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2

ACCOUNTING CONCEPTS AND CONVENTIONS

In the previous lesson, you studied the meaning and objectives of Financial Accounting. There are some concepts and conventions which are followed in accounting for a long time. These concepts constitute the very basis of accounting. All the concepts have been developed over the years from experience and thus, are universally accepted rules and are termed as 'Generally Accepted Accounting Principle' or GAAP. In accounting, there are many conventions or practices which are used while recording the transactions in the books of accounts. In this lesson you will learn accounting concepts and conventions.

OBJECTIVES

After studying this lesson, you will be able to :

- understand the meaning of the term accounting concepts;
- explain the meaning and significance of accounting concepts : Business Entity, Money Measurement, Going Concern and Dual Aspect;
- understand the meaning of the term accounting conventions and
- explain the meaning and significance of accounting conventions of Materiality, Conservatism and Consistency.

2.1 ACCOUNTING CONCEPTS

Accounting Concepts refer to the basic assumptions, rules and principles which work as the basis of recording of business transactions and preparing accounts. Main Accounting Concepts are:

- Business Entity Concept
- Money Measurement Concept
- Going Concern Concept
- Dual Aspect Concept

2.2 BUSINESS ENTITY CONCEPT

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

Let us take an example, Ms. Sakshi started business by investing ₹ 2,00,000. She purchased goods for ₹ 20,000, Furniture for ₹ 10,000, Plant and Machinery of ₹ 50,000 and ₹ 10,000 remained in hand. These are the assets of the business and not of the owner. According to the business entity concept ₹ 2,00,000 will be treated by business as capital i.e. a liability of business towards the owner of the business.

Now suppose she takes away from business ₹ 5,000 in cash and goods worth ₹5,000 for her domestic purposes. This withdrawal of cash & goods by the owner from the business are her private expenses and not the expenses of the business. These are termed as Drawings. Thus, the business entity concept states that business and the owner are two separate/distinct entities. Accordingly, any expense incurred by owner for himself/herself or for his/her family from business will not be considered as an expense but it will be treated as drawings. Since business and its owners according to this concept are treated as separate entities therefore, the transactions between these two are recorded in the books of accounts.

Significance

The following points highlight the significance of business entity concept:

- This concept helps in ascertaining the profit of the business as only the business expenses and revenues are recorded and all the private and personal expenses are ignored.
- This concept restraints accountants from recording of owner's private/ personal transactions.
- It also facilitates the recording and reporting of business transactions from the business point of view
- It is the very basis of accounting concepts, conventions and principles.

INTEXT QUESTIONS 2.1

Fill in the blanks with suitable word/words :

i. The accounting concepts are basic ____________ of accounting.

ii. ____________ concept assumes that business enterprise and its owners are two separate independent entities.

iii. The goods withdrawn from business for owner's personal use are called ____________ .

Notes

2.3 MONEY MEASUREMENT CONCEPT

This concept assumes that all business transactions must be in terms of money that is in the currency of the concerned country. In our country such transactions are in terms of rupees (₹). Thus, as per the money measurement concept, transactions which can be expressed in terms of money are recorded in the books of accounts.

For example, sale of goods worth ₹ 1,00,000, purchase of raw materials ₹ 50,000, rent paid ₹ 20,000 etc. are expressed in terms of money, and so they are recorded in the books of accounts. But the transactions which cannot be expressed in monetary terms are not recorded in the books of accounts. For example, sincerity, loyalty and honesty of employees are not recorded in books of accounts because these cannot be measured in terms of money although they do affect the profits and losses of the business concern.

Another aspect of this concept is that the records of the transactions are to be kept not in the physical units but in the monetary unit. For example, at the end of the year 2011, an organisation may have a factory on a piece of land measuring 5 acres, office building containing 10 rooms, 20 personal computers, 30 office chairs and tables, 50 kg of raw materials etc. These are expressed in different units, but for accounting purposes these are to be recorded in money terms i.e. in rupees (₹). In this case, the cost of factory land may be say ₹ 6 crore, office building ₹ 5 crore, computers ₹ 5 lakhs, office chairs and tables ₹ 1 lakh, raw material ₹ 15 lakhs. Thus, the total assets of the organisation are valued at ₹ 11 crore and ₹ 21 lakhs. Therefore, the transactions which can be expressed in terms of money are recorded in the books of accounts and not in terms of the quantity.

Significance

The following points highlight the significance of money measurement concept:

- This concept guides accountants what to record and what not to record.
- It helps in recording business transactions uniformly.
- If all the business transactions are expressed in monetary terms, it will be easy to understand the accounts prepared by the business enterprise.
- It facilitates comparison of business performance of two different periods of the same firm or of the two different firms for the same period.

INTEXT QUESTIONS 2.2

From the following identify the transactions that can be recorded in books of accounts and that cannot to be recorded?

i. Health of a Managing Director.

ii. Purchase of factory building ₹ 5 crore.

Notes

iii. Rent paid ₹ 20,000.

iv. Goods worth ₹ 40,000 given as charity.

v. Delay in supply of raw materials.

2.4 GOING CONCERN CONCEPT

This concept states that a business firm will continue to carry on its activities for an indefinite period of time. Simply stated, it means that every business entity has continuity of life. Thus, it will not be dissolved in the near future. This is an important assumption of accounting, as it provides a basis for showing the value of assets in the balance sheet; For example, a company purchased plant and machinery of ₹ 1,00,000 and its life span is 10 years. According to this concept every year some amount will be shown as expense and the balance amount as an asset. Thus, if an amount is spent on an item which will be used in business for many years, it is not correct to charge the amount from the revenues of the year in which the item is acquired. Only a part of the value is shown as expense in the year of purchase and the remaining balance is shown as an asset.

Significance

The following points highlight the significance of going concern concept:

- This concept facilitates preparation of financial statements.
- On the basis of this concept, depreciation is charged on the fixed assets.
- It is of great help to the investors, because, it assures them that they will continue to get income on their investments.
- In the absence of this concept, the cost of a fixed asset will be treated as an expense in the year of its purchase.
- Because of this concept business can be judged for its capacity to earn profits in future.

INTEXT QUESTIONS 2.3

Fill in the blanks by selecting correct words given in the bracket/brackets:

i. Going concern concept states that every business firm will continue to carry on its activities ____________ (for a definite time period, for an indefinite time period)

ii. Fixed assets are shown in the books at their ____________ (cost price, market price)

iii. The concept that a business enterprise will not be closed down in the near future is known as ____________ (going concern concept, money measurement concept)

iv. On the basis of going concern concept, a business prepares its ____________ (financial statements, bank statement, cash statement)

Notes

v. ____________ concept states that business is a distinct entity from its owner. (Going concern, Business entity)

2.5 DUAL ASPECT CONCEPT

Dual aspect is the foundation or basic principle of accounting. It provides the very basis of recording business transactions in the books of accounts. This concept assumes that every transaction has a dual effect, i.e. it affects two accounts in their respective opposite sides. Therefore, the transaction should be recorded at two places. It means, both the aspects of the transaction must be recorded in the books of accounts. For example, goods purchased for cash has two aspects which are:

(i) Giving of cash

(ii) Receiving of goods.

These two aspects are to be recorded. Thus, the duality concept is commonly expressed in terms of fundamental accounting equation:

Assets = Liabilities + Capital

The above accounting equation states that the assets of a business are always equal to the claims of owner/owners and the outsiders. Owner's claim is also termed as capital or owner's equity and that of outsiders, as liabilities or creditors' equity.

The knowledge of dual aspect helps in identifying the two aspects of a transaction, which help in applying the rules of recording the transactions in books of accounts. The implication of dual aspect concept is that every transaction has an equal impact on assets and liabilities in such a way that total assets are always equal to total liabilities.

Let us analyse some more business transactions in terms of their dual aspect:

i) Capital brought in by the owner of the business : First aspect Receipt of cash, Second aspect Increase in Capital (owner's equity).

ii) Purchase of machinery by cheque : First aspect Owning of Machinery, Second aspect Reduction in Bank Balance.

iii) Goods sold for cash : First aspect Receipt of cash, Second aspect, delivery of goods to the customer.

iv) Rent paid in cash to the landlord : First aspect Rent (Expenses incurred), Second aspect payment of cash.

Once the two aspects of a transaction are known, it becomes easy to apply the rules of accounting and maintain the records in the books of accounts properly. The interpretation of the Dual Aspect Concept is that every transaction has an equal effect on assets and liabilities in such a way that total assets are always equal to total liabilities of the business.

Significance

The following points highlight the significance of Dual Aspect Concept

- This concept helps the accountant in detecting errors.
- It encourages the accountant to post each entry in opposite sides of two affected accounts.
- It helps in preparing the Financial Position Statement/ Balance Sheet on a particular date.

INTEXT QUESTIONS 2.4

Write the two aspects (effects) of the following transactions :

S.No.	Transaction	Ist aspect	IInd aspect
i.	Owner brings cash in business		
ii.	Goods purchased for cash		
iii.	Goods sold for cash		
iv.	Furniture purchased for cash		
v.	Received cash from Sharma		
vi.	Purchased machine from Rama on credit		
vii.	Paid to Ram		
viii.	Salaries paid		
ix.	Rent paid		
x.	Commission received		

2.6 MEANING OF ACCOUNTING CONVENTIONS

Accounting conventions refer to common practices which are universally followed in recording and presenting accounting information of the business entity. These are followed like customs, traditions etc. in a society. Accounting conventions are evolved through the regular and consistent practice over the years to facilitate uniform recording in the books of accounts. Accounting conventions help in comparing accounting data of different business units or of the same unit for different periods. These have been developed over the years. The most important conventions which have been used for a long time are:

- Convention of Consistency.
- Convention of Materiality.
- Convention of Conservatism.

2.7 CONVENTION OF CONSISTENCY

The convention of consistency means that same accounting principles should be used for preparing financial statements year after year. A meaningful conclusion can be drawn from financial statements of the same enterprise when there is a comparison between them over a period of time. But this can be possible only when accounting policies and practices followed by the enterprise are uniform and consistent over a period of time. If different accounting procedures and practices are used for preparing financial statements of different years, then the result will not be comparable. Generally a businessman follows the same general practices or methods year after year, for preparing the books of accounts.

While charging depreciation on fixed assets or valuing unsold stock, once a particular method is used, it should be followed year after year. So that the financial statements can be analysed and compared provided that, the depreciation on fixed assets is charged or unsold stock is valued by using same method year after year. This can be further clarified in case of charging depreciation on fixed assets, accountant can decide to adopt any one method of depreciation such as diminishing value method or straight line method. Similarly, in case of valuation of closing stock it can be valued at actual cost price or market price, whichever is less. However, precious metals like gold, diamond, minerals are generally valued at market price only.

Therefore, as per this convention the same accounting methods should be adopted every year in preparing financial statements. But it does not mean that a particular method of accounting once adopted can never be changed. Whenever a change in method is necessary, it should be disclosed by way of footnotes in the financial statements of that year.

Significance

The following points highlight the significance of Convention of Consistency

- It facilitates comparative analysis of the financial statements.
- It ensures uniformity in charging depreciation on fixed assets and valuation of closing stock.

INTEXT QUESTIONS 2.5

Fill in the blanks with suitable word/words:

i. Convention of consistency means that same accounting principles should be followed for preparing financial statements __________ .

ii. Unsold goods are valued at cost price or __________ whichever is ________.

iii. Precious metals, like gold, silver etc. are generally valued at __________ .

iv. As per the convention of __________ year after year same methods of valuation of assets is followed.

2.8 CONVENTION OF MATERIALITY

The convention of materiality states that, to make financial statements meaningful, only material fact i.e. important and relevant information should be supplied to the users of accounting information. The question that arises here is what is a material fact? The materiality of a fact depends on its nature and the amount involved. Material fact refers to the information that will influence the decision of its user. For example, a businessman is dealing in electronic goods. He purchases T.V., Refrigerator, Washing Machine, Computer etc. for his business. In buying these items he uses larger part of his capital. These items are significant items; thus should be recorded in books of accounts in detail. At the same time to maintain day to day office work he purchases pen, pencil, match box, scented stick, etc. For this he will use very small amount of his capital. But to maintain the details of every pen, pencil, match box or other small items is not considered of much significance. These items are insignificant items and hence they should be recorded separately. Thus, the items that are significantly important in recording the details are termed as material facts or significant items. The items that are of less significance are immaterial facts or insignificant items. Thus, according to this convention important and significant items should be recorded in their respective heads and all immaterial or insignificant transactions should be clubbed under a different accounting head.

Significance

The following points highlight the significance of Convention of Materality

- It helps in minimising errors in calculation.
- It helps in making Financial Statements more meaningful.
- It saves time and resources.

INTEXT QUESTIONS 2.6

Fill in the blanks with suitable word/words :

i. __________ convention states that to make financial statements more meaningful, only significant and important items should be supplied to the users.

ii. Convention of materiality states that insignificant items should be disclosed under __________ .

Notes

iii. ___________ convention keeps accountants and manager to focus on important /significant items.

iv. ___________ means the information which will influence the decision.

2.9 CONVENTION OF CONSERVATISM

This convention is based on the principle that **"Anticipate no profit, but provide for all possible losses"**. It provides guidance for recording transactions in the books of accounts. It is based on the policy of playing safe in regard to showing profit. The main objective of this convention is to show minimum profit. Profit should not be overstated. If more profit is shown than the actual, it may lead to distribution of dividend out of capital. This is not a fair policy and it will lead to the reduction in the capital of the enterprise.

Thus, this convention clearly states that profit should not be recorded until it is earned. But if the business anticipates any loss in the near future, provision should be made in the books of accounts for the same. For example, valuing closing stock at cost or market price whichever is lower, creating provision for doubtful debts, discount on debtors, writing off intangible assets like goodwill, patent, etc. The convention of conservatism is a very useful tool in situation of uncertainty and doubts.

Significance

The following point highlight the significance of convention of conservatism

- It helps in ascertaining actual profit.
- It is useful in the situation of uncertainties and doubts.
- It helps in maintaining the capital at its real value.

INTEXT QUESTIONS 2.7

I. Give your decision in the following situations :

(i) A business has unsold stock at the end of year. The cost price is ₹20,000 and its market price is ₹25,000. At which price the unsold stock should be recorded?

(ii) What is your decision if the cost price in the above case is ₹21,000 ?

(iii) A businessman anticipates that it may not be possible to collect ₹5,000 from one of his debtors. Will he record this transaction in books of account?

II. Multiple Choice Questions

i. According to going concern concept, a business is viewed as having:
   a) a limited life
   b) a very long life
   c) an indefinite life
   d) a long life

ii. Valuation of stock at lower of cost or net realizable value is an example of
   a) Consistency convention
   b) Conservation convention
   c) Materiality convention
   d) None of the above

iii. According to which of the following concepts the two aspects of a transaction are recorded.
   a) Matching concept
   b) Money Measurement concept
   c) Dual aspect concept
   d) Realisation concept

iv. According to which of the following accounting concepts, even the owner of a business is considered as creditor to the extent of his capital.
   a) Money measurement concept
   b) Dual aspect concept
   c) Business entity concept
   d) Realisation concept

v. The convention of conservatism takes into account
   a) All prospective losses but leaves prospective profits
   b) All prospective profits & leaves prospective losses
   c) All prospective profits and prospective losses
   d) Leaves all prospective profits and prospective losses

WHAT YOU HAVE LEARNT

- An accounting concept refers to the basic assumptions which serve the basis of recording actual business transactions.
- The important accounting concepts are business entity, money measurement, going concern, dual aspect concept.

- Business entity concept assumes that for accounting purposes, the business enterprise and its owner(s) are two separate entities.
- Money measurement concept assumes that all business transactions must be recorded in the books of accounts in terms of money.
- Going concern concept states that a business firm will continue to carry on its activities for an indefinite period of time.
- Dual aspect concept states that every transaction has a dual effect.
- Accounting conventions are common practices which are followed in recording and presenting accounting information of business.
- Convention of consistency states that the same accounting methods should be adopted every year in preparing financial statements.
- Convention of materiality states that, to make financial statements more meaningful only significant information should be shown in the financial statements.
- Convention of conservatism states that, profit should not be recorded until it is earned. But if business anticipates any loss in near future, provision for it should be made in the books of accounts.

TERMINAL EXERCISE

1. Explain the meaning and significance of going concern concept.
2. What is meant by business entity concept?
3. State the meaning and significance of money measurement concept.
4. What do you mean by accounting concept? Explain any four accounting concepts.
5. Explain the convention of consistency with the help of an example.
6. Explain the accounting convention of conservatism with example.
7. Explain the convention of materiality.
8. State the meaning and significance of dual aspect concept.

ANSWER TO INTEXT QUESTIONS

2.1 i) Rules ii) Business Entity iii) Drawings

2.2 i) not recorded ii) recorded iii) recorded iv) recorded v) not recorded

2.3 i) for an indefinite time period ii) cost price iii) going concern concept iv) financial statements v) Business Entity

2.4	i) Cash, Owner's capital	ii) Goods received, cash
	iii) Cash received, goods sold	iv) Furniture, cash
	v) Cash, Sharma	vi) Machine, Rama
	vii) Ram, cash	viii) Salaries, cash
	ix) Rent, cash	x) Cash, Commission
2.5	i) Year after year	ii) Market Price, Less
	iii) Market Price	iv) Consistency
2.6	i) Materiality	ii) Different Accounting Heads
	iii) Materiality	iv) Materiality

2.7 **I.** i) ₹ 20,000 ii) ₹ 21,000 iii) yes

II. i) c ii) b iii) c iv) c v) a

ACTIVITY FOR YOU

- Enquire from various Business Entities and list various accounting periods in which these entities are not following same accounting practices.

224en03

3

ACCOUNTING TERMS

Every subject has certain important basic terms, and Accountancy is no exception. These terms facilitate the understanding of the subject. Hence, this lesson has been designed to acquaint you with the knowledge of some important basic accounting terms. The entire structure of Accounting rests upon these terms. The terms, that we frequently use, are Assets, Liabilities, Revenue and Expenses.

OBJECTIVES

After studying this lesson, you will be able to :

- define various accounting terms such as Capital, Drawings, Assets, Liability, Revenue, Expenditure, Expense, Profit, Losses, Purchases, Sales, Stock, Debtors, Creditors, Receivables, Payables, Debit, Credit etc. and
- identify these terms through case study.

3.1 ACCOUNTING TERMINOLOGY

One should be well aware of the various terms used in accounting so as to feel comfortable with various aspects of accounting and make it clear and understandable.

Capital : This is the amount invested by the owners in the business. It is also called as owner's equity. Owner's equity is the owner's stake in the business. It shows how much is his investment in the assets of the business.

Drawings : It is the amount of cash or goods drawn by the proprietor from the business for his personal or domestic use.

Assets : Any thing that is owned by an individual or business and which can be valued in terms of money is called an asset. In other words, any thing which will enable the firm to get cash or a benefit in future is an asset. For example land, building, machinery, furniture, stock, debtors, bank balance and cash etc.

Classification of Assets

i) **Fixed Assets :** The assets which are acquired not for resale but with the

purpose to increase the earning capacity of the business by employing them. For example - land, building, machinery, computer, furniture, vehicles, live stock etc.

ii) **Current Assets :** Current Assets are those assets which are retained in the business with the purpose to convert them into cash within a short period of time say one year. For example - cash in hand, bills receivables, debtors, stock (goods) etc.

iii) **Tangible Assets :** The assets which can be seen and touched or have physical existence. For example - building, machinery, furniture, computer etc.

iv) **Intangible Assets :** The assets which cannot be seen and touched or which do not have physical existence. For example - goodwill, trade mark, patents etc.

v) **Wasting Assets :** Wasting assets are those assets which are natural resources extracted and consumed as a raw material or otherwise. For example - mines, quarries, oil wells etc.

Liability : The assets of a business concern are financed by the funds supplied by the proprietors and outsiders. Money is invested by the proprietor to start his business. Money is also borrowed from others and invested in business. With this money assets are purchased. So the proprietor and outsiders have a claim against the assets of the business. This claim of the proprietor and outsiders is termed as 'Liabilities'. In other words, any amount which the firm owes to the proprietors and outsiders is liability for the business unit. Hence, liabilities are the obligations or debts payable by the business unit in future.

Liabilities have been classified as:

i) External Liabilities
ii) Internal Liabilities

i) External Liabilities

External liabilities are those liabilities which the business owes to the outsiders for goods purchased on credit, for expenses or for loans taken. For example :

Creditors for goods : Sundry creditors, bills payable

Creditors for expenses : Expenses yet to be paid like outstanding salaries, wages outstanding, rent due but not yet paid.

Creditors for loans : Bank loan, Bank overdraft, partners loan, loans taken from other outsiders.

ii) Internal liabilities

Internal liabilities are those liabilities which the business owe to the owners

or proprietors. It is the proprietor's claim against the assets of the business. The Business Entity Assumption states that business is separate from its owners. Any amount contributed by the owner towards the business concern is a liability for the business concern. This liability is also termed as Capital. Hence, the owner's claim against the assets of the business unit is called as capital. In case of one man business or sole proprietorship the capital is contributed by the proprietor himself. In case of partnership business firm, capital is contributed by the partners, and in case of companies, capital is contributed by the shareholders. Owners of the business are those who contribute capital. They get profit of the business, for the risk taken by them. So, the owners have a claim against the firm which is a liability for the firm.

Owner's claim can be expressed as:

a) Capital
b) Interest on Capital (unpaid)
c) Profits of the business (undistributed)
d) Reserves.

Hence, capital is also a liability for the business unit.

INTEXT QUESTIONS 3.1

I. Fill in the blanks with suitable words :

i. Outsider's and owner's claim against the assets of the firm is called __________ .

ii. Liabilities are classified into two categories _______ and ______ .

iii. Owner's claim is __________ liability.

iv. Outsider's claim is __________ liability.

v. Owner's claim against the assets of the business is also called as __________ .

II. Classify the following items into external and internal liabilities :

i. Bank loan
ii. Interest on capital (unpaid)
iii. Capital
iv. Sundry Creditors
v. Outstanding rent
vi. Undistributed Profits
vii. Bills Payable
viii. Bank Overdraft
ix. Salaries due but not paid
x. Reserves

Revenue : Revenue refers to the inflow of money or other assets that results from the sale of goods or services or from the use of money. It is the amount realized or receivable from the sale of goods. Amount received from sale of assets or borrowing loan is not revenue. In broader sense, revenue is also used to mean receipt of rent, commission, discount, etc. Such inflows should be regular in nature and should be concerned with the day-to-day affairs of the business. It should be calculated in the period in which it is earned or realized. For example, sale of goods, rent received, interest on investment received, etc.

Revenue should not be confused with income. Income is the difference between revenue and expense.

Expenses : Let us consider an example before we understand meaning of expense. Rakesh has a textile mill. He purchases raw cotton and converts it into cloth. For this purpose, he has engaged employees to whom he pays daily wages. He also has a showroom where he sells the cloth that he produces. He has three salesman to whom he pays salaries. In order to sell his product he has given advertisements in the newspapers and television. He has done all this to earn profits. For Rakesh, cost of raw cotton, wages, salaries and advertisement cost are all expenses which he has incurred in order to earn revenue. All costs incurred in earning revenue is called as expense. It refers to the cost which is incurred in acquiring an asset or service, e.g. transportation cost incurred in transferring the raw cotton from the village to the factory. It is the amount spent in order to produce and sell the goods and services to earn the revenue, for example, cost of raw material, carriage, wages, insurance premium, rent paid for office, etc.

Expenditure: Expense may be different from expenditure. Expenditure is generally the amount spent for the purchase of assets. It increases the profit earning capacity of the business, for example, furniture purchased, machines purchased, etc. Expense, on the other hand, is an amount to earn revenue. Some examples of expenses are the payments made for rent, wages, salaries, etc.

It can also be said that expenditure is considered as capital expenditure unless it is qualified with words like revenue expenditure on rent, salaries, etc. while expense is always considered as a 'revenue expense' because it is always incurred to earn revenue.

Profit : It is the excess of business revenue over the business expenses for a period. It is an addition to the owner's equity.

Losses : It is the decrease in the value of net assets. It is the excess of business expenses incurred over the business revenue earned during the year. It decreases the owners equity.

Notes

Purchases : Purchases always refer to purchases of merchandise. Purchases means the purchases of such goods and services in which a firm deals. Purchases of cars for an automobile dealer are purchases. For any other firm it is not a purchase.

Sales : It means exchange of such goods and services for money in which the firm deals in. One of the most important objective of a business is to make profit. This objective is achieved by selling goods and services at a price higher than their cost.

Stock : It means, in case of a trader, all the goods or merchandise that he has for sale in the ordinary course of business. In case of a manufacturer, stock may consist of :

(a) Raw-material to be used for manufacturing goods;

(b) Semi-finished products or goods (i.e., raw-material in the process of manufacturing and which has not yet been finished and which is not yet fit for sale or subsequent use);

(c) Finished products or goods.

The goods meant for sale in case of a trader and raw material/semi-finished goods/finished products for sale in case of a manufacturer are stock-in-trade or inventory.

Receivables : In addition to debtors there may be some other persons also who owe money to the business. They are called receivables. This includes Bills Receivables also.

Payables : In addition to creditors there may be some other persons to whom the business owes money. This includes Bills Payables also. These are called payables.

Debtor and Creditor : The two other terms which are quite often used in the recording of transactions are 'debtor' and 'creditor'. A thorough understanding of these terms is very essential.

A debtor is a person *who owes* money. A creditor is a person *to whom* money is *owing.* A person becomes a debtor when he receives some benefit. It may be in the form of money, goods, or services. A person becomes a creditor when he yields (gives) some benefit.

Example – Ram sells goods to Dass on credit.

From the point of view of Ram, Dass is a debtor, as Dass is receiving a benefit in the form of goods.

From the point of view of Dass, Ram is a creditor, as Ram is yielding a benefit in the form of goods.

Debit and Credit : You should observe that every business transaction involves a debit and a credit. The debit amounts are equal to credit amounts. This practice of having equal debits and credits is called Double Entry Book-keeping. Under this system every transaction has two aspects - as debit aspect and credit aspect and at the time of recording a transaction, both these aspects are recorded.

3.2 CASE STUDY

Jay started a business with cash ₹ 2,00,000 on 1.4.2012. He opened a bank account by depositing ₹ 50,000 on the same date. On 2.4.2012 he obtained a loan of ₹ 1,00,000 from SBI. On 3.4.2012 he purchased goods of ₹ 70,000 from Ravi on credit. On the same date he gave a bills payable to Ravi which will become due after two months. On 12.4.2012 the machinery purchased from M/s Kailash Stores on credit for ₹ 50,000. On 13.4.2012 he sold goods for cash ₹ 12,000 and on credit to Ram ₹ 9,000. On the basis of your knowledge about basic accounting terms identify the accounting terms involved in the above transaction of Jay.

Solution

On the basis of above case study the following accounting terms can be identified:

	₹
Capital	2,00,000
Bank Balance	1,50,000
Loan (Liability)	1,00,000
Ravi Creditor (Liability)	70,000
Bills Payable (In liew of Ravi Creditor liability)	70,000
Machinery (Assets)	50,000
Kailash Stores (Liability)	50,000
Sales (Revenue)	21,000
Cash (Assets)	12,000
Ram (Debtor)	9,000

INTEXT QUESTIONS 3.2

I. Fill in the blanks with suitable words :

i. Inflow of money from sale of goods is called as ___________ .

ii. Outflow of money to earn profit is called as ___________ .

iii. Expense is incurred in order to earn ___________ .

iv. Money spent in order to purchase assets is called ___________ .

