property or benefits of a lasting nature. For Example, Cash in hand, plant and machinery, furniture and fittings, bank balance, debtors, Goodwill, patents, etc.
- Liabilities: Liabilities refer to the financial obligations of a business. These denote the amounts which a business owes to others, e.g., loans from banks or other persons, creditors for goods supplied, etc.
- Drawings: It is the amount of cash or value of goods withdrawn from the business by the proprietor for his personal use.

Basic Accounting Terminologies

- Debtors: A person (individual or firm) who receives a benefit without giving money or money's worth immediately, but liable to pay in future or in due course of time is a debtor. *For example, Mr.Arul bought* goods on credit from Mr.Babu for Rs.10,000. Mr.Arul is a debtor to Mr.Babu till he pays the value of the goods.
- Creditors: A person who gives a benefit without receiving money or money's worth immediately but to claim in future, is a creditor. The creditors are shown as a liability in the balance sheet. In the above example Mr.Babu is a creditor to Mr.Arul till he receive the value of the goods.

Basic Accounting Terminologies

- Purchases: Purchases refers to the amount of goods bought by a business for resale or for use in the production. Goods purchased for cash are called cash purchases. If it is purchased on credit, it is called as credit purchases.
- Purchases Return or Returns Outward: When goods are returned to the suppliers due to defective quality or not as per the terms of purchase, it is called as purchases return.

Basic Accounting Terminologies

- Sales: Sales refers to the amount of goods sold that are already bought or manufactured by the business. When goods are sold for cash, they are cash sales but if goods are sold and payment is not received at the time of sale, it is credit sales.
- Sales Return or Returns Inward: When goods are returned from the customers due to defective quality or not as per the terms of sale, it is called sales return or returns inward.

Basic Accounting Terminologies

- Stock: Stock includes goods unsold on a particular date.
- Revenue: Revenue means the amount receivable or realized from sale of goods and earnings from interest, dividend, commission, etc.
- Expense: The terms ‘expense’ refers to the amount incurred in the process of earning revenue. If the benefit of an expenditure is limited to one year, it is treated as an
- expense (also know is as revenue expenditure) such as payment of salaries and rent..
- Income/Profit: Income is the difference between revenue and expense.

Basic Accounting Terminologies

- **Expenditure:** Expenditure takes place when an asset or service is acquired.
- The expenditure might be for a significant long term asset (capital expenditure), a short term asset (prepaid insurance), a reduction in a liability, or for an immediate expense such as rent (Revenue Expenditure).

Basic Accounting Terminologies

- Voucher: It is a written document in support of a transaction. It may be in the form of cash receipt, invoice, cash memo, bank pay-in-slip etc.
- Invoice: Invoice is a business document which is prepared when one sell goods to another. The statement is prepared by the seller of goods.
- Receipt: Receipt is an acknowledgement for cash received. It is issued to the party paying cash.
- Account: An account is a brief history of financial transactions of a particular person or item. An account has two sides called debit side and credit side.

Basis of Accounting

- Transactions are recorded either of the two basis.:
- ➢ Cash Basis (or)
- ➢ Accrual Basis
- ➢ **Cash Basis:** Under this method, income is not counted until cash (or a cheque) is actually received, and expenses are not counted until they are actually paid.
- ➢ **Accrual Basis:** In addition to actual receipts and payments of cash, income receivable and expenses payable are also recorded.

Basis of Accounting

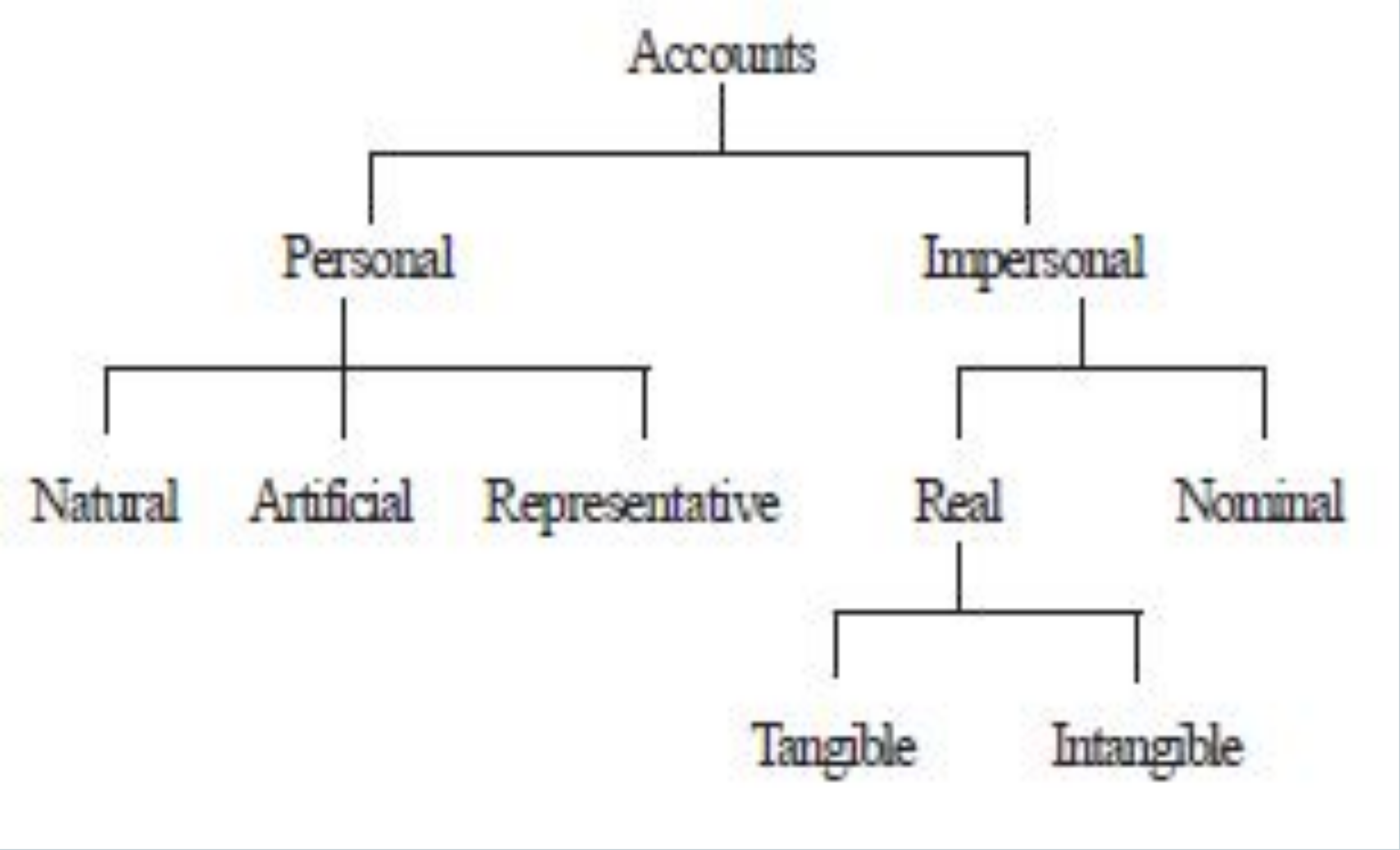
EXAMPLE

Your computer installation business finishes a job in November, and doesn't get paid until three months later in January. Under the cash method, you would record the payment in January. Under the accrual method, you would record the income in your November books.

