

BASIC ACCOUNTING

V SEMESTER

(UG-SDE)

OPEN COURSE

(For candidates with Core Course other than B.Com.)

(2014 Admission)



UNIVERSITY OF CALICUT

SCHOOL OF DISTANCE EDUCATION

CALICUT UNIVERSITY P.O. MALAPPURAM, KERALA, INDIA -

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BASIC ACCOUNTING

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CHAPTER 1

BASIC ACCOUNTING CONCEPTS

MEANING AND DEFINITION OF ACCOUNTING

Accounting is the systematic and comprehensive recording of business transactions of financial nature pertaining to a business and it also refers to the process of summarizing, analyzing and reporting these transactions to oversight agencies and tax collection entities. Accounting is one of the key functions for almost all business; it may be handled by a book keeper and accountant for a small firm or by sizeable finance departments with dozens of employees' at large companies. Accounting is an art as well as a science for recording business transactions which can be useful for the interested parties and at the same time it can also be used by the people for decision making.

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

In short, accounting is a system of collecting, classifying, summarizing, analyzing and reporting financial information about a firm.

OBJECTIVES OR FUNCTIONS OF ACCOUNTING

An analysis of the above definition bring out the following functions of accounting

1. **Recording:** this is the basic function of accounting, it is essentially concerned not only with ensuring that all business transaction of a financial character is recorded but also they are recorded in an orderly manner.
2. **Classifying:** classification is associated with a systematic analysis of recorded data with a view to group transaction or entries of one nature at one place. It is performed in ledger.
3. **Summarizing:** this involves presenting the data in a manner which is understandable and useful to the internal as well as external end users of accounting statement. This process leads to the preparation of trial balance, income statement and balance sheet.
4. **Dealing with financial transactions:** Accounting records only those transactions and events in terms of money and money's worth which are of financial character. Other transactions are not recorded in the books of accounts. It also helps in ascertaining the profitability position of the business.
5. **Analyzing and interpreting:** This is the final function of accounting. The recoded financial data is analyzed and interpreted in a manner that will enable the end user to make a meaningful judgment about the financial condition and profitability of the business operations. Thus it also facilitate decision making. It helps in evaluating the financial position of the firm.
6. **Communicating:** The accounting information after meaningful analysis and interpretation has to be communicated in proper form and manner to the interested parties.

FEATURES OR CHARACTERISTICS (NATURE) OF ACCOUNTING

The following are the salient features or characteristics of accounting:

1. Accounting is an art.
2. Accounting is a science.
3. Accounting is the art of recording the transactions in the books of accounts.
4. Accounting records only those transactions and events which are of financial character.
5. Accounting classifies the recorded transactions in a systematic manner.
6. Accounting summarizes the classified data.
7. Accounting analyses and interprets the summarized data.
8. Accounting provides information (after analysis and interpretation) to interested parties.

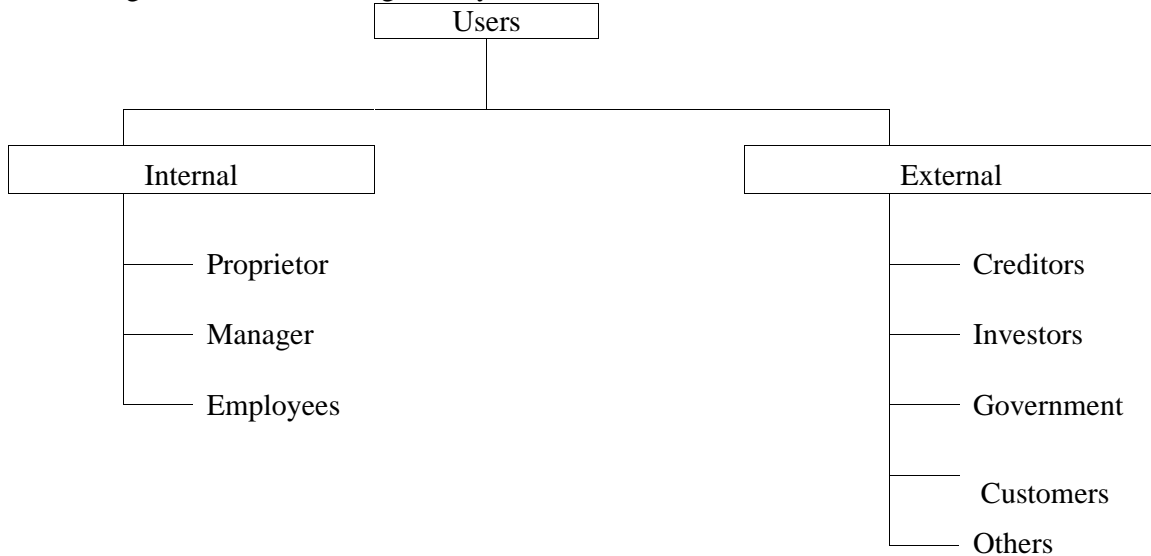
DIFFERENCE BETWEEN BOOK KEEPING AND ACCOUNTING

The terms accounting and book keeping can be used synonymously, but the fact is that there is

difference between these two terms. Book keeping is mainly concerned with recording of financial data relating to the business operations in a significant and orderly manner. It is primarily a work in clerical nature, responsible for keeping all records of business transactions. Accounting is primarily concerned with designing the system of recording, summarizing and classifying the recorded data and interpreting them for internal and external end users. Accountants often direct and review the work done by a book keeper. The responsibility with accountant is much higher than that of a book keeper.

END USERS OF ACCOUNTING INFORMATION

Accounting is of primary importance to the proprietors and the managers. However other persons such as creditors, prospective investors, employees, government, etc. are also interested to know about the accounting information given by the firms. The users of accounting information can be generally classified as internal and external.



I. Internal Users

- A. **Proprietor:** A business is done with the objective of making profit. Its profitability and financial soundness are therefore matters of prime importance to the proprietors who have invested their money in business.
- B. **Manager:** In a sole propitiatory business usually the proprietor is the manger. In the case of a partnership business either some or all the partners, participate in the management of the business. Therefore they act as both managers as well as owners. In the case of Joint Stock Companies the relationship between the owners and the management becomes all the more remote. In most cases, the share holders merely act as renders of capital and the management pass into the hands of professional mangers. The accounting disclosures help them in knowing about what has happened and what should be done to improve the profitability and financial position of the enterprise in the period to come.
- C. **Employees:** Employees are interested in the financial statements on account of various profit sharing and bonus schemes. Their interest may further increase in case if they purchase shares of the companies in which they are employed.

II. External Users

- a. **Creditors:** Creditors are the person who has extended credit to the company. They are also interested in the financial statements because these will help them in ascertaining whether the enterprise will be in a position to meet its commitment towards them- both regarding the payment of interest and of the principal.
- b. **Investors:** A person who is contemplating an investment in a business will like to know about

its profitability and financial position. The study of the financial statements will help him in this respect.

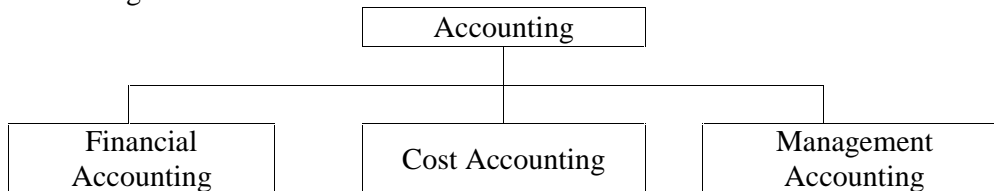
- c. **Government:** The Government is interested in the financial statement of the business enterprise on account of taxation, labour and corporate laws. If necessary, the Government may ask its officials to examine the accounting records of the business.
- d. **Customers:** Customers want to know whether they will get product or services at reasonable prices. For understanding this they can use accounting information.
- e. **Others:** Stock exchanges, Researchers, Public, etc. also require accounting information. Stock exchanges collect financial information about the company with a view to provide it to their members. Researchers need financial information for testing the hypothesis and for developing theories and models. Public is also interested to know about the financial information as the firm provides employment, amenities in the locality, etc.

ACCOUNTING AS AN INFORMATION SYSTEM

The major objective of accounting includes ascertaining the operating results of the business and its financial position. This facilitates decision making by providing vital information to the users of accounting information so accounting is considered as the language of business. The primary aim is to serve as a means of a communication. It is through accounting the business communicates to its stakeholders. In other words accounting is the means by which business information is communicated to the stakeholders. Business enterprises use accounting for their day to day activities and to report the result of these activities to shareholders, creditors, employees and Government agencies. A management proverb is “to measure is to manage”. Accounting is primarily concerned with measurement and valuation of economic events. Accounting is a system that converts inputs (business transactions and external events) to outputs (financial statements). In short accounting is concerned with communicating the results of the operation of the business and its financial problems.

BRANCHES OF ACCOUNTING

Different branches of accounting have been developed to fulfill the various objectives of accounting. The main branches are:



1. FINANCIAL ACCOUNTING

Financial accounting is the oldest branch of accounting. The aim is to ascertain the profit or loss made during a period and the financial position of the business at the end of accounting period, and to apply control measures thereby. The other branches of accounting have been developed from financial accounting. Thus financial accounting is the basic accounting.

NATURE OR CHARACTERISTICS OF FINANCIAL ACCOUNTING

We can understand the nature of financial accounting from its characteristics which are as follows:

1. The primary purpose of financial accounting is to provide information to external users. It is mainly concerned with the preparation of financial statements and communicating the information to investors, creditors and other external users.
2. Financial accounting provides historical data.
3. Transactions of financial character are recorded in the financial accounts.
4. Transactions are recorded on the basis of some concepts and conventions.
5. Financial accounts are subject to accounting standards to ensure uniformity.

6. Financial accounts deal with all commercial transactions.
7. Financial accounts deal with external transactions (i.e., transactions between the organisation and outsiders)
8. Financial accounts are the accounts of whole business.
9. Emphasis in financial accounting is on reporting, not on control.

2. COST ACCOUNTING

Cost accounting is the technique and the process of ascertainment of cost. Cost accounting is the process of accounting for costs, which begins with recording of expenses on the bases on which they are calculated and ends with the preparation of statistical data. Cost accounting is defined as the body of concepts, methods and procedures used to measure, analyze or estimate the cost, profitability and performance of individual products, departments and other segments of a company's operation for either internal or external use or both and to report on these questions to the interested parties. Thus there are three main divisions of cost accounting- cost ascertainment, Cost presentation and Cost control.

3. MANAGEMENT ACCOUNTING.

The term management accounting refers to accounting for the management. Management accounting provides necessary information to assist the management in the creation of policy and in the day to day operations. It enables the management to discharge all its functions efficiently with the help of accounting information. Generally speaking, any accounting which renders valuable information to help management may be called management accounting.

DIFFERENCE BETWEEN FINANCIAL ACCOUNTING AND MANAGEMENT ACCOUNTING

FINANCIAL ACCOUNTING	MANAGEMENT ACCOUNTING
1. The purpose is to ascertain profit or loss	The purpose is to provide information to management for decision making
2. Records historical data	Concerned with future plans and operations.
3. Compulsory	Optional
4. Users are external parties	Users are internal parties
5. Lays more emphasis on accuracy	Lays more emphasis on quick and prompt reporting.

ACCOUNTING PRINCIPLES

A principle that governs current accounting practice and that is used as a reference to determine the appropriate treatment of complex transactions. The accounting principles are classified into three they are: Accounting Postulates, Accounting Concepts and Accounting Conventions

ACCOUNTING POSTULATES

Accounting postulates are the basis assumptions relating to the business environment. The different accounting postulates are:

1. Business Entity Postulate:

In accounting, business is treated as separate entity from its owners. Accounts are prepared to give information about the business and not about those who own it. A distinction

is made between business transactions and personal transactions. Without such a distinction, the affairs of the business will be mixed up with the private affairs of the proprietor and the true picture of the firm will not be available. The 'Business' and 'owner' are taken as two separate entities. The accountant is interested to record transactions relating to business only. The private transactions of the owner will be recorded separately and will have no bearing on the business transactions. All the transactions of the business are recorded in the books of the business from the point of view of the business as an entity and even the proprietor is treated as a creditor to the extent of his capital.

The concept of separate entity is applicable to all of business organizations. For example, in case of a sole proprietorship business or partnership business, though the sole proprietor or partners are not considered as separate entities in the eyes of law, but for accounting purposes they will be considered as separate entities. In the case of joint stock Company, the business has a separate legal entity than the shareholders. The coming and going shareholders do not affect the entity of the business. Thus, the distinction between owner and the business unit has helped accounting in reporting profitability more objectively and fairly. It has also led to the development of 'responsibility accounting' which enables us to find out the profitability of even the different sub-units of the main business.

2. Going Concern Postulate:

According to going concern concept it is assumed that the business will exist for a long time to come. Transactions are recorded in the books keeping in view the going concern aspect of the business unit. A firm is said to be going concern when there is neither the intention nor necessary to wind up its affairs. In other words, it should continue to operate at its present scale in the future. On account of this concept the fixed assets are shown in the balance sheet at a diminishing balance method i.e., going concern value. There is no need to show assets at market value because these have been purchased for use in future and earn revenues and for sale purpose. If the business is not to continue then market value will have significance. Since business is to continue, fixed assets will be shown at cost less depreciation basis. It is due to the concept that the fixed assets are depreciated on the basis of their expected life than on the basis of market value. The concept also necessitates distinction between expenditure that will render benefit over a long period and that whose benefit will be exhausted quickly, say within one year. The going concern concept also implies that existing liabilities will be paid at maturity.

3. Property rights Postulate:

This is an essential condition for business. The term property right means the right of accounting entities to possess and alienate property value. This implies that the things of value to an entity can be transferred from one entity to another. Thus this becomes the basis of all business transactions.

4. Accounting period Postulate:

According to this concept, the life of the business is divided into appropriate segments for studying the results shown by the business after each segment. Since the life of the business is considered to be indefinite (according to going concern concept) the measurement of income and studying financial position of the business according to the above concept, after a very long period would not be helpful in taking proper corrective steps at the appropriate time. It is, therefore, absolutely necessary that after each segment or time interval the businessman must stop and see, how things are going on. In accounting such a segment or time interval is called accounting period. It is usually of a year.

At the end of each accounting period and income statement/profit & loss Account and a Balance Sheet are prepared. The income statement discloses the profit or loss made by the business during the accounting period while Balance Sheet discloses the financial position of

the business as on the last day of the accounting period. While preparing these statements a proper distinction has to be made between capital and revenue expenditure.

5. **Money Measurement Postulate:**

Accounting records only those transactions which can be expressed in terms of money. Transactions or events which cannot be expressed in money do not find place in the books of accounts though they may be very useful for the business. For example, if a business has got a team of dedicated and trusted employees, it is definitely an asset to the business, but since their monetary measurement is not possible, they are not shown in the books of business. It should be remembered that money enables various things of diverse nature to be added up together and dealt with. The use of a building and the use of clerical service can be aggregated only through money values and not otherwise.

ACCOUNTING CONCEPTS

The following are the different accounting concepts.

1. **Cost Concept:**

This concept is closely related to the going concern concept. According to this concept, an asset is ordinarily recorded in the books of accounts at the price at which it was acquired i.e., at its cost price. This cost serves the basis for the accounting of this asset during the subsequent period. The 'cost' should not be confused with 'value'. It must be remembered that as the real worth of the assets changes from time to time, it does not mean that the value of such an asset is wrongly recorded in the books. The book values of the assets as recorded do not reflect their real value. They do not signify that values noted therein are the values for which they can be sold. Though the assets are recorded in the books at cost, in course of time, they are reduced in value on account of depreciation charges. The idea that the transactions should be recorded at cost rather than at a subjective or arbitrary value is known as cost concept. With the passage of time, the market value of fixed assets like land and buildings vary greatly from their cost. These changes in the value are generally ignored by the accountants and they continue to value them in the balance sheet at historical cost. The principle of valuing the fixed assets at cost and not at market value is the underlying principle in cost concept. According to them the current values alone will fairly represent the cost to the entity. The cost principle is based on the principle of objectivity. There is no room for personal assessment in showing the figures in accounting records. If subjectivity is flowed in records the same assets will be valued at different figures by different individual. Everybody will have his own views about various assets. The cost concept is helpful in making truthful records. The records become more reliable and comparable.

2. **Dual Aspect Concept:**

This is the basic concept of accounting. Modern accounting system is based on dual aspect concept. Dual concept may be stated as "for every debit, there is a credit". Every transaction should have two sided effect to the extent of same amount. For example, if A starts a business with a capital of \$10,000. There are two aspects of the transaction. On the one hand the business has assets of \$10,000 while on the other hand the business has to pay to the proprietor a sum of \$10,000 which is taken as proprietor's capital. This expression can be shown in the form of following equation:

$$\begin{array}{rcl} \text{Capital (Equities)} & = & \text{Costs (Assets)} \\ 10,000 & = & 10,000 \end{array}$$

3. **Matching concept:**

The aim of business is to earn profit. In order to ascertain the profit the costs (expenses) are matched to revenue. The difference between income from sales and costs of producing the goods will be the profit. When business is taken as a going concern then it becomes necessary to evaluate the performance periodically.

A correct statement of income requires a distinction between past, present and future expenditures. A distinction between capital and revenue expenditure is also necessary. The revenues and costs of same period are matched. In other words, income made by the business during a period can be measured only when the revenue earned during a period is compared with the expenditure incurred for earning that revenue. The question when the payment was received or made is irrelevant.

4. Realization Concept:

This concept emphasizes that profit should be considered only when realized. The question is at what stage profit should be deemed to have accrued? Whether at the time of receiving the order or at the time of execution of the order or at the time of receiving the cash? For answering this question the accounting is in conformity with the law and Recognizes the principle of law i.e., the revenue is earned only when the goods are transferred. It means that profit is deemed to have accrued when property i goods passes to the buyer, viz., when sales are made.

5. Objectivity Concept:

This concept requires that accounting data should be verifiable and free from personal bias of the accountant. This means that recorded transactions should be adequately supported by evidences. It should have supportive documents like bills, vouchers, receipts, etc.

ACCOUNTING CONVENTIONS:

The term "conventions" includes those customs or traditions which guide the accountants while preparing the accounting statements. The following are the important accounting conventions.

1. Convention of Disclosure:

The disclosure of all significant information is one of the important accounting conventions. It implies that accounts should be prepared in such a way that all material information is clearly disclosed to the reader. The term disclosure does not imply that all information that anyone could desire is to be included in accounting statements. The term only implies that there is to a sufficient disclosure of information which is of material in trust to proprietors, present and potential creditors and investors. The idea behind this convention is that anybody who wants to study the financial statements should not be misled. He should be able to make a free judgment. The disclosures can be in the way of foot notes.