II. From the following identify revenues, expenses and expenditure.

i. Rent Received

ii. Salaries Paid
iii. Cost of Raw Material
iv. Furniture Purchased
v. Commission Received
vi. Insurance Premium Paid
vii. Machines Purchased
viii. Advertising

III. Classify the given items into assets, liabilities, capital, revenue and expense.

i. Stock-in-hand
ii. Rent Paid
iii. Advertising
iv. Creditors
v. Outstanding Expense (rent)
vi. Interest Received
vii. Capital Introduced
viii. Furniture and Fittings
ix. Insurance Premium Prepaid
x. Commission Received in Advance
xi. Debtors
xii. Dividend Received
xiii. Cash at bank
xiv. Salaries Paid
xv. Discount Received
xvi. Land and Building

IV. Multiple Choice Questions

i. Capital is the
a) Amount invested in business by people other than the owner.
b) Amount invested by the owners in the business.
c) Loan obtained by the business from bank.
d) Loan obtained by business from government.

ii. The accounting equation states that
a) Assets are equal to capital plus liabilities.
b) Assets are equal to capital minus liabilities.
c) Liabilities are equal to capital plus assets.
d) Capital minus liabilities is equal to assets.

iii. Out of the following which is not an external liability of the business:
a) Outstanding rent   b) Bank loan
c) Capital   d) Outstanding salary.

iv. Out of the following which is an item of expenditure.
   a) Rent paid
   b) Commission paid
   c) Goods purchased
   d) Furniture purchased

v. Out of the following which is not an item of revenue:
   a) Sale of goods.
   b) Rent received.
   c) Sale of old furniture.
   d) Commission received.

WHAT YOU HAVE LEARNT

- Capital : Amount invested by the owner(s) in the business:
- Drawing : Amount of cash or goods taken away by the owner for personal use.
- Liability : Obligations of the business.
- External Liabilities : Obligations or amount which the business owes to outsides.
- Revenue : Inflow of money as a result of sale of goods or providing of services.
- Expense : Cost incurred in earning revenue.
- Expenditure : Amount spent for purchase of assets.
- Profit : Excess of revenue over expense.
- Loss : Excess of expense over revenue.
- Purchases : Acquisition of such goods or services in which the business deals.
- Sale : Exchange of merchandise either for cash or on credit to customer.
- Stock : Value of merchandise available for sale, work in progress in the manufacturing process, raw material.
- Debtors : Customers to whom goods have been sold on credit & from whom payment is to be received.
- Creditors : Suppliers of goods from whom goods have been purchased on credit and to whom payment is to be made.

TERMINAL EXERCISE

1. Define the following terms:
   i. Capital
   ii. Drawings

iii. Debtors
iv. Creditors

2. Define liability, revenue & expense.
3. What is meant by Double Entry Book Keeping?
4. Give any five examples of external liabilities.
5. With the help of examples give the meaning of internal and external liabilities.
6. Give two examples each of the following:
   i. Creditors for goods;
   ii. Creditors for expenses;
   iii. Creditors for loans.

ANSWER TO INTEXT QUESTIONS

3.1 I. i) liability ii) external, internal iii) internal
iv) external v) owner's equity/capital

II. i) external ii) internal iii) internal iv) external
v) external vi) internal vii) external viii) external
ix) external x) internal

3.2 I. i) revenue ii) expense iii) profit iv) expenditure

II. i) revenue ii) expense iii) expense iv) expenditure
v) revenue vi) expense vii) expenditure viii) expense

III. i) asset ii) expense iii) expense iv) liability
v) liability vi) revenue vii) capital viii) asset
ix) asset x) liability xi) asset xii) revenue
xiii) asset xiv) expense xv) revenue xvi) asset

IV. i) b ii) a iii) c iv) d v) c

ACTIVITY FOR YOU

- Visit a business organization in a nearby area and identify the different terms which you have studied in this chapter.

Success Stories

Kavya Madhavan
Enrolment No. 090008103065

Kavya Madhavan is a highly acclaimed actress in the Malayalam film world. Making her debut as a child artiste, Kavya quickly managed to find a place in the hearts of malayalees. However, all this was at the cost of dropping out of school at the Secondary level. Like many others, she too nurtured a dream of acquiring a college degree. Motivated to join the National Institute of Open Schooling (NIOS), Kavya Madhavan appeared for the Senior secondary level examination in Malayalam medium and emerged successful. But this was not achieved easily, she says.

Thanks to the Open Schooling system, Kavya Madhavan has now registered for B.Com in M.G. University, Kottayam, Kerala.

Ganesh
Enrolment No. Secondary Course: 25001292005
Senior Secondary Course: 250012103570

Ganesh has cleared the Secondary course of NIOS with first division and has now appeared in 4 subjects of Senior Secondary course. What differentiates Ganesh from other students is that he is suffering from a non-healing ulcer of bone infection. There is no treatment for his ailment; his lower part below the belt has not grown. The puss leaks from his body continuously. He cannot move, and even has no sensation in the lower part of his body. He has to be carried to be moved from one place to another.

However, support from his family members and the Chief Commissioner of Disabilities facilitated his enrollment as a student under Sarva Shiksha Abhiyan as a private candidate, thereby enabling him to clear Class 5 and Class 8. It was at this point that NIOS came to his rescue by providing the flexibility of studying at his own pace through credit accumulation. He could also study subjects of his own choice and was further allowed to appear for the examination in his house. UT Chandigarh continued to support him by providing him with the facility of tutors, who taught him Maths and Science.

With a keen interest in religion, he has read about the various *Puranas, Ramayana* etc., from which he has derived a lot of internal strength.

Ganesh is certainly determined to study further and wishes to pursue a course in Computer Science after clearing his Senior Secondary course from the NIOS.

MODULE - II

Maximum Marks	Hours of Studies
25	60

Journal and Other Subsidiary Books

This module will help the students to understand the rules of Debit and Credit and develop the skill of applying these rules in recording the transactions in journal and other subsidiary books. It will also help them in preparing the different subsidiary books such as Cash Book, Purchase Book, Sales Book, Purchase Return Book and Sales Return Book.

5

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DOUBLE ENTRY SYSTEM

As stated earlier, in accounting, transactions are recorded in a systematic manner. But then what is that system. The system of accounting which has universal application is termed as, double entry system. This system is based on the basic concept of accounting i.e. dual aspect concept. In this lesson you will learn about double entry system of accounting, accounts and their types, accounting vouchers and method of preparing the vouchers.

OBJECTIVES

After going through this lesson you will be able to :

- state the meaning of double entry systems of book keeping;
- explain the advantages and limitations of double entry system;
- classify the accounts in different catagories;
- know the rules for debit and credit;
- identify the source documents;
- understand the meaning of accounting vouchers;
- understand the different types of vouchers and
- know the method of preparation of voucher.

5.1 MEANING OF DOUBLE ENTRY SYSTEM OF BOOK-KEEPING

The double entry system 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 giving the benefit - in the same set of books. In this theory, as the two fold aspects of each transaction are recorded, therefore it is called 'double entry system'.

As per dual aspect concept of accounting every transaction involves two aspects, an aspect of receiving and an other aspect of giving. One who receives is a debtor and one who gives is a creditor. Under the double entry system, both the aspects of giving and receiving are recorded in terms of accounts. The account which

Notes

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 thus, on any particular day the total of the debit entries and the credit entries on the various accounts must be equal.

For example, we bought machinery of ₹ 30,000 for business. It has brought two changes, machinery increases by ₹ 30,000 and cash decreases by an equal amount. While recording this transaction in the books of accounts, both the changes must be recorded. In accounting language, these two changes are termed as "a debit change" & "a credit change". Here machinery account will be debited and cash account will be credited.

Thus, we see that for every transaction there will be two entries, one debit entry and another credit entry. For each debit there will be a corresponding credit entry of an equal amount. Conversely, for every credit entry there will be a corresponding debit entry of an equal amount. So, the system under which both the changes in a transaction are recorded together, one change is debited, while the other change is credited with an equal amount, is known as double entry system of book- keeping. Double entry system is based on the principle that "Every debit has a credit and every credit has a debit."

5.2 ADVANTAGES & LIMITATIONS OF DOUBLE ENTRY SYSTEM

The main advantages of double entry system of book keeping are as follows:

1. The nominal aspects of transactions being recorded make it possible to prepare Trading and Profit and Loss Account from which the Gross Profit and Net Profit earned by the business during a particular period can be easily ascertained.
2. As all personal accounts of debtors and creditors as well as real accounts are kept, it is possible to prepare Balance Sheet.
3. The transactions being recorded in the most scientific and systematic way give the most reliable information of business.
4. It prevents frauds because doing alterations in any account becomes difficult.
5. 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.
6. Trial balance can be prepared on any day to prove the arithmetical accuracy of accounting records.

The main limitations of double entry system of book keeping are as follows:

1. This system requires the maintenance of a number of books of accounts which is not practical in small concerns.
2. This 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 inspite of agreement of the trial balance.

INTEXT QUESTIONS 5.1

Complete the sentences :

i. The Double entry theory of book-keeping is a system of recording transactions having _________.

ii. One who receives is a ___________ and who gives is a _____________.

iii. The Double entry system prevents frauds by not rendering ___________.

iv. There is ____________ of absolute accuracy of the books of accounts inspite of agreement of trial balance.

5.3 MEANING AND CLASSIFICATION OF ACCOUNTS

An accounting system records, retains and reproduces financial information relating to financial transaction flows and financial position. Financial transaction flows encompass primarily inflows on account of incomes and outflows on account of expenses. Elements of financial position, including property, money received, or money spent, are assigned to one of the primary groups i.e. assets, liabilities, and equity.

Within these primary groups each distinctive asset, liability, income and expense is represented by its respective "account". An account is simply a record of financial inflows and outflows in relation to the respective asset, liability, capital, income and expense. It is a record of all business transaction relating to a particular person or item. In accounting we keep a separate record of each individual, asset, liabilities, expense or income. The place where such a record is maintained is termed as an 'Account'. Such as the Account of Madan, the Account of Brij, the Account of Building, the Account of Rent, the Account of Discount and likewise. All transactions entered into with Madan will be recorded in the Account of Madan and similarly, all transactions relating to Brij will be recorded in the Account of Brij. Thus, an account is a systematic record of transactions pretaining to a particular item or person, which can be measured in terms of money during a particular period of time. Account is a head under which particular type of transactions are consolidated, classified and recorded. Example: A sales account is opened for recording the sales of goods or services. Similarly expenses during the financial period are

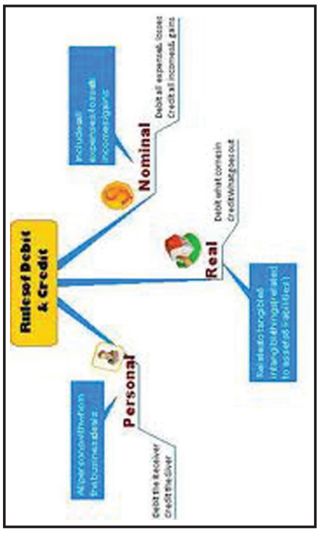


Table I Accounting entry rules (double entry method)

Nominal accounts	Debit the expenses Credit the gains
Personal accounts	Debit the receiver Credit the giver
Real accounts	Debit what comes in Credit what goes out

recorded using the respective expense accounts. The account may be classified in two ways:

i. Traditional classification

ii. Modern classification.

Classification of Accounts Based on Nature or Traditional Classification

On the basis of their nature accounts are of the following three types :

i) **Personal Accounts :** Accounts in the name of individuals or group of individuals are called personal accounts e.g. Ramesh, Mahesh, M/s M.K. Computers etc.

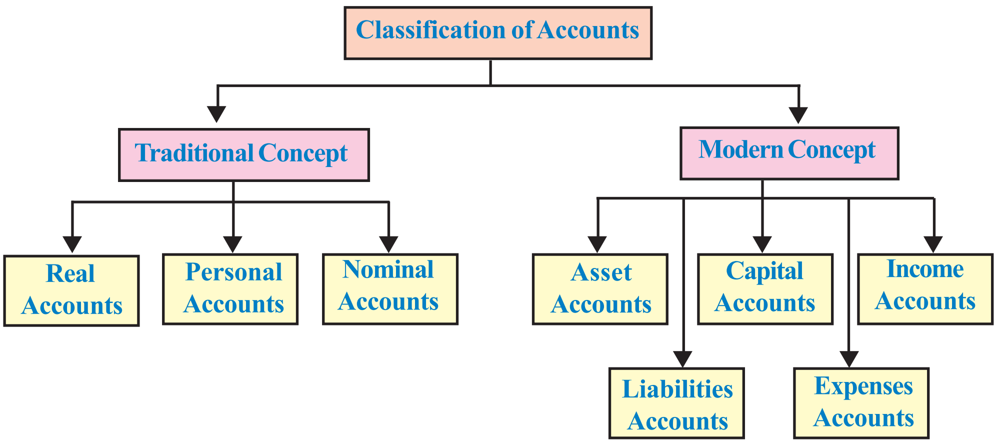
ii) **Nominal Accounts :** Accounts of expenses or losses incomes or gains are called nominal accounts e.g. wages paid, commission received etc.

iii) **Real Accounts :** Accounts of assets are called real accounts e.g. building, furniture etc.

Modern Classifications

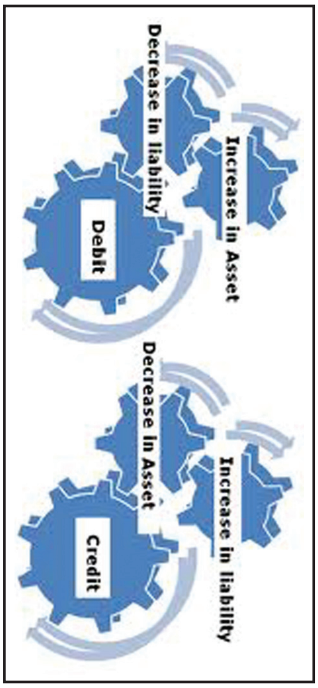
On the basis of this classification accounts are divided into five catagories as given below :

i. Capital, ii. Assets, iii. Liabilities, iv. Expenses and v. Income



- The further classification of accounts is based on the periodicity of their inflows or outflows in the context of the accounting year.
- Income is immediate inflow during the accounting year.
- Expense is the immediate outflow during the accounting year.
- An asset is a long-term inflow with implications extending beyond the financial period.
- Liability is long term outflow with implications extending beyond the financial period.

Notes



5.4 RULES OF ACCOUNTING (DEBIT AND CREDIT)

Using Debit and Credit

In Double Entry accounting both the aspects of the transaction are recorded. Every transaction has two aspects according to this system, both the aspects are recorded. If the business acquires something, it must have been acquired by giving something else. While recording each transaction, the total amount debited must be equal to the total amount credited. The terms 'Debit' and 'Credit' indicate whether the transaction is to be recorded on the left hand side or right hand side of the account. In its simplest form, an account looks like the English Language Letter 'T'. Because of its shape, this simple form of account is called T-account. You must have observed that the T format has a left side and a right side for recording increases and decreases in the item. This helps in ascertaining the ultimate position of each item at the end of an accounting period. For example, if it is an account of a supplier, all goods/materials supplied shall appear on the right (Credit) side of the Supplier's account and all payments made on the left (debit) side.

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

Account Title

(Left Side) **(Right Side)**

Specimen of T-account

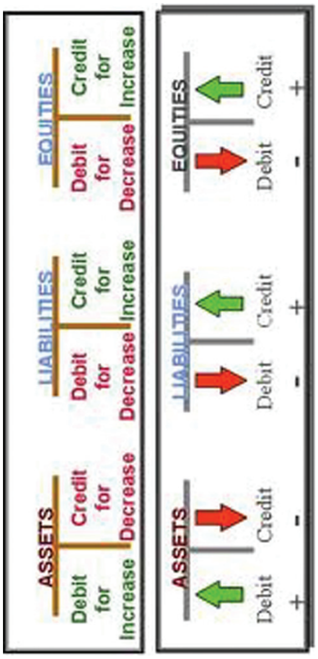
Rules of Accounting

All accounts are divided into five categories for the purpose of recording of the business transactions:

(i) Assets, (ii) Liability, (iii) Capital,
(iv) Expenses/Losses, and (v) Revenues/Gains.

Two Fundamental Rules are followed to record the changes in these accounts:

1. For recording changes in Assets/Expenses/Losses
   "Increase in Asset is debited, and decrease in Asset is credited."
   "Increase in Expenses/Losses is debited, and decrease in Expenses/ Losses is credited."
2. For recording changes in Liabilities, Capital and Revenue/Gains
   "Increase in Liabilities is credited and decrease in Liabilities is debited."
   "Increase in Capital is credited and decrease in Capital is debited."



"Increase in Revenue/Gains is credited and decrease in Revenue/Gain is debited".

The rules applicable to the five kinds of accounts are summarised in the following chart:

Rules of Accounting

Assets	
(Increase) + Debit	(Decrease) – Credit

Expenses/Losses	
(Increase) + Debit	(Decrease) – Credit

Capital	
(Decrease) – Debit	(Increase) + Credit

Liabilities	
(Decrease) – Debit	(Increase) + Credit

Revenue/Gains	
(Decrease) – Debit	(Increase) + Credit

I. Analysis of Rule Applied to Assets Accounts

Rohit Purchased Furniture for ₹ 80,000.

Analysis of Transaction : In this transaction, the two affected accounts are Cash account and Furniture account. Cash account is an assets account and has decreased. As per rule if asset decreases the affected account is credited, so cash account should be credited. Furniture is also an asset and it has increased. As per rule if asset increases the affected account is debited thus, furniture account is to be debited.

Cash	
Dr.	Cr
	80000 (Decrease)

Furniture	
Dr	Cr
80000 (Increase)	

II. Analysis of Rule Applied to Liabilities Accounts

Purchased Machinery for ₹ 60,000 on credit from M.B. Machinery Mart.

Analysis of Transaction : In this transaction, the two affected accounts are machinery and M.B. Machinery Mart. Machinery is an asset, an asset has increased therefore, machinery account is debited. M.B. Machinery Mart is the creditor on account of supply of machinery and constitutes the liability for the buying firm which has increased. Rule is that on increase of liability the concerned liability account is credited and vice-versa, therefore M.B. Machinery Mart A/c is credited.

Notes

Machinery A/c

Dr	Cr
60000 (Increase)	

M.B.Machinery Mart A/c

Dr	Cr
	60000 (Increase)

III. Analysis of Rule Applied to Capital Accounts

Cash of ₹ 50,000 introduced in business as Capital by Suman Sharma.

Analysis of Transaction : In this transaction, the two affected accounts are Cash account and Suman Sharma [Capital account]. Cash is an asset which increase when invested in business as per rule if an asset increases it is debited therefore cash account will be debited. Suman Sharma invested capital which increase the capital account, and as per rule if capital increases it is credited therefore capital account will be credited.

Cash A/c

Dr	Cr
50000 (Increase)	

Capital A/c

Dr	Cr
	50000 (Increase)

IV. Analysis of Rule Applied to Expenses/Losses Accounts

Paid ₹6000 to the employees as Salary.

Analysis of Transaction : In this transaction, the two affected accounts are Salary account and Cash account. Salary account is an expense and has increased. As per rule if expenses increase it will be debited. Cash is an asset and has decreased, as per rule if assets decrease, it will be credited.

Salary A/c

Dr	Cr
6000 (Increase)	

Cash A/c

Dr	Cr
	6000 (Decrease)

V. Analysis of Rule Applied to Revenue/Profit Accounts

Received interest for the month ₹4000.

Analysis of Transaction : In this transaction, the two affected accounts are Interest and Cash. Interest is an item of Income and Cash an item of asset, as per rule if revenue increases it will be credited and if asset increases it will be debited.

Cash A/c

Dr	Cr
4000 (Increase)	

Interest A/c

Dr	Cr
	4000 (Increase)

Notes

INTEXT QUESTIONS 5.2

I. Fill in the blanks:

i. On the basis of traditional classification accounts can be classified as –

a) ____________ b) ____________ c) ____________

ii. On the basis of Modern classification accounts can be classified as:

a) ____________ b) ____________ c) ____________

d) ____________ e) ____________

iii. ________________ is immediate inflow while ____________ is immediate outflow.

iv. Increase in assets is ______________ and decrease in Asset is ____________.

v. Left hand side of an account is called __________ and right hand side of account is called ____________.

II. A list of the accounts is given below. Tick the category to which each of the account belongs:

Type of Account

Name of Account	Asset	Liability	Capital	Revenue	Expense
i. Wages					
ii. Building					
iii. Cash					
iv. Gupta (Supplier)					
v. Sharma (Owner)					
vi. Sugam (Customer)					
vii. Interest received					
viii. Commission Earned					
ix. Discount allowed					
x. Rent Paid					

Illustration 1

From the following transactions, state the titles of the accounts that will be affected, types of the accounts and the account to be debited and the account to be credited:

Transaction	₹
1. Ankur started business with cash	6,00,000
2 Purchased goods for cash	80,000
3. Paid salaries	10,000
4. Sold goods to Rohit on credit	60,000
5 Office machine purchased for cash	2,000
6 Ankur took loan from Bank	30,000
7 Ankur received commission	4,000
8. Paid for printing and stationary	500
9. Paid rent	6,000
10 Received cash from Rohit a debtor	60,000

Solution

Tran. No.	Name of Accounts		Type of Accounts		Rules applicable to A/cs in Debit/Credit items of Increase/Decrease	
	1	2	1	2	1	2
1	Cash	Capital	Asset	Capital	Cash (Increase)	Capital (Increase)
2	Purchases	Cash	Expense	Asset	Purchase (Increase)	Cash (Decrease)
3	Salaries	Cash	Expense	Asset	Salaries (Increase)	Cash (Decrease)
4	Rohit	Sales	Asset (Debtor)	Revenue	Rohit (Increase)	Sales (Increase)
5	Office machine	Cash	Asset	Asset	Office machine (Increase)	Cash (Decrease)
6	Cash	Bank Loan	Asset	Liability	Cash (Increase)	Bank Loan (Increase)
7	Cash	Commission	Asset	Revenue	Cash (Increase)	Commission (Increase)

8	Printing & Stationary	Cash	Expense	Asset	Printing and Stationery (Increase)	Cash (Decrease)
9	Rent	Cash	Expense	Asset	Rent (Increase)	Cash (Decrease)
10	Cash	Rohit	Asset	Asset	Cash (Increase)	Rohit (Decrease)

5.5 SOURCE DOCUMENTS

Accounting process begins with the origin of a business transaction and is followed by analysis of such transaction. First, there should be a document showing that an accounting event took place. Such a document is usually called a source document. Source documents serve as a basis for an accounting entry. Source documents are documents on the basis of which the accountants record accounting transactions. Source documents are also called as business documents. Some examples of source documents are invoices, material requisition forms, bank statements, cash memos, receipts etc.

Each transaction in a business is supported by the documentary evidence, which are considered source documents. Examples of source documents are an invoice shows sale of goods on credit, a Cash Memo shows cash sales and the receipt issued by the payee shows the transaction against cash payment etc. Thus, documents which facilitate evidence of the transactions are known as the source documents. These are the primary evidence in support of the concerned business transactions, and are also termed as vouchers. Vouchers may be divided into two categories (a) Supporting vouchers and (b) Accounting vouchers.

Supporting Vouchers

The vouchers which support the business transactions are called supporting vouchers. Examples of supporting vouchers are: Rent receipt, Cash memo invoice etc

Accounting Vouchers

These are the source documents on the basis of which transactions are recorded in the books of accounts. Accounting vouchers are the written documents containing the analysis of business transactions for accounting and recording purposes prepared by the accountants on the basis of supporting vouchers and signed by another authorised person.

Features of an Accounting Voucher are as follows:

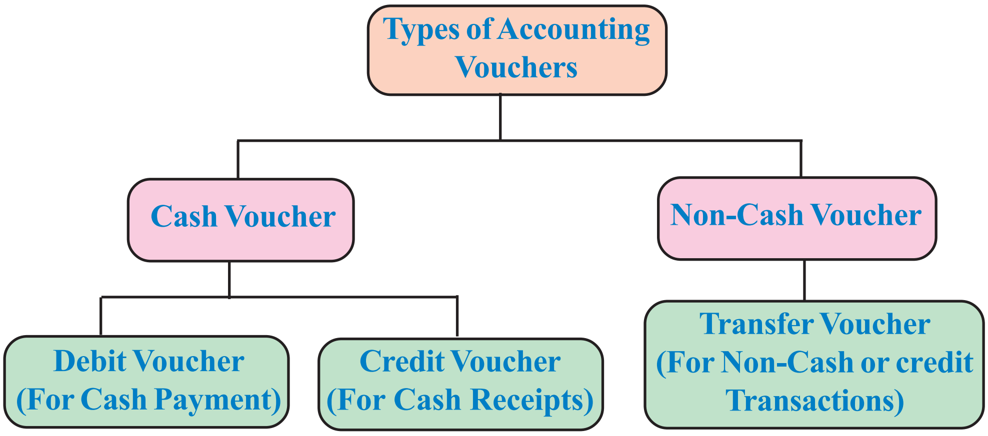
1. It is a written document.
2. It is the base for entries in the books of accounts.

Notes

3. It is prepared on the basis of evidence of the transaction.
4. It contains analysed information of a transaction so that the concerned accounts could be debited and credited.
5. It is prepared by an accountant and countersigned by the authorised signatory.

5.6 TYPES OF ACCOUNTING VOUCHERS

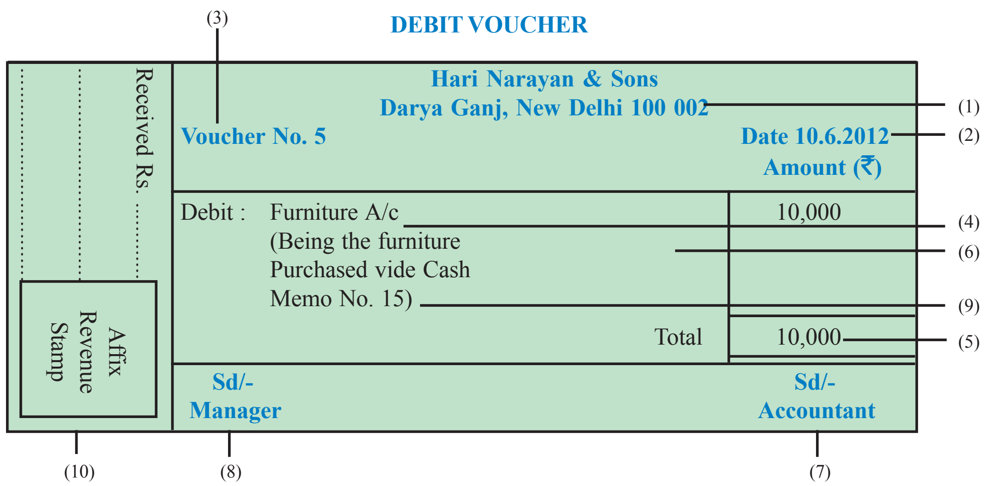
Accounting vouchers may be classified as cash vouchers and non-cash vouchers. There are two types of cash vouchers) debit vouchers and ii) credit vouchers. The non-cash vouchers are also called as transfer vouchers.