EXAMPLE

You purchase a new laser printer on credit in May and pay $1,000 for it in July, two months later. Using the cash method, you would record a $1,000 payment for the month of July, the month when the money is actually paid. Under the accrual method, you would record the $1,000 payment in May, when you take the laser printer and become obligated to pay for it.

Classification of Accounts



Classification of Accounts

I. **Personal Accounts :** The accounts which relate to persons. Personal accounts include the following.

i. **Natural Persons :** Accounts which relate to individuals. For example, Mohan's A/c, Shyam's A/c etc.

ii. **Artificial persons :** Accounts which relate to a group of persons or firms or institutions. For example, HMT Ltd., Indian Overseas Bank, Life Insurance Corporation of India, Cosmopolitan club etc.

iii. **Representative Persons:** Accounts which represent a particular person or group of persons. For example, outstanding salary account, prepaid insurance account, etc.

Classification of Accounts

II. **Impersonal Accounts:** All those accounts which are not personal accounts. This is further divided into two types viz. Real and Nominal accounts.

i. **Real Accounts:** Accounts relating to properties and assets which are owned by the business concern. Real accounts include tangible and intangible accounts. For example, Land, Building, Goodwill, Purchases, etc.

ii. **Nominal Accounts:** These accounts do not have any existence, form or shape. They relate to incomes and expenses and gains and losses of a business concern. For example, Salary Account, Dividend Account, etc.

Illustration

- 1. Capital 2. Sales
- 3. Drawings 4. Outstanding salary
- 5. Cash 6. Rent
- 7. Interest paid 8. Indian Bank
- 9. Discount received 10. Building
- 11. Bank 12. Chandrasekhar
- 13. Murugan Lending Library
- 14. Advertisement
- 15. Purchases

Accounting Equation

- Accounting equation is based on dual aspect concept (Debit and Credit). It emphasizes on the fact that every transaction has a two sided effect i.e., on the assets and claims on assets.
- Always the total claims (those of outsiders and of the proprietors) will be equal to the total assets of the business concern.
- The claims are also known as equities, are of two types: i.) Owners equity (Capital); ii.) Outsiders' equity (Liabilities).

Accounting Equation

- Assets = Equities
- Assets = Capital + Liabilities (A = C+L)
- Capital = Assets – Liabilities (C = A–L)
- Liabilities = Assets – Capital (L = A–C).

Accounting Equation

Assets	
Increases	Decreases
Debits	***Credits***

Liabilities and Owners' Equities	
Decreases	Increases
Debits	***Credits***

Expenses and Losses	
Increases	Decreases
Debits	***Credits***

Revenue and Income	
Decreases	Increases
Debits	***Credits***

Accounting Equation

- ***Illustration 1:*** If the total assets of a business are Rs.3,60,000 and capital is Rs.2,00,000, calculate liabilities.
- **Solution**

  Assets = Capital + Liabilities

  Liabilities = Assets – Capital

  Assets – Capital = Liabilities

  Rs. 3,60,000 – Rs. 2,00,000 = Rs. 1,60,000

Accounting Equation

- ***Illustration 2:***

1) ***Transaction 1: Murugan started business with Rs.50,000 as capital.***

Assets = Capital + Liabilities

Cash = Capital + Liabilities

Rs. 50,000 = Rs. 50,000 + 0

Accounting Equation

- ***Transaction 2:*** Murugan purchased furniture for cash Rs.5,000.

The accounting equation now is as follows:

Assets = Capital + Liabilities

Cash + Furniture = Capital + Liabilities

Transaction 1 50,000 + 0 = 50,000 + 0

Transaction 2 (–) 5,000 + 5,000 = 0 + 0

Equation 45,000 + 5,000 = 50,000 + 0

Accounting Equation

- ***Transaction 3: He purchased goods for cash Rs.30,000.***

Assets = Capital +Liabilities

Cash + Furniture + Stock = Capital +Liabilities

(Goods)

Transaction 1&2 45,000 + 5,000 + 0 = 50,000 + 0

Transaction 3 (–) 30,000 + 0 + 30,000 = 0 + 0

Equation 15,000 + 5,000 + 30,000 = 50,000 + 0

Generally Accepted Accounting Principles

- The common set of accounting principles, standards and procedures that companies use to compile their financial statements.
- GAAP are a combination of authoritative standards (set by policy boards) and simply the commonly accepted ways of recording and reporting accounting information.

Accounting Concepts

- Accounting Concepts may be considered as postulates i.e., basic assumptions or conditions upon which the science of accounting is based.
- The main objective is to maintain uniformity and consistency in accounting records.

Types of Accounting Concepts

- Business Entity
- Money Measurement
- Going Concern
- Cost
- Dual Aspect
- Accounting Period
- Matching
- Realisation
- Objective Evidence
- Accrual

Business Entity Concept

- This concept assumes that, for accounting purposes, the business enterprise and its owners are two separate independent entities. Thus, the business and personal transactions of its owner are separate.
- For example, when the owner invests money in the business, it is recorded as liability of the business to the owner. Similarly, when the owner takes away from the business cash/goods for his/her personal use, it is not treated as business expense.

Money Measurement Concept

- This concept assumes that all business transactions must be in terms of money, that is in the currency of a country. Thus, as per the money measurement concept, transactions which can be expressed in terms of money are recorded in the books of accounts.
- For example, sale of goods worth Rs.200000, purchase of raw materials Rs.100000, Rent Paid Rs.10000 etc. are expressed in terms of money, and so they are recorded in the books of accounts.

Going-concern Concept

- This concept states that a business firm will continue to carry on its activities for an indefinite period of time. Simply stated, it means that every business entity has continuity of life. Thus, it will not be dissolved in the near future.

Cost Concept

- Cost concept states that all assets are recorded in the books of accounts at their purchase price, which includes cost of acquisition, transportation and installation and not at its market price.
- For example, a machine was purchased by XYZ Limited for Rs.500000, for manufacturing shoes. An amount of Rs.1,000 were spent on transporting the machine to the factory site. In addition, Rs.2000 were spent on its installation. The total amount at which the machine will be recorded in the books of accounts would be the sum of all these items i.e. Rs.503000.