2. Convention of Materiality:

It refers to the relative importance of an item or even. According to this convention only those events or items should be recorded which have a significant bearing and insignificant things should be ignored. This is because otherwise accounting will be unnecessarily overburden with minute details. There is no formula in making a distinction between material and immaterial events. It is a matter of judgment and it is left to the accountant for taking a decision. It should be noted that an item material for one concern may be immaterial for another. Similarly, an item material in one year may not be material in the next year.

3. Convention of Consistency:

This convention means that accounting practices should remain un-changed from one period to another. For example, if stock is valued at cost or market price whichever is less; this principle should be followed year after year. Similarly, if depreciation is charged on fixed assets according to diminishing balance method, it should be done year after year. This is necessary for the purpose of comparison. However, consistency does not mean inflexibility. It does not forbid introduction of improved accounting techniques. If a change becomes necessary, the change and its effect should be stated clearly.

4. Convention of Conservatism:

This convention means a caution approach or policy of "play safe". This convention ensures that uncertainties and risks inherent in business transactions should be given a proper

consideration. If there is a possibility of loss, it should be taken into account at the earliest. On the other hand, a prospect of profit should be ignored up to the time it does not materialize. On account of this reason, the accountants follow the rule 'anticipate no profit but provide for all possible losses'. On account of this convention, the inventory is valued 'at cost or market price whichever is less.' The effect of the above is that in case market price has gone down then provides for the 'anticipated loss' but if the market price has gone up then ignore the 'anticipated profits.' Similarly a provision is made for possible bad and doubtful debt out of current year's profits.

Critics point out that conservatism to an excess degree will result in the creation of secrets reserves. This will be quite contrary to the doctrine of disclosure

SYSTEMS OF ACCOUNTING (BASES OF ACCOUNTING):

There are basically three systems of accounting:

1. Cash system of accounting:

It is a system in which accounting entries are made only when cash is received or paid. No entry is made when a payment or receipt is merely due. For example, the rent for December 2015 has not been paid till January 10th 2016. Under cash basis, rent expense for the month of December will not be recorded as payment has not been made. Government system of accounting is mostly on the cash system.

2. Accrual System of Accounting:

It is a system in which accounting entries are made on the basis of amount having become due for payment or receipt. This system recognizes the fact that if a transaction or an event occurred, its consequences cannot be avoided and therefore, should be brought into book in order to present a meaningful picture of profit earned or loss suffered.

3. Hybrid or Mixed System of Accounting

Under this system of accounting, revenues and assets are recorded on cash basis, while expenses and liabilities are recorded on accrual basis.

IMPORTANT TERMS IN ACCOUNTING

ASSET: Any item of economic value owned by an individual or corporation, especially that which could be converted to cash. Examples are cash, securities, accounts receivable, inventory, office equipment, real estate, a car, and other property. On a balance sheet, assets are equal to the sum of liabilities, common stock, preferred stock, and retained earnings. From an accounting perspective, assets are divided into the following categories: current assets (cash and other liquid items), long-term assets (real estate, plant, equipment), prepaid and deferred assets (expenditures for future costs such as insurance, rent, interest), and intangible assets (trademarks, patents, copyrights, goodwill).

LIABILITY: An obligation that legally binds an individual or company to settle a debt is called liability. When one is liable for a debt, they are responsible for paying the debt or settling a wrongful act they may have committed. For example, if John hits Jane's car, John is liable for the damages to Jane's vehicle because John is responsible for the damages. In the case of a company, a liability is recorded on the balance sheet and can include accounts payable, taxes, wages, accrued expenses, and deferred revenues. Current liabilities are debts payable within one year, while long-term liabilities are debts payable over a longer period.

EQUITY: In broad sense the term equity refers to total claims against the enterprise. It is further divided into two categories:

(1) Owners claim-capital and (2) Outsiders' claim-liability (3) Liability: Amounts owed by the enterprise to the outsiders i.e. to all others except the owner. For example, trade creditors, bank overdraft etc. (4) Capital: The excess of assets over liabilities of the enterprise. It is the difference between the total assets and the total liabilities of the enterprise. For example, if on a particular date the assets of the business amount to Rs. 1, 00,000 and liabilities to Rs. 30,000 then the capital on the date would be Rs. 70,000. It is also known as net worth.

REVENUE: It is the monetary value of the products or services sold to the customers during the period. It results from sales, services and sources like interest, dividend and commission, etc.

EXPENSES/ COSTS: Expenditure incurred by the enterprise to earn revenue is termed as expenses or costs. Distinction between expense and asset is that the benefit of the former is consumed by the business in present whereas in latter case benefit will be available for future activities of the business. Examples of expenses are raw materials consumed salaries etc.

LOSS: The term is used to convey, at least, two different meanings. First it refers to the result of the business for a period when expenses exceed the revenue. For example, if sales are Rs.10, 000 and expenses are Rs. 11,000 the loss will be Rs. 1,000. Second- It describes those efforts which fail to earn revenue. For example- un saleable stock, loss due to fire, theft, accident etc.

PROPRIETOR/ OWNER: The person who invests his money or money's worth and bears the risk of the business.

DRAWINGS: Money or value of goods belonging to business used by the proprietor for his personal use is termed as drawings. Goods Includes all merchandise commodities which are purchased by the business for selling.

TRADE DEBTOR: Person who owes money, to the business is a debtor. It happens when goods are sold on credit.

TRADE CREDITOR: Person to whom, the business owes money. It happens when goods or materials are purchased by the business on credit.

TRANSACTION: Any exchange (dealing) of goods or services, for cash or on credit by the business with any other business.

EVENTS: There are the occasions which cause changes in the value due to time element. Outsiders are not directly concerned. For example, interest accrued depreciation in the value of assets etc.

ENTRY: The record of a transaction or event in the books of accounts is known as entry.

ENTITY: All elements of financial statements are in relation to a particular entity which may be business enterprise, an educational or charitable organization, a government unit, a natural person or the like. An entity may comprise two or more affiliated entities and may not necessarily correspond, with 'legal entity'. Thus, the accounting information is recorded, compiled and presented with reference to identifiable entity. The term 'other entity' refers to a subsidiary company that is a part of the same entity as its parent company in consolidated financial statements but is an 'other entity' in the separate financial statements of its parent.

NET WORTH: Net worth is also known as "ownership equity" or "stockholders' equity" or "capital". It is the difference between total assets minus outside liabilities. Alternatively net worth is the sum of capital plus retained earnings.

CHAPTER 2

ORIGIN AND RECORDING OF BUSINESS TRANSACTIONS

BUSINESS TRANSACTIONS

Every business activity is not an accounting activity. That is why every activity is not recorded in the books of accounting. We record only business transactions in accounting.

Transaction is an event which involves transfer (exchange) of money or money's worth between the business and outsiders including the owner. For example, a business sells goods to a person for cash or on credit is a transaction. This event involves transfer of goods from the business to an outsider. The word 'transaction' is mathematically defined as follows:

Transaction = Action + Money

FEATURES OF BUSINESS TRANSACTIONS

1. They are financial in nature.
2. They are supported by documentary evidence.
3. They are expressed in numerical and monetary terms.
4. They cause an effect on assets, liabilities, capital, revenue and expenses.

TYPES OF BUSINESS TRANSACTIONS

Business transactions are of the following types:

- (a) **Cash transaction:** Any business transaction which involves immediate payment or receipt of cash is known as cash transaction. For example, sale of goods for cash is a cash transaction.
- (b) **Credit transaction:** In a credit transaction, there is no immediate payment or receipt of cash. The settlement of payment or receipt of cash is done at a later date. For example, goods are purchased on credit is a credit transaction.
- (c) **Non-cash transaction:** This transaction does not involve any payment or receipt of cash either immediately or at a later date. Examples of such transactions are depreciation, return of goods etc.

DOUBLE ENTRY SYSTEM

The double entry theory of bookkeeping can be defined as the system of recording transactions having two fundamental aspects - one involving the receiving of a benefit and the other to giving the benefit - in the same set of books.

In this theory, as the two fold aspects of each transaction are recorded, the name "double entry" has been given to this system.

Every transaction involves two fold aspects e.g., an aspect of receiving and an aspect of giving. One who receives is a debtor (Dr) and one who gives is a creditor (Cr). Under the double entry system, both the aspects of giving and receiving are recorded in terms of accounts. The account which receives the benefit is debited and the account which gives the benefit is credited. It is the ultimate result of this system that every debit must have corresponding credit and vice versa and on any particular day the total of the debit entries and the credit entries on the various accounts must be equal.

ADVANTAGES OF DOUBLE ENTRY SYSTEM

1. Trial balance can be drawn up on any day to prove the arithmetical accuracy of record.
2. The nominal sides of transactions being recorded: it is possible to prepare Trading and Profit and Loss Account from which the Gross Profit and Net Profit made by the business during a particular period can be easily ascertained.
3. As all personal accounts of debtors and creditors as well as real accounts are kept, it is possible to prepare Balance Sheet.
4. The transactions being recorded in the most scientific and systematic way gives the most reliable information of business.
5. It prevents fraud by rendering any alteration in any account more difficult.

6. It enables the trader to compare the different items, such as sales, purchases, opening stock and closing stock of one period with similar items of preceding period and the trader may thus know whether his business is progressing or not.

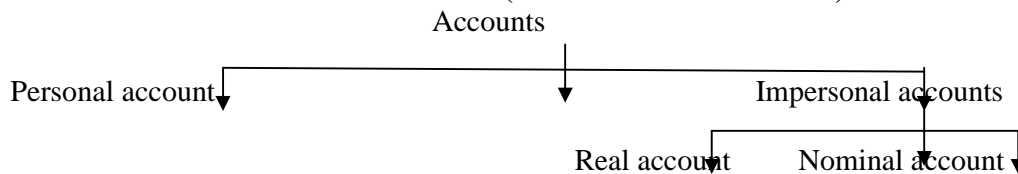
DISADVANTAGES OF DOUBLE ENTRY SYSTEM:

1. This system requires the maintenance of a number of books of accounts which is not practical in small concerns.
2. The system is costly because a number of records are to be maintained.
3. There is no guarantee of absolute accuracy of the books of accounts in spite of agreement of the trial balance.

ACCOUNT

In accounting we keep a separate record of each and individual assets, liabilities, expenses, incomes, equities etc. The place where such are maintained is known as an account. It is a place where similar transactions which take place during a period are summarized and accumulated. For example, all cash transactions will be summarized and accumulated in a separate account called cash account. Similarly, all transactions relating to an asset will be recorded in that asset account, all transactions relating to a person will be recorded in that person's account, etc.

CLASSIFICATION OF ACCOUNTS (TYPES OF ACCOUNTS)



CLASSIFICATION OR TYPES OF ACCOUNTS

The accounting equation reminds us that accounts can be classified in to the following categories:

1. **Real accounts:** These are the accounts of assets or properties of business. Examples of real accounts are cash account, land and building account, furniture account, machinery account etc.
2. **Personal accounts:** These are the accounts relating to persons with whom business deals. Personal accounts may be of the following three types:
 - (a) **Natural person's account:** These are the accounts of human beings. Examples include Midhun's account, Joseph's account, Thufal's account etc.
 - (b) **Artificial person's account:** These are the accounts of artificial persons created by law. Examples include firm's account, company's account, educational institution's account, bank account, co-operative society's account etc.
 - (c) **Representative person's account:** An account indirectly representing a person or persons is known as representative person's account. Outstanding expense account, prepaid expense account, outstanding incomes account etc. are examples of representative personal account.
3. **Nominal accounts:** Accounts relating to income, revenue, gain, expenses and losses are called nominal accounts. These are also known as fictitious accounts (accounts in name only). Rent account, salaries account, wages account, discount account, commission account, depreciation account, realization account etc. are some of the examples of nominal accounts.

MEANING OF DEBIT AND CREDIT

The word debit is derived from the Latin word 'Debitum'. It means due for that. In short, receiving aspect of a transaction is known as debit.

The word 'Credit' is derived from the Latin word 'Credere'. It means 'Due to that'. In short, the giving aspect of a transaction is known as credit.

The abbreviation 'Dr' for debit and 'Cr.' for credit is generally used.

BASIC RULES IN ACCOUNTING

Every transaction has two aspects debit and credit. To record a transaction completely, its debit aspect as well as credit aspect should be recorded. There are some rules for ascertaining debit and credit aspects of transactions. There are two approaches for finding debit and credit aspects of transactions. One is English approach and the other is American approach.

English approach: According to this approach the rules of double entry system depends upon the type of account to be recorded. Under this approach, all accounts are classified into three—real account, personal account and nominal account. The classification of accounts into real, personal and nominal is known as *traditional approach*. There are separate rules for each type of account. They are as follows:

Real account: In case of real account, what comes in the business is debited and what goes out is credited. In short,

Debit what comes in

Credit what goes out

Personal account: In case of personal account, who receives the benefit is debited and who gives the benefit is credited. In short,

Debit the receiver

Credit the giver

Nominal account: In case of nominal account all expenses and losses are debited and all incomes and gains are credited. In short,

Debit all expenses and losses

Credit all incomes and gains

The above rules for ascertainment of debit and credit are known as 'Golden Rule of Accounting'. It is so called because it is unique itself.

American approach: According to American approach accounts are classified into five categories such as assets, liabilities, capital, expenses and incomes. This classification is known as *modern approach*. The following are the debit– credit rule under this approach:

- (a) **Assets:** If there is increase in asset, this increase is debited in that asset account. If there is decrease in an asset, this decrease in asset is credited in that asset account. In short,
Increase in asset–Debit
Decrease in asset– Credit
- (b) **Liabilities:** When a liability is increased, it is credited and when a liability is decreased, it is debited. In short,
Increase in liability– Credit
Decrease in liability–Debit
- (c) **Capital:** When capital is increased, it is credited and when capital is reduced, it is debited. In short,
Increase in capital– Credit
Decrease in capital– Debit
- (d) **Expenses/ Losses:** When expense or loss is increased, it is debited and when expense or loss is decreased, it is credited. In short,
Increase in expenses/loss– Debit
Decrease in expenses/ loss– Credit

- (e) **Incomes/Gains:** When income or profit is increased, it is credited and when income or profit is decreased, it is debited. In short,
 Increase in incomes/gain– Credit
 Decrease in incomes/ gain– Debit

Of the two approaches, we follow the English approach.

Illustration 1

Find out debit and credit in each of the following transactions:

- (i) Vinayak started business with cash Rs. 10,00,000
- (ii) Deposited cash Rs. 2,00,000 into bank
- (iii) Bought goods for cash Rs. 40,000 on credit
- (iv) Bought goods from Lakshmi on credit for Rs. 20,000
- (v) Sold goods for cash Rs. 30,000
- (vi) Sold goods to Vinod for Rs. 10,000
- (vii) Bought furniture for Rs. 10,000
- (viii) Paid rent Rs. 5,000
- (ix) Paid wages Rs. 4,000
- (x) Received commission Rs. 1,000

Solution

- (i) This transaction involves two aspects. They are cash and proprietor's capital. Cash is a real account (asset). Proprietor's capital account is a personal account. In the case of real account what is coming into business is debited. Here cash is coming into the business. Hence cash is the debit aspect (increase in asset is debited). In the same time cash is received from the proprietor in the form of capital (personal account). In the case of personal account, giver is the credit. In this case proprietor is the giver of capital. Thus proprietor's capital is credit (increase in capital is credited).
- (ii) When cash is deposited with the bank, cash is going out of the business. Applying the rule of real account (credit what is going out) cash is the credit aspect. When cash is deposited, the bank (personal account) receives cash. Applying the rule of personal account (debit the receiver), bank is debit. Thus cash and bank are the two aspects of the transaction.
- (iii) When goods are purchased, goods (real account) are coming into business. According to the rule of real account (debit what comes in) goods is the debit aspect because goods are coming in. When goods are purchased for cash, cash (real account) goes out of the business. According to rule of real account (credit what goes out) cash is the credit aspect because cash goes out of the business.
- (iv) When goods are bought on credit, goods is the debit aspect because goods come into the business. This is a credit transaction (name of the party is given). Cash is not immediately paid. Lakshmi (personal account) is the giver of goods. When we apply the rule of personal account (credit the giver), Lakshmi is the credit aspect.
- (v) When goods are sold, goods (real account) go out of the business. Applying the rule of real account (credit what goes out), goods is the credit aspect. When goods are sold for cash, cash is received. In case of real account, what comes in is debit. Thus cash is the debit aspect.
- (vi) When goods are sold, goods are going out of the business. Hence goods are the credit aspect. Here goods are sold on credit; the receiver of goods (Vinod) is the debit according to the rule of personal account.
- (vii) In this transaction, the two aspects involved are furniture and cash. Both are assets. Hence both come under real accounts. Applying the rule of real account, furniture is debit (furniture comes into business) and cash is the credit (cash goes out of business).

- (viii) Rent is an expense. It comes under nominal account. Applying the rule of nominal account (debit expenses), rent is the debit aspect. Rent is paid in cash (real account). Since cash is going out, cash is credit.
- (ix) Wage is an expense. It is a nominal account. When we apply the rule of nominal account (debit all expenses) wage is the debit aspect. Wages are paid in cash (real account). Since cash is going out, cash is the credit aspect.
- (x) Commission received is an income. It is a nominal account. According to the rule of nominal account (credit all incomes), commission is credit aspect. It is received in cash (real account). Since cash is coming in, cash is debit aspect.

JOURNAL

The word "journal" has been derived from the French word "jour". Jour means day. So journal means daily. It is also known Day Book because it contains the account of every day's transactions. Journal is a book that is maintained on a daily basis for recording all the financial entries of the day. Passing the entries is called journal entry. Journal entries are passed according to rules of debit and credit of double entry system. Journal is also known as day book as it is recording all transactions on a chronological order.

JOURNALIZING

The act of recording transactions in journal is called journalizing.

1	2	3	4	5
Date	Particulars	L.F.	Amount	
			Debit	Credit
xx-xx-xx	... .. A/c Dr. To A/c (... .. Narration... ..)	xx xx	Xxxx	xxxx

Column 1: It represents the date of transaction.

Column 2: Line 1 (...) represents the name of account to be debited.

Line 2 (...) represents the name of account to be credited.

Line 3 (...) for narration of transaction

Column 3: Ledger Folio (L.F.) represents the page number of ledger account on which we post these entries.

Column 4: Amount(s) to be debited.