Debit Voucher

Debit Vouchers are prepared for recording of transactions involving cash payments only. Cash payments in the business are made on account of Payment to creditors, Purchases of goods, Purchases of assets, Repayment of loans, Depositing cash into Bank, Drawings & advances and expenses etc.

In case of all cash payments, one aspect is cash and the other is either the party to whom the payment is made, or an expense or an item of property for which the payment is made. A format of debit voucher is as follows:



A Debit Voucher gives the following information:

1. Name and Address of the Organisation.
2. Date of Preparing the Voucher.
3. Accounting Voucher Number.
4. Title of the Account Debited.
5. Net Transaction Amount.
6. Narration, *i.e., a brief decription of the transaction.*
7. Signature of the Person Preparing it.
8. Signature of the Authorised Signatory.
9. Supporting Voucher Number.
10. A Document in lieu of the Supporting Voucher.

Illustration 2

The following transactions took place in M/s. Tarun Retailers. Prepare debit voucher:

2012		₹
Jan. 1	Bought materials for cash vide Cash Memo No. 20	17,200
Jan. 5	Wages paid for the month of December 2011, wide Wage Sheet No. 35	5,000

Solution :

(i)

Received Rs. ....

Revenue Stamp

M/s. Tarun Retailers

Voucher No. 1 **Date 1.1.2012**

	Amount (₹)
Debit : Purchases A/c (Being the materials purchased vide Cash Memo No. 20)	17,200
	17,200

Sd/- **Manager** **Sd/-** **Accountant**

(ii)

Received Rs. ....

Revenue Stamp

M/s. Tarun Retailers

Voucher No. 2 **Date 5.1.2012**

	Amount (₹)
Debit : Wages A/c (Being wages paid for December 2011 vide Wage Sheet No. 35)	5,000
	5,000

Sd/- **Manager** **Sd/-** **Accountant**

Notes

Illustration 3

The following transactions took place in M/s. Sunil Traders. Prepare debit vouchers:

2012		₹
Jan. 1	Bought furniture from Relax Furniture for cash vide Cash Memo No. 24	9,500
Jan. 7	Wages paid for the month of December, 2011, vide Wage Sheet No. 30	3,500
Jan. 10	Paid cash to Hari & Sons A/c vide Cash Receipt No. 70	5,000
Jan. 15	Paid for Postage	720

Solution :

(i)

Received Rs. ....

Revenue Stamp

M/s. Sunil Traders

Voucher No. 1 **Date 1.1.2012**

	Amount (₹)
Debit : Furniture A/c (Being furniture purchased vide Cash Memo No. 24)	9,500
	9,500

Sd/- **Sd/-**
Manager **Accountant**

(ii)

Received Rs. ....

Revenue Stamp

M/s. Sunil Traders

Voucher No. 2 **Date 7.1.2012**

	Amount (₹)
Debit : Wages A/c (Being wages paid for December 2011 vide Wage Sheet No. 30)	3,500
	3,500

Sd/- **Sd/-**
Manager **Accountant**

(iii)

Received Rs. ....

Revenue Stamp

M/s. Sunil Traders

Voucher No. 3 **Date 10.1.2012**

	Amount (₹)
Debit : Hari & Sons A/c (Being amount paid vide Cash Receipt No. 70)	5000
	5000

Sd/- **Sd/-**
Manager **Accountant**

(iv)

Received Rs. .... Revenue Stamp	M/s. Sunil Traders	
	Voucher No. 4	Date 15.1.2012 Amount (₹)
	Debit : Postage A/c (Being the amount paid for Postage)	720
		720
	Sd/- Manager	Sd/- Accountant

Credit Vouchers

These vouchers are prepared for recording of transactions involving only cash receipts. Cash receipts in the business take place on account of Cash sales of goods, Cash receipts from debtors, Cash sales of assets, Cash withdrawn from bank for office use, Revenue income like interest, rent etc. received in cash, Loan taken and Receipts of advances etc.

In all cash receipts, one aspect is cash and the other is either person or party from whom cash is received or item of revenue on account of which cash is received or the property on the sale of which cash is received. A format of credit voucher is as follows:

CREDIT VOUCHER

Ram Narayan Printers (1) 7, Karol Bagh, New Delhi	
Voucher No. 302 (3)	Date 4.2.2012 (2) Amount (₹)
Credit : Sales A/c (4) (Being goods sold for cash vide Bill No. 15) (6) (9)	12,000
Total	12,000 (5)
Sd/- Manager (8)	Sd/- Accountant (7)

The Credit Voucher gives the following information:

1. Name and Address of the Organisation.
2. Date of Preparing the Voucher.
3. Accounting Voucher Number.
4. Title of the Account Credited.
5. Net Amount of the Transaction.
6. Narration, *i.e., a brief description of the transaction.*

7. Signature of the Person Preparing it.
8. Signature of the Authorised Signatory.
9. Supporting Voucher Number.

Illustration 4

Prepare Credit Vouchers from the source vouchers of M/s. M.K. Computers, Paschim Vihar, New Delhi based on the following transactions:

2012		₹
May 5	Sold Hard diskes for cash vide Cash Memo No. 10	72,000
May 16	Sold old Computer Monitor for cash vide cash Memo No. 34	13,000
May 30	Withdrawn cash from Bank for office use vide cheque No. 300407	8,700

Solution :

(i)

M.K. Computers
Paschim Vihar, New Delhi

Voucher No. 1 **Date : 5.5.2012**

	Amount (₹)
Credit : Sales A/c (Being the amount of Cash Sales vide Cash Memo No. 10)	72,000
	72,000

Sd/-
Manager

Sd/-
Accountant

(ii)

M.K. Computers
Paschim Vihar, New Delhi

Voucher No. 2 **Date : 16.5.2012**

	Amount (₹)
Credit : Old Computer Monitors A/c (Being old Computer Monior sold for cash vide Cash Memo No. 10)	13,000
	13,000

Sd/-
Manager

Sd/-
Accountant

(iii)

M.K. Computers
Paschim Vihar, New Delhi

Voucher No. 3	**Date : 30.5.2012** **Amount (₹)**
Credit : Bank A/c (Being Cash withdrawn from Bank vide Cheque No. 300407)	8,700
	8,700
Sd/- **Manager**	**Sd/-** **Accountant**

Illustration 5

Prepare Credit Vouchers from the following information, gathered from supporting vouchers of M/s. Genius Leather Stores, Meerut.

	2012		₹
(i)	July 5	Received cash from Sohan & Co. on Account vide cash receipt No. 35	12,000
(ii)	July 10	Commission received vice cash receipt No. 74	3,500
(iii)	July 15	Sold leather purses for cash vide Cash Memo No. 412	4,500
(iv)	July 24	Sold two old leather colouring machines vide Cash Memo No. 3714	12,500

Solution :

(i)

M/s. Genius Leather Stores, Meerut

Voucher No. 1	**Date : 5.7.2012** **Amount (₹)**
Credit : M/s. Sohan & Co. (Being Cash received on account from Sohan & Co. vide cash receipt No. 35)	12,000
	12,000
Sd/- **Manager**	**Sd/-** **Accountant**

(ii)

M/s. Genius Leather Stores, Meerut

Voucher No. 2	**Date : 10.7.2012** **Amount (₹)**
Credit : Commission A/c. (Being the amount of commission received vide cash receipt No. 74)	3,500
	3,500
Sd/- **Manager**	**Sd/-** **Accountant**

Notes

(iii)

M/s. Genius Leather Stores, Meerut

Voucher No. 3 **Date : 15.7.2012**

	Amount (₹)
Credit : Sales A/c. (Being the amount of cash sales vide Cash Memo No. 412)	4,500
	4,500

Sd/- **Sd/-**
Manager **Accountant**

(iv)

M/s. Genius Leather Stores, Meerut

Voucher No. 4 **Date : 24.7.2012**

	Amount (₹)
Credit : Leather Colouring Machine (Being two old leather colouring machine sold for cash vide Cash Memo No. 3714)	12,500
	12,500

Sd/- **Sd/-**
Manager **Accountant**

Transfer Voucher or Non Cash Voucher

Non cash vouchers refer to vouchers prepared for transactions not involving cash. They are also called transfer vouchers. The transfer vouchers are prepared to record non-cash transactions of the business involving Credit sales, Credit purchases, Depreciation on assets, Return of goods purchased on credit, Bad debts, Return of goods sold on credit etc.

These vouchers are prepared both in debit and credit forms simultaneously. A format of Transfer Voucher is given as follows:

TRANSFER VOUCHER

(3)

Radhika Pearls Store (1)
32, Vikas Nagar, Lucknow

Voucher No. .... **Date 1.4..2012** (2)

	Amount (₹)	
Debit : Machinery A/c	----------	(4a)

Credit : Raman	----------	(4b)
(Being the machinery purchased		(6)
vide Cash Memo No. ....)	----------	(5)

Sd/- **Sd/-**
Manager **Accountant**

(8) (7)

A Non-Cash Voucher gives the following information:

1. Name and Address of the Organisation.
2. Date of Preparing Voucher.
3. Accounting Voucher Number.
4. (a) Title of the Account Debited.
   (b) Title of the Account Credited.
5. Net Transaction Amount.
6. Narration, *i.e., a brief description of the transaction.*
7. Signature of the Person Preparing it.
8. Signature of the Authorised Signatory.
9. Supporting Voucher Number.

Illustration 6

Prepare Transfer Vouchers of Sunny Garments, Kanpur from the source vouchers based on the following transactions:

2012		₹
Jan 3	Purchased goods from M/s. Jim & Joney vide Bill No. 20	47,000
Jan. 8	Sold goods to M/s. Sita Ram vide Invoice No. 4171	13,980

Solution:

Sunny Garments, Kanpur

Voucher No. .... **Date: 3.1.2012**

		Amount (₹)
Debit :	Purshases A/c	47,000
		47,000
Credit :	M/s. Jim & Joney (Being goods purchased from M/s. Jim & Joney vide Bill No. 20)	47,000
		47,000

Sd/-
Manager

Sd/-
Accountant

Sunny Garments, Kanpur

Voucher No. .... **Date: 8.1.2012**

		Amount (₹)
Debit :	M/s. Sita Ram	13,980
		13,980
Credit :	Sales A/c (Being the amount of credit sales vide Invoice No. 4171 to M/s. Sita Ram)	13,980
		13,980

Sd/-
Manager

Sd/-
Accountant

Illustration 7

Prepare a transfer Voucher from the following supporting voucher.

Ratan & Sones

Sale Invoice No. 121 **Date : 15.3.2012**
To
M/s. Naresh Brothers

Qty.	Particulars	Rate (₹)	Amount (₹)
120 Nos.	Cricket balls	100	12,000
70 Nos.	Full size bat	1000	70,000
			82,000

Sd/-
Ratan & Sons

Solution :

Ratan & Sons

Voucher No. 1 **Date : 15.3.2012**

	Amount (₹)
Debit : M/s. Naresh Brothers	82,000
	82,000
Credit : Sales A/c (Being the credit sales vide Invoice No. 121 to M/s. Naresh Brothers)	82,000
	82,000

Sd/- **Sd/-**
Manager **Accountant**

INTEXT QUESTIONS 5.3

I. Which of the following statements is true and which is false?

i. For every transaction there will be two entries.

ii. 'One who gives is a debtor and one who receives is a creditor'.

iii. A system is called ‘double entry system’ because the two fold aspect of each transaction are recorded.

iv. The totals of debit entries on any day need not be equal to credit entries related to various accounts.

II. Put a mark against each transaction in the column of correct type of voucher.

	Debit Vouchers	Credit Vouchers	Transfer Vouchers
1. Purchase furniture for cash			
2. Sale of goods for cash			
3. Sale of goods to Vikram			
4. Depreciation charged on Building			
5. Withdrew cash from Bank for office use.			

III. Multiple Choice Questions

i. Which English alphabet is similar to the shape of an account?
a) I b) T c) H d) D

ii. How many sides does an account have?
a) One b) Two c) Three d) Four

iii. Where are all the transactions of a particular account recorded?
a) Under the particular account b) Under any account
c) Under more than two accounts d) Under many accounts

iv. Under how many heads accounts can be grouped under Modern System of accounting:
a) Two b) Three c) Four d) Five

v. Treatment of assets account is similar to
a) Expenses b) Revenue c) Capital d) Liabilities

WHAT YOU HAVE LEARNT

- System under which both the changes in a transaction are recorded together, one change is debited while the other change is credited with equal amount is known as double entry system.
- Account is a head under which particular type of transactions classified and consolidated are recorded.
- Traditional classifications of the accounts are as: personal, real and nominal.
- On the basis of modern classification accounts are divided into assets, liabilities, revenue, expense and capital.
- Effects of debits and credits on various types of accounts.

Notes

Assets	
Debit (increase) +	Credit (decrease) -

Expenses	
Debit (increase) +	Credit (decrease) -

Capital	
Debit (decrease) -	Credit (increase) +

Liabilities	
Debit (decrease) -	Credit (increase) +

Revenue	
Debit (decrease) -	Credit (increase) +

- Source Document and Vouchers: A document evidencing that an accounting event took place is called source document i.e. cash memo, invoice, receipt, Debit Note, Credit Note, Cheque and Pay-in slip.
- A voucher is documentary evidence in support of a transaction. They are cash voucher (Dr & Cr voucher) and transfer voucher for credit transaction.

TERMINAL EXERCISE

1. Define double entry system.
2. State various advantages of double entry system.
3. State the limitations of double entry system.
4. What is meant by an account?
5. Explain the modern classification of different types of Accounts.
6. State the fundamental rules, followed to record the changes (increase / decrease) in various accounts.
7. What is accounting voucher? Explain in brief different types of accounting vouchers.
8. Prepare debit vouchers from the following transactions:
   - i) Goods purchased for cash ₹1,50,000
   - ii) Cash paid to Raghav (creditor) ₹1,00,000
   - iii) Paid for office expense ₹15,000.
9. Prepare credit vouchers from the following transactions:
   - i) Additional capital introduced ₹2,00,000
   - ii) Compensation received from the Insurance company ₹50,000
   - iii) Drew cash for office from Bank ₹1,50,000
10. Prepare transfer vouchers from the following transactions:
    - i) Goods purchased from Mehta & Co. ₹25,000
    - ii) Sales return from customers ₹1,500
    - iii) Goods given as charity ₹3,000

11. Prepare necessary accounting vouchers from the following transactions:
    a) Goods sold to Salma on credit ₹8,000
    b) Withdraw cash for personal use ₹5,000
    c) Cash received from Bhoomi ₹15,000
    d) Salary paid ₹5,000
    e) Depreciation charged ₹7,000
    f) Cash deposited into Bank ₹10,000
12. Put the following on the proper side of Furniture Account:

	₹
Furniture purchased	20,000
Furniture sold	12,000
Furniture again purchased	6,000
Furniture discarded	1,500
A part of furniture worth ₹ 500 was broken	500

13. From the following data, prepare proprietors Capital Account:

	₹
Commenced business with Cash	30,000
Net loss as per Profit & Loss Account	4,000
Drawings during the year	5,000
Additional capital introduced during the year	3,000

ANSWER TO INTEXT QUESTIONS

5.1 i) dual aspect ii) debtor & creditor
iii) any alteration in an account iv) no guarantee

5.2 **I.** i) personal, real and nominal
ii) capital, liabilities, expense, revenue and assets
iii) assets, liabilities iv) debited, credited v) debit, credit

II. i) Wages – Expense, ii) Building – Asset, iii) Cash – Asset,
iv) Gupta (Supplier) – Liability, v) Sharma Owner – Capital
vi) Sugam (Customer) – Asset, vii) Interest received – Revenue
viii) Commission earned – Revenue,
ix) Discount allowed – Expense, x) Rent Paid – Expense.

5.3 **I.** i. False ii. False iii. True iv. False

II. i. Debit ii) Credit iii) Transfer iv) Transfer v) Credit

III. i) b, ii) b, iii) a, iv) d, v) a.

ACTIVITY FOR YOU

- Draft a list of activities involving your monetary transactions of last week and prepare vouchers from those transactions (atleast ten).

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6

JOURNAL

You have learnt that business transactions are recorded in various books of accounts in a systematic manner. You have also learnt the double entry system of accounting. Now, you would like to know what are those books of accounts? How are these prepared? What transactions are recorded in each such book. One of these books is Journal. This is a book which is prepared by every businessman small or big. Business transactions are recorded in this book date wise and in the order in which these transactions take place. In this lesson you will learn the meaning of journal, its purpose and the method of preparing the journal.

OBJECTIVES

After studying this lesson you will be able to:

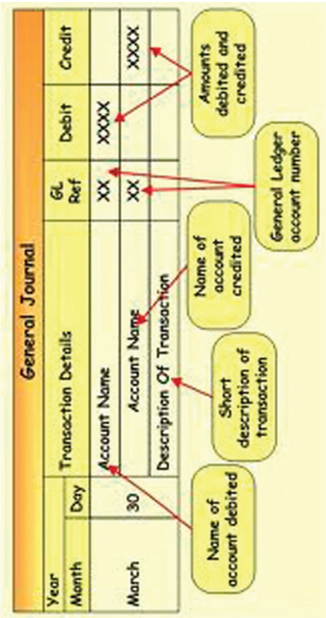
- explain the meaning of journal with its purpose;
- draw journal as per format;
- explain the process of journalising;
- journalise the simple and compound transactions and
- classify journal into special journal and journal proper.

6.1 MEANING OF JOURNAL

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

You have learnt that business transactions of financial nature are classified into various categories of accounts such as assets, liabilities, capital, revenue and expenses. All business transactions belonging to any of these categories can be recorded in a journal. The process of recording transactions in the journal is known as 'Journalising'.

Small business units generally maintain one journal in which all the business transactions are recorded. But in case of big business houses as the transactions are large in number, the journal is divided into various books which are called special journals. Different transactions are recorded in these books depending upon the nature of transactions for example all credit sales of goods are recorded in Sales Book, all credit purchases of goods are recorded in Purchase Book and Cash transactions in Cash Book and so on.



Purpose of Preparing Journal

1. It provides the date wise record of all the business transactions.
2. It gives complete information about a transaction at one place and also provides an explanation of the transaction.
3. It helps in the understanding of the principles of Double Entry System as entries in Journal are classified into Debit and Credit.
4. It is easier to post the entries of this book into ledger without any difficulty.

6.2 FORMAT OF JOURNAL

Every page of journal has the following format :

Journal

Date	Particulars	L.F.	Dr. Amount ₹	Cr. Amount ₹
(1)	(2)	(3)	(4)	(5)

You see that journal is a columnar book. Each column is given a name which is written on its top. Column wise details of journal is as follows :

1. **Date:** In this column we record the date of the transaction with its month and accounting year. Year is written only once. Month is also written only once for all the transactions belong to a particular month.

2. **Particulars:** The accounts affected by a transaction i.e. the accounts which have to be debited and credited are recorded in this column. In the first line write the name of the account to be debited against which Dr is written. In the second line after leaving some space name of the account which has to be credited is written. The word 'To' may be prefixed with it. In the next line narration is written. Narration is the explanation of a particular journal entry. It should be short, complete and clear. A line is drawn before making the next entry so as to separate the two.

Note : As per modern concept of Accounting you may write journal entry even without writing **'To'** for a credit entry.

3. **Ledger folio:** The transaction in the journal is posted in the ledger. Page number of ledger on which the two accounts are opened is written in the column of ledger folio.

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

You can understand the journalising of a transaction with the help of the following example:

2012
April 1 Commenced business with cash ₹10,000.
In this transaction two affected accounts are Capital A/c and Cash A/c. The journal entry for the same will be.

Journal

Date	Particulars		L.F.	Dr. Amount ₹	Cr. Amount ₹
2012 April 1	Cash A/c…	Dr.		10,000	
	Capital A/c				10,000
	(Business commenced with cash)				

At the end of each page the two columns are totalled and are carried forward to the next page with words 'carried forward' (c/f). This total is written in the next page on its top with words 'brought forward' (b/f).

INTEXT QUESTIONS 6.1

I. Complete the sentences stating the meaning of journal

i. Journal is book of accounts in which ______________________.

ii. Narration is the ______________________________.

iii. Ledger folio column is used ___________________________.

II. Following statements about journal are incorrect, correct them:

i. Only cash transactions are recorded in journal

ii. There is no other name of journal

iii. Every businessman big or small maintains one journal book.

6.3 PROCESS OF JOURNALISING

Following steps are taken while preparing a journal.

i) **Identify the accounts :** First of all the affected accounts of an accounting transaction are identified. For example 'Goods of ₹5000 sold for cash

Notes

is a transaction. The affected accounts are Sales A/c and Cash A/c.

ii) **Recognize the Account :** Now the type of two accounts are ascertained i.e. as asset, liability, capital, expense or revenue. In the given example Cash A/c is an asset A/c and Sales A/c is a revenue A/c.

iii) **Apply the rules of Debit and Credit :** You have learnt the rules of Debit and Credit. Now ascertain which account is to be debited and which is to be credited. In our example, sales account will be credited as sales (a revenue item) is increasing and cash A/c will be debited as cash (is an asset) is also increasing.

Now, the Journal entry will be recorded and narration will be written. Amounts will be written against the two accounts in their respective columns.

Journal entry of the above given transaction will be recorded as follows:

Journal

Date	Particulars	L.F.	Dr. Amount ₹	Cr. Amount ₹
	Cash A/c... Dr. Sales A/c (Goods sold for cash)		5,000	 5,000

Illustration 1

Analyse the following transactions using the Modern Approach for classification of Accounts in a Tabular Form.

2012		₹
Jan 1	Amogh started business with cash	50,000
Jan 2	Paid into Bank	20,000
Jan 4	Goods purchased for cash	10,000
Jan 8	Machinery purchased and paid by cheque	5,000
Jan 12	Sold goods to Pranaya	12,000
Jan 15	Purchased goods from Gunakshi	16,000
Jan 18	Sold goods for cash	8,000
Jan 20	Received cash from Pranaya	12,000
Jan 31	Withdrew cash for personal use	2,400
Jan 31	Rent Paid	2,000

Solution

Let us first analyze the transactions.

Tabular Analysis of Business Transactions

Date	Transaction	Affected Accounts	Kinds of Accounts	Increase/ Decrease	Account to be Debited	Account to be Credited
2012						
Jan. 1	Cash Received from owner Amogh	Cash Capital	Asset Capital	Increase Increase	Cash A/c	Capital A/c
Jan. 2	Paid into Bank	Bank Cash	Asset Asset	Increase Decrease	Bank A/c	Cash A/c
Jan. 4	Goods Purchased for cash	Purchases Cash	Expense Asset	Increase Decrease	Purchases A/c	Cash A/c
Jan. 8	Machinery Purchased and paid by cheque	Machinery Bank	Asset Asset	Increase Decrease	Machinery A/c	Bank A/c
Jan. 12	Sold goods to Pranaya	Pranaya Sales	Pranaya (Debtor) Sales (Revenue)	Increase Increase	Pranaya	Sales A/c
Jan. 15	Purchased goods from Gunakshi	Purchases Gunakshi	Expenses Gunakshi (Creditor)	Increase Increase	Purchases A/c	Gunakshi
Jan. 18	Slod goods for cash	Cash Sales	Asset Revenue	Increase Increase	Cash A/c	Sales A/c
Jan. 20	Cash received from Pranaya	Cash Pranaya	Asset Pranaya (Debtor)	Increase Decrease	Cash A/c	Pranaya
Jan. 31	Withdrew cash for personal use	Drawings Cash	Capital Asset	Decrease Decrease	Drawings A/c	Cash A/c
Jan. 31	Rend Paid	Rent Cash	Expense Asset	Increase Decrease	Rent A/c	Cash A/c

Illustration 2

On the basis of above analysis now you can prepare journal which will be as follows:

Journal of Amogh

Date	Particulars	L.F.	Dr. Amount ₹	Cr. Amount ₹
2012				
Jan. 1	Cash A/c… Dr.		50,000	
	Capital A/c			50,000
	(Capital brought in by Amogh)			
Jan. 2	Bank A.c ... Dr.		20,000	
	Cash A/c			20,000
	(Cash paid into bank)			
Jan. 4	Purchase A/c ... Dr.		10,000	
	Cash A/c			10,000
	(Goods purchase for cash)			
Jan. 8	Machinery A/c ... Dr.		15,000	
	Bank A/c			15,000
	(Machinery purchased & paid by cheque)			
Jan. 12	Pranaya A/c ... Dr.		12,000	
	Sales A/c			12,000
	(Goods sold on credit)			
Jan. 15	Purchases A/c ... Dr.		16,000	
	Gunakshi			16,000
	(Goods purchased on credit)			
Jan. 18	Cash A/c ... Dr.		8,000	
	Sales A/c			8,000
	(Goods sold for cash)			
Jan. 20	Cash A/c ... Dr		12,000	
	Pranaya A/c			12,000
	(Cash received from debtor Pranaya)			
Jan. 31	Drawings A/c ... Dr.		2,400	
	Cash A/c			2,400
	(Cash withdrawn for personal use)			
Jan. 31	Rent A/c ... Dr.		2,000	
	Cash A/c			2,000
	(Rent paid)			
			1,47,400	**1,47,400**

INTEXT QUESTIONS 6.2

Given below are some transactions. Write the names and types of accounts affected in the given debit and credit columns.

Transaction	Dr.		Cr.	
	Name of A/c	Type of A/c	Name of A/c	Type of A/c
i. Purchased goods and paid by cheque.				
ii. Paid salary.				
iii. Cash received from Apoorva a debtor.				
iv. Goods sold to Maya				
v. Cash withdrawn for personal use.				

Compound Entries

The journal entries which you have learnt so far affect two accounts only. There can be entries that affect more than two accounts. Such entries are called 'Compound' or 'Combined' entries. A compound entry contains more than one debit or credit or both, for example :-

- Cash paid for rent ₹2,000 and for salary ₹4,000.
- The Affected accounts are Rent A/c which is to be debited and Salary A/c which is also to be debited as both are items of expense and are increasing.
- Cash A/c is to be credited as Cash A/c is an asset A/c and it decreases by the total of Salary and Rent paid.