Dual Aspect Concept

- This concept assumes that every transaction has a dual effect, i.e. it affects two accounts in their respective opposite sides. Therefore, the transaction should be recorded at two places. It means, both the aspects of the transaction must be recorded in the books of accounts.
- For example, goods purchased for cash has two aspects which are (i) Giving of cash (ii) Receiving of goods. These two aspects are to be recorded.
- Thus, the duality concept is commonly expressed in terms of fundamental accounting equation :

  Assets = Liabilities + Capital
- The above accounting equation states that the assets of a business are always equal to the claims of owner/owners and the outsiders.

Accounting Period Concept

- All the transactions are recorded in the books of accounts on the assumption that profits on these transactions are to be ascertained for a specified period. This is known as accounting period concept.
- Thus, this concept requires that a balance sheet and profit and loss account should be prepared at regular intervals.

Matching Concept

- Though the business is a continuous affair, its continuity is artificially split into several accounting years for determining the periodical results. Thus, expenses of a particular period are compared with the revenues of that period to determine the net operational results of that accounting period.
- As for example; rent for twelve months whether paid or not is matched against the revenues earned during these twelve months.

Realisation Concept

- This concept states that revenue from any business transaction should be included in the accounting records only when it is realised.
- The term realisation means creation of legal right to receive money. Selling goods is realisation, receiving order is not.
- In other words, revenue is said to have been realised when cash has been received or right to receive cash on the sale of goods or services or both has been created.
- In short, the realisation occurs when the goods and services have been sold either for cash or on credit.

Objective Evidence Concept

- This concept means that all accounting entries should be evidenced and supported by business documents such as invoices, vouchers, etc.
- This concept also implies that the evidences must be completely objective, and must be subject to verification by auditors.

Accrual Concept

- The Accrual concept is concerned with the recognition of both revenues and expenses.
- The meaning of accrual is something that becomes due especially an amount of money that is yet to be paid or received at the end of the accounting period.
- It means that revenues are recognised when they become receivable. Though cash is received or not received and the expenses are recognised when they become payable though cash is paid or not paid.
- For example, if the firm received goods costing Rs.20000 on 29th March 2005 but the payment is made on 2nd April 2005 the accrual concept requires that expenses must be recorded for the year ending 31st March 2005 although no payment has been made until 31st March 2005 though the service has been received and the person to whom the payment should have been made is shown as creditor.

Accounting Conventions

- The term "accounting conventions" refer to the customs or traditions, which are used as a guide in the preparation of meaningful financial records in the form of the income statement (Profit and Loss Account) and the position statement (Balance Sheet).
- Conventions help in comparing accounting data of different business units or of the same unit for different periods. These have been developed over the years.

Types of Accounting Conventions

- Convention of consistency.
- Convention of full disclosure.
- Convention of materiality.
- Convention of conservatism.

Convention of Consistency

- This convention signifies that the accounting practices and methods should remain the consistent from one accounting year to another.
- For instance, when once a particular method of depreciation is adopted for a particular fixed asset, the same method should be followed for that asset year after year.

Convention of Full Disclosure

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

Convention of Materiality

- The convention of materiality states that, to make financial statements meaningful, only material fact i.e. important and relevant information should be supplied to the users of accounting information.
- Material fact means the information of which will influence the decision of its user.

Convention of Conservatism

- This convention is based on the principle that **"Anticipate no profit, but provide for all possible losses"**.
- The main objective of this convention is to show minimum profit. Profit should not be overstated.
- Thus, this convention clearly states that profit should not be recorded until it is realised. But if the business anticipates any loss in the near future, provision should be made in the books of accounts for the same.
- For example, while valuing stock in trade, market price or cost price whichever is less is considered.

Accounting Standards

- The term standard denotes a discipline, which provides both guidelines and yardsticks for evaluation.
- As guidelines, accounting standard provides uniform practices and common techniques of accounting.
- The Institute of Chartered Accountant of India (ICAI) constituted the Accounting Standards Board (ASB) in April, 1977 for developing accounting standards. However, the International Accounting Standards Committee (IASC) was set up in 1973, with its headquarter in London (U.K.).
- The Accounting Standards Board is entrusted with the responsibility of formulating standards on significant accounting matters keeping in view the international developments, and legal requirements in India.

Accounting Standards

- The main <u>function of the ASB</u> is to identify areas in which uniformity in standards is required and to develop draft standards after discussions with representatives of the Government, public sector undertaking, industries and other agencies.
- The <u>objective of ASB</u> is to standardize the diverse accounting policies and practices with a view to eliminate to the extent possible the non-comparability of financial statements and the reliability to the financial statements.

Compliance with Accounting Standards Issued by ICAI

- Sub Section(3A) to section 211 of Companies Act, 1956 requires that every Profit/Loss Account and Balance Sheet shall comply with the Accounting Standards. 'Accounting Standards' means the standard of accounting recomended by the ICAI and prescribed by the Central Government in consultation with the National Advisory Committee on Accounting Standards (NACAs) constituted under section 210(1) of companies Act, 1956.

Accounting Standards Issued by ICAI

AS 1	Disclosure of Accounting Policies
AS 2	Valuation of Inventories
AS 3	Cash Flow Statements
AS 4	Contingencies and Events Occurring after the Balance Sheet Date
AS 5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
AS 6	Depreciation Accounting
AS 7	Construction Contracts
AS 8	Accounting for Research and Development (Withdrawn pursuant to AS 26 becoming mandatory)
AS 9	Revenue Recognition
AS 10	Accounting for Fixed Assets
AS 11	The Effects of Changes in Foreign Exchange Rates
AS 12	Accounting for Government Grants
AS 13	Accounting for Investments
AS 14	Accounting for Amalgamations
AS 15	Employee Benefits
AS 16	Borrowing Costs
AS 17	Segment Reporting
AS 18	Related Party Disclosures
AS 19	Leases
AS 20	Earnings Per Share

Accounting Standards Issued by ICAI

AS 21	Consolidated Financial Statements
AS 22	Accounting for Taxes on Income
AS 23	Accounting for Investments in Associates in Consolidated Financial Statements
AS 24	Discontinuing Operations
AS 25	Interim Financial Reporting
AS 26	Intangible Assets
AS 27	Financial Reporting of Interests in Joint Ventures
AS 28	Impairment of Assets
AS 29	Provisions, Contingent Liabilities and Contingent Assets
AS 30	Financial Instruments: Recognition and Measurement
AS 31	Financial Instruments: Presentation

Accounting Standards (AS) 1 - Disclosure of Accounting Policies

- **Disclosure of Accounting Policies:** Accounting Policies refer to specific accounting principles and the method of applying those principles adopted by the enterprises in preparation and presentation of the financial statements.
- This Standard prescribes the basis for presentation of general purpose financial statements to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities.

Accounting Standard (AS) 2 - Valuation of Inventories

- **Valuation of Inventories:** The objective of this standard is to formulate the method of computation of cost of inventories / stock, determine the value of closing stock / inventory at which the inventory is to be shown in balance sheet till it is not sold and recognized as revenue.