Column 5: Amount(s) to be credited.

Notes

- If there are multiple transactions in a day, the total amount of all the transaction through a single journal entry may pass with total amount.
- If debit or credit entry is same and the corresponding entry is different, we may post a combined entry for the same. It is called '**compound entry**' regardless of how many debit or credit entries are contained in compound journal entry. For example,

1	2	3	4	5
Date	Particulars	L.F.	Amount	
			Debit	Credit
xx-xx-xx	... .. A/c Dr. A/c Dr. To A/c (Narration... ..)	xx xx xx	xx xx	xxxx

Analysis and Treatment of Transactions

Let us go through the nature of transactions and their treatment in our books of accounts. The

Basic Accounting Page 19

10	Outstanding Expenses	<p>Sometimes expenses remain outstanding at the end of the financial year, but due to the accrual basis of accounting, we need to book those expenses which are due for payment and to be paid in the next accounting year. For example, the salary due on the last day of the accounting year to be paid in the next year.</p> <p>Treatment:</p> <table><tr><td>Salary A/c</td><td>Dr.</td><td>xx</td><td></td></tr><tr><td>To salary outstanding A/c</td><td></td><td></td><td>xx</td></tr></table> <p>(Salary for the month ofdue)</p>	Salary A/c	Dr.	xx		To salary outstanding A/c			xx								
Salary A/c	Dr.	xx																
To salary outstanding A/c			xx															
11	Prepaid Expenses	<p>Sometimes we pay expenses in advance such as insurance paid three months before the closing of the accounting year. Since insurance is usually paid for the whole year, in this case, the insurance for nine months is treated as prepaid insurance. Similarly, rent for the first month of next accounting year may be paid in advance.</p> <p>Treatment:</p> <table><tr><td>Prepaid Expenses A/c</td><td>Dr.</td><td>xx</td><td></td></tr><tr><td>To Expenses/Cash A/c</td><td></td><td></td><td>xx</td></tr></table> <p>(Prepaid expenses for month paid)</p> <p>Note: Expenses account is replaced with the respective head of expense account.</p>	Prepaid Expenses A/c	Dr.	xx		To Expenses/Cash A/c			xx								
Prepaid Expenses A/c	Dr.	xx																
To Expenses/Cash A/c			xx															
12	Income Received	<p>Treatment:</p> <table><tr><td>Cash/Debtor A/c</td><td>Dr.</td><td>xx</td><td></td></tr><tr><td>To Income A/c</td><td></td><td></td><td>Xx</td></tr></table> <p>(Income received in cash)</p> <p>Note: Income account will be replaced with the respective head of Income account.</p>	Cash/Debtor A/c	Dr.	xx		To Income A/c			Xx								
Cash/Debtor A/c	Dr.	xx																
To Income A/c			Xx															
13	Banking Transactions	<p>(1) Cheque deposited in bank</p> <p>Cheque received from party is deposited in bank, Cheque direct deposit by party in our bank account, payment made by party through NEFT or RTGS, or cash directly deposited by party in our bank account. The entry remains same in all the above cases.</p> <table><tr><td>Bank A/c</td><td>Dr.</td><td>xx</td><td></td></tr><tr><td>To Debtor A/c</td><td></td><td></td><td>xx</td></tr></table> <p>(2) Payment made to party through cheque</p> <p>Cheque issued to party or directly deposited in his bank account, or payment made through either by NEFT, RTGS, or cash directly deposited in his bank account. Entry remains same in all the above cases except in the case of cash deposited in his bank account.</p> <table><tr><td>Debtor A/c</td><td>Dr.</td><td>xx</td><td></td></tr><tr><td>To Bank A/c</td><td></td><td></td><td>xx</td></tr></table> <p>(Payment made through)</p> <p>If we deposit cash in his bank account, entry will be as</p>	Bank A/c	Dr.	xx		To Debtor A/c			xx	Debtor A/c	Dr.	xx		To Bank A/c			xx
Bank A/c	Dr.	xx																
To Debtor A/c			xx															
Debtor A/c	Dr.	xx																
To Bank A/c			xx															

[illegible]

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.

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.

Illustration 2

Journalize the following transactions in the book of Mr. Ashish

2015 Sept. 1 Commenced business with cash Rs.180, 000

4. Purchased goods for cashRs.15, 000

8. Purchased furniture forRs.16,000
9. Sold goods for Rs1 4,000
15. Bought goods from Madhu for Rs. 20,000
17. Sold goods to Shyam for cash Rs. 8,000
20. Sold goods to Akhil for Rs. 9,000
22. Paid Madhu cash Rs. 7,500
23. Paid for stationeryRs.1000
25. Received cash from AkhilRs. 9,000
29. Received commission Rs. 300
30. Paid salaries to Accountant Rs. 12000
31. Paid rent to landlord Rs. 7500

Solution

In the Books of Ashish Journal

Date	Particulars	L.F	Debit Rs	Credit Rs.
2015 Sept 1	CashA/c To Ashish's Capital A/c (Started business with cash) Dr	.	180,000	180,000
4	Purchase A/c To Cash A/c (Cash Purchase) Dr		15,000	15,000
8	Furniture A/c To Cash A/c (Purchased Furniture) Dr		16,000	16,000

9	Cash A/c To Sales A/c (Cash Sales) Dr		14,000	14,000
15	Purchase A/c To Madhu (Bought goods from Madhu on Credit) Dr		20,000	20,000
17	Cash A/c To Sales A/c (Cash Sales) Dr		8,000	8,000
20	Akhil Dr To Sales A/c (Sold goods to Akhil on credit)		9,000	9,000
22	Madhu Dr To Cash A/c (Paid cash to Madhu)		7,500	7,500
23	Stationery A/c To Cash A/c (Paid stationery) Dr		1000	1000
25	Cash A/c To Akhil (Received cash from Akhil) Dr		9,000	9,000
29	Cash A/c To Commission A/c (Received commission) Dr		300	300
30	Salary A/c To Cash A/c (Paid salaries) Dr		12000	12,000
30	Rent A/c To Cash A/c (Paid rent) Dr		7,500	7,500

Illustration 3

Journalize the following transactions in the books of Arjun

2016 January

1. Opening Balance:

Furniture	12,500
Cash in hand	19,000
Cash at bank	24,000
Stock of goods	16,500
Due from Mohan	11,500
Due to Vijay	9,500

8. Purchased goods worth Rs. 20,000 less 10% trade discount

9. Received cash from Mohan Rs. 11,200 in full settlement

10. Sold goods to Anand Rs. 8,000
11. Took goods for personal use Rs. 3000
15. Purchase Machinery from Dileep for Rs. 25,000 and incurred Rs. 1,500 as installation charges
16. Paid to Vijay by cheque Rs. 9,000 and discount allowed by him Rs. 500
20. Purchased goods from Pradeep Rs. 9,400
21. Paid salary to Jayesh Rs. 8,000
24. Drawn from bank for private use Rs. 1,000
25. Paid for postage Rs. 50, stationery Rs. 200.
28. Received Rs. 5000 from Anand in full settlement, due to his insolvency. .
29. Rent due to land lord Rs. 4,500

Solution

**In the Books of Arjun
Journal**

Date	Particulars	LF	Dr. Amount	Cr. Amount
2016 Jan 1	Furniture A/c Dr. Cash A/c Dr Bank A/c Dr Stock A/c Dr Mohan A/c Dr To Vijay A/c To Capital A/c (The opening balance of Assets and Liabilities, Capital ascertained by deducting Liabilities from Assets)		12,500 19,000 24,000 16,500 11,500	9,500 74,000
8	Purchase A/c Dr. To Cash A/c (Goods purchased at a trade discount of 10%)		20,000	20,000
9	Cash A/c Dr. Discount A/c Dr To Mohan A/c (Cash received from Mohan in full Settlement)		11,200 300	11,500
10	Anand A/c Dr. To Sales A/c (Goods sold to Anand on credit)		5,000	5,000
11	Drawings A/c Dr. To Purchase A/c (Goods withdrawn for Personal use)		3,000	3,000
15	Machinery A/c Dr. To Dileep A/c To Cash A/c (Machinery purchased on Credit and payment of Rs. 1,500 as installation charges)		26,500	25,000 1,500
16	Vijay A/c Dr. To Bank A/c To Discount A/c (Cash paid to Vijay and discount allowed by him)		9,000	8,500 500
20	Purchases A/c Dr.		9,400	

	To Pradeep A/c (Goods purchased from Pradeep on Credit)			9,400
21	Salary A/c Dr. To Cash A/c (Salary paid in cash)		8,000	8,000
24	Drawing A/c Dr. To Bank A/c (Cash withdrawn from bank for personal use)		1,000	1,000
25	Postage A/c Dr. Stationary A/c Dr. To Cash A/c (Cash paid for Postage and Stationary)		50 200	250
28	Cash A/c Dr. Discount A/c Dr. To Anand A/c (Cash received from Anand at discount after being insolvent)		5,000 3,000	8,000
29	Rent A/c Dr. To Rent Outstanding A/c (Amount due to landlord as rent)		4,500	4,500

LEDGER:

When all the transactions of a given period have been journalized, the next thing is to classify them according to the accounts affected. All similar transactions must be brought together. For instance, all transactions relating to cash must be put in one place. Similarly, all transactions with a customer or a supplier must be assembled at one place. The book in which this classification is done is called the ledger. The ledger is a book which contains a condensed and classified record of all the pecuniary transactions of the business generally brought, transferred or posted from the books of original entry. Ledger is called the king of all books of accounts because all entries from the books of original entry must be posted to the various accounts in the ledger. It should be noted that journal contains a chronological record while ledger contains a classified record of all transactions.

POSTING

The act of separately transferring each entry from journal to the respective account in the ledger is called posting.

Ruling of Account in Ledger Account

Let us see the format of ledger accounts:

Format:

In the books of M/s. ABC Company							
Ledger account of M/s XYZ LTD.							
Dr.				Cr.			
Date	Particulars	JF	Amount	Date	Particulars	JF	Amount
xx/xx/20xx	To Balance b/d		Xxx	xx/xx/20xx	By Balance b/d		xxx
xx/xx/20xx	To Name of the debit account		Xxx	xx/xx/20xx	By Name of Credit account		xxx
xx/xx/20xx	To Balance c/d		Xxx	xx/xx/20xx	By Balance c/d		xxx
	Total		xxxx		Total		xxxx

FEATURES OF LEDGER:

1. It has two identical sides - left hand side and right hand side. The left hand side is called debit side and right hand side is called credit side.
2. Debit aspects of all the concerned transactions is recorded on the debit side, while credit aspect on credit side according to date.
3. The difference in the total of the two sides represents balance. The excess of debit side over credit side indicates debit balance, while excess of credit side over debit side indicates credit balance. If the total of the two sides are equal there will be no balance.
4. Usually balance is drawn at the year end and recorded on the deficit side to make the two sides equal. This balance is known as closing balance.
5. The closing balance of the current year will be the opening balance of the next year.

ADVANTAGES OF LEDGER:

1. It is the ledger through which successful application of double entry system of bookkeeping is ensured. Each and every transaction is divided into two parts - receiver and giver - and recorded in the two concerned accounts in ledger.
2. Transactions relating to different persons or concerns are recorded in the account of each person or concern separately. As a result, complete and reliable information is available in respect of each and every account.
3. Different types of income and expenses are recorded in different accounts separately. So, it is possible to ascertain the amount of income and expenditure under each head and the overall result at the yearend through trading and profit and loss account.
4. Separate account is opened for each item of assets and liabilities. It is, therefore, possible to ascertain the value of different assets and liabilities and the true financial position at the yearend through balance sheet.
5. Transactions being recorded primarily in journal and thereafter entered in ledger, the possibility of errors and defalcations are remote.
6. Valuable information and statistics are collected from ledger and supplied to the management to enable them to run the concern efficiently.

DIFFERENCE BETWEEN LEDGER AND JOURNAL:

The journal and the ledger are the most important books of the double entry system of accounting. Following are the points of difference between these two types of books:

1. The journal is the book of first entry (original entry); the ledger is the book of second entry. It is the goal where all the entries in the journal find their ultimate destination.
2. The journal is the book of chronological record; the ledger is the book for the analytical record.
3. The journal, as a book of source entry, ordinarily has greater weight as legal evidence than the ledger.
4. The unit of classification of data within the journal is the transaction; the unit of classification of data within the ledger is the account.
5. The process of recording in the journal is called journalizing; the process of recording in the ledger is called posting.

BALANCING OF ACCOUNTS (CLOSING OF ACCOUNTS)

After all transactions have been posted to the various accounts in the ledger, the next step is to balance the ledger accounts. The difference between the two sides of an account is known as balance. In the words of Kohler "Balance is the difference between the total debits and total credits of an account or total of an account containing only debits or credits". If debit

side

.of an account is more than the credit side, the balance is called debit balance. If credit side is more than the debit side, the balance is called 'credit balance'. The following steps should be taken in balancing an account:

1. Take totals of both the sides roughly.
2. Find out the difference between total debit and total credit.
3. If the total debit is more, put the difference (i.e. closing debit balance) on the credit side amount column by writing the words 'By Balance c/d' (c indicates 'carried down') in particulars column. If the total credit is more, put the difference (i.e. closing credit balance) on the debit side amount column by writing the words 'To Balance c/d' in particulars column.
4. After putting the difference in the appropriate side of an account, add both the sides of the account (alternatively, put the larger total on both sides). Draw a line above and below the total.
5. Bring down the debit balance on the debit side by writing the words 'To Balance b/d' (b indicates 'brought down') in the particulars column. Similarly bring down the credit balance on the credit side by writing the words 'By Balance b/d' in the particulars column.

Thus 'c/d' indicates closing balance and 'b/d' indicates opening balance. Closing debit balance is first written on the credit side (i.e. on closing date). On the next opening date it becomes an opening balance and it appears on the debit side i.e., opening debit balance is shown on the debit side. Similarly closing credit balance is first written on the debit side (i.e. on closing date). On the next opening date it becomes an opening credit balance and it appears on the credit side i.e. opening credit balance is shown on the credit side.

Posting the Opening Entry: -

Separate accounts should be opened for each opening asset, opening liability and capital. All opening assets show debit balances while, opening liabilities and capital (unless there is deficiency) show credit balances. In each account of opening assets opening debit balances should be written with the words "To Balance d". Similarly in each account of opening liabilities and also in capital account, opening credit balances should be written with the words 'By Balance b/d'. If capital/c shows a debit balance (overdrawn), such opening balance will appear on the debit side with the words 'To Balance b/d'.

BALANCING OF DIFFERENT TYPES OF ACCOUNTS

Balancing and closing of personal accounts: Some personal accounts are closed (i.e., nil balance). Others may show either a debit balance or a credit balance. If a personal account shows a debit balance, it indicates the amount owing from him (i.e., he is a debtor). On the contrary, if a personal account shows a credit balance, it indicates the amount owing to him (i.e., he is a creditor).

Capital is a personal account. It generally shows a credit balance. If there is a deficiency in capital it will show a debit balance. Similarly drawings account is a personal account. It always shows a debit balance. Bank account may show either a debit balance (i.e., deposit) or a credit balance (i.e., overdraft).

Balancing and Closing of Real Accounts: Real accounts are the accounts of assets. Asset account will not be closed if they are existing in the business. These show debit balances.

Balancing of Nominal Accounts:-

Nominal accounts are not balanced. At the end of every accounting period they are closed by transferring to Trading A/c or Profit and Loss A/c. Accounts of all direct expenses are closed by transferring the total to Trading A/c by writing the words 'By Trading A/c' on the credit side of the account of direct expenses. Sales account is closed by transferring the total to Trading A/c by writing the words 'To Trading A/c' on the debit side of sales account. All accounts of indirect expenses are closed by transferring the total to Profit and Loss A/c by writing the words 'By Profit and Loss A/c' on the credit side of indirect expense accounts. All accounts of incomes are closed by

transferring the total to Profit and Loss A/c by writing the words 'To Profit and Loss A/c' on the debit side of income accounts.

Illustration 4:

The following balances existed in the books of Star Agencies on 1st April 2016.

Cash Rs. 16,000, Bank (Dr) Rs. 15,000, Madhav (Debtor) Rs. 8,000, Furniture Rs. 10,000, Stock Rs. 24,000, Viashak (Creditor) Rs. 9,000

The following transactions took place during the month of April

April 5 Received from Madhav Rs. 3,000

8 Sold goods for cash 5,000

12 Paid to Viashak Rs. 4,000

15 Purchased goods for cash Rs. 6,000

17 Sold good to Sujith Rs. 5,000

19 Sujith returned goods worth Rs. 500

20 Received goods from Gopika Rs. 10,000 Paid carriage on the goods purchased Rs. 500

22 Bought furniture from Hari for Rs. 12,000

23 Returned goods worth Rs. 800 to Gopika

25 Withdrew cash Rs. 4,000 and goods worth Rs. 200 for private purpose

26 Received cash from Sujith Rs. 4,250 in full settlement of his account

29 Issued cheque for Rs. 9,000 to Gopika in full settlement

30 Paid salaries Rs. 3,000

Pass journal entries and post them in ledger accounts

Solution

Journal

Date	Particulars	L.F	Debit Rs	Credit Rs.
2009 April 1	Cash A/c Bank A/c Madhav A/c Furniture A/c Stock A/c To Vishak (Assets and liabilities at the beginning and the balance represents capital)		16,000 15,000 8,000 10,000 24,000	9,000 64,000
5	Cash A/c To Madhav (Cash received from Mashav)		3,000	3,000
8	Cash A/c To Sales A/c (Cash sales)		5,000	5,000
12	Vaishak To Cash A/c (Cash paid to Vaishak)		4,000	4,000

15	Purchase A/c To Cash (Cash purchases)		6,000	6,000
17	Sujith To Sales A/c (Sold goods to Sujith)		5,000	5,000
19	Sales Returns A/c To Sujith (Sujith returned goods)		500	500
20	Purchase A/c To Gopika (Credit purchase from Gopika)		10,000	10,000
20	Carriage A/c To Cash A/c (Paid carriage)		500	500
22	Furniture A/c To Hari (Bought furniture from Hari)		12,000	12,000
23	Gopika To Purchase Return (Returned goods to Gopika)		800	800
25.	wings A/c To Cash A/c To Purchase A/c (Withdrew cash & goods for personal use)		6,000	4,000 2,000
26	Cash A/c Discount Allowed A/c (5,000 - 500 = 4,250) To Sujith (Cash received from Sujith and discount allowed to him)		4,250 250	4,500

29	Gopika To Bank A/c To Discount Received (Issued Cheque to Gopika in Full settlement)		9,200		9,000 200
30	Salaries A/c To CashA/c (Paid salaries)		3,000	3,000	

Ledger
Cash A/c

Dr. Cr.