Journal entry

Rent A/c	Dr.		2,000	
Salary A/c	Dr.		4,000	
Cash A/c				6,000
(Cash paid for rent and salary)				

Similarly cash paid to Vikram ₹ 4900. He allowed us discount ₹100. Journal entry will be :

Vikram	Dr.		5,000	
Cash A/c				4,900
Discount A/c				100
(Cash paid to Vikram and discount allowed by him)				

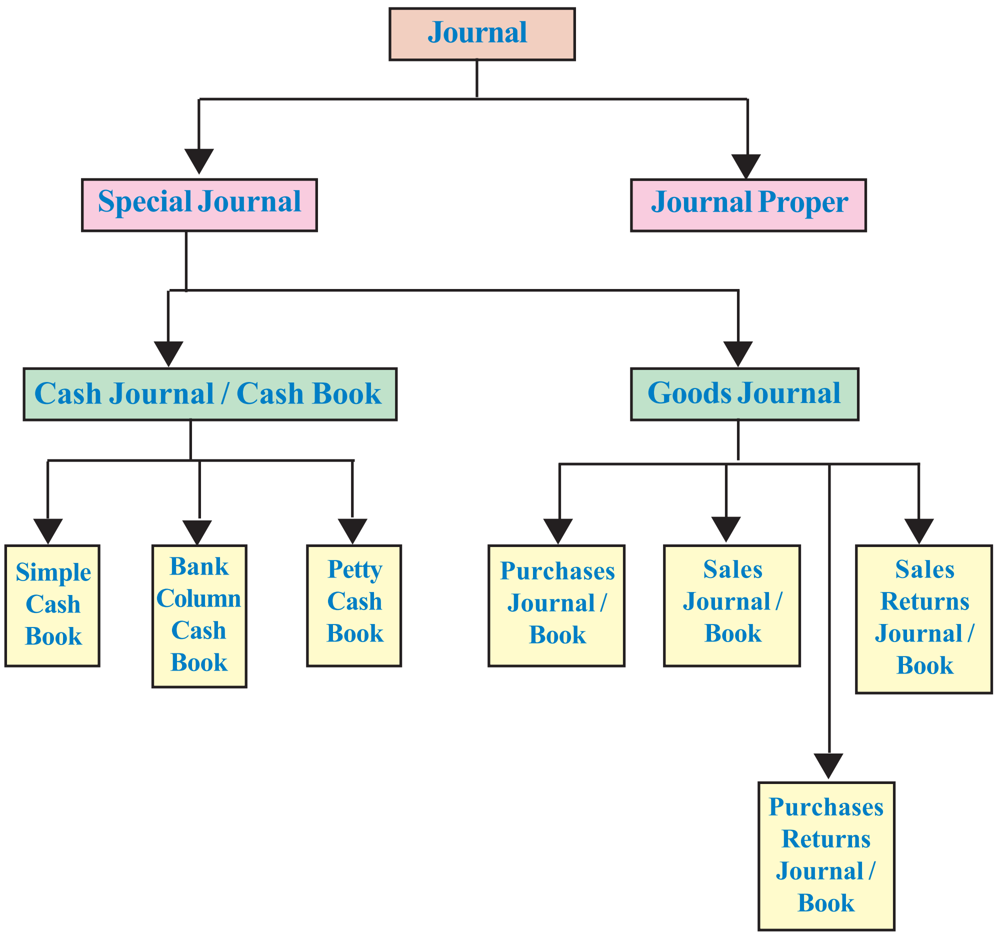
Thus, from the above examples you can understand that the entries having more than one debit or credit are known as compound entries.

6.4 CLASSIFICATION OF JOURNAL

Journal is a book in which transactions are recorded in chronological order date wise, therefore, it will be practically difficult to record all transactions in journal if the number of transactions are large. Hence, arises the need to divide journal into various journals each called a subsidiary book or Special Purpose Book and the journal itself is called Journal Proper. Following are the important subsidiary books (Journals) used by a business enterprise :

i. Cash book
ii. Sale book
iii. Purchases book
iv. Sale Returns book on Returns Inward book.
v. Purchases Returns Book or Returns Outward book.
vi. Journal proper or General Journal.

Chart Showing the Classification of Journal



Some basic transactions with their Journal Entries.

Journal Entries

Transactions	Journal Entry
1. Purchase of goods on credit	Purchases A/c ...Dr. Supplier A/c
2. Sale of goods of credit	Customer's A/c ...Dr. Sales A/c
3. Cash purchase of assets	Sundry Assets A/c ...Dr. Cash A/c
4. Started business with capital	Cash A/c ...Dr. Capital A/c
5. Collection of cash/cheque from customers (and discount allowed, if any)	Cash/Bank A/c (Net amount) ...Dr. Discount Allowed A/c (Discount) ...Dr. Customer's A/c
6. Goods purchased for cash	Purchases A/c ...Dr. Cash A/c
7. Cash sales	Cash A/c ...Dr. Sales A/c
8. Opening a Bank Account	Bank A/c ...Dr. Cash A/c
9. Recovery of Bad Debt	Cash A/c ...Dr. Bad Debt Recovered A/c
10. For payment of cash/cheque to suppliers (and discount received, if any)	Supplier ...Dr. Cash/Bank A/c (Net Amount) Discount Received A/c (Discount)
11. Bad Debts	Bad Debts A/c ...Dr. Customer's A/c
12. Distribution of goods as free samples.	Free Samples A/c / Advertisement A/c ...Dr. Purchases A/c
13. Purchase of machinery for cash	Machinery A/c ...Dr. Cash A/c

14. Depreciation charged on fixed assets	Depreciation A/c ...Dr. Asset A/c
15. Withdrawal of cash from bank for business	Cash A/c ...Dr. Bank A/c
16. Sale or disposal of any old asset at a profit	Cash A/c ...Dr. Asset A/c Profit on Sale of Asset A/c
17. Giving goods or cash in charity	Charity A/c ...Dr. Cash A/c Purchases A/c
18. Goods returned to the supplier	Supplier's ...Dr. Returns Outward A/c
19. Sale or disposal of any old asset at a loss	Cash/Bank A/c ...Dr. Loss on Sale or Assets A/c ...Dr. Asset A/c
20. Goods returned by the customer	Returns Inward A/c ...Dr. Customer's A/c

Illustration 3

Journalise the following transactions in the books of Pranaya:

2012		₹
Jan. 1	Commenced business with cash	50,000
Jan. 3	Paid into bank	25,000
Jan. 5	Purchased furniture for cash	5,000
Jan. 8	Purchased goods and paid by cheque	15,000
Jan. 8	Paid for carriage	500
Jan. 14	Purchased goods from Gaurav	35,000
Jan .18	Cash Sales	32,000
Jan. 20	Sold goods to Amol on credit	28,000
Jan. 25	Paid cash to Gaurav in full settlement	34,200
Jan. 28	Cash received from Amol	27,500
	Discount allowed to him	500
Jan. 31	Paid rent for the month	2,000
Jan. 31	Withdrew from the bank for private use	2,500

Notes

Solution

Date	Particulars	L.F.	Dr. Amount ₹	Cr. Amount ₹
2012				
Jan. 1	Cash A/c Dr.		50,000	
	Capital A/c			50,000
	(Commenced business with cash)			
Jan. 3	Bank A/c Dr.		25,000	
	Cash A/c			25,000
	(Cash paid in the bank)			
Jan. 5	Furniture A/c Dr.		5,000	
	Cash A/c			5,000
	(Purchased furniture for cash)			
Jan. 8	Purchases A/c Dr.		15,000	
	Bank A/c			15,000
	(Purchased goods and paid cheque)			
Jan. 8	Carriage A/c Dr.		500	
	Cash A/c			500
	(Cash paid for carriage charge)			
Jan. 14	Purchases A/c Dr.		35,000	
	Gaurav			35,000
	(Goods purchased on credit)			
Jan. 18	Cash A/c Dr.		32,000	
	Sales A/c			32,000
	(Goods sold for cash)			
Jan. 20	Amol Dr.		28,000	
	Sales A/c			28,000
	(Goods sold to Amol on credit)			
	C/F		**1,90,500**	**1,90,500**

	B/F	1,90,500	1,90,500
Jan. 25	Gaurav Dr. Cash A/c Discount A/c (Cash paid to Gaurav and discount allowed by him)	35,000	 34,200 800
Jan. 28	Cash A/c Dr. Discount A/c Dr. Amol (Cash received from Amol and discount allowed to him)	27,500 500	 28,000
Jan. 31	Rent A/c Dr. Cash A/c (Cash paid for rent)	2,000	 2,000
Jan. 31	Drawings A/c Dr. Bank A/c (Cash withdrawn from bank for domestic use)	2,500	 2,500
		2,58,000	2,58,000

INTEXT QUESTIONS 6.3

Multiple Choice Questions

i. Purpose of preparing Journal is
   a) To provide date wise record of all the business transactions.
   b) To know Profit or Loss of business.
   c) To know financial position of business.
   d) To ascertain cash avaliability on a particular date.

ii. Compound Journal entry is an entry which
   a) Contains more than one debit
   b) Contains more than one credit
   c) Contains more than one debit or credit or both.
   d) Does not contain more than one debit or credit.

iii. Journal is also known as
   a) Book of secondary entry.
   b) Book of Primary entry.
   c) Book of Primary and secondary entry.
   d) None of the above.

iv. Journal can be classified as

a) Special Journal b) Journal Proper

c) Special Journal and Journal Proper d) None of the above

v. Narration of Journal entry is written in the column of

a) Date b) Particulars c) Dr amount d) Cr amount

WHAT YOU HAVE LEARNT

- Journal is a book of accounts in which all day to day business transactions are recorded in a chronological order.
- The process of recording transactions in journal is known as Journalising
- Journal is divided into various journals so as to record different types of transactions in different books. These may be Cash- Book, Purchases Book, Sales book etc.
- Format of Journal is:

Date	Particulars	L.F.	Dr. Amount ₹	Cr. Amount ₹

- Steps in the process of journalising transactions
  - (i) Identify the Account.
  - (ii) Recognize the Account
  - (iii) Apply the rules of 'Debit' and 'Credit'
  - (iv) Write the amounts and narration
- Entries that affect more than one Debit or Credit accounts are called 'Compound' entries.
- When number of transactions are very large, journal is divided into various types of journals so journals divided are called, Special journals or Special purpose books or Subsidiary Books.

TERMINAL EXERCISE

1. What is meant by a journal?
2. Why is journal called 'book of original records'?
3. Explain various steps in the process of journalising.
4. Explain the meaning of compound journal entries with an example.
5. Journalise the following transactions in the books of Arun.

2012		₹
Apr. 1	Commenced business with cash	80,000
Apr. 3	Paid into Bank	50,000
Apr. 6	Purchased goods for cash	20,000
Apr. 9	Purchased furniture and paid for it by cheque	15,000
Apr. 14	Sold goods to Neha	18,000
Apr. 19	Purchased goods from Nirmal	24,000
Apr. 21	Withdraw cash for private use	8,000
Apr. 24	Received cheque from Neha	17,600
	Allowed her discount	400
Apr. 26	Paid to Nirmal by cheque	16,300
	She allowed discount	700
Apr. 27	Sold Goods to Maya for cash	80,000
Apr. 30	Paid Telephone bill	4,200

6. Journalise the following transactions in the journal of Mr. Ram Kumar.

	₹
Commenced business with cash	1,50,000
Purchased goods for cash	1,00,000
Purchased goods from Mohan on credit	26,000
Deposited into bank	15,000
Purchased furniture	72,000
Goods sold for cash	7,000
Goods sold to Kaushik on credit	5,000
Sale of old furniture	3,500
Received from Kamal	3,000
Paid salary	3,100
Paid Rent	4,200
Paid telephone bill	1,800

7. Journalise the following transactions in the books of Smt. Sheela.

	₹
Commenced business with cash	1,30,000
Paid into bank	21,000
Purchase goods	1,500
Withdrew cash from bank	3,000
Sold goods to Sharma	1,000
Purchased goods from Deepak	1,500
Received cash from Sharda	3,000
Paid to Malik	1,475
Rent paid	2,000

Salary paid to clerk	4,500
Paid for postage	1,000

8. Journalise the following transactions.

2012		₹
July 1	Commenced business with cash	2,00,000
July 2	Purchased goods on credit from Vivek	1,00,000
July 8	Sold goods for cash	22,400
July 9	Sold goods on credit to Ms/ Anuj & Co.	10,000
July 15	Paid to M/s Balbir Singh & Sons.	11,900
	Discount allowed by them	100
July 25	Sold goods to M/s Balkrishan & Sons	5,600
July 27	Received cheque from M/s Anuj & Co. in full settlement of amount due from them	9,750
July 31	Paid for electric charges	3,100
July 31	Paid Salary	2,000
July 31	Paid rent of building by cheque half of the building is used by the proprietor for residential use	5,000
July 31	Withdrew for private use	3,500

Notes

9. The following are the transactions of Ranbeer Singh for the month of August. You are required to journalise the same.

2012		₹
Aug. 1	Started business with cash	2,80,000
Aug. 1	Cash paid into bank	50,000
Aug. 1	Bought stationery for cash	300
Aug. 2	Bought goods for cash	20,000
Aug. 3	Bought postage stamps	100
Aug. 5	Sold goods for cash	7,500
Aug. 6	Bought office furniture from Bhalla furnitures	25,000
Aug. 11	Sold goods to Bhatia Traders	10,000
Aug. 12	Received cheque from Bhatia Traders	10,000
Aug. 14	Paid Bhalla Furnitures	24,500
Aug. 16	Sold goods to Bharat Bhushan	50,000
Aug. 20	Bought goods from Seth & Bros.	27,000
Aug. 23	Bought goods for cash from Ram Narain & Co.	22,500
Aug. 24	Sold goods to Prakash Electric Store	3,500
Aug. 26	Bhatia Traders paid on account	8,000
Aug. 28	Paid Sethi & Bros. by cheque in full settlement	25,000
Aug. 31	Paid salaries to office staff	25,000
Aug. 31	Rent paid for shop	5,000

10. Shivali Chadha commenced business on 1st January, 2012. Her transactions for the month are given below. Pass necessary journal entries for the same.

2012		₹
Jan. 1	Commenced business with cash	2,50,000
Jan. 2	Cash Paid into bank	35,000
Jan. 3	Bought goods from Praveen Chauhan	54,000
Jan. 3	Sold goods to Rajesh Agarwal	48,000
Jan. 7	Bought goods from Ram Chand Sahai	16,450
Jan. 8	Paid wages in cash	8,000
Jan. 8	Sold goods to Manish Chugh	15,000
Jan. 10	Received cheque from Rajesh Agarwal	47,800
Jan. 10	Paid into bank	10,000
Jan. 11	Paid to Ramesh	7,000
Jan. 12	Paid rent	4,000
Jan. 13	Bought from Khanna & Khanna	17,400
Jan. 15	Paid Electricity bill	2,800

ANSWER TO INTEXT QUESTIONS

6.1 **I.** i. all transactions are recorded in chronological order.

ii. explanation of journal entry.

iii. to record page number of ledger on which journal entry is posted.

II. i. All transactions are recorded in journal.

ii. Journal is also known as Day Book.

iii. Small businesses maintain one journal while big businesses maintain different special journals.

6.2 i. Purchase - Expense - Bank - Asset

ii. Salary - Expenses - Cash - Asset

iii. Cash - Asset - Apporva - Asset

iv. Maya - Asset - Sales - Revenue

v. Drawing - Capital - Cash - Asset

6.3 i) a, ii) c, iii) b, iv) c, v) b.

ACTIVITY FOR YOU

- Observe any ten activities, of a near by shop which can be termed as transactions of business and record them on a page as journal.

Notes

7

CASH BOOK

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In the preceding lesson you have already learnt that business transactions are recorded in Journal. In the case of a small business concern, where the number of business transactions are less, the work relating to Journalizing of all business transactions is easy. As the business grows, the number of business transactions increase and recording all the transactions only in the Journal becomes very inconvenient and cumbersome. It needs to be divided into many books. There are various kinds of journals that are maintained where the transactions are recorded according to their nature, such as Cash Book for cash transactions, Sales Book for credit sales of goods; Purchase Book for credit purchases of goods and so on. In this lesson you will learn about Cash Book, its meaning and preparation.

OBJECTIVES

After studying this lesson, you will be able to:

- understand the meaning of Cash Book;
- enumerate the types of Cash Books;
- state the meaning of and prepare a Simple Cash Book;
- state the meaning and prepare a Cash Book with Bank Column and
- describe the meaning of Petty Cash Book and its preparation.

7.1 MEANING OF CASH BOOK

Suppose you received your first salary in cash from your employer. Also you got back some money that you had given to your friend as loan. You spent this money in buying mobile phone and clothes and went to see movie with your friends. You purchased some toys for your nephew. As per habit you noted down all receipts and payments in your note book. At the end of the month, you may wish to calculate the balance of cash in the note book and compared it with the actual cash balance with you. You may maintain a separate book to record these items of receipts and payments. Such a book will be known as Cash Book.

Cash Book is a book of account maintained for recording transactions involving receipt and payment of cash. It is also one of the books of original entry. When a cash book is maintained, cash transactions are not recorded in the Journal, and no cash or bank account is required to be maintained in the ledger as Cash Book serves the purpose of Cash Account also.

7.2 CASH BOOK: TYPES AND PREPARATION

Cash Books are of the following types:

- Simple Cash Book.
- Bank Column Cash Book.
- Petty Cash Book.

Simple Cash Book

This records only cash receipts and cash payments. It has two sides, namely debit and credit. Cash receipts are recorded on the debit side i.e. left hand side and cash payments are recorded on the credit side i.e. right hand side. In a simple cash book there is only one amount column each on its debit side and on the credit side. The format of a Simple Cash Book is as under:

Format of a Simple Cash Book

Dr. **Cr.**

Receipts					Payments				
Date	Particulars	V. No.	L.F.	Amount (₹)	Date	Particulars	V. No.	L.F.	Amount (₹)

Column-wise explanation is as follows:

Date

In this column Year, Month and Date of transactions are recorded in chronological order.

Particulars

The name of the account under which cash has been received or payment has been made is written. Account pertaining to the receipts of cash is recorded on the debit side and those pertaining to cash payments on the credit side.

Voucher No. (V. No.)

The document supporting a transaction is called a voucher. Generally, a voucher has a serial number which is written in this column.

Ledger Folio

In this column is recorded the page number of the ledger book on which relevant entry is posted.

Amount

Amount column on debit side records cash received where as, amount column on credit side records cash payments.

Steps in Preparation of Simple Cash Book

i. On the debit side in the particulars column, the name of the account, form which cash is received, is recorded.

ii. On the credit side, in the particulars column the name of account for which cash is paid, is recorded.

iii. In the amount column of debit side the amount of cash received is recorded and in the amount column of credit side the amount of cash paid is recorded.

iv. At the end of the period, the total of the debit side of the cash book is compared with the total of the credit side and the difference if any, is entered on the credit side of the cash book under the particulars column as balance c/d.

v. In case of Simple Cash Book, the total of debit side is generally more than the total of the credit side, since the payment can never exceed the available cash. The difference is written in the amount column and total of both the sides of cash book becomes equal.

vi. The closing balance of the credit side if any becomes the opening balance for the next period and is written as Balance b/d on the Debit side of the Cash Book for the next period.

Illustration 1

Enter the following transactions in the cash book of M/s Ashok Traders:

Date 2011	Details	Amount ₹
Dec. 01	Cash in Hand	30,000
Dec. 05	Cash received from Tanvi	12,000
Dec. 08	Insurance Premium Paid	2,500
Dec. 10	Furniture Purchased	7,000
Dec. 14	Sold Goods for cash	16,500
Dec. 18	Purchased Goods from Mithun for cash	26,000
Dec. 22	Cash paid to Yash	3,200
Dec. 25	Sold Goods to Vineet for cash	18,700
Dec. 28	Cash Deposited into Bank	6,000
Dec. 30	Rent paid	4,000
Dec. 31	Salary paid	7,000

Solution

Dr. **Cash Book of M/s Ashok Traders** **Cr.**

Receipts					Payments				
Date 2011	Particulars	V. No.	L.F.	Amount (₹)	Date 2011	Particulars	V. No.	L.F.	Amount (₹)
Dec.01	Balance b/d			30,000	Dec. 08	Insurance Premium A/c			2,500
Dec.05	Tanvi			12,000	Dec. 10	Furniture A/c			7,000
Dec.14	Sales A/c			16,500	Dec. 18	Purchases A/c			26,000
Dec.25	Sales A/c			18,700	Dec. 22	Yash			3,200
					Dec. 28	Bank A/c			6,000
					Dec. 30	Rent A/c			4,000
					Dec. 31	Salary A/c			7,000
					Dec. 31	Balance c/d			21,500
2012				77,200					77,200
Jan. 01	Balance b/d			21,500					

Illustration 2

Record the following transactions in a Simple Cash Book of M/s Suresh & Co.

Date 2012	Details	Amount (₹)
Jan. 01	Cash in Hand	22,000
Jan. 05	Received from Ramesh (after allowing a discount ₹ 200)	3,000
Jan. 07	Paid Rent	300
Jan. 08	Sold Goods	3,000
Jan. 10	Paid Sanjay	7,000
Jan. 27	Purchased Furniture	2,000
Jan. 31	Paid Salaries	1,000

Solution

Dr. **Cash Book of M/s Suresh & Co.** **Cr.**

Receipts					Payments				
Date 2012	Particulars	V. No.	L.F.	Amount (₹)	Date 2012	Particulars	V. No.	L.F.	Amount (₹)
Jan.01	Balance b/d			22,000	Jan. 07	Rent A/c			300
Jan.05	Ramesh			3,000	Jan. 10	Sanjay			7,000
Jan.08	Sales A/c			3,000	Jan. 27	Furniture A/c			2,000
					Jan. 31	Salary			1,000
					Jan. 31	Balance c/d			17,700
				28,000					28,000
Feb.01	Balance b/d			17,700					

Note : Jan. 05 entry of discount will not be shown in Cash Book but it will be shown seprately in journal proper.

Illustration 3

Record the following in the Cash Book of Ranveet and show the balance:

Date 2012	Details	Amount (₹)
Oct. 01	Balance of cash in hand	25,000
Oct.08	Purchased goods for cash from X	3,200
Oct. 15	Sold goods to Y	4,800
Oct. 20	Received commission	650
Oct. 20	Paid commission	550
Oct. 28	Paid to Suresh on account	7,150
Oct. 31	Paid salary to the office clerk ₹1,000and office rent ₹ 600	

Solution

Cash Books of Ravneet

Dr. **Cr.**

Receipts					Payments				
Date 2012	Particulars	V. No.	L.F.	Amount (₹)	Date 2012	Particulars	V. No.	L.F.	Amount (₹)
Oct. 1	Balance b/d			25,000	Oct. 8	Purchases A/c			3,200
Oct.20	Commission A/c			650	Oct. 20	Commission A/c			550
					Oct. 28	Suresh			7,150
					Oct. 31	Salary A/c			1,000
					Oct. 31	Office Rent A/c			600
					Oct. 31	Balance c/d			13,150
				25,650					**25,650**
Nov.1	Balance b/d			13,150					

Note : Transaction dated Oct. 15 has not been recorded in the cash book because it is a credit transaction.

INTEXT QUESTIONS 7.1

Fill in the blanks :

i. Simple cash book records only cash ______and cash _____

ii. In a simple cash book all ______ are recorded in debit side and all _______ are recorded in credit side.

iii. The total of _______side of the simple column cash book is generally more than the total of its _____side.

iv. Closing balance of cash book becomes the _______ balance of next period.

Illustration 4

Prepare Cash Book of Kuldeep for the month of April 2011 from the following particulars :

Date 2012	Details	Amount (₹)
Apr. 01	Cash in hand	17,600
Apr. 03	Purchased Goods for cash from Santosh	7,500
Apr. 06	Sold Goods to Rohit	6,000
Apr. 10	Wages paid in cash	500
Apr. 15	Cash paid to Naveen	3,500
Apr. 17	Cash sales	10,000
Apr. 19	Commission paid	700
Apr. 21	Cash received from Tanya	1,500
Apr. 25	Furniture Purchased for cash	1,700
Apr. 28	Rent paid	3,000
Apr. 30	Paid Electricity bill in cash	1,300

Solution

Cash Book of Kuldeep

Dr. **Cr.**

Receipts					Payments				
Date 2012	Particulars	V. No.	L.F.	Amount (₹)	Date 2012	Particulars	V. No.	L.F.	Amount (₹)
Apr. 1	Balance b/d			17,600	Apr. 03	Purchases A/c			7,500
Apr.17	Sales A/c			10,000	Apr. 10	Wages A/c			500
Apr.21	Tanya			1,500	Apr. 15	Naveen			3,500
					Apr. 19	Commission A/c			700
					Apr. 25	Furniture A/c			1,700
					Apr. 28	Rent A/c			3,000
					Apr. 30	Elect. Bill A/c			1,300
					Apr. 30	Balance c/d			10,900
				29,100					29,100
May 01	Balance b/d			10,900					

Note: Credit transactions are not recorded in cash Book (i.e. a credit sales to Rohit ₹6000 on April 6, 2012).

Illustration 5

Naresh started a business with ₹20,000 on 1st April 2012. Out of this he deposited ₹15,000 into his Bank Account. His cash transactions during the week were:

Date 2012	Details	Amount (₹)
Apr.01	Purchased stationery for cash	100
Apr.01	Purchased goods for cash	2,500
Apr.02	Cash sales	1,500
Apr.03	Cash Received from Shiv on account	1,000
Apr.04	Paid to Ram	2,200
Apr.05	Paid for advertisement	400
Apr.06	Cash sales	1,800
Apr.06	Purchased old machinery for cash	800

Solution

Cash Book of Naresh

Dr. **Cr.**

Receipts					Payments				
Date 2012	Particulars	V. No.	L.F.	Amount (₹)	Date 2012	Particulars	V. No.	L.F.	Amount (₹)
Apr. 01	Capital A/c			20,000	Apr. 01	Bank A/c			15,000
Apr. 02	Sales A/c			1,500	Apr. 01	Stationery A/c			100
Apr. 03	Shiv			1,000	Apr. 01	Purchases A/c			2,500
Apr. 06	Sales A/c			1,800	Apr. 04	Ram			2,200
					Apr. 05	Advertisement A/c			400
					Apr. 06	Machinery A/c			800
					Apr. 06	Balance c/d			3,300
				24,300					24,300
Apr. 07	Balance b/d			3,300					

INTEXT QUESTIONS 7.2

I. Multiple Choice Questions

i. Simple Cash Book generally shows :
   a) Debit or Credit balances b) Credit balance
   c) Debit balance d) Both the balances

ii. Cash book is a :
   a) Subsidiary journal b) Subsidiary journal and ledger
   c) Ledger only d) None of these

iii. Cash sales are recorded in :
   a) Sales book b) Cash book
   c) Journal d) None of these

iv. The Cash Book records :
   a) All cash receipts & payment b) Cash and credit sales of goods
   c) Only cash receipts d) None of these

v. The balance in the Cash Book is :
a) An expense b) A profit c) An asset d) A liability

vi. If Sonu has sold goods for cash, the entry will be recorded :
a) In the Cash Book b) In the Sales Book
c) In the proper Journal d) None of the above

vii. Cash Book is a part of :
a) Journal b) Ledger
c) both Journal & Ledger d) None of the above

II. Some transactions are given below. On which side of the Cash Book would you record them? Put the tick mark in appropriate column.