Accounting Standard (AS) 3 - Cash Flow Statements

- **Cash Flow Statements:** Cash flow statement is additional information to user of financial statement. This statement exhibits the flow of incoming and outgoing cash. This statement assesses the ability of the enterprise to generate cash and to utilize the cash. This statement is one of the tools for assessing the liquidity and solvency of the enterprise.
- The objective of this Standard is to require the provision of information about the historical changes in cash and cash equivalents of an entity by means of a statement of cash flows which classifies cash flows during the period from operating, investing and financing activities.

Accounting Standard (AS) 4 - Contingencies and Events Occurring after the Balance Sheet Date

- **Contingencies and Events occurring after the balance sheet date:** In preparing financial statement of a particular enterprise, accounting is done by following accrual basis of accounting and prudent accounting policies to calculate the profit or loss for the year and to recognize assets and liabilities in balance sheet.
- While following the prudent accounting policies, the provision is made for all known liabilities and losses even for those liabilities / events, which are probable. Professional judgement is required to classify the likehood of the future events occuring and, therefore, the question of contingencies and their accounting arises.

Accounting Standard (AS) - 5 Net Profit or Loss for the Period, Prior Period Items and Changes in AS

- **Net Profit or Loss for the Period, Prior Period Items and change in Accounting Policies :** The objective of this accounting standard is to prescribe the criteria for certain items in the profit and loss account so that comparability of the financial statement can be enhanced. Profit and loss account being a period statement covers the items of the income and expenditure of the particular period.

Accounting Standard (AS) 6 - Depreciation Accounting

- *Depreciation* is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes.
- Different accounting policies for depreciation are adopted by different enterprises. Disclosure of accounting policies for depreciation followed by an enterprise is necessary to appreciate the view presented in the financial statements of the enterprise.

Accounting Standard (AS) 7 - Construction Contracts

- Accounting for long term construction contracts involves question as to when revenue should be recognized and how to measure the revenue in the books of contractor.
- As the period of construction contract is long, work of construction starts in one year and is completed in another year or after 4-5 years or so. Therefore question arises how the profit or loss of construction contract by contractor should be determined.
- There may be following two ways to determine profit or loss: On year-to-year basis based on percentage of completion or On completion of the contract.

Accounting Standard (AS) 8 - Accounting for Research and Development

- Standard deals with the treatment of costs of research and development in financial statements.
- Costs incurred for research and development include the following:

(i) salaries, wages and other related costs of personnel;

(ii) costs of materials and services consumed;

(iii) depreciation of building, equipment and facilities which have alternative economic use, to the extent that they are used for research and development;

(iv) an appropriate amortization of the cost of building, equipment and facilities which have no alternative economic use, to the extent that they are used for research and development;

(v) a reasonable allocation of overhead costs;

(vi) payment to outside bodies for research and development projects related to the enterprise; and

(vii) other costs, such as the amortization of patents and licenses.

Accounting Standard (AS) 9 - Revenue Recognition

- Revenue is a charge made to customers / clients for goods supplied and services rendered.
- The standard explains as to when the revenue should be recognized in profit and loss account and also states the circumstances in which revenue recognition can be postponed.

Accounting Standard (AS) 10 - Accounting for Fixed Assets

- Fixed asset is an asset, which is:- Held with intention of being used for the purpose of producing or providing goods and services. Not held for sale in the normal course of business. Expected to be used for more than one accounting period.
- Fixed assets often comprise a significant portion of the total assets of an enterprise, and therefore are important in the presentation of financial position. Furthermore, the determination of whether an expenditure represents an asset or an expense can have a material effect on an enterprise’s reported results of operations.

Accounting Standard (AS) 11 - The Effects of Changes in Foreign Exchange Rates

- An enterprise may have transactions in foreign currencies or it may have foreign branches. Foreign currency transactions should be expressed in the enterprise's reporting currency and the financial statements of foreign branches should be translated into the enterprise's reporting currency in order to include them in the financial statements of the enterprise.
- The principal issues in accounting for foreign currency transactions and foreign branches are to decide which exchange rate to use and how to recognize in the financial statements the financial effect of changes in exchange rates.

Accounting Standard (AS) 12 - Accounting for Government Grants

- Government grants are sometimes called by other names such as subsidies, cash incentives, duty drawbacks, etc.
- The receipt of government grants by an enterprise is significant for preparation of the financial statements for two reasons. Firstly, if a government grant has been received, an appropriate method of accounting therefore is necessary. Secondly, it is desirable to give an indication of the extent to which the enterprise has benefited from such grant during the reporting period. This facilitates comparison of an enterprise's financial statements with those of prior periods and with those of other enterprises.

Double Entry System

- Double entry system was introduced to the business world by an Italian merchant named Lucas Pacioli in 1494 A.D.
- According to **J.R.Batliboi "Every business transaction has a** two-fold effect and that it affects two accounts in opposite directions and if a complete record were to be made of each such transaction, it would be necessary to debit one account and credit another account. It is this recording of the two fold effect of every transaction that has given rise to the term Double Entry System".

Golden Rules of Accounting

S.No.	Name of Account	Debit Aspect	Credit Aspect
1.	Personal	The receiver	The giver
2.	Real	What comes in	What goes out
3.	Nominal	All expenses and losses	All incomes and gains.

Accounting Equation- Modern Approach

Assets	
Increases	Decreases
Debits	***Credits***

Liabilities and Owners' Equities	
Decreases	Increases
Debits	***Credits***

Expenses and Losses	
Increases	Decreases
Debits	***Credits***

Revenue and Income	
Decreases	Increases
Debits	***Credits***

Illustration

During the month of January 2001, ABC Ltd. has made the following transactions –

Item No.	*Date*	*Transactions*
1.	January 1	Issued 10,000 shares of Rs. 10 each in cash
2.	2	Purchased machinery costing Rs. 50,000 from Y Ltd.
3.	3	Purchased raw materials from Z Ltd. worth Rs. 10,000
4.	15	Paid wages in cash Rs. 15,000
5.	17	Sold goods to PQR Ltd. for Rs. 25,000
6.	18	Paid cash to Y Ltd. Rs. 20,000
7.	19	Received from PQR Ltd. Rs. 20,000

Solution

Item no.	*Accounts involved*	*Nature of A/c*	*Dr.(Rs.)*	*Cr.(Rs.)*
1.	Cash	Real	1,00,000	
	Shareholders	Personal A/c		1,00.000
2.	Machinery	Real	50,000	
	Y Ltd.	Personal		50,000
3.	Purchases	Nominal	10,000	
	Z Ltd.	Personal		10,000
4.	Wages	Nominal	15,000	
	Cash	Real		15,000
5.	PQR Ltd.	Personal	25,000	
	Sales	Nominal		25,000
6.	Y Ltd.	Personal	20,000	
	Cash	Real		20,000
7.	Cash	Real	20,000	
	PQR Ltd.	Personal		20,000

Journals

- The book in which the transaction is recorded for the first time is called journal or book of original entry.
- Journal is derived from French word “Jour” which means a day. Journal, therefore, means a daily record of business transactions.
- *Journal is one of the books of original entry in which transactions* are originally recorded in a chronological (day-to-day) order according to the principles of Double Entry System.