Date	Particulars	J.F	mountRs.	Date	Particulars	J.F	mountRs.
2009 Apr.1Apr .5Apr.8A pr.26	To Balance b/d ToMadhavTo SalesA/c To Sujith		16,000 3,000 5,000 4,250	Apr.12A pr.15Ap r.20Apr. 25Apr.3 0	By Vaishak By Purchase A/c By Carriage A/c By Drawing A/c By Salaries A/c By Balance c/d		4,000 6,000 500 4,000 3,000 10,750
May.1	To Balance b/d		28,250				28,250
			10,750				

Madhav A/c

Date	Particulars	J.F	mountRs.	Date	Particulars	J.F	mountRs.
2009 Apr.1	To Balance b/d		8,000	2009 Apr.5A pr.30	By Cash A/c By Balance c/d		3,000 5,000
May1	To Balance b/d		8,000				8,000
			5000				

Furniture A/c

Date	Particulars	J.F	mountRs.	Date	Particulars	J.F	mountRs.
2009				2009			
Apr.1	To Bal. b/d		10,000	April30	By Balance c/d		22,000
Apr.22	To Hari		12,000				
			22,000				22,000
May1	To Balance b/d		22,000				

Stock A/c

Date	Particulars	J.F	mount Rs.	Date	Particulars	J.F	mountRs.
2009				2009			
Apr.1	To Bal. b/d		24,000	Apr.30	By Trading A/c		24,000
			24,000				24,000

Vaishak A/c

Date	Particulars	J.F	mountRs.	Date	Particulars	J.F	mountRs.
2009				2009			
Apr.12A	To Cash		4,000	Apr.1	By Balance b/d		9,000
pr.30	To Balance c/d		5,000				
			9,000	May.1	By Balance b/d		9,000
							5,000

Sales A/c

Date	Particulars	J.F	mountRs.	Date	Particulars	J.F	mountRs.
2009				2009			
Apr.30	To Trading A/c		10,000	Apr.8Apr.17	By Cash A/c By Sujith.		5,000
							5,000
			10,000				10,000

Purchase A/c

Date	Particulars	J.F	mountRs.	Date	Particulars	J.F	mountRs.
2009 Apr.15	To Cash A/c		6,000	2009 Apr.25	By Drawings A/c		2,000
Apr.20	To Gopika		10,000	Apr.30	"Trading A/c(bal.)		14,000
			16,000				16,000

Sujith A/c

Date	Particulars	J.F	mountRs.	Date	Particulars	J.F	mountRs.
2009 Apr.17	To Sales A/c		5,000	2009 Apr.19A pr.26	By Sales Return A/c		500
					By Cash		4,250
					By Dis.Allowed		250
			5,000				5,000

Sales Return A/c

Date	Particulars	J.F	mountRs.	Date	Particulars	J.F	mountRs.
Apr.17	To Sujith		500	2009 Apr.30	By Trading A/c.		500
			500				500

Gopika A/c

Date	Particulars	J.F	mount Rs.	Date	Particulars	J.F	mountRs.
2009 Apr.23A pr.29	To Purchase Return A/c		800	2009 Apr.2	By Purchase A/c		10,000
	To Bank		9,000				
	To Dis. received		200				
			10,000				10,000

Carriage A/c

Date	Particulars	J.F	mountRs.	Date	Particulars	J.F	mountRs.
2009 Apr.20	To Cash A/c		500	2009 Apr.30	By Trading A/c		500
			500				500

Hari A/c

Date	Particulars	J.F	mountRs.	Date	Particulars	J.F	mountRs.
Apr.30	To Balance c/d		12,000	2009 Apr.22	By Furniture A/c By Balance b/d		12,000
			12,000	May1			12,000
							12,000

Purchase Return A/c

Date	Particulars	J.F	mountRs.	Date	Particulars	J.F	mountRs.
2009 Apr.30	To Trading A/c		800	2009 Apr.23	By Gopika		800
			800				800

Drawings A/c

Date	Particulars	J.F	mountRs.	Date	Particulars	J.F	mountRs.
2009 Apr.25	To Cash		4,000	2009 Apr.30	By Balance c/d		6,000
	To Purchase A/c		2,000				
May.1	To Balance b/d		6,000				6,000
			6,000				

Discount Allowed A/c

Date	Particulars	J.F	mountRs.	Date	Particulars	J.F	mountRs.
2009 Apr.26	To Sujith		250 250	2009 Apr.30	By P/LA/c		250 250

Bank A/c

Date	Particulars	J.F	mountRs.	Date	Particulars	J.F	mountRs.
2009 Apr.29	To Balance b/d		15,000	2009 Apr.29A pr.30	By Gopika A/c. By Balance c/d		9,000 6,000
May1	To Balance c/d		15,000				15,000
			6,000				

Salaries A/c

Date	Particulars	J.F	mountRs.	Date	Particulars	J.F	mountRs.
2009 Apr.30	To Cash A/c		3,000	2009 Apr.30	By P/L A/c		3,000
			3,000				3,000

Capital A/c

Date	Particulars	J.F	mountRs.	Date	Particulars	J.F	mountRs.
2009 Apr.30	To Balance c/d		64,000	2009 Apr.1	By Balance b/d By Balance b/d		64,000
			64,000	May1			64,000
							64,000

Discount Received A/c

Date	Particulars	J.F	mountRs.	Date	Particulars	J.F	mountRs.
2009 Apr.30	To P/LA/c		200	2009 Apr.29	By Gopika		200
			200				200

Illustration 5:

Post the following transactions into ledger and balance the accounts on 30th April 2015.

Rs

1	Sridhar started business with cash	1, 00,000
3	Paid into bank	15,000
4	Bought goods for cash	5,000
6	Bought furniture for office	10,000
7	Bought goods from Balu	10,000
9	Sold goods to Ramesh	5,000
11	Paid salaries	3,500
15	Received cash from Ramesh	4,900
	Discount allowed to him	100
18	Paid rent	2,500
25	Paid to Balu in full settlement of his account	9,500
29	Received interest	250
30	Withdrew cash from bank for personal use	1,000

Solution:

Drawings Account

Dr				Cr			
Date	Particulars	JF	Amount	Date	Particulars	JF	Amount
2015 Apr 30	To Bank A/c		1000	2015 Apr 30	By Balance c/d		1000
			1000				1000
			=====				=====
May 1	To Balance b/d		1000				

Furniture Account

Dr				Cr			
Date	Particulars	JF	Amount	Date	Particulars	JF	Amount
2015 Apr 6	To Cash A/c		10000	2015 Apr 30	By Balance c/d		10000
			10000				10000
			=====				=====
May1	To Balance b/d		10000				

Purchases Account

Dr				Cr			
Date	Particulars	JF	Amount	Date	Particulars	JF	Amount
2015 Apr 4 Apr 7	To Cash A/c To Balu		5000 10000 15000 =====	2015 Apr 30	By Trading A/c (Bal. Fig.)		15000 15000 =====

Balu

Dr				Cr			
Date	Particulars	JF	Amount	Date	Particulars	JF	Amount
2015 Apr 25	To Cash A/c To Discount received		9500 500 10000 =====	2015 Apr 7	By purchases A/c		10000 10000 =====

Ramesh Account

Dr				Cr			
Date	Particulars	JF	Amount	Date	Particulars	JF	Amount
2015 Apr 9	To Sales A/c		5000 5000 =====	2015 Apr 15	By Cash A/c By Discount A		4900 100 5000 =====

Sales Account

Dr				Cr			
Date	Particulars	JF	Amount	Date	Particulars	JF	Amount
2015 Apr 30	To Trading A/c		5000 5000 =====	2015 Apr 9	By Ramesh		5000 5000 =====

Discount Received Account

Dr				Cr			
Date	Particulars	JF	Amount	Date	Particulars	JF	Amount
2015 Apr 30	To P&L A/c		500 500 =====	2015 Apr 25	By Balu		500 500 =====

Discount Allowed Account

Dr				Cr			
Date	Particulars	JF	Amount	Date	Particulars	JF	Amount
2015 Apr 15	To Ramesh		100	2015 Apr30	By P& L A/c		100
			100				100
			=====				=====

Rent Account

Dr				Cr			
Date	Particulars	JF	Amount	Date	Particulars	JF	Amount
2015 Apr18	To Cash		2500	2015 Apr30	By P& L A/c		2500
			2500				2500
			=====				=====

Interest Account

Dr				Cr			
Date	Particulars	JF	Amount	Date	Particulars	JF	Amount
2015 Apr30	To P& L A/c		250	2015 Apr30	By Cash		250
			250				250
			=====				=====

CHAPTER 3

SUBSIDIARY BOOKS

It has already been explained that Journal is the book of Prime entry. It means all business transactions are to be first recorded in journal. But for big organizations, it will not be that much easy. Subsidiary books are nothing but a ledger, which can be maintained by big organization concerns. It is also known as sub- division of journal.

Subsidiary books includes that cash book, purchase book, Purchase returns book, sales book, sales return book, Bills Receivable book, Bills Payable book and journal proper.

In every trading concern, the transactions, however numerous they may be, can be grouped into small number of classes. They consist chiefly of receipts and payments of cash, purchases and sales of goods, returns of goods purchased and sold bills receivable and bills payable. The journal is divided in such a way that a separate book is used for each class of transactions.

The important subsidiary books used in modern business world are the following:-

1. **Cash Book:** It is used to record all cash receipts and payments.
2. **Purchases Book:** It is used to record all credit purchases.
3. **Sales Book:** It is used to record all credit sales
4. **Purchases returns book:** It is used to record all goods returned by us to our suppliers.
5. **Sales Returns Book:** It is used to record all goods returned to us by our customers.
6. **Bills Receivable Book:** It is used to record all accepted bills received by us.
7. **Bills payable Book:** It is used to record all bill accepted by us to our creditors.
8. **Journal Proper:** It is used for recording those transactions for which there is no separate book.

All these subsidiary books are called books of original entry, as transactions in their original form are entered therein.

ADVANTAGES OF SUBSIDIARY BOOKS

The advantages of having several books of original entry in place of one journal may be stated to as follows:

1. It may be impossible to record each transaction into the ledger as it occurs. Subsidiary books record the details of the transactions and therefore, help the ledger to become brief.
2. As similar transactions are recorded together in the same book, future reference to any of them becomes easy.
3. The chance of fraudulent alteration in an account is reduced as the book of original entry keeps records of the transactions in a chronological order.
4. The work of posting can be entrusted to several clerks at the same time and thus the ledger of a large business can be written up much more quickly.
5. As each journal contains separately transactions of similar nature any desired analysis can be made conveniently.

1. Cash Book:

Cash book is a book of original entry in which transactions relating only to cash receipts and payments are recorded in detail. When cash is received it is entered on the debit or left hand side. Similarly, when cash is paid out the same is recorded on the credit or right hand side of the cash book.

The cash book, though it serves the purpose of a cash book of original entry viz., cash journal really it represents the cash account of the ledger separately bound for the sake of convenience. It is more a ledger than a journal. It is journal as cash transactions are chronologically recorded in it. It is a ledger as it contains a classified record of all cash transactions. The balances of the cash book are recorded in the trial balance and the Balance Sheet.

Vouchers:

For Every entry made in the cash book there must be a proper voucher. Vouchers are documents containing evidence of payment and receipts. When money is received generally a printed receipt is issued to the payer but counterfoil or the carbon copy of it is preserved by the cashier. The copy receipts are called debit vouchers, and they support the entries appearing on the debit side of the cash book. Similarly when payment is made a receipt is obtained from the payee. These receipts are known as credit vouchers. All the debit and credit vouchers are consecutively numbered. For ready reference the numbers of the vouchers are noted against the respective entries. A column is provided on either side of the cash book for this purpose.

Balancing Cash Book:

The cash book is balanced at the end of a given period by inserting the excess of the debit on the credit side as "by balance carried down" to make both sides agree. The balance is then shown on the debit side by "To balance brought down" to start the next period. As one cannot pay more than what he actually receives, the cash book recording cash only can never show a credit balance.

Format:

The following is the simple format of a cash book:

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount

Types of cash book

a) Single Column Cash Book:

Single column cash book records only cash receipts and payments. It has only one money column on each of the debit and credit sides of the cash book. All the cash receipts are entered on the debit side and the cash payments on the credit side.

While writing a single column cash book the following points should be kept in mind:

1. The pages of the cash book are vertically divided into two equal parts. The left hand side is for recording receipts and the right hand side is for recording payments.
2. Being the cash book with the balance brought forward from the preceding period or with what we start. It appears at the top of the left side as "To Balance" or "To Capital" in case of a new business.
3. Record the transactions in order of date.
4. If any amount of cash is received on an account, the name of that account is entered in the particulars column by the word "To" on the left hand side of the cash book.

5. If any amount is paid on account, the name of the account is written in the particulars column by the word "By" on the right hand side of the cash book.
6. It should be balanced at the end of a given period.

Posting:

The balance at the beginning of the period is not posted but other entries appearing on the debit side of the cash book are posted to the credit of the respective accounts in the ledger, and the entries appearing on the credit side of the cash book are posted to the debit of the proper accounts in the ledger.

Format of the Single Column Cash Book:

Following is the format of the single column cash book:

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount

Illustration 6:

Enter the following transactions in the cash book.

2016

January 1	Balance in hand	25,000
3	Paid into bank	8,000
6	Purchased goods for cash	6,000
13	Cash sales	5,000
18	Purchased Furniture	4,000
24	Paid Rent	2,500
30	Salary paid	4,000

Solution

Single Column Cash Book

Dr

Cr

Date	Receipts	JF	Amount	Date	Payments	JF	Amount
2016 Jan 1	To Balance b/d		25,000	2016 Jan 3	By Bank A/c		8,000
13	To Sales A/c		5,000	6	By Purchases A/c		6,000
				18	By Furniture A/c		4,000
				24	By Rent A/c		2,500
				30	By Salaries A/c		4,000
				31	By Balance C/d		6,000
			30,000				30,000

Cash Book (Double Column)

Dr.					Cr.				
Date	Receipt	LF	Disc.	Cash	Date	Payment	LF	Disc.	Cash
2016					2016				
Jan.	To Balance			20,000	Jan 3	By Bank A/c			4,000
1	B/d			1,000	20	By Gopal A/c		100	3,900
23	To bank A/c		50	2950	30	By Ganesh		200	8,800
25	To Vinod A/c				31	A/c			7,250
						By Balance			
						C/d			
			50	23,950				300	23,950
			===	=====				=====	=====
				7,250					
Feb 1	To Balance								
	B/d								

c) Three Column Cash Book:

A three column cash book or treble column cash book is one in which there are three columns on each side - debit and credit side. One is used to record cash transactions, the second is used to record bank transactions and third is used to record discount received and paid.

When a trader keeps a bank account it becomes necessary to record the amounts deposited into bank and withdrawals from it. For this purpose one additional column is added on each side of the cash book. One of the main advantages of a three column cash book is that it is very helpful to businessmen, since it reveals the cash and bank deposits at a glance

Writing a Three column Cash Book:***Opening Balance:***

Put the opening balance (if any) on cash in hand and cash at bank on the debit side in the cash book and bank columns. If the opening balance is credit balance (overdraft) then it will be put in the credit side of the cash book in the bank column.

Cheque or Cash Received:

If a cheque is received from any person and is paid into the bank on the same date it will appear on the debit side of the cash book as "To a Person". The amount will be shown in the bank column. If the cheque received is not deposited into the bank on the same date then the amount will appear in the cash column. Cash received will be recorded in the usual manner in the cash column.

Payment by Cheque or Cash:

When we make payment by cheque, this will appear on the credit side "By a person" and the amount in the bank column. If the payment is made in cash it will be recorded in usual manner in the cash column.

Contra Entries:

If an amount is entered on the debit side of the cash book, and the exact amount is again entered on the credit side of the same account, it is called "contra entry". Similarly an amount entered on the credit side of an account also may have a contra entry on the debit side of the same account.

Contra entries are passed when:

1. Cash is deposited into bank by office: It is payment from cash and receipt in bank. Therefore, enter on credit side, cash column "By Bank" and on debit side bank column "To Cash". The reason for making two entries is to comply with the principle of double entry which in such transactions is completed and therefore, no posting of these items is necessary. Such entries are marked in the cash book with the letter "C" in the folio column

2. Cheque is drawn for office use: It is payment by bank and receipt in cash. Therefore, enter on the debit side, cash column "To Bank" and on credit side, bank column "By Cash".

Bank Charges and Bank Interest Allowed:

Bank charges appear on the credit side, bank column "Bank Charges." Bank interest allowed appears on the debit side, bank column "To Interest".

The method of posting three column cash book into the ledger is as follows:

1. The opening balance of cash in hand and cash at bank are not posted.
2. Contra Entries marked with "C" are not posted.
3. All other items on the debit side will be posted to the credit of respective accounts in the ledger and all other items on the credit side will be posted to the debit of the respective accounts.
4. As regards discounts the total of the discount allowed will be posted to the debit of the discount account in the ledger and total of the discount received to the credit side of the discount account.

Format of the Three Column Cash Book:

Debit Side						Credit Side					
Date	Particulars	L.F.	Discount	Cash	Bank	Date	Particulars	L.F.	Discount	Cash	Bank

Illustration 8:

Enter the following transactions in a three column cash book

2016

April 1	Cash in hand	13,000
	Balance at bank	12,500
April 5	Purchased goods for cash	9,500
April 8	Cash sales	6,800
April 12	Rent Paid by cheque	3,400
April 18	Received from Mohan by Cheque	1,200
	Discount allowed to him	100
April 24	Paid to Kiran & Co. by Cheque	4,000
	Discount earned	150
April 30	Salary Paid	1,800

Solution

Cash Book- Three Column

Dr.						Cr.					
Date	Receipt	L F	Disc .	Cash	Bank	Date	Payment	L F	Disc .	Cash	Bank
2016 Apr. 1	To BalanceB/d			13,00 0	12,50 0	2016 Apr. 5	By Purchase			9,500	
8	To Sale A/c		100	6,800		12	By Rent A/c		150		3,400
18	To Mohan				1,200	24	By Kiran & Co			1,800	4,000
						30	By Salaries			8,500	6,300
						30	By Balance C/d				
			100	19,80 0	13,70 0				150	19,80 0	13,70 0
May 1	To BalanceB/d			8,500	6,300						

d) Petty Cash Book:

In almost all businesses, it is found necessary to keep small sums of ready money with the cashier or petty cashier for the purpose of meeting small expenses such as postage, telegrams, stationery and office sundries etc. The sum of money so kept in hand generally termed as petty cash and book in which the petty cash expenditures are recorded is termed as petty cash book.