S.No.	Transactions	Debit Side	Credit Side
(i)	Mukesh started business with cash		
(ii)	Goods purchased for cash		
(iii)	Goods sold for cash		
(iv)	Closing cash balance		
(v)	Cash received from Ankur		

7.3 BANK COLUMN CASH BOOK

When the number of bank transactions are large in an organization, it is necessary to have a separate book to record bank transactions. Instead of having a separate book to record Bank transactions, a Bank column is added on each side of the Simple Cash Book. This type of cash book is known as Bank column Cash Book. All payments into Bank are recorded on the debit side and all withdrawals / payments through the Bank are recorded on the credit side of the cash book. The format of a Bank column Cash Book is as under:

Format of a Bank Column Cash Book

Dr. **Cr.**

Receipts					Payments				
Date	Particulars	L.F.	Cash (₹)	Bank (₹)	Date	Particulars	L.F.	Cash (₹)	Bank (₹)

Accounting Technique

i) Payment in cash or by cheque : Payment by cheque will be entered in the Bank column and those payments made in cash will be written in the cash column, on the credit side.

ii) **Received Cash or Cheque :** Cheque received will be recorded in the Bank column and cash received will be recorded in the cash column, on the debit side.

iii) **Cash withdrawn from Bank :** There are two accounts involved in it. Firstly, the amount of cash at bank will reduce and secondly the amount of cash in hand will increase. It will first be written on the debit side in the cash column and then on the credit side in 'bank column'. This is because both the accounts involved in this transaction are there in this Cash Book viz. – Cash Account and Bank Account. As per double entry system one account will be debited and the other account will be credited. Cash in hand is increasing and 'Cash at Bank' is decreasing. Therefore, on the credit side in the particulars column "By Cash" will be written and the amount will be entered in the bank column, on the debit side in the particulars column 'To Bank' will be written and the amount will be entered in the "Cash Column". This is called a 'Contra-Entry' i.e., entry in both sides of the Cash Book once in the 'Cash Column' and once in the 'Bank Column'. This fact is denoted by writing letter (C) in the L.F. columns on both sides.

iv) **Cash Paid-into Bank :** This will also be recorded through a contra entry as explained above. Here also there are two accounts involved – 'Cash in hand' and 'Cash at Bank'. First of all amount of cash in hand will reduce and secondly the amount of cash at bank will increase. Both these accounts are there in this Cash Book. Cash at bank is increasing therefore, the amount will be written in the bank column on the debit side by writing 'To Cash' in the particulars column. Cash in hand is reducing therefore, the amount will be written in the cash column on the credit side by writing 'By Bank' in the particulars column. As it is a contra entry letter (C) will be written in the L.F. column on both sides.

v) **Dishonors of a Cheque :** (a) If any cheque sent to the bank is dishonored and is sent back by the bank, its amount will be entered in the 'bank column' on the credit side. In the particulars column the name of the party, who gave the cheque, will be written. (b) If any cheque issued by the firm to a creditor is dishonored and is returned by the creditor, it will be entered in the bank column on the debit side. The name of the creditor will be written in the particulars column.

vi) **Bank Charges :** Bank charge some money for the services provided by it. Every half year some amount is charged by them. This amount will be written in the bank column on the credit side because cash at bank is reduced. In the particulars column 'By Bank Charges Account' will be written.

vii) **Cheques Received but not Sent to Bank :** Such cheques should be crossed and kept under lock and key and should be straight away entered into bank column the next day when it is sent to bank. As the cheque is crossed, there is no danger of its being misused. This is the best course. However, if the cheque is treated as cash and is entered in the cash column on the day it is received, the cash in hand will increase which will be different from the actual cash in hand. This is not desirable. Moreover, next day it will have to be sent to the bank by passing a contra-entry. This increases the work unnecessarily. Therefore, the first approach is the best.

viii) **Endorsement of cheque :** If a received cheque is to be endorsed, then it is not deposited in bank account but is to be recorded in cash column Dr. side of Cash Book and simultaneously in cash column Cr side of Cash Book.

ix) **Balancing the Cash Book :** Both the 'cash' column and the 'bank' column will be balanced.

a. Total of the debit side of 'Cash' column will generally be more than the total of credit side of cash column. It will be totalled first and the same total will be written just opposite to it in the cash column on the credit side. The balance will be calculated on the credit side above the total by writing "By Balance c/d" in the particulars column. This balance will be carried forward to the next date and will be taken to the debit side below the total and 'To Balance b/d' will be written in the particulars column.

b. In case of bank column, the total of any side may be more. In case the debit side bank column is more, it means that there is a balance in the bank. The balancing will be done just in the same way as in the case of cash column as described above.

If the total of credit side bank column is more this means that there is an overdraft from the bank. In this case first total the bank column on the credit side. Then put the same total in the bank column on the debit side in front of each other. The balance will be calculated on the debit side above the total and phrase, 'To Balance c/d' will be written in the particulars column. This balance of overdraft will be carried to the next date on the credit side below the total of the bank column and the phrase 'By Balance b/d' will be written in the particulars column.

Illustration 6

Enter the following transactions in the Two Column Cash Book of Ratan for the month of June 2012 :

Notes

Date 2012	**Detail**	**Amount (₹)**
June 1	Balance of Cash in hand	12,000
June 1	Balance of Cash at Bank	1,80,000
June 2	Bought goods by cheque	15,000
June 4	Bought goods by cash	8,000
June 5	Cash Sales	28,000
June 8	Sold goods by cheque	10,000
June 9	Paid wages in cash	400
June 15	Paid salaries by cheque	8,000
June 20	Paid cash into Bank	20,000
June 21	Paid for stationery by cheque	1,200
June 21	Paid to Naresh by cheque	1,280
June 22	Cash purchases	8,000
June 23	Received a cheque from Gopal and deposited the same into bank	1,880
June 24	Withdrew cash from bank	35,000
June 26	Drawings in cash for personal use	4,000
June 28	Purchases by cheque	9,500
June 29	Received cheque from Sohan	4,600
June 30	Paid rent by cheque for the month	1,200

Solution

Cash Book of Ratan

Dr. **Cr.**

Receipts					Payments				
Date 2012	**Particulars**	**L.F.**	**Cash (Rs.)**	**Bank (Rs.)**	**Date 2012**	**Particulars**	**L.F.**	**Cash (Rs.)**	**Bank (Rs.)**
June1	Balance b/d		12,000	1,80,000	June2	Purchase A/c		---	15,000
June5	Sales A/c		28,000		June4	Purchase A/c		8,000	
June8	Sales A/c			10,000	June9	Wages A/c		400	
June20	Cash A/c	(C)		20,000	June15	Salaries A/c			8,000
June23	Gopal			1,880	June20	Bank A/c	(C)	20,000	
June24	Bank A/c	(C)	35,000		June21	Stationery A/c			1,200
June29	Sohan			4,600	June21	Naresh			1,280
					June22	Purchase A/c		8,000	
					June24	Cash A/c	(C)		35,000
					June26	Drawings A/c		4,000	
					June28	Purchases A/c			9,500
					June30	Rent A/c			1,200
					June30	Balance c/d		34,600	1,45,300
			75,000	**2,16,480**				**75,000**	**2,16,480**
July 1	Balance c/d		34,600	1,45,300					

7.4 PETTY CASH BOOK

The Business enterprises which prefer to maintain Bank column cash book feel the necessity of having another Cash book for recording small payments. A large number of repetitive small payments such as, for conveyance, cartage, postage, telegrams, courier and other expenses are made. These organizations appoint an assistant to the Head Cashier. The appointed assistant is known as petty cashier. He makes payments of these expenses and maintains a separate cash book to record these transactions. Such a cash book is called Petty Cash Book.

The petty Cash Book is generally prepared on imprest basis. Under this system initially a fixed amount is given to the petty cashier. He makes the petty payments out of this amount. When he uses approximately the whole amount he hands over the payment vouchers to the main cashier and the main cashier reimburses the total amount of payments to the petty cashier. The format of the petty Cash Book is given below:

Date	Particulars	Amt. (₹)	Conveyance (₹)	Cartage (₹)	Postage (₹)	Telegram (₹)	Refreshment (₹)	Courier (₹)	Total (₹)

Illustration 7

On 1.1.2012 an imprest of ₹500 was given by the main cashier to the petty cashier. The petty cashier made the following payments:

Date 2012	Detail	Amount (₹)
Jan 1	Paid Conveyance	130
Jan 2	Paid for refreshments	45
Jan 3	Paid for postage stamps	45
Jan 15	Paid for courier	35
Jan 17	Paid for telegram	25
Jan 18	Paid for cartage	12
Jan 20	Paid for conveyance	21
Jan 21	Paid cartage	57
Jan 27	Paid for refreshment	28
Jan 28	Paid for Courier	14

Prepare a Petty Cash Book.

Solution

Petty Cash Book

Date 2012	Particulars	Amt. (₹)	Conveyance (₹)	Cartage (₹)	Postage (₹)	Telegram (₹)	Refreshment (₹)	Courier (₹)	Total (₹)
Jan.1	Cash	500							
Jan.1	Coneveyance		130						130
Jan.2	Refreshment						45		45
Jan.3	Postage Stamp				45				45
Jan.15	Courier							35	35
Jan.17	Telegram					25			25
Jan.18	Cartage			12					12
Jan.20	Conevyance		21						21
Jan.21	Cartage			57					57
Jan.27	Refreshment						28		28
Jan.28	Courier							14	14
Jan.28	**Total**	**500**	**151**	**69**	**45**	**25**	**73**	**49**	**412**
	Balance								**88**
		500							**500**
Jan.29	Balance b/d	88							
Feb.01	Cash	412							

INTEXT QUESTIONS 7.3

Fill in the blanks with suitable word/words:

i. In Bank column cash book , Bank and __________ columns are shown on each side.

ii. The Bank column cash book records transactions relating to ________as well as ________.

iii. A separate cash book maintained to record small transactions is called____________.

WHAT YOU HAVE LEARNT

- Cash Book is a Book in which all cash receipts and cash payments are recorded. It is also a book of original entry.

Type of Cash Book

- Simple Cash Book
- Bank Column Cash Book
- Petty Cash Book

- **Simple Cash Book**
  A Simple Cash Book records only cash receipts and cash payments. It has two sides, namely debit and credit.
- **Bank Column Cash Book**
  In this type of Cash Book, Bank and Cash columns are shown on each side.
- **Petty Cash Book :** In business organizations, a large number of repetitive small payments such as, for conveyance, cartage, postage, telegrams and other expenses are made. These organizations appoint an assistant to the Head Cashier. The so appointed cashier is known as petty cashier. He makes payment of these expenses and maintains a separate cash book to record these transactions. Such a cash book is called Petty Cash Book.

TERMINAL EXERCISE

1. What is meant by a Cash Book? Explain the types of Cash Book.
2. What is meant by a ‘Bank Column Cash Book’ ? Draw the format of ‘Bank Column Cash Book’.
3. What do you mean by Petty Cash Book?
4. State the meaning of a ‘Contra Entry’ with the help of an example.
5. Enter the following transactions in the Simple Cash Book of M/s Ronark Traders:

Date 2012	Details	Amount (₹)
Jun. 01	Started Business with cash	30,000
Jun. 02	Goods purchased for Cash	10,000
Jun. 03	Furniture Purchased	1,000
Jun. 06	Goods Sold for Cash	7,000
Jun. 09	Cartage Paid	200
Jun. 10	Postage Paid	100
Jun. 12	Cash Sales	3,000
Jun. 14	Cash withdrawn for Personal use	2,000
Jun.18	Deposited into Bank	10,000
Jun. 22	Goods purchased for Cash	13,000
Jun. 25	Wages paid	500
Jun. 27	Rent Paid	3,000
Jun. 28	Cash Sales	2,000

Notes

6. Enter the following in Srinath's cash book and show the balance:

Date	Details	Amount
2012		(₹)
Oct. 01	Balance of cash in hand	25,000
Oct. 08	Purchased goods for cash from X	3,200
Oct. 15	Sold goods to Y	4,800
Oct. 20	Received commission	650
Oct. 20	Paid Commission	550
Oct. 28	Paid to Suresh on account	7,150
Oct. 31	Paid salary to the office clerk	1,000
	and office Rent	600

7. From the following transactions prepare Simple Cash Book:

Date	Details	Amount
2012		(₹)
Mar.01	Cash in Hand	32,500
Mar. 08	Cash paid to Sumit	8,000
Mar. 12	Goods Purchased	3,000
Mar. 15	Cash received from Nidhi	2,000
Mar. 18	Cash Sales	4,000
Mar. 22	Paid Wages	4,000
Mar. 25	Salary Paid	3,000
Mar. 28	Cash paid to Nitin	3,500
Mar. 31	Rent Paid	2,500

8. Enter the following transactions in a Single Column Cash Book :

Date	Details	Amount
2012		(₹)
Apr. 01	Cash in Hand	15,000
Apr. 05	Cash Purchases	1,000
Apr. 08	Cash Sales	800
Apr. 10	Received from Munish	1,000
Apr. 15	Purchased Furniture	500
Apr. 22	Paid Wages	200
Apr. 25	Received Commission	100
Apr. 30	Paid Rent	600

9. Enter the following transactions in a Petty Cash Book of Manohar.

Date 2012	Details	Amount (₹)
Jan 1	Imprest received	1,000
Jan 1	Paid Cartage	200
Jan 2	Paid Postage	102
Jan 4	Paid Conveyance	22
Jan 8	Paid for refreshments	115
Jan 9	Paid for courier	27
Jan 10	Paid for telegram	17
Jan 12	Paid Conveyance	38
Jan 20	Paid for refreshment	124
Jan 21	Paid Conveyance	127
Jan 22	Paid Postage	34
Jan 27	Paid Cartage	120

10. Enter the following transactions in the Bank Column Cash Book of Mohan for the month of September 2012 :

Date 2012	Details	Amount (₹)
Sept. 1	Balance of Cash in hand	1,20,000
Sept. 1	Balance of Cash at Bank	1,80,000
Sept. 2	Bought goods by cheque	15,000
Sept. 4	Bought goods by cash	18,000
Sept. 5	Cash Sales	28,000
Sept. 8	Sold goods by cheque	70,000
Sept. 9	Paid wages in cash	11,400
Sept. 10	Purchased furniture and paid by cheque	20,000
Sept. 12	Received a cheque from Suresh for ₹ 10,000, which was endorsed to Naresh on the same day.	
Sept. 15	A debtor Harish deposited ₹ 5,000 directly in our bank account.	
Sept. 20	Bank charges ₹ 200 for issuing a new cheque book.	
Sept. 24	Goods sold for ₹ 30,000, as 1/3 cash and 2/3 on credit to Gurdeep.	
Sept. 25	Received a cheque from Chunnu for ₹ 8,000 goods sold to him before one month, deposited in bank.	
Sept. 28	Cheque received from Chunnu was dishonoured for which bank charges ₹ 50.	

11. Prepare a Bank column Cash Book from the following transactions :

Date	**Details**
2012	
Mar. 1	Cash in hand ₹ 2,780, Bank overdraft ₹ 3,125
Mar. 2	Cheque of ₹ 400 issued to the petty cashier.
Mar. 5	₹ 350 was paid to Hari for the repair of electricity.
Mar. 12	Received ₹ 1200 for sale of goods.
Mar. 17	Received ₹ 950 from Sheila after allowing a rebate of ₹ 20 on account of retering a bill of exchange.
Mar. 24	Girdhari Lal paid ₹ 2000 in cash and ₹ 3000 in cheque, for the sale of goods to him.
Mar. 25	Bought goods worth ₹ 1700 from Rahim and paid by cheque.
Mar. 30	Interest on overdraft ₹ 50 was charged by Bank
Mar. 31	Cash in excess of ₹ 1000 was deposited into the Bank

12. Prepare a Bank column Cash Book from the following transactions particulars.

Date	**Details**	**Amount**
2012		**(₹)**
Mar. 1	Cash in hand ₹ 70,000 and at Bank ₹ 80,000.	
Mar. 5	Bought goods for cheque	10,000
Mar. 10	Sold goods for cash	20,000
Mar. 12	Received a cheque for sale of goods	40,000
Mar. 15	Paid Hari Om by cheque	7,000
Mar. 16	Paid telephone bill	2,000
Mar. 17	Received from Malti	4,000
Mar. 18	Received a cheque from Shweta	8,000
Mar. 20	Withdrawn from Bank for office use	12,000
Mar. 22	Paid wages to workers	18,000
Mar. 25	Cheque of Shweta returned dishonoured	—
Mar. 25	Banks debits the accounts for bank charges	120
Mar. 30	Interest collected by bank	190
Mar. 31	Cash sales	4,000

13. Prepare a Bank column Cash Book from the following transactions:

Date	**Details**	**Amount**
2012		**(₹)**
Jan. 1	Cash in hand ₹ 26,800 and at Bank ₹ 72,400	
Jan. 5	Discounted a bill receivable for ₹ 8,000 at 3% through Bank for two months	

Jan. 8	Bought goods for cheque	4,000
Jan. 10	Purchased goods for cash	7,000
Jan. 13	Paid by cheque for a bill payable	12,000
Jan. 15	Paid trade expenses in cash	9,000
Jan. 17	Paid cash into bank	10,000
Jan. 19	Jacky who owed us ₹ 600 became insolvent and paid only 50 P in the rupee.	
Jan. 20	Received ₹ 4,800 from Gianchand	
Jan. 22	Paid ₹ 2,390 to Malika Singh	
Jan. 25	Withdrew Cash from bank for office	6,000
Jan. 25	Withdrew cash from bank for private use	7,000
Jan. 28	Sold goods for cash	20,000
Jan. 28	Received a cheque for sale of goods	18,000
Jan. 30	Received a refund of Loan of ₹ 15,000 and deposited ₹ 13,000 in the bank.	

14. From the following transactions prepare Bank column Cash Book.

Date 2012	**Details**	**Amount (₹)**
Feb. 1	Cash in hand	10,000
Feb. 1	Bank Balance	40,000
Feb. 3	Cash Sales	13,000
Feb. 4	Deposited into Bank	17,000
Feb. 8	Jimy settled his account by giving a cheque	12,000
Feb. 12	Bought goods by cheque	10,000
Feb. 15	Purchased stationery for cash	5,000
Feb. 20	Jimy's cheque returned dishonoured with bank charges of ₹ 50	
Feb. 20	Received a cheque from Janakidas	11,000
Feb. 26	Withdrew from Bank for office use	16,000
Feb. 29	Paid salary by cheque ₹ 11,200 and rent in cash ₹ 7,240	

15. Prepare a Bank column Cash Book from the following transactions:

Date 2012	**Details**	**Amount (₹)**
Oct. 1	Cash in hand	27,100
Oct. 1	Cash at Bank	72,000
Oct. 6	Bought goods by cheque	14,000
Oct. 7	Bought goods for cash	15,000

Oct. 15	Paid trade expenses	4,150
Oct. 16	Paid into Bank	2,000
Oct. 19	Ram who owed us ₹ 8,000 became insolvent and paid only 60 paise in the rupee.	
Oct. 21	Received cash from Malti	5,800
Oct. 24	Withdrew from Bank	7,500
Oct. 25	Paid cash to Das & Co.	4,490
Oct. 28	Withdrew from Bank for private use	13,000
Oct. 28	Sold goods for cash	14,000
Oct. 28	Received cheque for goods sold	10,000
Oct. 30	Received refund of loan of ₹ 18,000 and deposited ₹ 6,000 into Bank.	
Oct. 31	Bank charges	250

16. Prepare Bank column Cash Book:

Date 2012	**Details**	**Amount (₹)**
Apr. 1	Cash in hand ₹ 26,500 and balance in Bank Current Account ₹ 46,400	
Apr. 3	Received from Neeraj Singh	7,900
Apr. 10	Paid salaries to the staff	18,000
Apr. 12	Cash Sales	3,750
Apr. 15	Paid to Vivek by cheque	4,200
Apr. 16	Cash purchases	3,300
Apr. 18	Paid bill payable by a cheque	6,400
Apr. 18	Paid to Meena by cheque	1,685
Apr. 19	Cash Sales	8,680
Apr. 19	Paid cash for cartage and coolie	450
Apr. 20	Withdrew cash from bank for office use	7,000
Apr. 20	Paid rent for the month in cash	2,500
Apr. 21	Cash sales	19,000
Apr. 22	Received cheque form Manish	2,694
Apr. 23	Deposited cash into Bank	3,400
Apr. 24	Purchased a Scooter and paid by a cheque	26,800
Apr. 25	Collections by Bank	18,000
Apr. 25	Received a cheque from Alok Gupta in full settlement of his account of ₹ 8,000.	7,900
Apr. 25	Cash Sales	2,700
Apr. 27	Bank notifies that Alok Gupta's cheque has been dishonoured	

Apr. 28	Deposited Cash in the Bank	5,400
Apr. 29	Paid wages	8,200

17. Enter the following transaction in Petty Cash Book. The imprest amount is ₹ 5,000.

Date 2012	**Details**	**Amount (₹)**
Aug. 1	Peon's wages	1,400
Aug. 3	Pencils and Pens	70
Aug. 5	Carriage on goods	250
Aug. 10	Postage Stamps bought	135
Aug. 12	Telegrams & Telephones	210
Aug. 14	Sundry Expenses	900

18. A petty cashier received ₹ 8,000 as impreset amount on September 1, 2012. During the week, his expenses were as follows:

Date 2012	**Details**	**Amount (₹)**
Sept. 1	Taxi Charges	400
Sept. 2	Wages to casual labourers	250
Sept. 4	Bus fare to peon	20
Sept. 4	Stationery purchased	300
Sept. 5	Postage stamps bought	75
Sept. 5	Revenue stamps bought	25
Sept. 5	Repair to furniture	830
Sept. 5	Paid electricity bill	1,400
Sept. 6	Wages paid for coolie-hire	150
Sept. 6	Taxi hire	400
Sept. 6	Telegram	80
Sept. 6	Locks & Keys purchased	70
Sept. 6	Stationery bought	140
Sept. 7	Refreshments to customers	350

ANSWER TO INTEXT QUESTIONS

7.1 (i) Receipts , Payments (ii) Receipts , Payments
(iii) Debit,Credit (iv) Opening

7.2 **I.** i) c ii) b iii) b iv) a
v) c vi) a vii) c

Notes

II.

S.No.	Transactions	Debit Side	Credit Side
(i)	Mukesh started Business with cash	√	
(ii)	Goods Purchased for cash		√
(iii)	Goods sold for cash	√	
(iv)	Closing Cash Balance		√
(v)	Cash received from Ankur	√	

7.3 (i) Cash (ii) Cash, Bank (iii) Petty Cash Book

ANSWER TO TERMINAL EXERCISE

5. Closing Cash in hand ₹ 2,200
6. Closing Cash in hand ₹. 13,150
7. Closing Cash in hand ₹ 14,500
8. Closing Cash in hand ₹ 14,600
9. Cash in hand ₹ 74
10. Cash in hand ₹ 1,28,600 and Bank Balance ₹ 2,19,750
11. Cash in hand ₹ 1,000 and Bank Balance ₹ 3,305
12. Cash in hand ₹ 90,000 and Bank Balance ₹ 91,070
13. Cash in hand ₹ 33,900 and Bank Balance ₹ 89,970
14. Cash in hand ₹ 14,760 and Bank Balance ₹ 25,750
15. Cash in hand ₹ 45,560 and Bank Balance ₹ 55,250
16. Cash in hand ₹ 34,280 and Bank Balance ₹ 29,809
17. Cash in hand ₹ 2,035
18. Cash in hand ₹ 3,510

ACTIVITY FOR YOU

- Every Student gets pocket money on regular basis from his parents and spends it judiciously on purchasing different type of goods/services. You may also be receiving money from your grandparents and / or from grand maternal parents and maintain a record of the money spent by you. Procure the note book/diary in which you keep the notes regarding receipts and payments and prepare a Cash Book on the basis of your receipts and payments for a month.

11

TRIAL BALANCE AND ACCOUNTING ERRORS

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You have learnt the method of recording transactions in journal and its sub-divisions. You have also learnt their posting to various accounts in the ledger. This process of recording and posting continues throughout the year. At the end of the year it becomes necessary to check the arithmetical accuracy of the books of accounts before the preparation of final accounts. For this purpose we prepare a statement called Trial Balance. In this unit you will learn about the preparation of Trial Balance and the extent up to which it can be relied upon for testing the accuracy of accounts. You will also learn about the errors that may be disclosed and that may not be disclosed by the preparation of Trial Balance and the method of locating such errors.

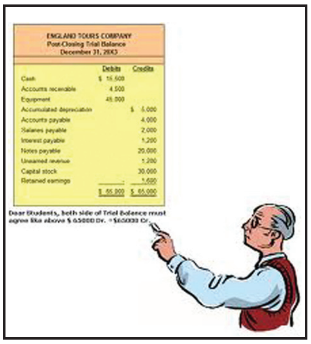
OBJECTIVES

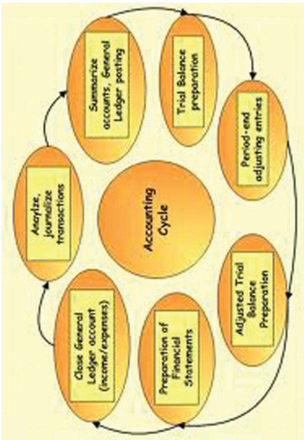
After studying this chapter, you will be able to:

- define trial balance;
- describe the objectives of preparing a trial balance;
- explain the causes of disagreement of a trial balance;
- identify the types of errors disclosed and not disclosed by a trial balance;
- describe the procedure for locating the errors;
- explain the limitations of trial balance;
- prepare the trial balance and
- explain the meaning and disposal of suspense account.

11.1 MEANING OF TRIAL BALANCE

Numerous transactions take place in business everyday. They are first recorded in books of original entry i.e., Journal Proper or one of its sub-divisions. Then they are posted to the appropriate accounts in the ledger. Each ledger account is balanced periodically so as to ascertain the net effect of various transactions posted therein. In the process, some accounts may get closed; the final accounts are prepared for ascertaining the profit or loss and the financial position of the business. The quality and reliability of the results obtained depend, largely on the correctness of the entries made





in various books of accounts and their ledger posting. Hence, it is necessary to ascertain the accuracy of these entries and ledger postings before we proceed with the preparation of final accounts. For this purpose, we prepare a statement called 'Trial Balance', which shows balances of all the ledger accounts. The names of each account having debit balances are shown in the debit column and if it shows a credit balance, the amount is entered in the credit balances column. You know that the total of the debit balances column must tally with the total of the credit balance column, because for every debit there is a corresponding credit and vice versa. When the two totals tally, it is considered as a preliminary proof of the arithmetical accuracy of the accounts. It is an assurance that entries in the journal and posting into ledger have been correctly done and that equality between debits and credits has been maintained throughout. However, if the two totals do not tally it implies that there are some errors in the books of accounts.

Trial Balance can thus, be defined as a statement (or a schedule) listing, in separate columns, the debit and credit balances of all ledger accounts on a particular date. It indicates that the books of accounts have been prepared in accordance with the rules of double entry and ensures, to a great extent, the arithmetical accuracy of accounting entries. Trial Balance provides a check on arithmetical accuracy of the recording of financial transactions in different books such as journal and the ledger. Such a check can be performed by preparing a statement called trial balance. Trial balance is a statement prepared by taking up the debit and credit totals or balances of all ledger accounts on a particular date.

11.2 OBJECTIVES OF PREPARING A TRIAL BALANCE

i) **To check arithmetical accuracy :** With the help of trial balance we can identify the arithmetical error, committed by the accountant or his assistant, because in such a situation the trial balance will not agree. Under such situations it is assumed that some errors have been committed. After identifying such errors the same are rectified.

ii) **To prepare final accounts of the enterprise :** Trial balance becomes the basis of preparing final accounts. If we do not prepare trial balance and just start preparing final accounts, it may be possible that we forget to record some transactions that were not recorded while preparing the final accounts because information about the same was not available at that time.

iii) **Comparative study of each account :** Trial balance helps in comparing the present balance of an account with the previous period balance. By preparing trial balance, we can estimate whether closing balance of accounts will increase or decrease within two accounting periods. It can also be used as a tool to decide whether there is need to decrease the rate of depreciation for showing improved profit position.

iv) **To make financial budget :** Previous years trial balance figures are also helpful to estimate the future amount. In other words, we can make different financial budgets with the help of trial balance.

INTEXT QUESTIONS 11.1

Given below are some statements. Some of these statements are correct and some of these statements are incorrect. Write 'correct' if the statement is correct and 'incorrect' if it is not correct.

i. Trial Balance is an essential part of the accounting process.

ii. Trial Balance is prepared only once in a year.

iii. If the totals of the two columns of a Trial Balance are equal it means the posting has been done correctly.

iv. Debit Balances of the accounts are written in the Debit column and Credit balances in the credit column of the Trial Balance.

v. The Assets and Expenses accounts have the credit balance.