Characteristics of Journal

1. Journal is the first successful step of the double entry system. A transaction is recorded first of all in the journal. So the journal is called the book of original entry.
2. A transaction is recorded on the same day it takes place. So, journal is called Day Book.
3. Transactions are recorded chronologically, So, journal is called chronological book
4. For each transaction the names of the two concerned accounts indicating which is debited and which is credited, are clearly written in two consecutive lines. This makes ledger-posting easy. That is why journal is called "Assistant to Ledger" or "subsidiary book"
5. Narration is written below each entry.
6. The amount is written in the last two columns - debit amount in debit column and credit amount in credit column.

Format of Journal

Date (1)	Particulars (2)	L.F (3)	Amount (Dr.) (4)	Amount (Cr.) (5)
DD/MM	Account to be debited ....Dr. To Account to be credited (Narration)		XXX	 XXX

Explanation on Format of Journal

- ***1. <u>Date</u> :*** In the first column, the date of the transaction is entered. The sequence of the dates and months should be strictly maintained.

- ***2. <u>Particulars</u> :*** Each transaction affects two accounts, out of which one account is debited and the other account is credited.
- The name of the account to be debited is written first, very near to the line of particulars column and the word **Dr. is also written at the end of the** particulars column.
- In the second line, the name of the account to be credited is written, starts with the word '**To', a few space away from** the margin in the particulars column to the make it distinct from the debit account.

Explanation on Format of Journal

- ***3.*** **<u>Narration :</u>** After each entry, a brief explanation of the transaction together with necessary details is given in the particulars column with in brackets called **narration**. The words ‘For’ or ‘Being' are used before starting to write down narration. Now, it is not necessary to use the word ‘For’ or ‘Being’.
- ***4.*** **<u>Ledger Folio *(L.F):*</u>** All entries from the journal are later posted into the ledger accounts. The page number or folio number of the Ledger, where the posting has been made from the Journal is recorded in the L.F column of the Journal. Till such time, this column remains blank.
- ***5.*** **<u>Debit Amount :</u>** In this column, the amount of the account being debited is written.
- ***6.*** **<u>Credit Amount :</u>** In this column, the amount of the account being credited is written.

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**'.

Steps in Journalising

Step 1 → Determine the two accounts which are involved in the transaction.

Step 2 → Classify the above two accounts under Personal, Real or Nominal.

Step 3 → Find out the rules of debit and credit for the above two accounts.

Step 4 → Identify which account is to be debited and which account is to be credited.

Step 5 → Record the date of transaction in the date column. The year and month is written once, till they change. The sequence of the dates and months should be strictly maintained.

Step 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. in the same line. Against this, the amount to be debited is written in the debit amount column in the same line.

Step 7 → Write the name of the account to be credited in the second line starts with the word 'To' a few space away from the margin in the particulars column. Against this, the amount to be credited is written in the credit amount column in the same line.

Step 8 → Write the narration within brackets in the next line in the particulars column.

Step 9 → Draw a line across the entire particulars column to seperate one journal entry from the other.

Advantages of Journal

1. Each transaction is recorded as soon as it takes place. So there is no possibility of any transaction being omitted from the books of account.
2. Since the transactions are kept recorded in journal, chronologically with narration, it can be easily ascertained when and why a transaction has taken place.
3. For each and every transaction which of the two concerned accounts will be debited and which account credited, are clearly written in journal. So, there is no possibility of committing any mistake in writing the ledger.
4. Since all the debits of transaction are recorded in journal, it is not necessary to repeat them in ledger. As a result ledger is kept tidy and brief.
5. Journal shows the complete story of a transaction in one entry.
6. Any mistake in ledger can be easily detected with the help of journal.

Points to be noted while passing journal entries

- All business transactions are recorded in the books of the business form the point of view of the business, and not from the point of view of the proprietor.
- When the proprietor commences business with loan borrowed from his wife, children or friend, the two accounts that are required to taken into consideration are (1) cash a/c and (2) Wife's/Friend's/Children's Loan a/c.

Points to be noted while passing journal entries

- When a business withdraws cash or goods for personal use (called drawings), it should be debited to drawings a/c and credited to cash/purchase a/c. Eg:- Income tax, chariry, life insurance premium, etc.
- When it is not clearly stated in the transaction whether goods are bought for cash or on credit, the purchase should be considered as cash purchase, if the name of the supplier (i.e, seller) of goods is not stated. On the other hand, if the name of the supplier is mentioned, the purchase should be considered as credit purchase and vice versa for sale of good for cash or credit.

Points to be noted while passing journal entries

- Purchase or sale of Investment, a/c involved is Investment a/c and not Purchase a/c. The purchase or sale of investment Market value is considered and not the face value.
- Brokerage is added for purchase of investment and is deducted when it is sold.

Points to be noted while passing journal entries

- **Trade discount** is an allowance or concession granted by the seller to the buyer, if the customer purchases goods above a certain quantity or above a certain amount. The amount of the purchase made, is always arrived at after deducting the trade discount, ie., only the net amount is considered.
- For example, if the list price (price prescribed by the manufacturers or wholesalers) of a commodity is Rs.100, and trade discount granted by manufacturer to the wholesaler is 20% then cost price of the commodity to the wholesaler is Rs.80.
- Trade discount is not recorded in the books. They are used for determining the net price.

Points to be noted while passing journal entries

- Sale of goods on credit is a common phenomenon in any business. When goods are sold on credit the customers enjoy a facility of making payment on some date in the future. In order to encourage them to make the payment before the expiry of the credit period a deduction is offered. The deduction so made is known as **cash discount**.
- For example, If Ram purchases goods worth Rs.5,000 on 30 days credit then, as per the terms of contract, he is authorised to make payment 30 days after the date of purchase. If he is offered a cash discount of 2% on payment within 10 days and if he does so, he is entitled to deduct Rs.100 from the invoice price and pay Rs.4,900. In this case Rs.100 is cash discount. But if he does not choose to make payment within 10 days then he will not get any cash discount. In this case he will pay Rs.5,000 after 30 days.

Difference between Trade and Cash Discount

S.No	Basis of Distinction	Trade Discount	Cash Discount
1.	Parties	It is a reduction granted by a manufacturer/ supplier	It is a reduction granted by a whole-saler (creditor) to the buyer (debtor).
2.	Purpose	To help the retailer to earn some profit.	To encourage prompt payment within a stipulated period.
3.	Time when allowed	It is allowed on the purchase of goods.	It is allowed when payment is made within the specified period.
4.	Variation	It is usually given at the same rate which is applicable to all customers and will vary with the quantity purchased.	It varies from customer to customer depending on the time and period of payment.
5.	Disclosure	It is shown by way of deduction in the invoice itself.	It is not shown in the invoice.
6.	Ledger Account	A separate Account is not opened in the Ledger.	A separate Account is opened in the Ledger for discount received and discount allowed.