In large business houses, the cashier has to handle every day a large number of receipts and payments and if in addition to this he is further saddled with petty cash payments, his position becomes embarrassing. Besides, it is most common to find with large commercial establishments that all receipts and payments are made through bank. Since expenses like postage, telegrams, traveling etc, cannot be made by means of cheques, the maintenance of a small cash balance to meet these petty payments becomes all the more necessary.

A petty cash book is generally maintained on a columnar basis - a separate column being allotted for each type of expenditure. There is only one money column on the debit side and all sum received from time to time by the petty cashier from the chief cashier are entered in it. The credit side consists of several analysis columns. Every payment made by the petty cashier is entered on this side twice - Firstly it is recorded in the total column and then to the appropriate column to which the expense is concerned. The total of the "total column" will naturally agree with the total of all subsidiary columns. The difference between the total of the debit items and that of the "total column" on the credit side at any time will represent the balance of the petty cash in hand and this should tally with the petty cashier's actual holding of cash.

The posting from the petty cash book to the respective accounts in the ledger are made directly in total at the end of every month or any other fixed period.

The Imprest System:

The more scientific method of maintaining petty cash so far introduced into practice is the imprest system. Under this system a fixed sum of money is given to the petty cashier to cover the petty expenses for the month. At the end of a month the petty cashier submits his statement of petty expenses to the chief cashier. The chief cashier on the receipt of such statement refunds to the petty cashier the exact amount spent by him during the month, thus making the imprest for the next month the same as it was at the beginning of the current month.

It is to be noted that the amount of cash in the hands of the petty cashier is a part of the cash balance; therefore it should be included in the cash balance when the latter is shown in the trial balance and the balance sheet. It should also be kept in mind that petty cash book is not like the cash book. It is a branch of cash book.

Advantages of Imprest System:

The main advantages of imprest system of petty cash are as follows:

1. As the petty cashier has to produce to the chief cashier the petty cash book for inspection, it acts as a healthy check on the petty cashier.
2. As the petty cashier has to account for his expenses, before he can draw further sums, the petty cash book remains up to date.
3. As the petty cashier cannot draw as and when he likes, it prevents unnecessary accumulation of cash in his hand thus the chances of defalcation of cash are minimized.

Format of the Petty Cash Book:

Amount Received	Date	Particulars	V.N.	Total	Postage	Printing and Stationary	Cartage	Traveling Expenses	Misc.

Illustration 9:

Prepare a columnar petty cash book on imprest system.

2015

December 1	Cash Received from the chief cashier	300
December 2	Paid postage	40
December 5	paid stationery	25
December 8	Paid wages	100
December 15	Paid Travelling expense	20
December 28	Paid telegram	10

Solution

Petty Cash Book

Cash Received	Date	Particulars	L F	Total Payments	Postage	Stationery	wages	Travelling allowance	Telegram
300	2015 Dec 1	To Cash							
	2	By Postage		40	40				
	5	By Stationery		25		25			
	8	By wages		100			100		
	15	By Travel.		20				20	

	25	Exp By telegram	10					10
	31	By Balance b/d						
	2016 Jan 1	To Balance/d	195	40	25	100	20	10
		To Cash						
		Received	105					
300			300					
105								
195								

2. Purchases Day Book:

Purchases book or purchases day book is a book of original entry maintained to record credit purchases. You must note that cash purchases will not be entered in purchases day book because entries in respect of cash purchases must have been entered in the cash book. At the end of each month, the purchases book is totaled. The total shows the total amount of goods purchased on credit. Purchases book is written up daily from the invoices received. The invoices are consecutively numbered. The invoice of each number is noted in the purchases book.

Rule

It is not ruled like the ordinary journal. The first column in this book is for date. In the second column, the name of the supplier or the seller, quantity of each article bought, description of the article, rate etc., are recorded. Sometimes a separate column to record the details of the transactions is added in the purchases day book. The third column is for invoice number. The fourth column is for ledger folio. The last column gives the total amount to the supplier.

Posting:

The total of the purchases book is posted to the debit of purchases account. Names of the suppliers appear in the purchases book. These parties have supplied the goods. They are, therefore, credited with the amount appearing against their respective names. The double entry will thus be completed.

Format:

The following is the format of purchases day book:

Date	Particulars	Inv.No.	L.F.	Amount

Illustration 10:

Enter the following transactions in the Purchase book

2015

April 6

Bought from Boots India Ltd.

40 pairs of Gents Shoes @ Rs. 200

	20 Pairs of children Shoes @ 120
	Trade Discount @10%
April 12	Purchased from Woodlands
	30 pairs of chappals @ Rs.130
	20 pairs of Gents shoes @ Rs. 180
	Packing and delivery Rs. 30
April 28	Purchased from VKC Ltd.
	10 pairs of lady chappals @ Rs. 80
	Packing Rs. 20

Solution

Purchase Book

Date	Particulars	Inv. No.	L F	Details Rs.	Amount Rs.
2016	Bought from Boots India Ltd.				
April 6	40 pairs of Gents Shoes @ Rs. 200			8000	
	20 Pairs of children Shoes @ 120			2400	
	Trade Discount @10%			10400	
				1040	9360
	Purchased from Woodlands				
	30 pairs of chappals @ Rs.130			3900	
	20 pairs of Gents shoes @ Rs. 180			3600	
	Packing and delivery Rs. 30			30	7530
	Purchased from VKC Ltd.				
	10 pairs of lady chappals @ Rs. 80			800	
	Packing Rs. 20			20	820
	Total				17,710

3. Purchases Returns Book:

Purchases returns book is a book in which the goods returned to suppliers are recorded. It is also called returns outward book or purchases returns day book. Goods may be returned because they are of the wrong kind or not up to sample or because they are damaged etc. The ruling of this book is absolutely the same as of purchases day book. The book and entries are made therein just the same as those made in the purchases day book.

Posting:

The total of the purchases returns or returns outwards book is credited to returns outward account or purchases return account (being the goods sent out). Individual suppliers to whom goods are returned are debited (because they receive the goods).

Debit Note:

When the goods are returned to the suppliers, intimation is sent to them through what is known as a debit note. These debit notes serve as vouchers for these entries. A debit note is a statement sent by a businessman to another person, showing the amount debited to the account of the later. Debit notes are usually serially numbered and are prepared in the same form as that of the invoice.

Format of Purchases Returns Book:

Date	Particulars	D/N	L.F.	Amount

4. Sales Day Book:

A sales book is also known as sales day book is a book of original entry in which are recorded the details of credit sales made by a businessman. Total of sales book shows the total credit sales of goods during the period concerned. Usually the sales book is totaled every month. The sales day book is written up daily from the copies of invoices sent out.

Posting:

The total of the sales book is credited to sales account. Customers whose names appear in the sales book are debited with the amount appearing against their names. Double entry is thus completed.

Format of Sales Day Book:

Date	Particulars	Inv. No.	L.F.	Amount

Illustration 11:

Enter the following transactions in the Sales book

2016

- March 6 Sold to Kapoor and Sons Ltd.
 50 Electric Irons Shoes @ Rs. 50
 10 Electric Stoves @ 200
- March 8 Sold to Philips India Ltd
 25 Heaters @ Rs.50
 10 Water heaters @ Rs. 100
- March 15 Sold to Mohan
 10 table fans @ Rs. 300
 5 table lamps @Rs. 100
- March 25 Sold to Indu Electricals
 10 Electric Kettles @ Rs.70
 30 Philips Tube light @ Rs. 60

Solution

Sales Book

Date	Particulars	Inv. No.	L F	Details Rs.	Amount Rs.
2016 March 1	Kapoor and Sons Ltd. 50 Electric Irons Shoes @ Rs. 50 10 Electric Stoves @ 200			2500 2000	4500
March 8	Philips India Ltd 25 Heaters @ Rs.50 10 Water heaters @ Rs. 100			1250 1000	
					2250

March 15	Mohan 10 table fans @ Rs. 300 5 table lamps @Rs. 100			3000 500	3500
March 25	Indu Electricals 10 Electric Kettles @ Rs.70 30 Philips Tube light @ Rs. 60			700 1800	2500
	Total				12750

5. Sales Returns Book:

Sales returns book is also called returns inwards book. It is used for recording goods returned to us by our customers. The ruling of this book is exactly as for sales day book.

Posting:

The returns inwards book or sales returns book is debited to returns inwards account or sales returns account. The customers who have returned the goods are credited with the amount shown against their names.

Credit Note:

Customers who return goods should be sent a credit note. It is a statement sent by a business to another person showing the amount credited to the account of the later. Credit notes are serially numbered and are similar in form to the invoices. These are usually printed in red ink. Credit notes issued to customers are vouchers for the entries appearing in the sales returns book.

Format of Sales Returns Book:

Date	Particulars	C/N	L.F.	Amount

6. Bills Receivable Book:

Bills receivable book is used to record the bills received from debtors. When a bill is received, details of it are recorded in the bills receivable book.

Posting:

In the ledger the account of the person from whom each bill is received is credited with the amount of that bill and the periodical total of the book is posted to the debit of bills receivable account.

The bills receivable book is ruled according to the requirements of a particular account.

Format of Bills Receivable Book:

Bills Receivable Book

Date	From whom received	Term	Due date	L.F.	Amount

7. Bills Payable Book:

Bills payable book is used to record bill accepted by us. When a bill drawn by our creditor is accepted particulars of the same are recorded in this book.

Posting:

In the ledger, the account of each person whose bill has been accepted is debited with the amount of the bill. The monthly total of the bills accepted is credited to the bills payable account ledger.

Format of Bills Payable Book:

Bills Payable Book

Date	To whom given	Term	Due date	L.F.	Amount

8. Journal Proper:

Journal proper is book of original entry (simple journal) in which miscellaneous credit transactions which do not fit in any other books is recorded. It is also called miscellaneous journal. The form and procedure for maintaining this journal is the same that of simple journal. The use of journal proper is confined to record the following transactions:-

1. Opening entries
2. Closing entries
3. Transfer entries
4. Adjustment entries
5. Rectification entries
6. Entries for which there is no special journal
7. Entries for rare transactions

Transaction for which there is No Special Journal:

When a trader cannot record the entries in the above mentioned sub-journals, the same are entered in the journal proper. The common transactions which cannot be recorded in any of the book of original entry are:

- Distribution of goods as free sample.
- Distribution of goods as charity.
- Goods destroyed by fire.
- Goods stolen away by employees.
- Exchange of one asset for another asset etc.

CHAPTER 4

TRIAL BALANCE

When transactions take place, first they are recorded in the journal. Then the journal entries are posted to ledger. Then each ledger account is balanced. After this a list of these ledger balances is prepared to make sure that posting has been done correctly. This list is called Trial Balance.

MEANING AND DEFINITION OF TRIAL BALANCE

When all entries in the journal (or subsidiary books) have been posted into the ledger, it is necessary to test whether the accounting work is done accurately and correctly. For this purpose a statement is prepared by taking all balances (debit and credit) from ledger accounts. This statement is known as Trial Balance. Thus a trial balance is a statement of debit and credit balances extracted from all accounts in the ledger for testing the arithmetical accuracy. It is a device for verifying the equality of debits and credits. Pacioli is said to have advised that a person should not go to sleep at night until debits equaled the credits. The debit balances are shown in one column and the credit balances are shown in another column, the amounts of the two columns are totaled. If the debit total is equal to credit total, we can say 'there is an arithmetical accuracy in books of account'. It is drawn at any time, or at periodic intervals, or at the end of an accounting period.

OBJECTIVES OR FUNCTIONS OF TRIAL BALANCE

- To ensure arithmetical accuracy of books of accounts.
- To provide a base for preparing final accounts
- To help in detecting certain errors
- To serve as an aid to management in decision making

METHODS OF PREPARING TRIAL BALANCE

Following are the three methods of preparing the trial balance:

1. Total method: Under total method, debit totals and credit totals of each account are entered in the trial balance in the debit and credit columns respectively. Both the sides of the trial balance should be equal. If they are not equal, we can understand that there are certain errors.

2. Balance method: This method is based on the assumption, "If equals are subtracted from equals, the remainders are equal." Under this method, trial balance is prepared with the balances extracted from the ledgers and not total. Debit balances should be entered in debit column and credit balances shall be taken in credit column. Generally trial balance is prepared under balance method.

3. Total and balance method: This method is a combination of the first and second methods. In this method trial balance is prepared by taking totals as well as balances from each ledger account

POINTS TO REMEMBER WHILE PREPARING TRIAL BALANCE

1. All assets accounts have debit balances. Cash A/c, Cash at Bank A/c, B/R A/c, Debtors A/c, Stock A/c, Building A/c, Plant and Machinery A/c, Furniture A/c, Goodwill A/c etc. have debit balances. These should be written on the debit side.
2. All liabilities accounts have credit balances. Creditors A/c, Outstanding expense A/c, Income received in advance A/c, bank overdraft A/c, B/P A/c etc have credit balances.

3. Capital A/c shows a credit balance (if there is deficiency in Capital A/c, it will show a debit balance).
4. Reserves on assets and reserves created out of profits show credit balances.
5. Drawings A/c shows a debit balance.
6. Loan taken is a liability. Hence it is a credit balance. Loan given is an asset. Hence it is debit balance. If only Loan A/c is given it should be taken as liability.
7. Purchase A/c shows a debit balance and Purchase Returns (Returns outward) shows a credit balance.
8. Sales A/c shows a credit balance and Sales Returns A/c (Returns inward) shows a debit balance.
9. Losses and expenses are debit balances, while incomes and gains are credit balances.
10. There are certain items which are not specified as paid or received. Such items should be taken as paid (i.e. expenses or debit balances). For example, commission paid is an expense and commission received is an income, but if only commission is given, it may be taken as commission paid. Other examples include rent, interest, discount etc.

Illustration 12:

The following balances were extracted from the books of a trader on March 31, 2015. Prepare a trial balance.

Capital	49,200	Purchases Returns	600
Creditors	11,000	Sales	1, 00,000
Building	30,000	Sales Returns	400
Furniture	6,000	Salaries	7,000
Debtors	13,200	Wages	9,600
Bad Debts	400	Rent	5,000
Purchases	64,000	Bank	15,200
Cash	10,000		

Note: Stock in hand on March 31, 2015 Rs.2, 400

Solution

Trial balance as on March 31,2015

Name of the Account	LF	Debit Rs.	Credit Rs.
Capital			49,200
Creditors			11,000
Building		30,000	
Furniture		6,000	
Debtors		13,200	
Bad Debts		400	
Purchases		64,000	
Purchases Returns			600
Sales			1, 00,000
Sales Returns		400	
Salaries		7,000	
Wages			
Rent		,600	
Bank		5,000	
Cash		15,200	

		10,000	
		Purchases Returns 1,60,800 =====	1,60,800 =====

ERRORS

If the debit and credit balances of trial balance do not agree, it is sure that there have been some errors. Trial Balance serves to prove only the arithmetical accuracy of the books. There are several types of which may exist and may remain undisclosed in spite of the agreement of Trial Balance.

TYPES OF ERRORS

1. Errors of Principles

When a transaction is recorded in contravention of accounting principles it is an error of principle.

2. Errors of Omission

When a transaction is omitted to be recorded in the books of original entry or omitted to be posted from the books of original entry to the ledger, it is an error of omission. In case of complete omission it will not effect Trial Balance. But trial balance will show disagreement if the omission is partial.

3. Errors of Commission

If while making an entry, the wrong amount is written either in the subsidiary book or in the ledger or the entry is made on the wrong side of the account, the error will be an error of commission. Wrong totaling and balancing are also called errors of commission.

4. Compensating errors

If the effect of an error in one account is cancelled by the effect of one or more errors in some other accounts, it is called a compensating error.

RECTIFICATION OF ERRORS

Errors should not be corrected by overwriting. It should be corrected by making a fresh entry. The errors may be such as affecting only one account called one sided errors or they may affect both the accounts involved called two sided errors.

One-sided errors:

It will cause for the disagreement of the trial balance because this error is committed only on one aspect of a transaction. It may be noted that one sided errors do not require any journal entry for rectification. They require physical correction of wrong figures or an opposite entry in the same account.

Illustration 13:

The purchase book is under cast by Rs. 500

The effect of the error is that purchase account has been debited short by rs.500. So purchase account is to be corrected. This will be done by making an entry for rs.500 on the debit side, "to under casting of purchase book rs.500

Two sided errors:

Complete omission, error of principle, wrong account posting etc. are common type of two sided errors.

Illustration 14:

Purchase of machinery for rs.5000 has been entered in the purchase book

Wrong entry: Purchase a/c dr. 50000

To creditor 50000

Correct entry: Machinery a/c dr. 5000

To Creditor 5000

Rectification entry: Machinery a/c dr. 5000

To Purchase a/c 5000

CHAPTER 5

BANK RECONCILIATION STATEMENT:

From time to time the balance shown by the bank and cash column of the cash book required to be checked. The balance shown by the cash column of the cash book must agree with amount of cash in hand on that date. Thus reconciliation of the cash column is simple matter. If it does not agree it means that either some cash transactions have been omitted from the cash book or an amount of cash has been stolen or lost. The reason for the difference is ascertained and cash book can be corrected. So far as bank balance is concerned, its reconciliation is not so simple. The balance shown by the bank column of the cash book should always agree with the balance shown by the bank statement, because the bank statement is a copy of the customer's account in the banks ledger. But the bank balance as shown by the cash book and bank balance as shown by the bank statement seldom agrees. Periodically, therefore, a statement is prepared called bank reconciliation statement to find out the reasons for disagreement between the bank statement balance and the cash book balance of the bank, and to test whether the apparently conflicting balance do really agree.

Causes of Disagreement Between Bank statement and Cash book:

Usually the reasons for the disagreement are:

1. That our banker might have allowed interest which has not yet been entered in our cash book.
2. That our banker might have debited our account for any such item as interest on overdraft, commission for collecting cheque, incidental charges etc., which we have not entered in the cash book.
3. That some of the cheque which we drew and for which we credited our bank account prior to the date of closing, were not presented at the bank and therefore, not debited in the bank statement.
4. That some cheques or drafts which we have paid into bank for collection and for which we debited our bank account, were not realized within the due date of closing and therefore, not credited by the bank.
5. The banker might have credited our account with amount of a bill of exchange or any other direct payment into bank and the same may not have been entered in the cash book.
6. That cheques dishonored might have been debited in the bank statement but have not been given effect to in our books.