11.3 CAUSES FOR THE DISAGREEMENT OF A TRIAL BALANCE

As mentioned earlier, when the Trial Balance does not tally it means that some errors have been committed while preparing the accounts. Let us, now analyze the errors which usually affect the Trial Balance and lead to its disagreement.

i) **Omission of posting in one account :** You are aware that both the debit and credit aspects of a transaction have to be posted in the ledger accounts. If you post it to the debit of one account and forget its posting to the credit of the other concerned account, it is bound to affect the Trial Balance. For example, an amount of ₹ 200 received from Ali, correctly entered on the debit side of the cash book but is not posted to the credit side of Ali's Account, because of this error the totals of the debit column of the trial balance will be more than the total of the credit column and hence the trial balance will not agree.

ii) **Double posting in one account :** If by mistake you post an entry two times to the debit or to the credit of an account it would result in extra debit or credit and as such cause disagreement in the Trial Balance for example ₹ 4000 received from Ashok were credited twice in his account will increase the total of the credit column by ₹ 4000 and the trial balance will not agree.

iii) **Posting in the wrong side of an account :** When an entry is posted in the wrong side of an account i.e. instead of debit side it is posted in the credit side and vice-versa, it would also cause disagreement of the Trial Balance. In such a situation, the difference will be for double the amount. For example, ₹ 300 received from Khan which is correctly entered on the debit side of the Cash Book, but while posting it to Khan's Account it is wrongly posted to the debit side of his account instead of the credit side. This would mean that a debit of ₹ 600 (₹ 300 in Cash Account and ₹ 300 in Khan's Account) has no corresponding credit. With the result the total of the Credit column of the trial balance will be lesser by ₹ 600.

iv) **Posting wrong amount in an account :** If you post an entry to the correct side of an account but commit an error in writing the amount, this would affect the Trial Balance. Suppose, in the above example you post the entry correctly on the credit side of Khan's Account but the amount is wrongly written as ₹ 200. It would cause a difference of ₹ 100. In the Trial Balance, the credit side will be lesser by ₹ 100.

v) **Wrong Casting of the subsidiary books :** If any subsidiary book is overcast or undercast, it affects the concerned account in ledger. Suppose the correct total of Sales Journal is ₹ 5,600, but it has been totalled as ₹ 5,300 when now posted to the credit of Sales Account, the Sales Account will be short by ₹ 300, and the Trial Balance will not tally.

vi) **Omitting to post the total of a subsidiary book :** If the total of a subsidiary book is not posted to the concerned account, it would affect the Trial Balance. Such mistake relates only to the account where posting was to be done and as such affects only one account. For example, if the totals of the Sales Book ₹ 18,900 are not posted to the credit of Sales Account, the credit side on the Trial Balance will be lesser by ₹ 18,900.

vii) **Wrong totaling or balancing of an account :** When an account is wrongly totaled or wrongly balanced, this would affect the Trial Balance. Suppose total of the debit side of Shyam's Account has been written as ₹ 1,300 instead of ₹ 1,100. It would lead to wrong balance in Shyam's Account. Consequently, the debit total in the Trial Balance will be higher by ₹ 200. Similarly, if the totaling is correctly done but a mistake is committed in balancing the account, it would also cause a difference in the Trial Balance.

viii) **Omission of an account from Trial Balance :** You know that all accounts which show some balance must be included in the Trial Balance. If you forget to write the balance of any account in the Trial Balance, it will not tally. In practice cash book balances are often omitted from Trial Balance.

ix) **Writing the balance of an account in the wrong column of the Trial Balance :** If the balance of an account which is to be shown in the debit column of the Trial Balance is actually shown in the credit column, the Trial Balances will not tally. It will be affected by double the amount.

x) **Wrong totaling of the Trial Balance :** If an error is committed in totaling the amount columns of the Trial Balance itself, the Trial Balance will not tally.

Thus, you have learnt about various errors which may cause difference in the Trial Balance. Note that these errors affect only one aspect (debit or credit). This upsets the debit-credit equality leading to the disagreement of the Trial Balance

11.4 ERRORS NOT DISCLOSED BY TRIAL BALANCE

Agreement of the trial balance is not a conclusive proof of the accuracy of the accounts. There may be certain errors which might have been crept into the accounts but do not affect the agreement of the trial balance. Such errors have been discussed below :

i) **Errors of Complete Ommission :** If a transaction is completely omitted from being recorded in the books of accounts, such an omission will not affect the agreement of the trial balance for example a credit purchase of ₹ 6000 from Ravi was omitted from being recorded in the Purchase Book. Because of this omission the totals of the purchases book and Ravi's account will not be affected and hence trial balance will also not be affected.

ii) **Errors of commission :** These types of errors happen due to the negligence of accountants and cannot be located by preparing trial balance. Suppose a sales of ₹ 10,000 was recorded in books as ₹ 100. The balances both the accounts i.e sales accountant and cash account will be affected only by ₹ 100 and hence the trial balance will not be affected.

iii) **Compensating Errors :** Suppose, an accountant posted ₹ 500 less in the debit side of purchase account and at the same time he also posted ₹ 500 less in credit side of sales account. In this case an error has been compensated by another error. Such errors are called compensating error and will not affect the trial balance.

iv) **Errors of principles :** When an accounting principle has been violated while recording a transaction in the books of accounts, such errors are called errors of principle e.g. the purchase of an asset if recorded in the purchases account will be an error of principle but since the purchase account will be debited and the suppliers accounts will be credited with the same amount this error will not affect the trial balance

11.5 ERRORS DISCLOSED BY TRIAL BALANCE

If the Trial Balance does not tally, it will indicate that certain errors have been committed which have affected the agreement of the Trial Balance. The accountant will then proceed to locate such errors. On location such errors are rectified. Errors disclosed by trial balance have been explained below:

i) **Wrong Casting :** If the total of the Cash Book or some other Subsidiary Book is casted wrong, the Trial Balance will not tally. For example, the total of the Purchase book has been casted ₹ 2000 more. When this total will be posted to the debit side of the purchase account, it will also show an excess debit of ₹ 2000 and hence, the Trial Balance will not agree.

ii) **Posting to the Wrong Side of an Account :** If instead of posting an amount on the debit side of an account, it is posted on the credit side, or vice versa, the Trial balance will not tally. For example, goods for ₹ 2,000 purchased from Sohan. If instead of posting the amount on the credit side of Sohan's account it is posted to his debit, the debit side of the Trial Balance will exceed the credit side by ₹ 4,000.

iii) **Posting of Wrong Amount :** The Trial Balance will not tally if the posting in an account is made with an incorrect amount. For example, goods for ₹ 600 have been purchased from Anil. If, it has been correctly entered in the Purchase Book or purchase account, but while posting to Anil's account, in credit side (correct side) the amount posted is ₹ 60 instead of ₹ 600, the Trial Balance will not tally.

iv) **Omission of Posting of One aspect of a Transaction :** For example, if ₹ 500 has been received from Shyam and correctly entered in the Cash Book but if it is omitted to be posted on the credit side of Shyam's Account, the Trial Balance will not tally.

v) **Posting an amount twice in an Account :** For example ₹ 500 has received from Vinod and correctly entered in the Cash Book, but if it is posted twice on the credit side of Vinod's account, the Trial Balance will not tally.

vi) **Errors of Totaling and Balancing of Accounts in the Ledger :** Errors may occur in the totaling of debit or credit sides of accounts in the Ledger or in the balancing of accounts in the Ledger. Because the balances of accounts are transferred to the Trial Balance, resulting in transferring wrong balances in the Trial Balance. This will result into the disagreement of the trial balance.

INTEXT QUESTIONS 11.2

Fill in the blanks with suitable word or words

i. Trial Balance is said to have agreed when its _________ are equal.

ii. The agreement of Trial Balance is a proof of __________ accuracy of the ledger posting.

iii. There is a ___________ column and a _________ column for balances of accounts in a Trial Balance.

iv. Cash in hand is written in the _________ column of the Trial Balance.

11.6 PROCESS OF LOCATING THE ERRORS

If an error exists in the books, it affects the accuracy of results of business operations revealed by the financial statements. Therefore, the errors must be located for rectification. The task of locating errors is, however not easy. The location of errors will be easier if the following steps are systematically taken.

i. Check the total of the trial balance.

ii. Compare the ledger account balances carried to the trial balance.

iii. Verify the total of subsidiary books and their posting to ledger accounts.

iv. Verify that all journal entries have been correctly posted to the different ledger accounts.

v. If you find that you have an unbalanced trial balance, in other words the debits don't equal the credits, it indicates that some errors have been committed during the course of accounting process. Such errors have to be found and corrected. The first step in finding an error is to simply add the credit and debit columns again to verify your totals. If they still don't agree then subtract the smaller totals from the bigger and look for the missing amount in the smaller column. If you find it, you've found your error.

vi. There are other standard techniques to track down an error in a trial balance. If the debits and credits are not equal, see if the numeral 2 divides equally the difference. If it does, look for an account, incorrectly in the column with the larger total that equals half the difference. If you find this, you've found your error.

vii. Another technique is to use the numeral 9 to find a transposition error. If the numeral 9 divides evenly the difference between the credits and debits, you have a transposition error. Go back over your credit and debit entries to try to find your transposition error.

S Firth   Trial balance as at 1/1/2001

	debits	credits
Petty cash	25	
Bank overdraft	4130	
Accounts receivable		4500
Land & buildings	30000	
Office equipment	1500	
Accounts payable	3700	
Mortgage	2000	
Drawings	800	
Salaries	8200	
Rent received	250	
Office expenses	1200	
Purchases	52000	
Sales		85000
Stock	3000	
Sales discount		250
Purchases returns	280	
Sales returns		350
Purchases discount	120	
Capital - S Firth		6345

11.7 PREPARATION OF A TRIAL BALANCE

After recording all financial transactions in the subsidiary books and journal proper the same are posted into the ledger. The ledger accounts are then, balanced. The Balances of the ledger accounts are then transferred to the relevant columns of the trial balance to verify that the debits are equal to the credits. The trial balance is the next step in the accounting cycle. Trial balance is not an account. It is only a statement that lists the balances of ledger accounts including cash and bank balances. It is prepared on a particular date. It is prepared on a sheet with two amount columns for debit and credit balances. The accounts having debit balances are entered in the debit amount column and the accounts having credit balances are entered in the credit amount column. The sum of each column should be equal. It is actually the first step in the "end of the accounting period" process. In practice the trial balance is prepared with debit and credit balances of various accounts in the ledger along with balances in the cash book. The following is the format of a Trial Balance :

Trial Balance of (Name of the Firm)
As on (Date of Preparation)

Name of the Account	Debit Balance Amount (₹)	Credit Balance Amount (₹)

It can be well understood with the help of the following example.

Example: Journalise the following transactions, post them into ledger, balance the accounts and prepare a trial balance :

Date 2012	Particulars	Amount (₹)
May 1	Commission received	10,000
May 2	Rent paid	5,000
May 5	Interest received	6,000
May 7	Brokerage paid	2,000

Notes

Solution

JOURNAL

Dr. **Cr.**

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
2012					
May 1	Cash Account	Dr.		10,000	
	To Commission received Account				10,000
	(Being commission received)				
May 2	Rent Account	Dr.		5,000	
	To Cash Account				5,000
	(Being rent paid)				
May 5	Cash Account	Dr.		6,000	
	To Interest received Account				6,000
	(Being interest received)				
May 7	Brokerage Account	Dr.		2,000	
	To Cash Account				2,000
	(Being brokerage paid)				

Dr. **Rent Account** **Cr**

Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
2012				**2012**			
May 2	To Cash A/c		5,000	May 31	By Balance c/d		5,000
			5,000				5,000
June 1	To Balance b/d		5,000				

Dr. **Commission Account** **Cr**

Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
2012				**2012**			
May 31	To Balance c/d		10,000	May 01	By Cash A/c		10,000
			10,000				10,000
				June 1	Balance b/d		10,000

Dr. **Interest Received Account** **Cr**

Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
2012				2012			
May 31	To Balance c/d		6,000	May 5	By Cash		6,000
			6,000				6,000
				June 1	By Balance b/d		6,000

Dr. **Brokerage Account** **Cr**

Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
2012				2012			
May 7	To Cash		2,000	May 31	By Balance c/d		2,000
			2,000				2,000
June 1	To Balance b/d		2,000				

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

Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
2012				2012			
May 1	To Commission A/c		10,000	May 2	By Rent		5,000
May 5	To Interest Received A/c		6,000	May 7	By Brokerage		2,000
				May 31	By Balance c/d		9,000
			16,000				16,000
June 1	To Balance b/d		9,000				

Trial Balance as on 31st May 2012

Name of Account	Debit Balance (₹)	Credit Balance (₹)
Rent A/c	5,000	
Brokerage A/c	2,000	
Cash A/c	9,000	
Commission A/c		10,000
Interest Received A/c		6,000
Total	**16,000**	**16,000**

11.8 LIMITATIONS OF A TRIAL BALANCE

i) As there are certain errors which are not disclosed by a trial balance. Therefore again it can be said that the agreement of a trial balance is not a conclusive proof of the accuracy of accounts.

ii) A trial balance gives only condensed information of each account.

iii) It does not give the information about the profit or loss made by the business in the accounting period.

iv) If trial balance is not prepared accurately, the final accounts prepared from such a trial balance would not be reliable.

v) It does not ensure that all the transactions have been actually recorded in the subsidiary books.

vi) It is prepared only by those enterprises which make use of double entry system.

INTEXT QUESTIONS 11.3

Few errors have been committed in the books of Ram. State with reasons which errors would affect the trial balance.

i. Sales ₹ 2500 to Shyam omitted from being recording in the books of accounts.

ii. Purchase journal was overcast by ₹ 2000.

iii. Sales journal was under cast by ₹ 3000

iv. Amount paid to Anil wrongly posted to the debit of Sunil's account.

v. Bank overdraft shown in the debit column in the trial balance.

vi. Sales of ₹ 3000 to Rohtas entered in sales journal as sales to Ram.

vii. Wages paid for installation of machine debited to wages account.

11.9 SUSPENSE ACCOUNT

When the trial balance does not agree, because of errors committed by the accountant during the accounting process and he decides to prepare the final accounts then the difference is written on the shorter column against an account called 'Suspense Account'. After wards the errors that affect the trial balance are rectified through the suspense account. Once all such errors are rectified the suspense account opened to artificially balance the trial balance will finally be balanced.

INTEXT QUESTIONS 11.4

I. Fill in the blanks with suitable word or words :

i. If there is the error in totaling the Subsidiary Day Books, the totals of Trial Balance will _______________.

ii. The Trial Balance will not agree if there is an error in carrying out __________ from ledger.

iii. Agreement of Trial Balance is not a ____________ of the correctness of posting.

iv. When the total of the two columns of Trial Balance are not equal, the difference is put in __________ Account to make the Trial Balance agree.

II. Multiple Choice Questions

i. Which of the following errors will not affect the Trial Balance.
   a) Wrong balancing of an account
   b) Writing an amount in the wrong account but on the correct side
   c) Wrong totaling of an account
   d) None of the above

ii. Which of the following is not the main objective of preparing a Trial Balance ?
   a) To check arithmetical accuracy
   b) To prepare final accounts
   c) To have comparative study of each account
   d) To present trial balance in court as a proof of transaction

iii. Which of the following errors will affect the Trial Balance?
   a) Repairs to buildings have been debited to building account
   b) The total of purchases journal is Rs. 10,000 short
   c) Carriage paid on new machinery has been debited to the carriage account.
   d) None of the above

iv. Which of the following errors will be disclosed by Trial Balance?
   a) Error of complete omission
   b) Wrong casting
   c) Compensating error
   d) Error of Principles

v. Which of the following errors will not be disclosed by Trial Balance?
   a) Error of complete ommission
   b) Posting of wrong amount
   c) Posting an amount twice in an account
   d) Posting to the wrong side of an account

WHAT YOU HAVE LEARNT

- It is necessary to prepare a Trial Balance before preparing the final accounts. It verifies the arithmetical accuracy of the books of accounts.

- When a Trial Balance does not tally, it means there are errors in books of account. A series of steps are taken to locate such errors.
- There are certain errors which affect the Trial Balance and there are some which do not.
- Errors of principle, errors of complete omission, certain errors of commission in subsidiary books, and the compensating errors are not disclosed by the Trial Balance.
- The limitations of a trial balance are that it does not give the information about the profit or loss made by the business in the accounting period and trial balance gives only condensed information in a summary form for each account.
- **Errors :**
  → **Compensating Errors :** A group of errors wherein the effect of an error is counter-balanced (or compensated) by the effect of one or more errors, as a result of which the agreement of Trial Balance remains unaffected.
  → **Errors of Principle :** An error committed by ignoring or misapplying some principle of accounting while recording a transaction in the books of account.
  → **Errors of Complete Omission :** When a transaction is completely omitted from being recorded in the books of accounts the resultant errors are called errors of complete omission.
  → **Errors of Partial Omission :** When transaction is partly omitted from being recorded in the books of accounts the resultant errors are errors of partial ommission.
  → **Errors of Commission :** A clerical error committed by the accountant while recording or posting of a transaction is called error of commission.

TERMINAL EXERCISE

1. Why do you consider Trial Balance as a test of the arithmetical accuracy of the books of accounts? List the errors that will be disclosed by the Trial Balance.
2. If the Trial Balance does not tally, it means there are some errors in books of accounts. State the procedure of locating errors.
3. State the limitations of Trial Balance.
4. Is the Trial Balance a conclusive proof of the accuracy of the books of accounts? Discuss the errors not disclosed by the Trial Balance.

5. Explain with examples the different types of errors that are usually committed in recording of transactions?

6. What do you mean by Trial Balance? Discuss the objectives of preparing a Trial Balance.

7. What is a Suspense Account? What does its appearance in Trial Balance indicate?

8. Prepare a Trial Balance of M/s Jai Jawan Jai Kisan Enterprises as on 31.12.2012 from the following balances.

Account	Amount ₹	Account	Amount ₹
Cash in hand	31,000	Sales A/c	76,000
Cash at Bank	12,000	Opening Stock	10,000
Capital A/c	80,000	Rent A/c	2,000
Drawings A/c	28,000	Wages A/c	6,000
Debtors A/c	20,800	Carriage Inward A/c	500
Creditors A/c	17,800	Machine A/c	1,500
Purchases A/c	62,000		
Closing Stock	5,000		

9. Prepare a Trial Balance as on 31.3.2013 from the following balances :

Account	Amount ₹
Cash in Hand	3,200
Cash at Bank	12,600
Capital A/c	27,450
Furniture A/c	12,300
Building A/c	15,000
Wages A/c	3,500
Sales A/c	20,000
Rent A/c	250
Bank Charges A/c	400
Depreciation A/c	200

ANSWER TO INTEXT QUESTIONS

11.1 (i) correct (ii) incorrect (iii) incorrect (iv) correct (v) incorrect

11.2 (i) debit and credit totals (ii) airthmatic (iii) debit, credit (iv) debit

11.3 Errors ii), iii) and v) would affect the trial balance.

11.4 I. (i) not agree (ii) balance (iii) proof (iv) suspense

II. (i) b (ii) d (iii) b (iv) b (v) a.

ANSWER TO TERMINAL EXERCISE

8. Total of Trial Balance ₹ 1,73,800.
9. Total of Trial Balance ₹ 47,450.

ACTIVITY FOR YOU

- Ask your parents regarding the various expenditure and income of a particular month, pass journal entries for the same and then post them in the ledger. After closing the ledger accounts find the balances and prepare a trial balance, which should be tallied, so as to ensure that the books of accounts prepared by you are arithematically correct.

Mukta Vidya Vani

Mukta Vidya Vani is a pioneering initiative of the National Institute of Open Schooling (NIOS) for using Streaming Audio for educational purposes. This application of ICT will enhance accessibility as well as quality of programme delivery of NIOS Programmes. This is a rare accomplishment of NIOS as the first Open and Distance Learning Institute to start a two way interaction with its learners, using streaming audio and the internet.

Keeping in mind the fact that the transmission is done through the web, the NIOS website (www.nios.ac.in) has a link that will take any user to the Mukta Vidya Vani. Mukta Vidya Vani thus enables a two way communication with any audience that has access to an internet connection, from the studio at its Headquarters in NOIDA, where NIOS has set up a state-of-art studio, which will be used for this purpose as well as for recording educational audio programmes meant for NIOS learners, though others can also take advantage of this facility.

Mukta Vidya Vani is a modern interactive, participatory and cost effective programme, involving an academic perspective along with the technical responsibilities of production of audio and video programmes, which are one of the most important components of the multi channel package offered by the NIOS. These programmes will attempt to present the topic/ theme in a simple, interesting and engaging manner, so that the learners get a clear understanding and insight into the subject matter.

NIOS has launched a scheme to motivate the learners to participate in the Mukta Vidya Vani by sending their Audio CD's to the respective regional centre on various subjects such as-

1. Poetry / Shloka recitation
2. Story telling
3. Radio Drama
4. Music
5. Talks on various topic related to the NIOS curriculum including Painting, Vocational Subjects etc.
6. Quiz
7. Mathematics puzzles etc.

The selected CD can be webcast on Mukta Vidya Vani and the winner participant be rewarded suitably.

Learners may visit the NIOS website and participate in live programmes from 2pm to 5pm on all week days and from 10.30am to 12.30pm on Saturdays, Sundays and all Public Holidays. The Subject Experts in the Studio will respond to their telephonic queries during this time. A weekly schedule of the programmes for webcast is available on the NIOS website. The Studio telephone number are 0120-4626949 and Toll Free No. 1800-180-2543.

MODULE - IV

Maximum Marks	Hours of Studies
12	32

Depreciation, Provisions and Reserves

This module will help the learners to understand the methods of spreading the cost of fixed assets throughout their working life using the concept of Depreciation. They will also be able to describe the need and importance of creating Provisions and Reserves.

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12

DEPRECIATION

Expenditure on assets of the business like furniture, fixtures and fittings of the shop, motor vans, machines and equipments are neither goods nor expenses of a year. Expenditures of this nature give services to the business for many years and therefore called fixed assets. If the expenditure on the fixed assets is deducted from the profit of any one year, it would be wrong. Since their benefit is enjoyed by the business for more than one years. The correct thing will be to distribute their cost over the years of their useful life to the business. The portion of the cost of fixed assets charged each year as expense is named as depreciation.

In this lesson you will learn about the meaning and methods of charging depreciation and how depreciation is recorded in the books of accounts, together with the preparation of Fixed Assets account.

OBJECTIVES

After studying this lesson you will be able to:

- understand the meaning and concept of depreciation;
- explain the causes of depreciation;
- explain the objectives of depreciation;
- learn methods of charging depreciation and
- prepare fixed asset account showing the amount of depreciations charged for every year.

12.1 MEANING OF DEPRECIATION

You already know the meaning of terms assets and liabilities. Assets are broadly divided in to two categories- current assets (cash, debtors or customers balances, stock of materials and goods) and fixed assets (buildings, furniture and fixtures, machinery and plant, motor vehicles).

Fixed assets are also called long term assets as they provide benefits to the business for more than one year. Most fixed assets loose their value over time as these are put in use and as the years pass by. The fixed assets loose their usefulness due to arrival of new technologies and change of fashions etc. These are then generally required to be replaced, as their useful life is over. Hence, the cost of a fixed asset is allocated over its useful life. Each year's allocation of the cost is charged as depreciation expense for that year.

For example an office chair is purchased for ₹ 2,500 and it is estimated that after ten years it will be scraped. The useful life of the chair is ten years over which the cost of ₹ 2,500 will be distributed. Each year's allocation may be calculated as:-

$$\text{Depreciation} = \frac{\text{Cost of Assets} - \text{Scrap Value (if any)}}{\text{Life of Assets}}$$

$$\frac{₹\ 2500}{10} = ₹\ 250$$

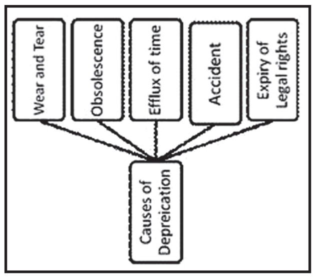
Thus ₹ 250 is the depreciation expense for each year.

Thus, depreciation is an expense charged during a year for the reduction in the value of fixed assets, arising due to:

- Normal wear and tear out of its use and passage of time
- Obsolescence due to change in technology, fashion, taste and other market conditions

12.2 CAUSES OF DEPRECIATION

Following are the causes for which depreciation is provided in accounts.



i) Normal wear and tear

(a) Due to usage - Every asset has a life for which it can run, produce or give service. Thus, as we put the asset to use its worth decreases. Like decrease in the efficiency and functioning of a bicycle due to its running and usage.

(b) Due to passage of Time – As the time goes by elements of nature, wind, sun, rain etc, cause physical deterioration in the worth of an asset. Like reduction in the worth of a piece of furniture due to passage of time even when it is not used.

ii) Obsolescence

(a) Due to development of improved or superior equipment : Sometimes fixed assets are required to be discarded before they are actually worn out due to either of the above reasons. Arrival of superior equipments and machines etc. allow production of goods at lower cost. This makes older equipments worthless as production of goods with their use will be costlier and non competitive. For example, Steam engines became obsolete with the arrival of diesel and electric locomotives.

(b) Due to change in fashion, style, taste or market conditions : Obsolescence may also result due to decline in demand for certain goods and services with a change in fashion, style, taste or market conditions. The goods and services that are no longer in vogue lead to decrease in the value of the assets which were engaged in their production - like factories or machines meant for making old fashioned hats, shoes, furniture etc.

Loss in the value of fixed assets for such reasons is called obsolescence and also charged as depreciation.

12.3 OBJECTIVES OF DEPRECIATION

Following are the objectives of charging depreciation of Assets:

i) **To show the True Financial Position of the Business :** As are Fixed Assets have some effective working life during which it can be economically operated. Depreciation is the gradual loss in the value of fixed assets. If depreciation is not provided, profit and loss A/c will not disclose the true profit made during the accounting period. At the same, the Balance Sheet will not disclose the true Financial position as Fixed assets appearing in the Balance Sheet will be over valued. If depreciation is ignored year after year, ultimately when asset is worn out, the proprietor will not be is a position to continue the business smoothly.

ii) **To retain funds in the business for replacement of the asset :** Net profit is the yield of the capital invested by proprietor and may be wholly withdrawn by him in the form of cash. If depreciation is provided, this figure of net profit will be reduced and the amount withdrawn by the proprietor will also be decreased. As such the cash equivalent to the change for depreciation will be left over the business. This accumulated amount will enable the proprietor to replace a new asset.

INTEXT QUESTIONS 12.1

Fill in the blanks :

i. Depreciation represents a ___________ in the value of fixed assets.

ii. Scrap value of an asset means the __________ that it fetched on sale at the end of its ___________.

iii. Depreciation is calculated as cost of assets less scrap value divided by ___________.

iv. Obsolescence is one of the situations on fixed assets which arises due to change in ________, and fashion, taste and other market conditions.