Ledger

- The term ‘Ledger’ is derived from the Dutch word ‘Legger’, which means to lie. Therefore , Ledger means a book where the various accounts lie (i.e., are kept).
- A ledger account is a summary statement of all the transactions relating to particular person, thing (i.e., an asset) or a service (i.e., an expense or an income) which have taken place during a given period of time, showing their net effect.
- According to **L.C. Cropper, ‘the book which contains a classified** and permanent record of all the transactions of a business is called the Ledger’.

Features of Ledger

- Ledger is an account book that contains various accounts to which various business transactions of a business enterprise are posted.
- It is an analytical record of transactions.
- It is a derived or secondary record.
- It is a book of final entry.
- It is the principle book of accounts. It is rightly called the king of books of accounts.
- It is a permanent record of transactions.
- It is the ‘reference book of accounting system

Format of Ledger

Name of Account

Dr. Cr.

Date	Particulars	J.F	Amount Rs. P.	Date	Particulars	J.F	Amount Rs. P.
Year Month Date	To (Name of Credit Account in Journal)			Year Month Date	By (Name of Debit account in Journal)		

Explanation on format of Ledger

- Each ledger account is divided into two parts. The left hand side is known as the debit side (Dr.) and the right hand side is known as the credit side (Cr.).
- The name of the account is mentioned in the top (middle) of the account.
- The date of the transaction is recorded in the date column.
- The word ‘To’ is used before the accounts which appear on the debit side of an account in the particulars column. Similarly, the word ‘By’ is used before the accounts which appear on the credit side of an account in the particulars column.

Explanation on format of Ledger

- The name of the other account which is affected by the transaction is written either in the debit side or credit side in the particulars column.
- The page number of the Journal or Subsidiary Book from where that particular entry is transferred, is entered in the Journal Folio (J.F) column.
- The amount pertaining to this account is entered in the amount column.

Examples

Personal Accounts

Santhosh Account

Dr.	Cr.
Debit Santhosh when he receives goods, money or value from the business	Credit Santhosh when he gives goods, money or value to the business

Real Accounts

Computer Account

Dr.	Cr.
Debit Purchase of asset	Credit Sale of asset

Nominal Accounts

Salaries Account

Dr.	Cr.
Debit expenses or losses	

Commission Received Account

Dr.	Cr.
	Credit incomes or gains

Importance of Ledger

- Knowledge of Business results
- Knowledge of book value of assets
- Useful for management
- Knowledge of Financial Position
- Instant Information
- Arithmetical Accuracy

Types of Ledger

Types of Ledger

1. **Assets Ledger :** It contains accounts relating to assets only e.g. Machinery account, Building account, Furniture account, etc.
2. **Liabilities Ledger :** It contains the accounts of various liabilities e.g. Capital (Owner or partner), Loan' account, Bank overdraft, etc.
3. **Revenue Ledger :** It contains the revenue accounts e.g.. Sales account, Commission earned account, Rent received account, interest received account, etc.
4. **Expenses Ledger :** It contains the various accounts of expenses incurred, e.g. Wages account, Rent paid account, Electricity charges account, etc.
5. **Debtors Ledger :** It contains the accounts of the individual trade debtors of the business. Individuals, firms and institutions to whom goods and services are sold on credit by business become the 'trade debtors' of the business.
6. **Creditors Ledger :** It contains the accounts of the individual trade Creditors of the business. Individuals, firms and institutions from whom a business purchases goods and services on credit are called 'trade creditors' of the business.
7. **General Ledger :** It contains all those accounts which are not covered under any of the above types of ledger. For example Landlord A/c, Prepaid insurance A/c etc.

Posting

- The process of transferring the entries recorded in the journal or subsidiary books to the respective accounts opened in the ledger is called **Posting.**
- In other words, posting means grouping of all the transactions relating to a particular account at one place.
- It is necessary to post all the journal entries into various accounts in the ledger because posting helps us to know the net effect of various transactions during a given period on a particular account.

Procedure of posting

I. Procedure of posting for an Account which has been debited in the journal entry.

Step 1 → Locate in the ledger, the account to be debited and enter the date of the transaction in the date column on the debit side.

Step 2 → Record the name of the account credited in the Journal in the particulars column on the debit side as "To..... (name of the account credited)".

Step 3 → Record the page number of the Journal in the J.F column on the debit side and in the Journal, write the page number of the ledger on which a particular account appears in the L.F. column.

Step 4 → Enter the relevant amount in the amount column on the debit side.

Procedure of posting

II. **Procedure of posting for an Account which has been credited in the journal entry.**

Step 1 → Locate in the ledger the account to be credited and enter the date of the transaction in the date column on the credit side.

Step 2 → Record the name of the account debited in the Journal in the particulars column on the credit side as "By...... (name of the account debited)"

Step 3 → Record the page number of the Journal in the J.F column on the credit side and in the Journal, write the page number of the ledger on which a particular account appears in the L.F. column.

Step 4 → Enter the relevant amount in the amount column on the credit side.

Illustration 1

Mr. Ram started business with cash Rs. 5,00,000 on 1st June 2003.

The above transaction will appear in Journal and Ledger as under.

Solution :

In the Books of Ram
Journal

Date	Particulars		L.F	Debit Rs.	Credit Rs.
2003 June 1	Cash A/c. To Ram's Capital A/c (Ram started business with Rs.5,00,000)	Dr		5,00,000	5,00,000

Note : Here two accounts are involved, Cash Account and Ram's capital account, so we should allot in the ledger a page for each account.

Ledger

Dr. **Cash Account** Cr.

Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
2003 June 1	To Ram's Capital A/c		5,00,000				

Dr. **Ram's Capital Account** Cr.

Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
				2003 June 1	By Cash A/c		5,00,000

Difference Between Journal and Ledger

Basis of Distinction	Journal	Ledger
1) Nature of Book	Book of original or prime entry.	Book of final or secondary entry.
2) Basis for Preparation	Source Documents.	Journal.
3) Stage of Recording	First.	Second.
4) Objective of Preparation	To record all transactions in chronological order.	To know the net effect of various transactions affecting a particular account.
5) Format	5 columns: date, particulars, L.F., Dr. amount and Cr. Amount.	Identical 4 Columns on Dr. and Cr. Side: Date, Particulars, folio and amount.
6) Narration	Yes.	No.
7) Process of recording entries	Journalising	Posting
8) Tax authorities	Do not rely upon these Books	Rely on the ledger for assessment purpose.