How to Prepare a Bank Reconciliation Statement:

To prepare the bank reconciliation statement, the following rules may be useful for the students:

1. Check the cash book receipts and payments against the bank statement.
2. Items not ticked on either side of the cash book will represent those which have not yet passed through the bank statement.
3. Make a list of these items.
4. Items not ticked on either side of the bank statement will represent those which have not yet been passed through the cash book.
5. Make a list of these items.
6. Adjust the cash book by recording therein those items which do not appear in it but which are found in the bank statement, thus computing the correct balance of the cash book.
7. Prepare the bank reconciliation statement reconciling the bank statement balance with the correct cash book balance in either of the following two ways :
 - (i) First method (Starting with the cash book balance) .
 - (ii) Second method (Starting with the bank statement balance)

First Method (Starting With the Cash Book Balance):

- (a) If the cash balance is a debit balance, deduct from it all cheques, drafts etc., paid into

the bank but not collected and credited by the bank and added to it all cheques drawn on the bank but not yet presented for payment. The new balance will agree with bank statement.

- (b) If the bank balance of the cash book is a credit balance (overdraft), add to it all cheques, drafts, etc., paid into the bank but not collected by the bank and deduct from it all cheques drawn on the bank but not yet presented for payment. The new balance will then agree with the balance of the bank statement.

Second Method (Starting With the Bank Statement Balance):

- (a) If the bank statement balance is a debit balance (an overdraft), deduct from it all cheques, drafts, etc., paid into bank but not collected and credited by the bank and add to it all cheques drawn on the bank but not yet presented for payment. The new balance will then be agreeing with the balance of the cash book.
- (b) If the bank statement balance is a credit balance (in favor of the depositor), add to it all cheques, drafts, etc., paid into the bank but not collected and credited by the bank and deduct from it all cheques drawn on the bank but not yet presented for payment. The new balance will agree with the balance of the cash book.

Alternatively:

Information	Cash book shows debitbalance i.e., bank statement shows creditbalance		Cash book shows credit balance i.e., bank statement shows debit balance	
	CB to BS	BS to CB	CB to BS	BS to CB
Cheques issued but not presented in the bank	Add	Less	Less	Add
Cheques paid into bank but not collected and credited by the bank	Less	Add	Add	Less
Credit, if any in the bank statement	Add	Less	Less	Add
Debit, if any in the bank statement	Less	Add	Add	Less

Illustration 15:

On December 31 2015 the balance of the cash at bank as shown by the cash book of a trader was Rs. 1,401 and the balance as shown by the bank statement was 2,253.

On checking the bank statement with the cash book it was found that a cheque for Rs.116 paid in on the 31st December was not credited until the 1st January, 2016 and the following cheques drawn prior to 31 December were not presented at the bank for payment until the 5th January 1992. Rashid & Sons Rs. 29, Bashir & Co. Rs. 801, MA JalilRs.6, Khalid Bros, Rs.132.Prepare a statement recording the two balances:

Solution:

Bank Reconciliation Statement on 31st December 2015

First Method:

Balance as per cash book - Dr.	1,401
Less cheques paid in but not collected	116
	1,285
Add cheques drawn but not presented:	
Rashid & Sons	29
Bashir & Co.	801

MA Jalil	6	
Khalid Bros.	132	968
Balance as per bank statement - Cr.		2,253
Second Method:		
Balance as per bank statement - Cr.		2,253
Less cheques drawn but not presented		968
		1,285
Add cheques paid in but not collected		116
Balance as per cash book - Dr.		1,401

Illustration 16:

On 31st March, 2015 the bank statement showed the credit balance of Rs.10,500. Cheque amounting to Rs.2,750 were deposited into the bank but only cheque of Rs.750 had not been cleared up to 31st March. Cheques amounting to Rs.3,500 were issued, but cheque for Rs.1,200 had not been presented for payment in the bank up to 31st March. Bank had given the debit of Rs.35 for sundry charges and also bank had received directly from customers Rs.800 and dividend of Rs.130 up to 31st March. Find out the balance as per cash book.

Solution:

Bank Reconciliation Statement as on 31st March, 2015

Balance as per bank statement - Cr.	10,500
Add cheques deposited but not credited	750
	11,250
Less cheques issued but not presented	1,200
	10,050
Add bank charges made by the bank	35
	10,085
Less omission in cash book (Rs. 800 + Rs. 130)	930
Balance as per cash book	9,155

CHAPTER 6

FINAL ACCOUNTS OF A SOLE TRADER

Accounts produced at the end of the year giving details of the profit and loss and balance made over the year and the worth of the business.

Trading account

A **trading account** is an account which contains, "in summarized form, all the transactions, occurring, throughout the trading period, in commodities in which he deals" and which gives the gross trading result. In short, trading account is the account which is prepared to determine the gross profit or the gross loss of a trader.

Items of Trading Account:

The following items usually appear in the debit and credit sides of the trading account.

Debit Side Items:

1. The value of opening stocks of goods (i.e., the stock of goods with which the business was started).
2. Net purchase made during the year (i.e., purchases less returns).
3. Direct expenses, if any.

Credit Side Items:

1. Total sales made during the period less the value of returns, i.e., net sales.
2. The value of closing stock of goods.

The difference between the two sides of the trading account represents either gross profit or gross loss. Thus if the credit side is heavier that would mean that the trader has earned gross profit i.e., the excess of selling price of the goods sold over their purchase price. If the debit side is heavier it would mean that the trader has suffered gross loss i.e., purchase price of goods exceeds the selling price.

The balance of trading account which represents either gross profit or gross loss is transferred to profit and loss account.

Format of Trading Account (T or Account Form):

Trading Account for the year ending20.....

Particulars	Dr.	Particulars	Cr. Amt
Amt			
To Opening stock	By Sales	.....
To purchases	Less returns	.....
Less Returns	By Closing stock	.....
To Carriage inwards	By Gross loss	
To Cartage	transferred to profit and	
To dock charges	loss account	.....
To Wages		
To Duty		
To Freight		
To Clearing charges		
To Etc. Etc.,		
To Gross profit			
(Transferred to profit and			
loss account)		

Trading Accounts Items:

Now we shall discuss the items of trading account one by one.

Opening Stock:

In case of trading concerns it will consist of only finished goods or goods to be sold without alteration. In manufacturing concerns, the opening stock will consist of three parts

(a) Stock of raw materials.

(b) Stock of partly completed goods or work-in-progress.

(c) Stock of finished goods.

In case of new business there will be no opening stock.

Purchases:

This item includes both cash and credit purchases of goods bought with the object of sales.

Return Outwards or Purchases Returns:

It means the goods returned by a trader to his suppliers from out of his purchases. Return outwards reduce the purchases. It is shown by way of deduction from purchases in the trading account.

Discount on Purchases:

It is also shown by way of deduction from purchases in the trading account.

Sales:

This item includes total of both cash and credit sales of goods in which businessman deals in.

It is credited to trading account.

Returns Inwards or Sales Returns:

It means goods returned to a trader by his customers from out of goods sold to them. It is shown by way of deduction from sales on the credit side, of the trading account.

Discount on Sales:

This account has always a debit balance and is shown by deduction from sales in the trading account.

Direct Expenses:

Direct expenses are those expenses which are incurred to convert raw-materials into finished goods or which may be regarded as a part of the cost of purchasing the goods. e.g., wages paid by a manufacturer to construct furniture out of raw wood, the expenses incurred to bring goods from the place of purchase to the business place of the trader etc. All the direct expenses are charged to the trading account. The items usually included in the direct expenses are:

1. **Wages:** This item usually signifies some hourly, daily or piecework remuneration paid to laborers. It is direct expenditure and should be charged to trading account.
2. **Manufacturing or Productive Wages:** This item usually signifies the wages of factory workmen actually engaged in making or producing something. It is a direct charge on the cost of manufacturer. It is debited to manufacturing account or trading account.
3. **Carriage Inward:** Carriage means conveyance charges of goods by land. Carriage inward is the conveyance expenses incurred to bring the goods purchased in the godown or shop. It is debited to trading account. In examination questions when the item only "carriage" is given and is not expressly stated to be inward or outward, it should be assumed to be inward and debited to trading account. The reason is that carriage on goods is usually paid by the purchaser.
4. **Cartage:** The cartage charges on goods purchased are direct expenses and should be debited to trading account.
5. **Freight:** Freight is the charge made for conveyance of goods by sea. Freight on goods purchased is charged to trading account.
6. **Customs Duty, Octroi Duty etc:** When goods are purchased from a foreign country import duty will be payable. When goods are received from another city, the municipal corporation may charge octroi duty. All duties on goods purchased should be debited to trading account.
7. **Excise Duty:** It is a tax levied by the government. If the duty is levied on production it will be treated as manufacturing expenses and debited to trading account.

8. **Stores Consumed:** This item stores denote lubricating oil, tallow, grease, cotton and jute waste, etc., required for running the machinery of manufacturing concern. The amount of stores consumed is a direct expense and should be charged to trading account.
9. **Motive Power:** This item includes, coke, gas, water or electric energy consumed in propelling the machinery. It is debited to manufacturing account in the absence of a manufacturing account; it is debited to trading account.
10. **Royalty:** Royalty is an amount paid to a person for exploiting rights possessed by him it is usually paid to patentee, author, or landlord for the right to use his patent, copyright or land. If they are productive expenses, they are debited to manufacturing account; but in the absence of a manufacturing account, they are debited to trading account.
11. **Manufacturing Expense:** All other expenses such as factory rent, factory insurance, factory repair etc., are direct expenses and should be charged to trading account.

Closing Stock and its Valuation:

Closing stock represents the value of goods lying unsold in the hands of a trader at the end of a trading period. The value of closing stock is ascertained by means of compilation of list of materials, stores and goods actually in possession at the close of the trading period. This work is known as taking the inventory. The inventory or lists of physical stock are then faired and valued. The total of the lists will be closing stock. The closing stock is valued at cost or market price whichever is lower. As this item materially affects the gross profit (or gross loss), it is essential that all possible care should be taken to calculate the closing stock at a proper value.

The value of closing stock is taken into consideration only at the time of preparing the trading account and not before. The trial balance is prepared before the preparation of the trading account. Hence the closing stock does not appear in a trial balance. It is brought into account by means of a journal entry debiting stock account and crediting the trading account.

Closing Entries for Trading Account:

Closing entries are those which are passed at the end of each financial period for the purpose of transferring the various revenues items to the trading and profit and loss account and thus the nominal accounts are closed. In preparing a trading account, the opening stock, purchases, sales, and returns both inwards and outwards, direct expenses and closing stock are transferred to it by means of journal entries as follows:

1. Trading Account
 - To Purchases Account
 - To Returns Inwards Account
 - To Direct Expenses Account (wages, carriage etc.)
 (Being the transfer of the latter accounts to the former.)
2. Sales Account
 - Returns Outward Account
 - To Trading Account
 (Sales etc., transferred to trading account)
3. Closing Stock Account
 - To Trading Account
 (Being to record closing stock)

Advantages of Trading Account:

The advantages of the trading account are as follows:

1. A trader can find out the gross profit and thereby can ascertain the percentage of profit he has earned on the cost of goods sold. This percentage of gross profit may serve as his ready guide for the adjustment of future sale price.

2. A trading account helps a trader to compare his stock at open with that at the close. He can further find out whether the purchases he has made during the period of account have been judicious.
3. Once can compare the figure of sales with similar figure of the previous year and can find out whether business is improving or declining.
4. If the gross profit disclosed by the trading account is less than expected, an enquiry can be made into the cause responsible for the decline. And if the gross profit is more than was expected, steps can be taken to maintain it.

Illustration 17:

From the following ledger balances extracted from the books of a trader prepare the trading account for the year ending 31st march 2015

Stock (Opening)	6,000	Carriage inwards	800
Purchases	25,000	Wages	2,300
Stock (Closing)	3,000	Purchases Return	1,100
Sales	43,000	Sales Returns	900

Trading Account			
For the year ending 31st March 2015			
Dr.			Cr.
Particulars	Amount	Particulars	Amount
To Opening Stock	6,00	By Sales	43,000
To Purchase	25,000	(Less) Returns	<u>900</u>
(Less) Returns	<u>1,100</u>		42,100
	23,900		
To Carriage inwards	800	By Closing Stock	3,000
To Wages	2,300		
To Gross Profit C/d (transferred to P& L A/c)	12,100		
	45,100		45,100

PROFIT AND LOSS ACCOUNT

Profit and loss account is the account whereby a trader determines the net result of his business transactions. It is the account which reveals the net profit (or net loss) of the trader. The profit and loss account is opened with gross profit transferred from the trading account (or with gross loss which will be debited to profit and loss account). After this all expenses and losses (which have not been dealt in the trading account) are transferred to the debit side of the profit and loss account. If there are any incomes or gains, these will be credited to the profit and loss account. The excess of the gain over the losses is called the net profit and that of the loss over the gain is called the net loss. The account is closed by transferring the net profit or loss to capital account of the trader.

Format of the Profit and Loss Account:

Profit and Loss Account For the year ended.....

To Gross Loss	xxxx	By Gross Profit	xxxx
To Salaries	xxxx	By Interest Received	xxxx
To Rent	xxxx	By Discount Received	xxxx
To Rent and Rates	xxxx	By Commission Received	xxxx
To Discount Allowed	xxxx	By Other Receipts	xxxx
To Commission Allowed	xxxx	By Etc., Etc.	xxxx
To Insurance	xxxx		
To Bank Charges	xxxx	By Net Loss (transferred to	xxxx

To Legal Charges	XXXX	capital account of the trader)	
To Repairs	XXXX		
To Advertising	XXXX		
To Trade Expenses	XXXX		
To Office Expenses	XXXX		
To Bad Debts	XXXX		
To Traveling Expenses	XXXX		
To Net Profit (transferred to capital account of the trader)	XXXX		

Closing Entries for Profit and Loss Account:

The following usual entries are passed at the end of each trading period.

1. **Transferring all expenses or losses:**

Profit and loss account

To Each of the various expenses or losses

(This entry will close the expenses accounts)

2. **Transferring all items of gains etc.:**

Various nominal accounts (representing gains)

To Profit and loss account

(This entry will close all the remaining nominal accounts)

3. **Transferring net gain to capital account:**

Profit and loss account

To Capital account

(This entry closes the P & L account)

4. **Transferring net loss to capital account:**

Capital account

To Profit and loss account

(This entry closes the P & L account)

Illustration 18:

From the following balances extracted from the books of a trader prepare the Profit and Loss account for the year ending 31st march 2015

Gross Profit	13,500	Salaries	9,700
Rent	3,200	General Expenses	1,200
Interest Received	2,500	Bank Charges	450
Commission Received	125	Bad Debt	150
Discount	230	Insurance	500

Solution:

Profit and Loss Account			
For the year ended 31 st March 2015			
Dr.			Cr.
Particulars	Amount	Particulars	Amount
To Salaries	9 700	By Gross Profit B/d	13 500
To Rent	3 200	By Interest Received	2 500
To General expenses	1 200	By Commission Received	125
To Bad Debt	150		
To insurance	500		
To Discount	230		
To Net Profit C/d			
(Transferred to Capital Account)	695		
	16,125		16,125

BALANCE SHEET

A **balance sheet** is a statement drawn up at the end of each trading period stating therein all the assets and liabilities of a business arranged in the customary order to exhibit the true and correct state of affairs of the concern as on a given date.

A balance sheet is prepared from a trial balance after the balances of nominal accounts are transferred to the trading account or to the profit and loss account. The remaining balances of personal or real accounts represent either assets or liabilities at the closing date. These assets and liabilities are shown in the balance sheet in a classified form - the assets being shown on the right side and the liabilities on the left hand side.

Grouping and Marshalling:

In a balance sheet assets and liabilities should be properly grouped and classified under appropriate headings. The individual balance of each debtor's and creditor's account need not be shown. Debtors and creditors should be shown in total. The grouping together of dissimilar assets will make the balance sheet misleading.

The term marshalling means the order in which assets and liabilities are stated on the balance sheet as the balance sheet exhibits the financial position of a concern even to a non-technical observer. It is of great importance that the different assets and liabilities should be arranged in the balance sheet on certain principles. The balance sheet is generally marshaled in three ways:

1. The Order of Liquidity or Realizability:

According to this method assets are entered up in the balance sheet following the order in which they can be converted into cash and the liabilities in the order in which they can be paid off. The following is a format of a balance sheet based on this order:

Balance Sheet as at.....

Liabilities	Rs.	Assets	Rs.
Bills Payable		Cash in hand	
Loans		Cash at Bank	
Trade Creditors		Investments	
Capital		Bills Receivables	
		Debtors	
		Stock (Closing)	
		Stores	
		Furniture & Fixtures	
		Plant & Machinery	
		Land & Buildings	

2. The Order of Permanence:

This method is the reverse of the first method. Under this method the assets are stated according to their permanency i.e., permanent assets are shown first and less permanent are shown one after another. Similarly the fixed liabilities are stated first and the floating liabilities follow. The following is a specimen of a balance sheet based on this order:

Balance Sheet as at.....

Liabilities	Rs.	Assets	Rs.
Capital		Land & Buildings	
Trade Creditors		Plant & Machinery	
Loans		Furniture & Fixtures	
Bills Payable		Stores	
		Stock (Closing)	
		Debtors	
		Bills Receivables	
		Investments	
		Cash at Bank	

		Cash in hand	
--	--	--------------	--

3. Mixed Order of Arrangement:

This method is the combination of the first two methods. Under this method the assets are arranged in order of realisability and liabilities are arranged in order of permanence.

The first method is adopted by sole proprietors, firms and partnership concerns. The second method is adopted by companies and the third method is adopted by banking concerns.

Objectives of the Balance Sheet:

The function of the correctly prepared balance sheet is to exhibit the true and correct view of the state of affairs of any concern. In a balance sheet as the assets and liabilities are shown in details after being properly valued, a trader can judge the position of his business from it.

Classification of Assets:

The properties and possessions of a business are called assets and they are classified into the following classes:

Fixed assets:

Fixed assets are assets which are acquired not for sale but for permanent use in the business e.g., land and buildings, plant and machinery, furniture etc. These assets help the business to be carried on.

Current Assets or Circulating Assets or Floating Assets:

Current assets denote those assets which are held for sale or to be converted into cash after some time e.g., sundry debtors. Bills receivables, stock of goods etc.

Liquid Assets:

Liquid assets are those assets which are with us in cash or easily converted into cash e.g., cash in hand, cash at bank, investments etc.