12.4 FACTORS AFFECTING THE DEPRECIATION

Following are the factors that affect the amount of depreciation of an asset.

i) **Cost of Asset :** Cost of asset is the purchase price of the asset and includes all such expenses which are incurred before it is first put to use. For example expenses on loading, carriage, installation, transportation and unloading of the asset up to the point of its location, expense on its erection and assembly.

ii) **Useful Life of the Asset :** Useful life is the expected number of years for which the asset will remain in use.

iii) **Scrap Value :** Scrap value is the residual value at which the asset could be sold to scrap dealer *(Kabari)* after its useful life.

iv) **Depreciable value of asset :** Depreciable value is the cost of asset minus the scrap value.

Illustration 1

A generator was purchased for ₹ 5,00,000. ₹ 1,500 was paid for the crane for its loading on the truck, ₹ 7,000 was paid for transporting the generator to the factory. ₹ 2,000 was spent on its unloading at the factory site. The generator was estimated to run for 10 years and thereafter would be saleable for ₹ 60,000. Calculate the depreciable value of the generator.

The cost of the asset is :	Purchase price	₹ 5,00,000
	Expenses on Loading	₹ 1,500
	Transportation	₹ 7,000
	Expenses on unloading	₹ 2,000
	Total	**₹ 5,10,500**

The useful life of the generator is 10 years

The scrap value is ₹ 60,000.

Depreciable value of the generator = ₹ 5,10,500 – ₹ 60,000 = ₹ 4,50,500

12.5 METHOD OF CHARGING DEPRECIATION

Most popularly used methods for charging depreciation are: i. Straight Line Method and ii. Diminishing Balance Method

Straight Line Method of Depreciation

Under this method, the amount of depreciation is uniform from year to year. Suppose, if an asset costs ₹ 1,00,000 and depreciation is fixed @ 10%, then ₹ 10,000 would be written off every year. That is why this method is also called 'Fixed Installment Method' or 'Original Cost Method'. In this method, the amount to be written off every year is arrived at as under:

$$\text{Depreciation of Each Year} = \frac{\text{Cost of Assets} - \text{Estimated Scrap Value}}{\text{Number of years of expected life}}$$

Out of the cost of the asset, its scrap value is deducted and it is divided by the number of years of its estimated life.

For example: a machine is purchased for ₹ 1,20,000 and it is estimated that its useful life is 10 years. After its useful life its scrap value is ₹ 20,000. Depreciation of one year can be calculated as under:

$$\text{Depreciation of one Year} = \frac{₹\ 1,20,000 - ₹\ 20,000}{₹\ 10} = ₹\ 10,000$$

If its scrap cannot be sold or no money can be realized from its scrap, then depreciation of one year is:

$$\text{Depreciation of one Year} = \frac{₹\ 1,20,000}{₹\ 10} = ₹\ 12,000$$

In this method the amount of depreciation is same for each year. Therefore this method is called Straight Line Method, Fixed Installment Method or Original Cost Method.

Illustration 2

A machine was purchased on January 1, 2011 for ₹ 1,00,000 and its useful life is 10 years. After completing its useful life the machine will be scraped and nothing will be realized from it. It is decided to charge depreciation on this machine @ 10% p. a. on Straight Line Method.

Calculate amount of depreciation for each year during the useful life of this machine.

Year	Rate of Depreciation	Amount of Depreciation (₹)
2011	10%	10,000

2012	10%	10,000
2013	10%	10,000
2014	10%	10,000
2015	10%	10,000
2016	10%	10,000
2017	10%	10,000
2018	10%	10,000
2019	10%	10,000
2020	10%	10,000

Amount of depreciation is same in every year, so this method is called 'Straight Line Method' or 'Fixed Installment Method' or 'Original Cost Method'.

12.6 MERITS OF STRAIGHT LINE METHOD

i) **Simplicity :** Calculation of depreciation under this method is very simple and therefore the method is widely popular. Once the amount of depreciation is calculated, the same amount is written off as depreciation each year. Hence this method is simple and calculations are easier to understand.

ii) **Asset is completely Written Off :** Under this method, the book value of an asset is reduced to net scrap value or zero value. In other words, in the books of accounts the value of the asset at the end of its useful life is equal to zero or its residual value.

12.7 LIMITATIONS OF STRAIGHT LINE METHOD

i) **Difficulty in Computation :** When there are various machines having different life-spans, the computation of depreciation becomes complicated because the depreciation on each machine will have to be calculated separately for each asset.

ii) **Illogical :** It is well known that the expense on its repairs and maintenance increases as the asset becomes older. Thus, the total burden on Profit and Loss Account, depreciation plus repair expenses, is more in later years in comparison to earlier years. This is illogical because the efficiency and productivity of the asset is more in earlier years and less in later years.

Illustration 3

X limited purchased a machine on April 1, 2011 for ‘ 1,00,000 whose life was expected to be 10 years. Its estimated scrap value at the end of 10 years was ‘ 10,000. Find the amount of depreciation to be charged to Profit and Loss Account every year. Calculate the rate on which depreciation is to be charged every year.

Solution

In this question the information available is as under: The amount of depreciation that will be charged to Profit and Loss Account will be calculated as :

(i) Calculation of amount of depreciation

$$\text{Annual Depreciation} = \frac{\text{Cost of Machine} - \text{Estimated Scrap Value}}{\text{Expected Life of the Asset}}$$

$$= \frac{₹\ 1,00,000 - ₹\ 10,000}{₹\ 10} = ₹\ 9,000$$

(ii) Calculation of Rate of Depreciation

$$\text{Rate of Depreciation} = \frac{\text{Annual Depreciation Amount X 100}}{\text{Cost Asset}}$$

$$= \frac{₹\ 9,000 \text{ X } 100}{₹\ 1,00,000} = 9\%$$

Illustration 4

Salman and Usman Bros. acquired a machine on July 1, 2008 at a cost of ₹ 70,000 and spent ₹ 5,000 on its installation. The firm writes off depreciation @ 10% on straight line method. The books are closed on December 31 every year. Show the machinery and depreciation account for three years.

Solution

Cost of Machine	₹ 70,000
Cost of Installation	₹ 5,000
Total	₹ 75,000

Rate of Depreciation is 10%.

Then annual depreciation will be 10% of 75000 = ₹ 7,500.

Dr. Depreciation Account Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
2008				**2008**			
Dec. 31	To Machinery A/c		3,750	Dec.31	By P & L A/c		3,750
2009				**2009**			
Dec. 31	To Machinery A/c		7,500	Dec.31	By P & L A/c		7,500
2010				**2010**			
Dec. 31	To Machinery A/c		7,500	Dec.31	By P & L A/c		7,500

Notes

Dr. **Machinery Account** **Cr.**

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2008				**2008**			
July 01	To Bank A/c		70,000	Dec. 31	By Depreciation A/c		3,750
					$7000\times\frac{10}{100}\times\frac{6}{12}$		
July 01	To Bank A/c		5,000	Dec. 31	By Balance c/d		71,250
			75,000				75,000
2009				**2009**			
Jan. 01	To Balance b/d		71,250	Dec. 31	By Depreciation A/c		7,500
					$75000\times\frac{10}{100}$		
					By Balance c/d		63,750
			71,250				71,250
2010				**2010**			
Jan. 01	To Balance b/d		63,750	Dec. 31	By Depreciation A/c		7,500
					$75000\times\frac{10}{100}$		
				Dec. 31	By Balance c/d		56,250
			63,750				63,750

Illustration 5

On April 1, 2006, a company purchases machinery worth ₹ 1,00,000 . On October 1, 2008, it purchased additional machinery worth ₹ 20,000 and spends ₹ 2,000 on its erection. The accounts are closed each year on March 31. Assuming the annual depreciation to be 10%, show the Machinery Account for 5 years under the straight line method.

Solution

Dr. **Machinery Account** **Cr.**

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2006				**2007**			
Apr. 01	To Bank A/c		1,00,000	Mar. 31	By Depreciation A/c		10,000
					$100000\times\frac{10}{100}$		
				Mar. 31	By Balance c/d		90,000
			1,00,000				1,00,000
2007				**2008**			
Apr. 1	To Balance b/d		90,000	Mar. 31	By Depreciation A/c		10,000
					$100000\times\frac{10}{100}$		
				Mar. 31	By Balance c/d		80,000
			90,000				90,000

2008				**2009**			
Apr. 1	To Balance b/d		80,000	Mar. 31	By Depreciation A/c		11,100
					$100000 \times \frac{10}{100}$		
Oct. 1	To Bank A/c		20,000				
					$22000 \times \frac{10}{100} \times \frac{6}{12}$		
	To Bank A/c		2,000	Mar. 31	By Balance c/d		90,900
			1,02,000				1,02,000
2009				**2010**			
Apr. 1	To Balance b/d		90,900	Mar. 31	By Depreciation A/c		12,200
					$100000 \times \frac{10}{100}$		
					$22000 \times \frac{10}{100} \times \frac{6}{12}$		
				Mar. 31	By Balance c/d		78,700
			90,900				90,900
2010				**2011**			
Apr. 1	To Balance b/d		78,700	Mar. 31	By Depreciation A/c		12,200
					$100000 \times \frac{10}{100}$		
					$22000 \times \frac{10}{100} \times \frac{6}{12}$		
				Mar. 31	By Balance c/d		66,500
			78,000				78,700
2011							
Apr. 1	To Balance b/d		66,500				

Illustration 6

On 1st January, 2003 a Company purchased a plant for ₹ 20,000. On 1st July in the same year, it purchased additional plant worth ₹ 8,000 and spent ₹ 2,000 on its erection. On 1st July, 2004, the plant purchased on 1st jan., 2003 having become obsolete, was sold off for ₹ 12,500. On 1st October, 2005, fresh plant was purchased for ₹ 28,000 and on the same date, the plant purchased on 1st July, 2003 was sold at ₹ 6,000.

Depreciation is provided at 10% per annum on original cost on 31st December every year. Show the plant account for 2003 to 2005.

Solution

Dr. **Plant Account** **Cr.**

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2003				**2003**			
Jan. 01	To Cash A/c		20,000	Dec. 31	By Depreciation A/c		
July 01	To Cash A/c		8,000		(i) for a year 2,000		
	To Cash A/c				(ii) for six months 500		2,500
	(expenses)		2,000		By Balance c/d		
					(i) 18,000		
					(ii) 500		27,500
			30,000				30,000
2004				**2004**			
Jan. 1	To Balanc b/d			July 1	By Cash A/c (sale)		12,500
	(i) 18,000			Dec. 31	By Depreciation A/c (i)		1,000[1]
	(ii) 9,500		27,500		By Profit & Loss A/c		4,500[1]
				July 1	By Depreciation A/c (ii)		
							1,000
				Dec. 31	By Balance c/d		
					(₹ 9,500 - ₹ 1,000)		8,500
			27,500				27,500
2005				**2005**			
Jan. 1	To Balance b/d (ii)		8,500	Oct. 1	By Cash A/c (sale)		6,000
Oct. 1	To Cash A/c (iii)		28,000	Oct. 1	By Depreciation A/c (ii)		750[2]
				Oct. 1	By Profit & Loss A/c (loss)		1,750
				Dec. 31	By Depreciation A/c (iii)		
					(28,000 x 10/100 x 3/12)		700
				Dec. 31	By Balance c/d		
					(₹ 28,000 - ₹ 700)		27,300
			36,500				36,500

Note : Calculation of loss on sale of plant :

		₹
(i)	On 1-1-2004 book value of the plant sold [Plant (i)]	18,000
	Less : Depreciation for 6 months *i.e.* 20,000 x 10/100 x 6/12	1,000
	On 1-7-2004 book value of plant sold	17,000
	Less : Sale price of plant	12,500
	Loss on sale of plant	4,500
(ii)	On 1-1-2005 book value of plant sold [Plant (ii)]	8,500
	Less : Depreciation for 9 months is 10,000 x 10/100 x 9/12	750
	On 1-10-2005 book value of plant sold	7,750
	Less : Sale Price	6,000
	Loss on Sale of Plant	1,750

INTEXT QUESTIONS 12.2

Fill in the blanks :

i. The assumption underlying the fixed installment method of depreciation is that the amount of the fixed assets over different years of its useful life remain the _________.

ii. Straight line method of charging depreciation is also known as _________ or _________.

iii. Under straight line method the value of the assets at the end of its useful life is equal to __________ or its ___________.

iv. Under straight line method the total burden on Profit and Loss Account in Comparision to earlier years is _____________.

12.8 DIMINISHING BALANCE METHOD

Under this method, as the value of asset goes on diminishing year after year, the amount of depreciation charged every year goes on declining. The amount of depreciation is calculated as a fixed percentage of the diminishing value of the asset shown in the books at the beginning of each year. Under this method the value of an asset never comes to zero.

Suppose, the cost of the asset is ₹ 40,000 and the percentage to be written off each year is 10%. In the first year the amount of the depreciation will be ₹ 4,000 i.e., 10% of ₹ 40,000. This will reduce the book value to ₹ 36,000 i.e. ₹ 40,000 – ₹ 4,000. Now, at the beginning of the next year the book value is ₹ 36,000. The amount of the depreciation for the next year will be ₹ 3,600, i.e., 10% of ₹ 36,000. Thus, every year the amount of the depreciation will go on reducing. This method of charging depreciation is also known as Reducing Balance Method or written down value method.

Illustration 7

A machine was purchased on January 1, 2011 for ₹ 1,00,000 and its useful life is 10 years. After completing its useful life the machine will be scraped and ₹ 4,000 will be realized from it. It is decided to charge depreciation on this machine @ 10% p. a. on Diminishing Balance Method.

Calculate amount of depreciation for each year during the useful life of this machine.

Solution

Year	Rate of Depreciation	Amount of Depreciation
2011	10%	10,000
2012	10%	9,000
2013	10%	8,100
2014	10%	7,290
2015	10%	6,561
2016	10%	5,905
2017	10%	5,314
2018	10%	4,783
2019	10%	4,305
2020	10%	3,874

Amount of depreciation is decreased year after year in this method that is why this method is called 'Diminishing Balance Method' or 'Reducing balance method' or 'written down value method'.

12.9 MERITS OF DIMINISHING BALANCE METHOD

i) Equal Burden on Profit & Loss Account

The productivity of the asset is more hence its contribute to profit is also relatively greater. Therefore the cost charged in terms of depreciation should also be greater.

In the initial year, the depreciation charges are more and repair expenses are less. In later years, depreciation charges are less and repair expenses are more. Hence the total burden, depreciation plus repair expenses, is some what equal on Profit & Loss Account for each year.

12.10 DEMERITS OF DIMINISHING BALANCE METHOD

i) **Asset cannot be completely written off :** Under this method, the value of an asset is not reduced to zero even when there is no scrap value.

ii) **Complexity :** Under this method, the rate of depreciation cannot be determined easily.

INTEXT QUESTIONS 12.3

Fill in the blanks with suitable words

(i) Depreciation represents a ________ in the value of fixed assets.

(ii) The amount of depreciation on machinery is credited to ______ account.

(iii) Depreciation is calculated on _______ under the straight line method.

(iv) Depreciation is calculated on ________ under the diminishing balance method.

(v) The value of an assets is not reduced to ________ even when there is no scrap value in diminishing balance method of depreciation.

Illustration 8

Widson enterprise purchases Plant and Machinery for ₹ 1,00,000 on 1st October 2012. It decides to write off depreciation 20% per annum on Written Down Value Method. On 1st January, 2015 purchases additional Machinery for ₹ 40,000.

Show Machinery Account upto the year ending 31st March, 1996. The accounting year ends on 31st March.

Solution

Dr. Plant and Machinery Account Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2012 Oct. 01	To Bank		1,00,000	**2013** Mar. 31	By Depreciation (for six months)		10,000
					By Balance c/d		90,000
			1,00,000				1,00,000
2013 Apr. 01	To Balance b/d		90,000	**2014** Mar. 31	By Depreciation (on ₹ 90,000 for one year)		18,000
					By Balance c/d		72,000
			90,000				90,000
2014 Apr. 01	To Balance b/d		72,000	**2015** Mar. 31	By Depreciation (On ₹ 72,000) for one year ₹ 14,400 On ₹ 40,000 for 3 months ₹ 2,000		16,400
2015 Jan. 01	To Bank		40,000		By Balance c/d		95,600
			1,12,000				1,12,000
2015 Apr. 01	To Balance b/d		95,600	**2016** Mar. 31	By Depreciation (On ₹ 96,600 for one year)		19,120
					By Balance c/d		76,480
			95,600				95,600
2016 Apr. 01	To Balance b/d		76,480				

Illustration 9

On April 1, 2009 Ganga Bros. purchased two machines for ₹ 75,000 each. Depreciation at the rate of 10% on diminishing balance method was provided. On March 31, 2011, one machine was sold for ₹ 55,000. An improved model with a cost of ₹ 80,000 was purchased on the same day. You are required to show the Machinery Account for 2009-10 to 2010-11.

Solution

Dr. **Machinery Account** **Cr.**

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2009				**2010**			
Oct. 01	To Bank		1,50,000	Mar. 31	By Depreciation A/c		15,000
				Mar. 31	By Balance c/d		1,35,000
			1,50,000				1,50,000
2010				**2011**			
Apr. 01	To Balance b/d		1,35,000	Mar. 31	By Depreciation A/c		13,500
Mar. 31	To Bank A/c		80,000	Mar. 31	By Bank A/c		55,000
					By P & L A/c		5,750
					By Balance c/d		1,40,750
			2,15,000				2,15,000
2011							
Apr. 01	To Balance b/d		1,40,750				

Note : Calculation of loss on sale of machine :

Initial Cost	75,000
Dep. in 2010	- 7,500
	67,500
	- 6,750
	60,750
	- 55,000
Loss on Sale	5,750

Illustration 10

On October 1, 2008, the Akash Transport Company purchased a Truck for ₹ 8,00,000. On April 1, 2010, this Truck was involved in an accident and was completely destroyed and ₹ 6,00,000 were received from Insurance Company in full settlement. On the same date another Truck was purchased by the company for ₹ 10,00,000. The company writes off 20% depreciation p. a. on written down value method. Give the Truck Account from 2008 to 2010.

Solution

Dr. **Truck Account** **Cr.**

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2008				**2008**			
Oct. 01	To Bank A/c		8,00,000	Dec. 31	By Depreciation A/c		40,000
					$8,00,000 \times \frac{20}{100} \times \frac{3}{12}$		
				Dec. 31	By Balance c/d		7,60,000
			8,00,000				8,00,000
2009				**2009**			
Jan. 01	To Balance b/d		7,60,000	Dec. 31	By Depreciation A/c		1,52,000
					$7,60,000 \times \frac{20}{100}$		
				Dec. 31	By Balance c/d		6,08,000
			7,60,000				7,60,000
2010				**2010**			
Jan. 01	Balance b/d		6,08,000	Apr. 01	By Bank A/c		6,00,000
Apr. 01	To P & L A/c		22,400	Apr. 01	By Depreciation A/c		30,400
					$6,08,000 \times \frac{20}{100} \times \frac{3}{12}$		
Apr. 01	To Bank A/c		10,00,000	Dec. 31	By Depreciation A/c		1,50,000
					$1,00,000 \times \frac{20}{100} \times \frac{9}{12}$		
				Dec. 31	By Balance c/d		8,50,000
			16,30,400				16,30,400

Distinction between Straight Line Method and Diminishing Balance Method

Basis	Straight Line Method	Diminishing Balance Method
Basis of Calculation	Depreciation is calculated on original cost of the asset.	Depreciation is calculated on original cost in first year and on written down value of the asset in subsequent years.
Amount of Depreciation	The amount of depreciation remains the same for all years.	The amount of depreciation goes on reducing year after year.
Value of Asset	The book value of the asset can be reduced to zero.	The book value of the asset can never be reduced to zero.

Depreciation and Repairs	The combined cost on account of depreciation and repairs is lower in the initial years and higher in the later years.	The combined cost on account of depreciation and repairs remains, more or less, equal throughout the period.

INTEXT QUESTIONS 12.4

I. State which of the following statements are true and which are false:

i. Amount of depreciation goes on reducing year after year in Straight Line Method.

ii. The amount of depreciation remains the same for all years in Diminishing Balance Method.

iii. The book value of the asset can be reduced to zero in Straight Line Method.

iv. The book value of the asset can never be reduced to zero in Diminishing Balance Method.

II. Multiple Choice Questions

i. Depreciation is charged on :

a) Stock of Goods b) Current Assets

c) Fixed Assets d) Liquid Assets

ii. Obsolescence term is used for :

a) Tear and wear of the Assets

b) Decrease in the value of the assets which are engaged in production

c) Development of improved or superior quality of equipment.

d) Due to usage and age of assets

iii. Changing depreciation on Fixed Assets by Straight line method. The value of the asset is taken into consideration:

a) Original value b) Diminished value

c) Scrap value d) Book value

iv. Charging depreciation on Fixed assets by Reducing balance method, the value of the asset is taken into consideration.

a) Original cost method b) Diminished value

c) Scrap value d) Book value

v. The amount calculated for charging depreciation :

a) Includes the amount of scrap value of the Asset

b) Do not include the amount of scrap value of the asset

c) Cost of assets less scrap value

d) None of the above.

vi. Out of the following which is not the cause of depreciations:
a) Normal wear and tear b) Obsolescence
c) Cost of asset. d) Decrease or increase in market price

vii. Out of the following what will before annual depreciations :
a) Total Depreciation + Plus installation charges cost
b) Total lost – Scrap value ÷ Expected life
c) Total cost + Scrap value ÷ Expected life
d) None of the above.

viii. Which one of the following is not a factor affecting annual depreciation on an asset.
a) Cost of the Asset b) Scrap Value of the asset
c) Useful life of the asset d) Annual maintenance on the asset.

ix. Out of the following on which asset depreciation will be charged :
a) Stock b) Debtors c) Machinery d) Land

x. Out of the following assets on which depreciation will not be charged:
a) Machinery b) Plant c) Photo Copier d) Stock

WHAT YOU HAVE LEARNT

- Depreciation is the gradual and permanent decrease in the value of an asset due to defluxion of time, wear and tear, obsolescence or any other reason.
- **Causes of Depreciation**
  - → Physical Wear and Tear due to usage
  - → Physical wear and tear due to passage of time
  - → Obsolescence due to advancement in technology
- **Objective of Depreciation**
  - → To show the True Financial Position of the business.
  - → To retain funds in the business for replacement of the Asset.
- **Methods of Charging Depreciation**
  - → Straight Line Method
  - → Diminishing Balance Method
- **Merits of Straight Line Method**
  - → Simplicity
  - → Assets can be Completely Written Off
- **Demerits of Straight Line Method**
  - → Difficulty in Computation
  - → Illogical

- **Merits of Diminishing Balance Method**
  - → Equal burden on Profit & Loss Account.
  - → Balance of Asset is never written Off to Zero
- **Demerits of Diminishing Balance Method**
  - → Asset can not be completely written off
  - → Complexity

TERMINAL EXERCISE

1. What is depreciation? Write the various objectives of providing depreciation.
2. What are the causes of providing depreciation?
3. What are the two methods of providing depreciation? Explain their merits and demerits.
4. What are the objectives of providing depreciation?
5. Distinguish between Straight Line Method and Diminishing Balance Method of Depreciation.
6. Krishnamohan Limited purchased a machinery on October1, 2008 for ₹ 90,000 and spent ₹ 10,000 on its erection. The depreciation is to be charged @ 10% p. a. on original cost. Show the Machinery Account for three years if books are closed on March 31 every year.
7. On April 1, 2008 Asahi Limited purchased a machinery for ₹ 80,000 and spent ₹ 20,000 on its repairs and installation. On September 30, 2011, the machinery was sold for ₹ 60,000. Prepare Machinery Account for the year 2008 to 2011, if depreciation is charged @ 10% p. a. by Straight Line Method.
8. Ajay Kumar and Company purchased machinery for ₹ 20,000 on April 1, 2007. The Machinery is depreciated at 10% per annum on the straight line method. On October 1, 2010, the machinery was sold for ₹ 8,000. Give the Machinery Account if books are closed on March 31 every year.
9. A Plant is purchased for ₹ 80,000 on January 1, 2008. It is estimated that the residual value of the plant at the end of its working life of 10 years will be ₹ 27,894. Depreciation is to be provided at 10% p.a. on diminishing balance method.

   You are required to show the Plant Account for 4 years assuming that the books are closed on March 31 every year.
10. On January 1, 1987 Machinery Account showed a balance of ₹ 10,000. On 1st July, 19888, a new machine costing ₹. 6,000 was purchased. On 30th June, 1990, Machinery other than the machine bought on 1st July, 1988, was disposed of for ₹ 6,000.

Show the Machinery Account for four years. The accounting year ends on 31st December, and depreciation is to be provided at 10% p.a. on written down value.

ANSWER TO INTEXT QUESTIONS

12.1 i) Diminution ii) Amount, life iii) Life of assets iv) Technology

12.2 i) Same
ii) Fixed in statement method, Original cost method
iii) Zero, Net Scrap value iv) More

12.3 i) Falls ii) Machinery iii) Original cost
iv) Opening balance of the year v) Zero

12.4 **I.** i) False ii) False iii) True iv) True

II. i) c ii) c iii) a iv) b v) c
vi) d vii) b viii) d ix) c x) d

ACTIVITY FOR YOU

- Ask your parents about the date of various fixed assets purchased by them like T.V., Fridge, Motorcycle, Car etc., with its useful life and then calculate the amount of depreciation to be charged on each asset.

Notes

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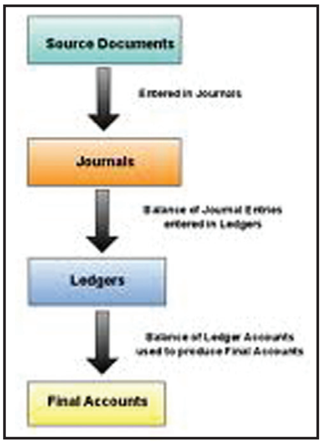
14

FINANCIAL STATEMENTS (WITHOUT ADJUSTMENTS)

In the previous lessons you have learnt to record the business transactions in different books of accounts and their posting into the main book i.e. ledger. You have also learnt the balancing of accounts and preparation of trial balance. One of the important purposes of accounting is to find out the profit or loss of a business for a particular accounting period and also to know its financial position on a particular date.



For this purpose, Income Statement and Position Statement are prepared every year by all business organisations. Income statement is divided into two parts, which are as follows:

(i) Trading Account and

(ii) Profit and Loss Account.

Income Statement is prepared to know the earnings of a business during a particular accounting year or the loss suffered during the year. Position Statement, also known as Balance Sheet, is prepared to know the financial position of a business on a particular date.

In this lesson you will learn as to how the financial statements are prepared to find out the profit for an accounting year and to know its financial position on a particular date.

OBJECTIVES

After studying this lesson you will be able to:

- explain the meaning of financial statements;
- explain the objectives of financial statements;
- classify the financial statements into Trading Account, Profit and Loss Account and Balance Sheet and
- prepare Trading Account, Profit and Loss Account and Balance Sheet.

14.1 MEANING OF FINANCIAL STATEMENTS

Like a student who eagerly waits for his/her annual examination result, every businessman also eagerly waits to know the result of his business for a particular financial year. The businessman also wants to know the financial position of his business on a particular date. This date is normally the last date of the financial year for which the accounts have been prepared. The statements, prepared to know the result of the business and the financial position of the business, are called financial statements. The statement prepared for ascertain gross profit/loss is called Trading Account. The statement prepared to ascertain the net profit is called Profit and Loss Account. Trading and Profit and Loss Account taken together is called the Income Statement. Statement prepared to know the financial position of the business is called the Balance Sheet or Position Statement.