Balancing an Account

- Balance is the difference between the total debits and the total credits of an account.
- **Balancing means the writing of the difference between the amount** columns of the two sides in the lighter (smaller total) side, so that the grand totals of the two sides become equal.

Procedure for Balancing

(i) Take the total of the two sides of the concerned account.

(ii) Ascertain the difference between the totals of both sides.

(iii) If the debit side is more than the credit side it means the account has a debit balance and the difference is written on the credit side by writing 'By balance c/d' in the particulars column and the amount in the amount column. 'C/d' means 'carried down'. On the other hand, if the credit side is more than the debit side it means that the account has a credit balance and the difference is written on the debit side by writing the words 'To Balance c/d' in the particulars column and the amount in the amount column.

(iv) In the beginning of the next accounting period the 'balance c/d' is posted as 'balance b/d' on the other side as opening balance before posting any other transaction, for e.g., if in an account there is 'By balance c/d Rs. 6,000' then in the beginning of the next accounting period it will be shown as 'To balance b/d', 'Balance c/d' means 'Balance Carried down' and 'Balance b/d' means 'balance brought down'.

Trial Balance

- Trial balance is a statement which shows debit balances and credit balances of all accounts in the ledger.
- “Trial balance is a statement, prepared with the debit and credit balances of ledger accounts to test the arithmetical accuracy of the books” – **J.R. Batliboi.**

Objectives

- The objectives of preparing a trial balance are:

1. To check the arithmetical accuracy of the ledger accounts.
2. To locate the errors.
3. To facilitate the preparation of final accounts.

Advantages

i. It helps to ascertain the arithmetical accuracy of the book-keeping work done during the period.

ii. It supplies in one place ready reference of all the balances of the ledger accounts.

iii. If any error is found out by preparing a trial balance, the same can be rectified before preparing final accounts.

iv. It is the basis on which final accounts are prepared.

Methods

1. **The Total Method : According to this method, the total** amount of the debit side of the ledger accounts and the total amount of the credit side of the ledger accounts are recorded.
2. **The Balance Method : In this method, only the balances** of an account either debit or credit, as the case may be, are recorded against their respective accounts.

Format

Trial Balance of ABC Ltd.

as on ....

Sl.No	Name of Account	L.F	Debit Rs.	Credit Rs.

Important Points to be noted while preparing Trial Balance

- Only those ledger accounts which show balances should appear in trial balance.
- If the Ledger a/c shows a Dr. balance, it should appear on Dr. side of the trial balance and vice versa.
- The nature of the balances of the various ledger a/c's and their treatment are as follows

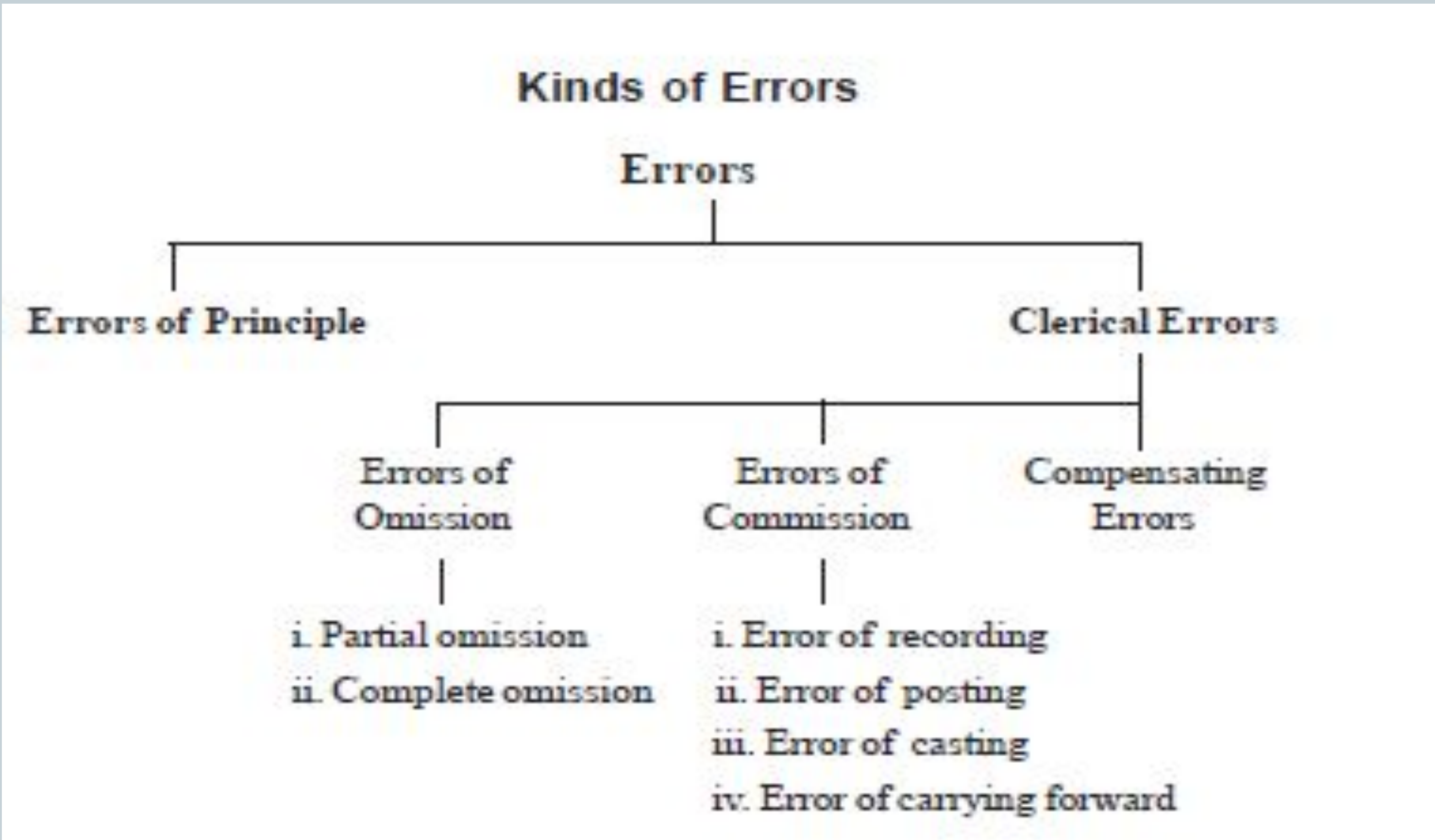
Important Points to be noted while preparing Trial Balance

Ledger A/c	Type of Balance (Dr. Balance or Cr. Balance)	Treatment in Trial Balance (Dr. side or Cr. Side)
Capital	Cr.	Cr.
Drawings	Dr.	Dr.
Sundry Debtors	Dr.	Dr.
Sundry Creditors	Cr.	Cr.
Cash at Bank	Dr.	Dr.
Bank Overdraft	Cr.	Cr.
Cash in Hand	Dr.	Dr.
Purchases	Dr.	Dr.
Purchase Returns	Cr.	Cr.
Sales	Cr.	Cr.
Sales Returns	Dr.	Dr.
Opening Stock	Dr.	Dr.
Accounts of Fixed Assets	Dr.	Dr.
Accounts of Expenses & Losses	Dr.	Dr.
Accounts of Incomes and Gains	Cr.	Cr.