Wasting Assets:

Those assets that depreciate through "wear and tear", and whose values expire with lapse of time or that become exhausted through working are known as **wasting assets**. This is a sub-class of fixed assets e.g., plant machinery, mines etc.

Intangible or Fictitious Assets:

There are assets which have no physical existence. Which can neither be seen with eyes not touched with hands. These are called **intangible assets** or **fictitious assets**. They do not represent any thing valuable. They include debit balance of profit and loss account, goodwill etc.

Contingent Assets:

A **contingent asset** is one which comes into existence upon the happening of a certain event. If that event happens the asset becomes available, otherwise not. For example, the uncalled capital of a limited company is a contingent asset.

Outstanding Assets:

Expenses paid in advance i.e., prepaid expenses, and income earned but not received are known as **outstanding assets**.

Classification of Liabilities:

The liabilities of a business are classified as follows:

Fixed Liabilities:

These are the liabilities which are payable immediately or in the near future. These liabilities are payable after a long period. Long term loans, capital of the proprietor are the examples of such kind of liabilities.

Current Liabilities:

These are the liabilities which are payable immediately or in the near future, such as creditors, bank loans etc.

Contingent Liabilities:

Contingent liabilities are those liabilities which arise only on the happening of some event. The event may or may not happen. Thus a contingent liability may or may not involve the payment of money. Examples of contingent liabilities are:

1. **Liabilities on bills discounted:** In case the bill is dishonored by the acceptor, the holder may be called upon to pay the amount to the discountor.
2. **Liability under guarantee:** In case the debtor fails to fulfill his obligation, the man who has given a guarantee or surety have to make good the loss to the creditor.
3. **Liability in respect of a pending suit:** A suit pending against a person in a court is a contingent liability because if the decision of the court goes against him, he may thereby become liable to pay compensation.

Contingent liabilities are not recorded in the books not they are included in the balance sheet. They are simply referred to by way of foot notes on the balance sheet.

Outstanding Liabilities:

Outstanding expenses and unearned income are examples of outstanding liabilities.

Classification of Capital:

The surplus or excess of assets over liabilities is called the capital or the proprietor. Capital may be classified as follows on the basis of the capital fund invested:

Trading Capital:

The portion of the funds of a concern which is represented by the fixed and floating assets is called the trading capital

Fixed Capital:

The portion of the funds of a concern which is represented by the fixed assets is called fixed capital.

Circulating Capital:

The portion of the funds of a concern which is represented by the floating or circulating assets is called the circulating or floating capital.

Working capital:

It is the amount which remains for the working of the business after the liabilities for acquiring the fixed assets have been discharged. The excess of the floating assets over the floating liabilities is also called the working capital.

Loan Capital:

The debentures and other fixed loans are sometimes called loan capital.

Watered Capital:

It is represented by fictitious assets.

Valuation of Assets:

In order to exhibit a true financial position of a business, assets are to be valued carefully. The basis upon which the various assets are valued depends to some extent on the nature of the business and the objects for which the assets are held. The following principles, however, will serve as a valuable guide in this respect:

Fixed assets

Fixed assets are valued on the method "**going concern.**" Valuation of the fixed assets must be ascertained from their capacity to earn revenue and that is why they should be valued for the purpose of the balance sheet at cost price less depreciation which is an estimated loss arising out of the use of the fixed assets in course of the business.

Floating assets

Floating assets are valued on the principle of the "**cost or market price whichever is less.**" They are valued at a figure which they are likely to realize when converted into cash and as such they are valued at cost price or market price if the same is below the cost price at the date of valuation. It is never valued at a price exceeding the cost even if the market price is in

excess of the cost price at the date of such valuation.

Illustration 19:

From the Following Trial balance of Mr. Ram Kumar prepare Trading, Profit & Loss Account and Balance sheet as on 31st March 2016

Trial Balance

Particulars	Dr. Amount	Cr. Amount
Capital		52,000
Drawings	2000	
Bills Payable		6500
Discount received		200
Rent received		6,000
Purchases	75,500	
Sales		1,26,800
Return inwards	800	
Salaries	15,600	
Wages	10,500	
Carriage Outwards	500	
Bad Debts	600	
Cash in Hand	2,300	
Cast at Bank	7,500	
Stock (Opening)	11,000	
Furniture	8,000	
General Charges	1,800	
Printing & Stationery	1,700	
S. Debtors	27,000	
S. Creditors		18,000
Investment	10,000	
Interest on Investment		1,500
Buildings	35,000	
Commission	1,200	
	2,11,000	2,11,000

Additional Information:

Closing Stock is valued at Rs. 10,800

Solution:

Trading, Profit & Loss Account

for the Year ended 31st March 2016

Dr.			Cr.
Particulars	Amount	Particulars	Amount
To Opening Stock	11,000	By Sales	1 26,800
To Purchases	75,500	(Less) Inwards	<u>800</u>
To Wages	10,500		1,26,000
To Gross Profit C/d	39,800	By Closing Stock	10,800
	1,36,800		1,36,800
To Salaries		By Gross Profit B/d	
To Carriage Outwards	15,600	By Discount Received	39,800
	500		200

To Bad debts	600	By Rent Received	6,000
To General Charges	1,800	By Interest on Investment	
To Printing & Stationery	1,700		1,500
To Net Profit	1,200		
(Transferred to Capital)			
	26,100		
	47,500		47,500

Balance Sheet of Mr. Ram kumar as on 31st March 2016

Liabilities		Amount	Assets		Amount
Capital			Building		35,000
Opening Balance	52,000		Furniture		8,000
Add Net Profit	<u>26,100</u>		Investment		10,000
	78,100	76,100	Stock		10,800
Less Drawings	<u>2,000</u>		S. Debtors		27,000
			Cash in Hand		7,500
Bills Payable		6,500	Cash at Bank		2,300
S. Creditors		18,000			
		1,00,600			1,00,600

Difference between trial balance and balance sheet:

Trial Balance	Balance Sheet
It is a list of balance extracted from the ledger accounts	It is a statement of assets and liabilities
It contains the balance of all accounts - real, nominal and personal.	It contains the balance of only those accounts which represents assets and liabilities.
It is prepared before the preparation of trading and profit and loss account.	It is prepared after the preparation of trading and profit and loss account.
It does not contain the value of the closing stock of goods.	It contains the value of closing stock, which appears on the assets side.
Expenses due but not paid and incomes due but not received do not appear in the trial balance	Expenses due but not paid appear on the liability side and income due but not received appear on the asset side of the balance sheet.

FINAL ACCOUNTS WITH ADJUSTMENTS

Final accounts are prepared from trial balance. But the trial balance is not a complete tool to prepare final account. This is due to the reason that it contains the summary of only those transactions which have been already recorded in the books of accounts during a given

period. It does not include information relating to pending transactions. For example, rent for a year is amounted to Rs. 60000. But rent paid (say, Rs. 50,000) would appear in trial balance. Similarly there might be expenses paid in advance. Hence while preparing final accounts certain adjustments should be made. Only then final accounts will reveal true values. Adjustments are made with the help of adjusting entries. The treatment of important adjustments is given below:

1. Closing stock: Generally closing stock is not given in trial balance. It will be given under adjustment. The adjusting entry is:

Closing Stock A/c Dr.
 To Trading A/c

Generally closing stock is not given in trial balance because it is valued at the end of the year after the accounts have been closed. In other words, closing stock is not a ledger balance.

Treatment in Final Accounts

(i) Closing stock is shown on the credit side of Trading A/c

(ii) It also appears on the asset side of the balance sheet

Sometimes the value of closing stock appears in the trial balance. This means closing stock has already been adjusted in the purchases (deducted from purchases) in arriving at cost of goods sold. In such a case closing stock should be shown only in the balance sheet (asset side).

2. Outstanding expenses: Outstanding expenses are those expenses which remain unpaid at the end of the accounting period. In order to arrive at true profit or loss, it is necessary to take into account the outstanding or accrued expenses. The adjusting entry is:

Expenses A/c Dr.
 To Outstanding Expenses A/c

Treatment in Final Accounts

(i) Outstanding expenses should be added to the concerned expenses on the debit side of the Trading A/c or P/L A/c

(ii) It should also be shown in the Balance Sheet as liability (current liability)

If outstanding expenses are given in Trial Balance (Cr. balance) then it should be shown only in the B/S as a liability.

3. Prepaid expenses: Prepaid expenses are payments made in the current year but relate to the next accounting year. In short, prepaid expense is expense paid in advance. For example, insurance premium for Rs.6,000 is paid upto 30th June 2009. The accounting year ends on 31st March 2009. This mean insurance premium of Rs.1,500 for 3 months April to June has been paid in advance ($6,000 \times \frac{3}{12} = \text{Rs } 1,500$). Prepaid expenses are also known as unexpired expenses.

The adjusting entry is:

Prepaid Expenses A/c Dr.
 To Expenses A/c

Treatment in Final Accounts

(i) Prepaid expenses should be deducted from the concerned expenses on the debit side of Trading A/c or P/L A/c.

(ii) Prepaid expense should also be shown on the asset side of the balance sheet.

If prepaid expense is given in trial balance (Dr. balance) then it should be taken only in the B/S as asset.

4. Accrued income: This is the income earned but not received by the end of the accounting year.

Such incomes arise in case of interest on investments, rent on building, commission etc. This is also known as outstanding income.

Accrued income A/c Dr

To Income A/c

Treatment in Final Accounts

(i) Outstanding income should be added to the concerned income on the credit side of P/L A/c

(ii) It is also shown on the assets side of the Balance Sheet.

If accrued income is given in trial balance (Dr. balance) then it should be taken only on the asset side of the B/S

5. Income received in advance: Sometime the whole amount of income received in an accounting year does not belong to the current year. A part of it may relate to the next year. Such portion of income received but not earned is called income received in advance or unearned income. The adjusting entry is:

Income A/c Dr.

To Outstanding Income A/c

Treatment in Final Accounts

(i) Income received in advance should be deducted from the concerned income on the credit side of the P/L A/c

(ii) It should also be shown on the liability side of the B/S

If this item is given in trial balance (Cr. balance) then it should be shown only in the B/S on the liability side.

6. Depreciation: Decrease in the value of fixed assets due to wear and tear, passage of time or obsolescence etc. is called depreciation.

The entry for providing depreciation is:

Depreciation A/c Dr.

To Asset A/c

Treatment in Final Accounts

(i) Depreciation should be shown on the debit side of Trading A/c (in case of depreciation on factory assets) or P/L A/c.

(ii) It should be deducted from the concerned asset on the asset side of the B/S.

If depreciations is given in trial balance (i.e. the entry has already been made and the asset appearing in the trial balance is at a reduced value), the depreciation should be taken only at one place i.e. on the debit side of P/L A/c.

Increase in the value of asset is called *appreciation*. In this case the appreciation (increase) is credited to P/L A/c. It is also added to the cost of the asset in the Balance Sheet.

7. Provision for Depreciation: Sometimes the depreciation charge is credited to Provision for Depreciation Account (also called Depreciation Fund or Accumulated Depreciation) and not to the asset directly.

Treatment in Final Accounts

The current year depreciation should be debited to P/L A/c. The adjusting entry is P/L A/c. Dr.

To Provision for Depreciation A/c.

The total Provision for Depreciation (i.e. existing provision as per T/B credit plus current year provision) should be deducted from the original cost of the asset on the asset side of the balance sheet.

8. Bad debts: When the amount due from debtors (to whom goods are sold on credit) is found irrecoverable it is called bad debts. In short, irrecoverable debt is known as bad debt. It is a loss to the business. The adjusting entry is as follows:

Bad Debt A/c Dr

To Sundry Debtors

The bad debt account is closed by transferring to P/L A/c

Treatment in Final Accounts

(a) *When bad debt is given in trial balance:* In this case no adjusting entry is needed. It should be taken on the debit side of P/L A/c (appears at one place only).

(b) *When bad debt is given outside the trial balance:* In case bad debt is given outside the trial balance (i.e. in adjustments) it should be taken at two places. One is at the debit side of P/L A/c (added to bad debt already given in trial balance). The bad debt (given in adjustment) should also be deducted from debtors on the asset side of the Balance Sheet.

9. Drawings in goods: When goods are withdrawn by the proprietor for private use, it should be treated as drawings. The entry is

Drawings A/c Dr

To Purchase A/c

Treatment in Final Accounts

It is deducted from purchase in the Trading A/c. Alternatively, it can be shown on the credit side of Trading A/c. It is also deducted from capital as drawings on the liability side of the B/S

10. Goods distributed as free samples: Sometimes goods are distributed as free samples. It is treated as advertisement. The entry is:

Advertisement A/c Dr.

To Purchase A/c

Treatment in Final Account

This is deducted from purchase on the debit side of Trading A/c (or added to sales on the credit of Trading A/c). It is also shown on the debit side of P/L A/c as advertisement.

Illustration 20

From the following trial balance prepare Final accounts as on 31st March 2016.

Particulars	Dr. Amount	Cr. Amount
Furniture & Fittings	440	
Motor Vehicle	6250	
Buildings	7500	
Capital		12500
Bad Debts	125	
Debtors & Creditors	3800	2700
Stock (as on 1 st April 2015)	3460	
Purchases & Sales	5475	15450
Bank Over Draft		2850
Purchase Return		125
Sales Return	200	
Advertising	450	
Interest (On Bank OD)	118	
Commission		375
Cash	650	
Taxes and insurance	1250	
General expenses	782	
Salaries	3300	
Total	34,000	34,000

Additional Information:

1. Closing Stock 3250
2. Salary unpaid 300

3. Insurance paid in advance 250
4. Commission received in advance 25
5. Depreciation on buildings @ 10%

Solution:

Trading, Profit & Loss Account as on 31st March 2016

Particulars	Amount	Particulars	Amount
To Opening Stock	3460	By Sales 15450	
To Purchase 5475		Less: Returns <u>200</u>	15250
Less Returns <u>125</u>	5350		
To Gross Profit C/d	9690	By Closing Stock	3250
	18500		18500
To salaries 3,300		By Gross Profit b/d	9690
Add : Outstanding <u>300</u>		By Commission 375	
To General Expenses		Less: Received <u>25</u>	350
To Taxes and Insurance 1250	3600	In advance	
Less Prepaid <u>250</u>	782		
To Interest on Bank OD			
To Bad Debt	1000		
To Advertising	118		
To Depreciation	225		
Building @ 10%	450		
To Net Profit B/d	750		
	3115		
	10040		10040

Balance Sheet as on 31st March 2106

Liabilities	Amount	Asset	Amount
Capital		Building	
Opening Balance: 12500		7500	6750
Add: Net Profit <u>3115</u>	15615	Less Depreciation 750	640
Commission Received in advance	25	Furniture	6250
Salary Outstanding	300	Motor Vehicles	3250
Bank Over Draft	2850	Stock in trade	3700
S. Creditors	2700	S. Debtors	250
		Insurance Prepaid	650
		Cash in Hand	
	21490		21490

Illustration 21:

Prepare Final Accounts in the books of Mr. Rajesh as on 31st December 2015

Stock (as on 1st January 2015) 22,000 Rent and rates 1,600

Bills Receivable	9,000	Salaries	1,450
Purchases	78,000	Return from Customers	2,600
General Expenses	400	Cash at Bank	8,000
Furniture	2,000	Printing and Stationery	950
Cash in Hand	1,000	Carriage outwards	2,900
Wages	5,600	sales	1, 20,000
Return to Creditors	1,000	Bills Payable	6,000
Insurance	1,400	Debtors	60,000
Creditors	39,300	Carriage inwards	1,600
Capital	35,800	Commission Paid	3,600

Additional Information:

1. Stock (as on 1st January 2015) 50,000
2. Salary for the month December is unpaid amounting to Rs 150
3. Insurance includes Rs 100 for the month of January 2016.
4. Depreciate furniture by 10%.
5. Debtors include Rs. 1000 from Mr. Mohan, who is insolvent.
6. Mr. Rajesh has withdrawn goods worth Rs. 100 for personal use.

Solution:

Trading, Profit and Loss Account of Mr. Rajesh for the year ended 31st December 2015

Particulars	Amount	Particulars	Amount
To Opening Stock	22,000	By Sales 1,20,000	
To Purchase 78000		Less Returns <u>2,600</u>	
Less Returns <u>1000</u>			1,17,400
	77,000	By Drawings	100
To Wages 5,600		By Closing Stock	50,000
To carriage inwards 1,600			
To Gross Profit c/d 61,300			
	1,67,500		1,67,500
To General Expenses 400		By Gross Profit b/d	61,300
To Insurance 1400			
Less: Prepaid <u>100</u>			
To Commission 1,300			
To Rent and rates 3,600			
To salaries 1,450	1,600		
Add: Outstanding <u>150</u>	1,600		
To Printing and stationery			
To carriage outwards			
To Depreciation 950			
To bad Debts 2,900			
To Net Profit c/d 200			
	1,000		
	47,750		
	61,300		61,300

Balance sheet as on 31st December 2015

Liabilities	Amount	Asset	Amount
Capital		Furniture 2,000	
Opening Balance: 35,800		Less: Depreciation <u>200</u>	1,800
Add: Net Profit : <u>47,750</u>		Closing Stock	50,000
83,550		Debtors 60,000	
Less Drawings <u>100</u>		Less Bad Debt <u>1,000</u>	59,000
	83,450	Bills Receivable	9,000
Creditors	39,300	Cash at Bank	8,000
Bills payable	6,000	Cash in hand	1,000
Salary Outstanding	150	Insurance Prepaid	100
	128900		128900

CHAPER 7

NON-PROFIT ORGANISATIONS

MEANING AND CHARACTERISTICS

You must have come across organizations which are not engaged in business activities. Their objective is not to make profits but to serve. Examples of such organizations are: schools, hospitals, charitable institutions, welfare societies, clubs, public libraries, resident welfare association, sports club etc. These are called Not-for-Profit Organizations (NPOs). These organizations provide services to their members and to the public in general. Their main source of income is membership fees, subscription, donation, grant-in-aid, etc. As the money is involved in the activities of these organizations, they also maintain accounts. These organizations prepare certain statements to ascertain the results in financial terms of their activities for a particular period say, one year.