Errors in Accounting

- The tallying of the two totals (debit balances and credit balances) of the trial balance ensures only arithmetic accuracy but not accounting accuracy.
- If however, the two totals do not tally, it implies that some errors have been committed while recording the transactions in the books of accounts.

Kinds of Errors



Errors of Principle

- Transactions are recorded as per generally accepted accounting principles. If any of these principles is violated or ignored, errors resulting from such violation are known as **errors of principle.**
- For example, Purchase of assets recorded in the purchases book.

Clerical Errors

- These errors arise because of mistakes committed in the ordinary course of accounting work.
- These can be further classified into three types as follows.
- ***a) Errors of Omission***

This error arises when a transaction is completely or partially omitted to be recorded in the books of accounts.

Clerical Errors

i. Error of Complete Omission: This error arises when a transaction is totally omitted to be recorded in the books of accounts.

- For example, Goods purchased from Ram completely omitted to be recorded.
- This error does not affect the trial balance.

Clerical Errors

ii. Error of Partial Omission: This error arises when only one aspect of the transaction either debit or credit is recorded.

- For example, a credit sale of goods to Siva recorded in sales book but omitted to be posted in Siva's account.
- This error affects the trial balance.

Clerical Errors

b) Errors of Commission

- This error arises due to wrong recording, wrong posting, wrong casting, wrong balancing, wrong carrying forward etc. Errors of commission may be classified as follows:

i. Error of Recording: This error arises when a transaction is wrongly recorded in the books of original entry.

- For example, Goods of Rs.5,000, purchased on credit from Viji, is recorded in the book for Rs.5,500.
- This error does not affect the trial balance.

Clerical Errors

ii. Error of Posting: This error arises when information recorded in the books of original entry are wrongly entered in the ledger.

- Error of posting may be

1. Right amount in the right side of wrong account.
2. Right amount in the wrong side of correct account
3. Wrong amount in the right side of correct account
4. Wrong amount in the wrong side of correct account
5. Wrong amount in the wrong side of wrong account
6. Wrong amount in the right side of wrong account, etc.

This error may or may not affect the trial balance.

Clerical Errors

- ***iii. Error of Casting (Totalling) : This error arises when a*** mistake is committed while totalling the subsidiary book.
- For example, instead of Rs.12,000 it may be wrongly totalled as Rs.13,000. This is called overcasting. If it is wrongly totalled as Rs.11,000, it is called undercasting.

Clerical Errors

iv. Error of Carrying Forward : This error arises when a mistake is committed in carrying forward a total of one page to the next page.

For example, Total of purchase book in page 282 of the ledger Rs.10,686, while carrying forward the balance to the next page it was recorded as Rs.10,866.

Clerical Errors

c) Compensating Errors

- The errors arising from excess debits or under debits of accounts being neutralised by the excess credits or under credits to the same extent of some other account is compensating error.
- For example, If the purchases book and sales book are both overcast (excess totalling) by Rs.10,000, the errors mutually compensate each other.

Errors disclosed and not disclosed by trial balance

ERRORS

Errors disclosed by Trial Balance

1. Errors of partial omission
2. Errors of casting
3. Errors of carrying forward
4. Errors of posting in the wrong side of the correct account
5. Errors of posting to correct account with wrong amount
6. Double posting in the same account

Errors not disclosed by Trial Balance

1. Errors of complete omission
2. Errors of recording
3. Errors of principle
4. Errors of posting to wrong account in the right side with the correct amount
5. Compensating Errors

Location of Errors

(i) Recast the totals of the debit and credit columns of the trial balance.

(ii) Re-check to ensure that the ledger balances of all the accounts have correctly been transferred in the respective debit and credit columns of the trial balance.

(iii) Re-check the balances of the individual accounts in the ledger.

(iv) Re-check the corrections of the balances of all accounts individually in the ledger.

(v) Re-check that all the entries from the subsidiary books have been correctly posted in the respective ledger accounts.

(vi) Find out the difference in the totals of the debit column and the credit column and see whether it is divisible by 2. If it is so than there is a possibility that an amount equal to one half of the difference may have been posted to the wrong side of another ledger account, for e.g., if there is a difference of Rs. 2,000 between the two totals of the trial balance than it is quite possible that a credited item of Rs 1000 has been posted wrongly in the ledger as a debit item. For locating side errors, the accountant must scrutinise all the debit entries of Rs. 1,000.

(vii) If the difference between the totals of the debit and credit columns of the trial balance is divisible by 9 than there is a possibility of the transposition of the digits of the amount figure, for e.g. if a debit amount of Rs. 575 is posted as Rs. 755, the debit trial in the trial balance will exceed by Rs.180. This difference is divisible by 9.

Suspense Account

- When it is difficult to locate the mistakes before preparing the final accounts, the difference in the trial balance is transferred to newly opened imaginary and temporary account called '**Suspense Account**'.
- If the total debit balances of the trial balance exceeds the total credit balances, the difference is transferred to the credit side of the suspense account.
- On the other hand, if the total credit balances of the trial balance exceeds the total debit balances the difference is transferred to the debit side of the suspense account.

Illustration 1

The following balances were extracted from the ledger of Rahul on 31st March, 2003. You are requested to prepare a trial balance as on that date in the proper form.

	Rs.		Rs.
Salaries	36,320	Purchases	1,44,670
Sales	1,73,500	Sundry Debtors	1,430
Plant & Machinery	34,300	Travelling Expenses	2,630
Commission Paid	1,880	Carriage Inward	240
Stock on 1.4.2002	11,100	Sundry Creditors	14,260
Repairs	1670	Capital, 1.4.2002	62,500
Sundry Expenses	460	Drawings	3,500
Returns Inward	1,000	Cash at Bank	1,090
Discount Allowed	1,150	Returns Outward	400
Rent and Rates	3,220	Investments	6,000

Illustration 2

The following balances were extracted from the ledger of Mr.Ramakrishna as on 31st March 2003. You are required to prepare a trial balance as on that date.

	Rs.		Rs.
Drawings	60,000	Salaries	95,000
Capital	2,40,000	Sales return	10,000
Sundry creditors	4,30,000	Purchases return	11,000
Bills payable	40,000	Commission paid	1,000
Sundry debtors	5,00,000	Trading expenses	25,000
Bills receivable	52,000	Discount earned	5,000
Plant & Machinery	45,000	Rent	20,000
Opening stock	3,70,000	Bank overdraft	60,000
Cash in hand	9,000	Purchases	7,08,000
Cash at bank	25,000	Sales	11,80,000