Characteristics of Non-profit organizations (NPOs)

Following are the main characteristics or the salient features of Non- Profit organizations (NPOs):

1. The objective of such organizations is not to make profit but to provide service to its members and to the society in general.
2. The main source of income of these organizations is not the profit earned from purchase and sale of goods and services but is admissions fees, subscriptions, donations, grant-in-aid, etc.
3. These organizations are managed by a group of persons elected by the members from among themselves. This group is called managing committee.
4. They also prepare their accounts following the same accounting principles and systems that are followed by business for profit organizations that are run with an objective to earn profits: The types of financial statements that are generally prepared by not-for- Profit Organizations (NPOs) are:

1. Receipts and Payments Account
2. Income and Expenditure Account
3. Balance Sheet

The receipts and payments account is the summary of cash and bank transactions which helps in the preparation of Income and expenditure Account and the Balance Sheet.

Income and Expenditure A/c is similar to Profit and Loss Account. NPOs usually prepare the Income and Expenditure Account and balance Sheet with the help of Receipts and Payments Account.

RECEIPTS AND PAYMENTS ACCOUNT–MEANING AND NEED

Like any other organizations Not-for-Profit Organizations (NPOs) also maintain cash book to record cash transactions on day to day basis. But at the end of the year they prepare a summary of cash transactions based on the cash-book. This summary is prepared in the form of an account. It is called Receipts and Payments account. All cash receipts and payments are recorded in this account whether these belong to current year or next year or previous year. All receipts and payments are recorded in this account whether these are of revenue nature or capital nature. As it is an account so it has the debit side and the credit side. All receipts are recorded on its debit side while all payments are shown on the credit side. This account begins with opening cash or/and bank balance. Closing balance of this account is cash in hand and or cash at bank/overdraft. Items in this account are recorded under suitable heads.

Following are the main features of Receipts and Payments Account:

1. It is prepared at the end of the year taking items from the cash book.
2. It is the summary of all cash transactions of a year put under various heads.
3. It records all cash transactions which occurred during the year concerned irrespective of

the period that relate to i.e. previous/current/next year.

4. It records cash transactions both of revenue nature and capital nature.

5. Like any other account it begins with opening balance and ends with closing balance.

Need for preparing Receipts and Payments Account

As most of the transactions of Not-for-Profit Organizations are for cash, the Receipts and Payments Account shows most of the items at one place

As it is in a summary form, it gives an idea of large number of transactions at a glance. It contains accounting information under various heads. So it gives information item wise for the accounting year.

It shows the closing cash or/and bank balance, this cash/Bank balance is taken to the Balance Sheet.

The Receipts and Payments Account serves the purpose of trial balance and becomes the basis of preparing financial statements i.e. Income and

Expenditure Account and Balance sheet for the organization.

Very small Not-for-Profit Organizations (NPOs) prepare only Receipts and Payments Account.

As the name itself suggests, Receipts and Payments Account is an account which has two sides, the debit side and the credit side. All receipts are written on the debit side and payments on the credit side. It has a definite format which is given below:

Format of Receipts and Payments Account

Receipts and Payments Account For the year ended on

Dr.		Cr	
Particulars	Amount Rs	Particulars	Amount Rs
Balance b/d :		Purchase of Assets	
Cash		Printing and stationery	
Bank		Repairs and Renewal	
Donations		Newspapers/Magazines	
Legacies		Rent and taxes	
Membership fees		Postage	
Entrance fees		Investments	
Subscriptions		Conveyance	
Donations		Honorarium	
Lockers Rent		Charity	
Sale of fixed assets		Insurance Premium	
Interest on investments		Upkeep of Ground	
Miscellaneous Receipts		Telephone Charges	
Sale of old periodicals		Balance c/d :	
		Cash	
		Bank	

SPECIFIC ITEMS OF RECEIPTS AND PAYMENTS ACCOUNT

1. Subscription

It is a regular payment made by the members to the organization. It is generally contributed annually. It is one of the main sources of income. It appears on the debit side i.e. Receipts side of the Receipts and Payments Account. Apart from amount for current year, it may include amount pertaining to previous year or advance payment for next years.

2. Entrance fees or Admission fees

Whenever a person is admitted as a member of the organization certain amount is charged from him/her to give him/her admission. This is called entrance fee or admission fee. It is an item of income and is shown on the debit side of the Receipts and Payments Account.

3. Life membership fees

Membership, if granted to a person for the whole life, special fee is charged from him/her,

this is called life membership fees. It is charged once in the life time of a member. It is a capital receipt for the organization

4. Endowment fund

It is a fund which provides permanent means of support for the organization. Any contribution towards this fund is an item of capital receipt.

5. Donation

Donation is the amount received from some person, firm, company or any other body by way of gift. It is also an important item of receipt. It can be of two types:

(a) Specific donation: It is a donation received for a specific purpose.

Examples of such donations are: donation for library, donation for building, etc.

(b) General donation: It is a donation which is received not for some specific purpose. It can be of two types:

(i) General donation of big amount

(ii) General donation of small amount

6. Legacy

It is the amount which is received by organizations as per the will of a deceased person. It is treated as a capital receipt.

7. Sale of old newspapers/periodicals and sports material

Old newspapers used/condemned sport material is sold and fetches some money. It is a source of revenue. It is taken to the debit of Receipts and Payments account.

8. Purchase of fixed assets

Assets such as building, machinery, furniture, books etc. are purchased for the organization. These are items of capital expenditure. These are shown on the credit side i.e. the payment side of Receipts and Payments Account.

9. Payment of honorarium

This is another item of payment. This is an amount paid to persons who are not the employees of the organization but take part in the management of the organization. Remuneration paid to them is called honorarium. For example, payment made to the secretary of the club as honorarium. This is a payment of revenue nature

10. Purchase of consumable items

Items such as stationery, sports material, drugs and medicines etc. are called consumable items. Payments are regularly made by Not-for-Profit Organization (NPO). These are shown on the payment side.

Payments are made for rent, salary, and insurance, office expenses etc. which are payments made as revenue expenditure by both businesses for profit and not for Profit Organizations (NPOs).

Receipts and Payments Account

It is a summary of cash book for a given period, but the Receipts and Payments account shows the totals of cash transactions under different heads. All the receipts, be cheque or cash are entered on the debit (receipts) side (as in cash book) whereas all the payments (both by cheque or cash) are shown on the credit (payments) side. Following features of the receipts and payments account will help to identify its nature clearly.

Preparation of Receipts and Payments Account

Following are the steps followed to prepare Receipts and Payments A/c:

At first the cash and bank balance carried forward from the last year is written on its debit side. In case there is bank overdraft at the beginning of the year, enter the same on the credit side of this account.

The amounts are written under relevant heads such as subscription, donations etc. on the receipts side and salary, rent, purchase of sports equipment, books etc. on the Payment side.

The amounts comprise of only cash and all cash received or paid during the period for which Receipts and Payments Account is prepared. No distinction is made between the items of revenue nature or capital nature and whether these belong to current year, previous year or the coming year.

Finally, this account is balanced by deducting the total of the credit side i.e. the total payments from the total of the debit side i.e. total receipts and is put on the credit side as 'balance cld'. It shows the closing cash and Bank balance which is written on the asset side of the Balance sheet of the concerned organization

Difference between Receipts and Payments Account and Cash Book

RECEIPTS AND PAYMENT ACCOUNT	CASH BOOK
<ol style="list-style-type: none"> 1. It is prepared at the end the accounting year 2. Every item appears only once 3. It serves the purpose of Trial Balance to prepare the financial statements. 4. It reflects the activities of the organization 5. It is prepared only by Not-for- Profit Organizations (NPOs) 	<p>It is prepared on day to day basis.</p> <p>Items appear number of times on different dates depending upon their occurrence.</p> <p>It is a means of maintaining record of cash transactions.</p> <p>It is only a systematic record of day to day cash transactions</p> <p>It is also prepared by business organizations meant to earn profit</p>

Income and expenditure account

This account is prepared by non-trading concerns who want to know if during the financial year their income has been more than their expenditure i.e. profit or vice versa (i.e. loss). Since the object of these concerns is not primarily to 'earn profit', therefore, they feel shy in giving it the name of profit and loss account. Because the word 'profit' is a taboo which any society 'looks down upon'. Of course, it discloses whether the concerned institution earned or lost. It is equivalent to and serves the purpose of 'profit and loss account'. It is prepared on "accrual basis" (not on receipt basis) meaning thereby that all incomes are to be included which have been earned in the relevant period (whether actually received or not). Similarly, it includes all expenses incurred in the relevant period (whether actually paid or not). This account serves exactly the purpose which 'profit and loss account' serves in a trading concern. On the pattern of 'profit and loss account' income is shown on the credit side and expenditure on the debit side. It also distinguishes between 'capital & revenue' items i.e. it does not take into consideration capital items {both receipts and payments}. It follows double entry principles faithfully.

Steps to prepare income and expenditure account

In the absence of the trial balance, the income and expenditure account will be prepared on the basis of the receipts and payments account. The steps are as follows:

1. Ignore opening and dosing cash and bank balances appearing in receipts and payments account.
2. Eliminate all items of capital receipts and payments.
3. Ascertain income of the relevant year by deducting from the total receipts the income received on account of previous and future years and by adding the income accrued due in the year but not received and income received in the previous year but relating to this year.
4. Ascertain expenditure of the relevant period by deducting expenditure both relating to

preceding period and succeeding period from the total payments and by adding the expenditure outstanding at the end and expenditure prepaid in the beginning.
5. Make adjustments, as per additional information, such as depreciation, bad debts etc., if any.

6. The income and expenditure account, when balanced, will disclose surplus (if the credit side is bigger) or deficit (if the debit side is bigger). If surplus i.e. excess on income over expenditure add it to the capital or accumulated fund. However, if deficit i.e., excess of expenditure over income deduct it from the capital or accumulated fund.

Balance Sheet

The balance sheet of a non-trading concern is on usual lines. Liabilities are recorded on left hand side and assets on right hand side. In trading concerns, excess of assets over liabilities is called 'capital'. Here, in non-trading concerns, excess of assets over liabilities is called 'capital fund'. The capital fund is built up out of surplus from income and expenditure account.

RECEIPTS AND PAYMENTS ACCOUNT	INCOME AND EXPENDITURE ACCOUNT
1. It is a real account. 2. It need not be accompanied by a balance sheet. 3. It is like a cash book. 4. Closing balance is carried forward to the next period. 5. Debit side is for receipts and credit side is for payments. 6. Closing balance represents cash in hand and at bank. 7. It includes both capital and revenue items. 8. It usually shows a debit balance. 9. It ignores outstanding items. 10. It ignores credit sales and purchases. 11. It includes prepaid items. 12. It begins with a balance. 13. It includes items relating to past, present or future periods. 14. It is not a part of double entry system. 15. It ignores non-cash items like depreciation, bad debts etc.	1. It is a nominal account. 2. Must be accompanied by a balance sheet. 3. It is like a profit & loss account. 4. Closing balance is merged into capital fund. 5. Debit side is for expenses and credit side for incomes. 6. Closing balance represents either surplus or deficiency. 7. It includes only revenue items. 8. It may show a debit or credit balance. 9. It records outstanding items. 10. It records credit sales and purchases. n. It excludes prepaid items. 12. It does not begin with a balance. 13. It includes items relating to current period only. 14. It is a part of double entry system. 15. It records non-cash items like depreciation, bad debts etc.

Illustration 22

From the following, find out the amount of subscription to be recorded in income and expenditure account as on 31st December 2015

Subscription received during the year	22,400
Subscription outstanding on 1 st January 2015	850
Subscription outstanding on 31 st December 2015	3,100
Subscription received in advance on 1 st January 2015	1,100
Subscription received in advance on 31 st December 2015	1,850

Solution:

Total amount of subscription received during 2015	22,400
Add	

Subscription received in advance on 1 st January 2015	1,100	
Subscription outstanding on 31 st December 2015	<u>3,100</u>	
		<u>4,200</u>
		26,600
Less:		
Subscription received in advance on 31 st December 2015	1,850	
Subscription outstanding on 1 st January 2015	<u>850</u>	
		<u>2,700</u>
		23,900
		=====

Illustration 23

From the information given below prepare Receipts and Payments Account for the year ending 31st December, 2015.

Opening Balance :	1650	Purchase of Books	10000
Cash in hand	18250	Purchase of Sports Material	20000
Cash at Bank	15000	Purchase of Bicycle	2000
Subscription	1200	Sale of Investment	25000
Entrance Fees	18000	Life Membership Fees	4000
Donation	16000	Rent paid	12000
Salaries	500	Purchase of Development Bonds	10000
Stationery	800	Closing Balance :	
Insurance Premium	1540	Cash in hand	
Sale of old Furniture	3670	Cash at Bank	1510
Interest on Securities	4500		20000
Lockers Rent			

Solution:

Receipts & Payments A/c for the year ending 31st Dec. 2015

Receipts	Amount (Rs)	Payments	Amount (Rs)
To Balance b/d		By Salaries	16000
Cash in hand	1650	By Stationery	500
Cash at Bank	18250	By Insurance Premium	800
To Entrance Fees	1200	By Purchase of Books	10000
To Donation	18000	By Purchase of Sports Material	20000
To Sale of old furniture		By Purchase of Bicycle	2000
To Interest on securities	1540	By Rent paid	12000
To Lockers Rent		By Purchase of development	10000
To Sale of Investment	3670	bonds	
To Subscription	4500	By Balance c/d	1510
To Life Membership	25000	Cash in hand	20000
fees	15000	Cash at bank	
	4000		
	92810		92810

Illustration 24:

From the following Receipt and Payment account of Calicut sports club, prepare income and expenditure account and balance sheet as on 31st December 2015.

Receipt and Payment Account

Receipt	Amount	Payment	Amount
To Balance b/d	1,800	By Rent	1,200
To Subscription	12,700	By Tournament Expense	1,200
To Entrance Fee	900	By Sports Equipment	3,600
To Donation for Building	12,000	By stationery	900
To Bank Interest	100	By 8% Investment	20,000
To Tournament Fund	3,000	Misc. Expense	800
To Sale of old Newspaper	300	By Periodicals	600
		By Balance B/d	2,500
	30,800		30,800

Additional Information: Investment was purchased on 1st July 2015 includes building donation of Rs.12, 000. Subscription includes Rs. 700 for 2014 and Rs 400 for 2016. Subscription for the current year amounting to Rs. 800 is still receivable. Rent for 2014 Rs 400 was paid during 2015. The value of furniture on 31st December 2015 was Rs. 5,000. Entrance fee are to be capitalized. Opening Capital (as on 1st January 2015) is Rs. 7,100.

Solution:

Calicut Sports Club**Income and Expenditure Account for the year ended 31st December 2015**

Expenditure	Amount	Income	Amount
To Rent 1200		By Subscription	
Less for 2014 <u>400</u>		Op. Balance: 12,700	
	800	(+) Outstanding <u>800</u>	
To Stationery	900		13,500
To Misc. Expenses	800	(-) for 2014 and	
To Periodicals	600	2016 (700 & 400) <u>11,00</u>	
To Excess of income over Expenditure	10,020	By Bank Interest	
		By Sale of old newspaper	12,400
		By interest Accrued on investment	100
		(20,000-12000) x 8% x 6/12)	300
			320
	13,120		13,120

Balance Sheet of Calicut Sports Club as on 31st December 2015

Liabilities	Amount	Assets	Amount
Capital Fund 7100		Cash Balance 2500	
(+) Surplus <u>10,020</u>		Subscription outstanding 800	
17,120		Sports equipments 3,600	
(+) Entrance fee <u>900</u>		Accrued interest (480 + 320) 20,000	
	18,020	8% Investment 5,000	
Subscription received in advance 400		Furniture	
Tournament Fund 3000			
Less Expenses <u>1200</u>	1,800		
Donation for Building 12,000			
(+) Interest on investment <u>480</u>	12,480		
	32,700		32,700

Illustration 25:

From the following Receipt and Payment account of Ernakulam Cricket club, prepare income and expenditure account and balance sheet as on 31st December 2015.

Receipt and Payment Account
as on 31st December 2015

Receipt	Amount	Payment	Amount
To Balance b/d		By Rent 52,000	
Cash 1,000		By Printing & Stationery 30,680	
Bank 2,000		By Salaries 53,300	
To Subscription- 2014 2,000		By Billiard table 39,000	
2015 1,69,000		By Misc. Expense 8,060	
2016 3,000		By Interest paid 15,000	
To Entrance Fee 5,500		By Balance B/d	
To Locker Rent 5,000		Cash 5,960	
To Subscription for		Bank 18,000	
Governors' Party 34,500			
	2,22,000		2,22,000

Additional Information:

- (i) Locker rent Rs. 600 relates to 2014 and Rs. 900 is still due
- (ii) Printing & Stationery Rs. 3120 relates to 2014 and Rs. 3,640 is outstanding for 2015.
- (iii) Subscription unpaid for 2015 is Rs. 4,800, Special subscription for Governor's Party outstanding Rs. 5,600
- (iv) Capitalize 50% of entrance fee.

Solution:

Ernakulam Cricket Club
Income and Expenditure Account for the year ended 31st December 2015

Expenditure	Amount	Income	Amount
To Rent 52,000		By Subscription	
Add for 2015 <u>13,000</u>		Op. Balance: 1,69,000	
65,000		(+) Outstanding <u>4,800</u>	
Less for 2014 <u>13,000</u>	52,000		1,73,800
To P& S 30,680		By Locker Rent 5,000	
Add for 2015 <u>3,640</u>		Add Outstanding <u>900</u>	
34,320		5,900	
Less for 2014 <u>3,120</u>	31,200	Less for 2014 <u>600</u>	5,300
To Misc. Expenses 8,060		By Entrance fee	2,750
To Salaries 53,300			
To Interest 15,000			
To Excess of income over Expenditure 22,290			
	1,81,850		1,81,850

Balance Sheet of Calicut Sports Club as on 31st December 2015

Liabilities	Amount	Assets	Amount
Capital Fund		Cash Balance	5,960
(+) Surplus 22,290		Bank	18,000
(+) Entrance fee <u>2,750</u>		Accrued Locker Rent	900
25,040		Subscription outstanding	4,800
Less; Deficit (2014) <u>10,520</u>	14,520	Subscription outstanding for Governors' party	5,600
Subscription received in advance 3,000		Billiards table	39,000
Governors' party 34,500			
Add Outstanding <u>5,600</u>	40,100		
Outstanding Rent 13,000			
Outstanding Printing & Stationery 3,640			
	74,260		74,260

Working Note:

Balance Sheet as on 1st January 2015

Liabilities	Amount	Assets	Amount
Outstanding Rent	13,000	Cash	1,000
Outstanding Printing & Stationery	3,120	Bank	2,000
		Outstanding Subscription	2,000
		Accrued Locker Rent	600
		Deficit (Balancing Figure)	10,520
	16,120		16,120