14.2 OBJECTIVES OF FINANCIAL STATEMENTS

Following are the objectives of preparing financial statements:

i) **Ascertain the result of business activities :** One of the important objectives of preparing financial statements is to ascertain the Income. Financial statements provide information about the profit earned or loss incurred during a particular accounting period or year.

ii) **Ascertain the financial position of business :** Balance Sheet provides information about the financial position of business on a particular date.

iii) **Correct decision making :** Financial statements are helpful in decision making for the business on the basis of the information provided by financial statements, future decisions can be taken correctly.

iv) **Judging the performance of management :** Financial statements are helpful in judging the performance of management and utilization of resources of a business house.

v) **Ascertaining the cash position of business :** The cash position indicated by the financial statements helps the business in planning the payment of cash to creditors, suppliers etc.

14.3 CLASSIFICATION OF FINANCIAL STATEMENTS

Financial Statements of a sole trader comprise of the following statements:

I. Income Statement
   - (i) Trading Account and
   - (ii) Profit and loss Account

II. Position Statement or Balance Sheet

Notes

Income Statement

Income statement is prepared to find out the profit or loss of business for a particular accounting year. Income statement is made up of the following accounts:

a) Trading Account and

b) Profit and loss Account

a) Trading Account : Trading Account is prepared to find out the Gross profit earned or Gross loss suffered by the business from business activities during an accounting year. This account is prepared in T-form. Following is the proforma of a Trading Account:

Trading Account of M/s XYZ
for the year ending..........

Dr. **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Opening Stock	______	By Sales	
To Purchases		(i) Cash Sales ______	
(i) Cash Purchases ______		(ii) Credit Sales ______	
(ii) Credit Purchases ______		Total Sales ______	
Total Purchases ______		Less Sales Returns ______	
Less Purchase Returns ______		Net Sales	______
Net Purchases	______	By Closing Stock	______
Direct Expenses :		By Gross Loss transferred to	
To Wages ______		P & L A/c (Balancing fig.)	______
To Freight/Freight Inward ______			
To Carriage/Carriage Inward ______			
To Fuel & Power ______			
To Factory Rent ______	______		
To Gross Profit transferred to			
P & L A/c (Balancing fig.)			
	______		______

Illustration 1

From the following balances extracted from the books of M/s Luxmi & Sons, prepare a Trading Account for the year ended 31st March, 2012.

Particulars	Amount (₹)
Opening stock	6,500
Purchases	45,000
Sales	72,000
Purchases Returns	500
Sales Returns	1,500
Carriage	1,200
Wages	4,800
Fuel & Power	3,200
Closing stock	8,000

Solution

Trading Account of M/s Luxmi & Sons
for the year ended March 31, 2012

Dr. | **Cr.**

Particulars		Amount (₹)	Particulars		Amount (₹)
To Opening Stock		6,500	By Sales	72,000	
To Purchases	45,000		*Less* : Returns	1,500	70,500
Less : Returns	500	44,500	By Closing Stock		8,000
To Carriage		1,200			
To Wages		4,800			
To Fuel & Power		3,200			
To Gross Profit transferred to P & L A/c (Balancing Figure)		18,300			
		78,500			**78,500**

Illustration 2

From the following balances extracted from the books of M/s Bhanu Bros, prepare a Trading Account for the year ended 31st March, 2012.

Particulars	Amount (₹)
Opening Stock as on 1.4.2011	32,000
Purchases	1,65,000
Freight	4,000
Power	6,500
Custom Duty	5,500
Sales	80,000
Closing Stock as on 31st March, 2012	30,000

Solution

Trading Account of M/s Bhanu Bros.
for the year ended March 31, 2012

Dr. | **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Opening Stock	32,000	By Sales	80,000
To Purchases	1,65,000	By Closing Stock	30,000
To Freight	4,000	By Gross Loss transferred to P & L A/c (Balancing Figure)	1,03,000
To Power	6,500		
To Custom Duty	5,500		
	2,13,000		**2,13,000**

Notes

INTEXT QUESTIONS 14.1

Fill in the blanks with suitable word/words :

i. Carriage is debited to ____________ account.

ii. Total Sales – Sales Returns = ____________

iii. Wages are debited to ____________ account.

iv. Closing stock is shown on the ____________ side of Trading Account.

v. Total Purchases – Purchase Returns = ____________

b) Profit and Loss Account : After finding out the gross profit/ gross loss by preparing the Trading Account, Profit and Loss Account is prepared to find out the net profit / net loss of the business during an accounting year. This account is also prepared in T-form. Following is the proforma of a Profit and loss Account

Profit and loss Account of M/s ABC
for the year ended_________

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Gross Loss transferred from Trading A/c	______	By Gross profit transferred from Trading A/c	______
To Salaries	______	By Commission Received	______
To Office Rent	______	By Discount received from creditors	______
To Printing & Stationery	______	By Rent Received	______
To Insurance Premium	______	By Interest Received	______
To Interest Paid	______	By Net Loss Transferred to Capital Account (Balancing Figure)	______
To Freight outwards	______		
To carriage outwards	______		
To Discount Allowed to customers	______		
To Postage	______		
To Telephone Charges	______		
To Office Expenses	______		
To Sales Expenses	______		
To Net Profit Transferred to Capital Account (Balancing Figure)	______		
	______		______

Illustration 3

From the following information, prepare Profit and loss Account of M/s Sahil Bros for the Year ending on 31.03.2012.

	₹
Gross Profit	97,000
Discount allowed to customers	2,000
Printing and stationery	2,000
Office rent	5,000

Repair	2,400
Insurance Premium	5,100
Telephone Charges	1,000
Discount received from Creditors	3,000
Interest earned during the year	5,000

Solution

Profit and loss Account of M/s Sahil Bros.
for the year ended March 31, 2012

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Discount allowed to customers	2,000	By Gross profit transferred from Trading A/c	97,000
To Printing and Stationery	2,000	By Discount received from creditors	3,000
To Office Rent	5,000	By Interest earned during the year	5,000
To Repairs	2,400		
To Insurance Premium	5,100		
To Telephone Charges	1,000		
To Net Profit transferred to Capital Capital A/c (Balancing fig.)	87,500		
	1,05,000		**1,05,000**

Illustration 4

From the following information, prepare Profit & Loss Account of M/s Sarthak Traders for the year ending on 31.03.2012

	₹
Gross Profit	43,000
Discount allowed to customers	7,000
Salaries	45,000
Interest paid on loan	13,000
Postage	2,400
Discount received from creditors	6,000
Commission received	1,000
Sales expenses	10,000

Solution

Profit and loss Account of M/s Sarthak Traders
for the year ended March 31, 2012

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Discount allowed to customers	7,000	By Gross profit transferred from Trading A/c	43,000
To Salaries	45,000	By Discount received from Creditors	6,000
To Interest on loan	13,000	By Commission Received	1,000
To Postage	2,400	By Net Loss transferred to capital A/c	27,400
To Sales expenses	10,000		
	77,400		77,400

INTEXT QUESTIONS 14.2

State whether the following statements are True or False:

i. Carriage inward is shown in Profit& Loss Account.

ii. Telephone expenses are shown in Trading Account.

iii. Carriage outward is shown in P&L A/c.

iv. Gross Profit is transferred from Profit & Loss Account to Trading Account.

Distinction between Trading Account and Profit and Loss Account

The distinction between Trading A/c and Profit & Loss A/c is as follows:

S.No.	Trading Account	Profit and Loss Account
1.	This account shows the gross profit or gross loss for an accounting year.	This account shows the net profit or net loss for an accounting year.
2.	All direct expenses relating to business are shown on the debit side of this account.	All indirect expenses relating to business are shown on the debit side of this account.
3.	All direct revenue items are shown on the credit side of this account.	All indirect revenue items are shown on the credit side of this account.
4.	The balance of this account i.e. gross profit or gross loss is transferred to P&L. A/c.	The balance of this account i.e. net profit or net loss is transferred to the capital account of the proprietor .

II. Position Statement or Balance Sheet

Balance Sheet or Position Statement is prepared to find out the financial position of a business on a particular date. Generally it is prepared on the last date of an accounting year. It is prepared after preparing Trading Account and Profit & Loss Account.

Balance Sheet has two sides. Left hand side is known as Liabilities side and right hand side is known as Assets side.

The Liabilities side is used for showing liabilities of the business. The term liabilities include 'Internal Liabilities' and 'External Liabilities' of the business. Internal liabilities means the amount payable by the business to its owner, while external liabilities mean the amount payable to outsiders.

Classification of Internal and External Liabilities

	Internal liabilities	External liabilities
a.	Capital	Creditors
b.	Profits of business	Bank loan and other loans
c.	Reserves of business	Expenses payable or due

The Assets side is used for showing the assets of the business. The term assets includes fixed assets and current assets of the business.

Classification of Assets

	Fixed Assets	Current Assets
a.	Land and building	Cash in hand
b.	Plant &Machinery	Cash at Bank
c.	Furniture	Stock of goods
d.	Motor Vehicles etc.	Debtors etc.

Objectives of Preparing Balance Sheet

Balance sheet is prepared to achieve following objectives:

i) To know the financial position of the business.

ii) To know the position of internal liabilities and external liabilities of the business so that timely arrangement can be made for their payment.

iii) To know the position of fixed assets and current assets.

iv) To plan activities for future on the basis of present financial position.

Proforma of Balance Sheet

Balance Sheet of M/s ______________
as on _________________

Liabilities		₹	Assets	₹
Bank overdraft		_______	Cash in hand	_______
Creditors		_______	Cash at Bank	_______
Loans/Bank Loan		_______	Debtors	_______
Capital	_______		Stock	_______
Add : Net Profit	_______		Investments	_______
Less : Net Loss	_______		Furniture	_______
Less Drawings	_______	_______	Motor Vehicles	_______
			Plant & Machinery	_______
			Land & Building	_______
		_______		_______

Illustration 5

From the following information supplied by Mr. Roshan Lal, prepare a Balance Sheet of Mr. Roshan Lal as on 31st March, 2012

	₹
Capital	50,000
Furniture	15,000
Debtors	25,000
Creditors	30,000
Plant and Machinery	58,000
Investments	5,000
Cash in hand	1,000
Cash at Bank	1,000
Stock at the end	10,000
Bank Overdraft	8,000
Bank Loan	20,000
Net Profit	10,000
Drawings	3,000

Solution

Balance Sheet of Mr. Roshan Lal
as on March 31, 2012

Dr. **Cr.**

Liabilities		₹	Assets	₹
Bank overdraft		8,000	Cash in hand	1,000
Creditors		30,000	Cash at Bank	1,000
Bank Loan		20,000	Debtors	25,000
Capital	50,000		Stock	10,000
Add : Net Profit	10,000		Investments	5,000
	60,000		Furniture	15,000
Less Drawings	- 3,000	57,000	Plant & Machinery	58,000
		1,15,000		**1,15,000**

Illustration 6

From the following information supplied by Mr. Arun Kumar, prepare a Balance Sheet as on 31st March, 2012.

	₹
Creditors	30,000
Debtors	35,000
Cash in hand	24,500
Cash at Bank	27,500
Stock	22,500
Furniture	25,000

Loan	50,000
Plant & Machinery	32,500
Land & Building	52,000
Capital	1,37,000
Net Profit	12,000
Drawings	10,000

Solution

Balance Sheet of Mr. Arun Kumar
as on March 31, 2012

Dr. Cr.

Liabilities		₹	Assets	₹
Creditors		30,000	Cash in hand	24,500
Loan		50,000	Cash at Bank	27,500
Capital	1,37,000		Debtors	35,000
Add : Net Profit	12,000		Stock	22,500
	1,49,000		Furniture	25,000
Less : Drawings	10,000	1,39,000	Plant & Machinery	32,500
			Land & Building	52,000
		2,19,000		**2,19,000**

INTEXT QUESTIONS 14.3

I. Fill in the Blanks :

i. Assets are shown on the __________ side of the Balance Sheet.

ii. Capital is shown on the liabilities side of __________ .

iii. Total of Assets side and liabilities side of balance sheet are always __________.

iv. Stock is an example of ____________ asset.

v. Furniture is an example of ____________ asset.

II. Classify the following assets as fixed assets and current assets:

Assets	Type of Asset (Fixed or Current)
i. Debtors	
ii. Land & Building	
iii. Plant & Machinery	
iv. Cash at Bank	
v. Motor Vehicle	
vi. Cash in hand	

Illustration 7

From the following Balances of M/s Pawan Sales on 31/3/2012, prepare a Trading and Profit & Loss Account and a Balance Sheet as on that date.

Particulars	Amount (₹)	Particulars	Amount (₹)
Drawings	8,000	Sales	2,58,000
Capital	48,000	Return Inwards	2,000
Sundry Creditors	80,000	Return Outwards	2,200
Sundry Debtors	1,26,000	Office Salaries	18,000
Bills Receivable	10,000	Manufacturing Wages	8,000
Opening stock	90,000	Commission	9,000
Fixtures and Fittings	13,000	Trade Expenses	5,000
Cash in hand	2,000	Rent	4,400
Machinery	24,800	Discount received	8,000
Bank Overdraft	10,000	Bills Payable	14,000
Purchases	1,00,000		

The closing stock on 31.3.2012 was ₹ 1,04,000

Solution

Trading and Profit and Loss A/c M/s Pawan
for the year ended March 31, 2012

Dr. Cr.

Particulars		Amount (₹)	Particulars		Amount (₹)
To Opening Stock		90,000	By Sales	2,58,000	
To Purchases	1,00,000		*Less* : Returns	2,000	2,56,000
Less : Returns	2,200	97,800	By Closing Stock		1,04,000
To Manufacturing Wages		8,000			
To Gross Profit c/f		1,64,200			
		3,60,000			**3,60,000**
To Office Expenses		18,000	By Gross Profit b/f		1,64,200
To Commission		9,000	By Discount received		8,000
To Trade Expenses		5,000			
To Rent		4,400			
To Net Profit c/f		1,35,800			
		1,72,200			**1,72,200**

Balance Sheet
as on March 31, 2012

Liabilities	₹	Assets	₹
Bills Payables	14,000	Cash in hand	2,000
Sundry Creditors	80,000	Bills Receivable	10,000
Bank Overdraft	10,000	Sundry Debtors	1,26,000

Capital	48,000		Stock	1,04,000
Less : Drawings	8,000		Fixtures and Fittings	13,000
	40,000			
Add : Net Profit	1,35,800	1,75,800		
		2,79,800		**2,79,800**

INTEXT QUESTIONS 14.4

I. Mention whether following statements are True or False :

i. A Balance Sheet shows the financial position of a business for the whole year.

ii. Both P & L Account and Balance Sheet are position statements.

iii. Asset side of a balance sheet shows only the fixed assets of a business.

iv. Liabilities side of a Balance Sheet shows both internal and external liabilities.

II. Multiple Type Questions

i. Which of the following financial statement is prepared to ascertain gross profit of a business?

a) Profit and Loss Account   b) Trading Account
c) Balance Sheet   d) None of the above

ii. Which of the following financial statements is prepared to ascertain the positions of assets and liabilities of the business?

a) Balance Sheet   b) Profit and Loss Account
c) Trading Account   d) None of the above

iii. Gross profit is the difference between

a) Total assets and total liabilities
b) Sales and all expenses
c) Sales and indirect expenses
d) Sales and cost of goods solds

iv. Which of the following is not an indirect expense?

a) Freight inward   b) Discount allowed
c) Rent paid   d) Commission paid

v. Which of the following is a current asset?

a) Land   b) Building
c) Cash at bank   d) Machinery

WHAT YOU HAVE LEARNT

- Financial Statements are prepared to ascertain the Gross Profit and Net profit earned by a business enterprise during a period and the positions of its assets and liabilities on a particular date, generally on the last date of the accounting year.
- Trading account is prepared to ascertain gross profit earned or gross loss suffered during a period and profit and loss account is prepared to ascertain the net profit earned or net loss suffered by the business during a period. Trading and profit and loss account taken together is called income statement.
- Balance sheet is prepared to know the position of assets and liabilities of the business on a particular date. This is called the position statement.
- Financial statements are prepared to know the result of business activities, to know the financial position of the business, to help in decision making, to judge the performance of the management, to know the cash position of the business etc.

TERMINAL EXERCISE

1. What do you mean by term financial statements?
2. State the objectives of preparing financial statements.
3. State the objectives of preparing Balance Sheet.
4. Distinguish between direct expenses and indirect expenses.
5. Distinguish between Trading Account and Profit and Loss Account.
6. Give five examples each of fixed assets and current assets.
7. Give three examples each of internal liabilities and external liabilities.
8. From the following balances prepare trading account for the year ended 31st March 2012

Particulars	₹	Particulars	₹
Opening Stock	6,000	Purchases	11,500
Purchase return	500	Sales	48,000
Sales return	600	Freight & Octori	500
Carriage on purchases	1,000	Wages	2,500
Factory lighting	600	Import duty	900
Office rent	1,200	Carriage on sales	3,000
Coal, gas & water	800		

9. Prepare Profit and Loss account for the year ended 31st March 2012 from the following particulars.

Particulars	₹	Particulars	₹
General Expenses	800	Gross Profit	32,100
Charity	100	Carriage on sales	900
Electricity charges	175	Office expenses	650
Law charges	180	Insurance premium	1,200
Advertisement	440	Telephone expenses	600
Commission	870	Sales tax	800
Rent	1,800	Establishment expenses	700
Interest on investment	700	Miscellaneous expenses	750
Sundry receipts	700	Discount received	1,090
Indirect expenses	340	Traveller salary	300
Printing and stationary	65	Repair	270

10. From the following trial balance of Gopal Nath and Sons, prepare Trading and Profit and Loss Account for the year ending 31st December 2012 and a Balance Sheet as at that date:

Particulars	₹	Particulars	₹
Opening Stock	4,000	Bills Payable	1,200
Purchases	12,000	Purchase return	300
Carriage	1,170	Sundry creditors	2,700
Wages	1,000	Sales	20,000
Sales return	200	Capital	30,000
Drawings	1,500	Commission received	120
Office expenses	250		
Salaries	1,600		
Discount	300		
Repairs	1,200		
Advertisements	500		
Sundry debtors	6,000		
Plant & Machinery	12,000		
Building	10,000		
Cash in hand	600		
Cash at bank	2,000		
	54,320		**54,320**

The value of stock in hand on 31st December 2012 was ₹ 6,000.

ANSWER TO INTEXT QUESTIONS

14.1 (i) Trading Account (ii) Net Sales (iii) Trading Account
(iv) Credit Side (v) Net Purchases

14.2 (i) False (ii) False (iii) True (iv) False

14.3 **I.** (i) Right hand side (ii) Balance Sheet (iii) Equal
(iv) Current (v) Fixed

II. (i) Current (ii) Fixed (iii) Fixed
(iv) Current (v) Fixed (vi) Current

14.4 **I.** (i) False (ii) False (iii) False (iv) True

II. (i) b (ii) a (iii) d (iv) a (v) c

ANSWER TO TERMINAL EXERCISE

8. Gross Profit Rs. 24,100
9. Net Profit Rs. 24,450.
10. Gross Profit Rs. 7,930; Net Profit Rs. 4,200; Total of Balance Sheet Rs. 36,600.

ACTIVITY FOR YOU

- Visit a small business organisation in a nearby area, request them to show you their final accounts, with the help of an accountant learn the technique of preparing the final accounts.

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15

FINANCIAL STATEMENTS (WITH ADJUSTMENTS)

You have learnt in the previous lesson, how to prepare Trading A/c, Profit & Loss A/c and Balance Sheet.

These financial statements are prepared with the help of a given Trial Balance. It is possible that the expenses given in the Trial Balance may not be the total expenses for that accounting year for which trial balance has been prepared.

Similarly a portion or part of the expenses given in the Trial Balance may relate to future year(s).

If Financial Statements are prepared with the help of such a Trial balance, they will not present a correct picture of the business. The income statement will not show correct net profit or net loss. Similarly the Balance sheet will not show the correct financial picture of the business.

So, before preparing the financial statement, it is necessary to find out the items of expenses which relate to the current year but have not been paid.

Similarly it is necessary to find out the items of expenses which relate to future year but have been paid or received during current year.

Therefore, it becomes necessary to make some 'adjustments' in respect of some items of expense and income. These are called accounting adjustments.

OBJECTIVES

After studying this lesson you will able to :

- understand the need for accounting adjustments;
- understand the adjustments relating to closing stock, outstanding expenses, prepaid expenses and depreciation on fixed assets;
- explain adjustment entries relating to above adjustments and
- understand the accounting treatment of the adjustments in Trading A/c, Profit and Loss A/c and Balance Sheet.

15.1 NEED FOR ACCOUNTING ADJUSTMENTS

Accounting adjustments are required because of the following purposes:

i) To know the correct net profit or net loss of the business for an accounting year.

ii) To know the correct financial position of the business.

iii) To record the expenses which have become due but have not been paid

iv) To record the expenses which have been paid in advance for future year(s)

v) To provide for depreciation on fixed assets.

15.2 TYPES OF ADJUSTMENTS

The number and nature of adjustments will differ from business to business. You will study the following common adjustments in this lesson :

i) Closing Stock

ii) Outstanding Expenses

iii) Prepaid Expenses

iv) Depreciation on Fixed assets

Let us discuss the above items of adjustments and their accounting treatment in the financial statements.

i) Closing Stock

Closing stock is the stock of goods which remains unsold at the end of the accounting year. This item is, normally, not shown inside the Trial balance. It appears outside the trial balance as additional information. For example the books of Mr. X showed the value of closing stock as on 31.3.2012 ₹30,000.

The accounting treatment of closing stock in the financial statements of Mr. X., will be as follows:

(a) The following adjustment entry will be passed at the end of the year:

31.3.2012	Closing Stock A/c Dr. To Trading A/c (For Closing stock transferred to Trading A/c)	30,000	30,000

(b) Trading A/c of Mr. X for the year ending 31.3.2012

Dr. **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
		By Closing Stock	30,000

(c) **Balance Sheet of Mr. X as on 31.3.2012**

Liabilities	Amount (₹)	Assets	Amount (₹)
		Closing Stock	30,000

Note : If Closing stock is given inside the Trial balance, the above mentioned adjustment entry will not be passed and the closing stock will not be shown on the credit side of Trading A/c. The closing stock will be shown on the assets side of Balance Sheet only.

ii) Outstanding Expenses

An expense which relates to the current year but has not been paid till the end of the accounting year is known as outstanding expenses such as Factory rent, Wages, Salaries, Office rent, Telephone charges etc. for current year may not have been paid till the end of the accounting year, for example the books of accounts of Mr. X showed that, Wages paid during the year 2011-2012 ₹ 45,000. Wages outstanding for the year 2011-2012 ₹ 5,000.

The accounting treatment of wages outstanding in the books of Mr.X will be as follows:

(a) The adjustment entry will be:

31.3.2012	Wages A/c Dr. Wages outstanding A/c (For wages outstanding for the year 2011-12)	5,000	 5,000

(b) **Trading A/c of Mr. X for the year ending 31.3.2012**

Dr. **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
Wages : 45,000 (+) Wages O/S : 5,000	50,000		

(c) **Balance Sheet of Mr. X as on 31-3-2012**

Liabilities	Amount (₹)	Assets	Amount (₹)
Wages Outstanding	5,000		

Let us take another example, regarding outstanding salary which affects the net profit.

Example: The books of accounts of Mr.X showed the following:

Salaries for the year 2011-12 already paid during the year ₹ 1,00,000. Salaries for 2011-12 due but not paid till 31-3-12 ₹ 10,000. Its accounting treatment in the books of Mr.X will be as follows.

(a) Adjustment entry will be as under:

31.3.2012	Salaries A/c Dr. To Salaries outstanding A/c (For salary outstanding for the year 2011-12)	10,000	 10,000

(b) **Profit & Loss A/c for Mr.X**
For the year ending 31-3-2012

Particulars	Amount (₹)	Particulars	Amount (₹)
To Salaries : 1,00,000 (+) Salaries O/S : 10,000	 1,10,000		

(c) **Balance Sheet**
as on 31-3-2012

Liabilities	Amount (₹)	Assets	Amount (₹)
SalariesOutstanding	10,000		

INTEXT QUESTIONS 15.1

Give exact term for your answer :

i. Stock remains unsold at the end of year.

ii. Amount not paid for the good or services whose benefits was already availed.

iii. Value of unsold goods shown outside the trial balance as additional information.

iv. Transaction shown outside the trial balance to be incorporated before the preparation final accounts.

iii) Prepaid Expenses

Sometimes, a part of the expenses given in the trial balance may relate to future year(s). Such part of expenses is known as 'Prepaid Expenses' or 'Expense paid in

Advance' such as, out of the salaries paid during the current year, a part may relate to next accounting year. Similarly factory rent, wages, office rent, insurance premium, taxes, etc. may be prepaid in some cases. For example the books of accounts of Mr.X showed the following:

Total salaries paid during the accounting year 2011-2012 ₹ 2,00,000 out of which ₹ 25,000 relates to the next accounting year, i.e, 2012-13. The accounting treatment, of prepaid salaries in the books of Mr. X will be as follows:

(a) Adjustment entry for prepaid salaries will be as under:

31.3.2012	Prepaid Salaries A/c Dr. To Salaries A/c (For salaries paid in advance for next year 2012-13)	25,000	25,000

(b) **Profit & Loss A/c for Mr.X for the year ending31-3-2012**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Salaries : 2,00,000 (-)Prepaid Salaries : 25,000	1,75,000		

(c) **Balance Sheet of Mr.X as on 31-3-2012**

Liabilities	Amount (₹)	Assets	Amount (₹)
		Prepaid Salaries	25,000

iv) Depreciation on Fixed Assets

The value of fixed assets such as Plant and Machinery, Building, Furniture, Computers, Motor Vehicles, etc. goes on decreasing or reducing every year due to their use, wear and tear. This decrease in the value of assets is called depreciation.

Depreciation is an expense like any other expense of the business.

Depreciation on various fixed assets is shown on the debit side of P&L A/c.

The amount of depreciation on fixed asset is deducted from the concerned or related asset on the asset side of Balance Sheet. For example the books of accounts of Mr. X showed the following:

The value of Plant and Machinery is ₹ 5,00,000 as on 31-3-2012 and value of Furniture is ₹ 50,000 as on 31-3-2012. Depreciation is to be charged on these assets @10% p.a. The accounting treatment of depreciation in the financial statements of Mr. X, will be as follows :

(a) Entry for charging depreciation will be as under:

31-3-2012	Depreciation A/c Dr. To Plant&Machinery A/c To Furniture A/c (For depreciation charged on Plant and Machinery and Furniture @10% for one year)	55,000	 50,000 5,000

(b) **Profit & Loss A/c for Mr. X**
Dr. for the year ending 31-3-2012 Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Depreciation on Plant & Machinery Furniture	 50,000 5,000		

(c) **Balance Sheet of Mr.X**
as on 31-3-2012

Liabilities	Amount (₹)	Assets		Amount (₹)
		Plant & Machinery (-) Dep.	5,00,000 50,000	4,50,000
		Furniture (-) Dep.	50,000 5,000	45,000

INTEXT QUESTIONS 15.2

Match column 'A' with column 'B'

'A'		'B'	
i.	Closing Stock	(a)	Deducted from the value of assets
ii.	Outstanding Expenses	(b)	Those expenses which have not became due but have been paid during the accounting year in question.
iii.	Depreciation	(c)	Those expenses which have became due but have not been paid in the concerned accounting year.
iv.	Prepaid expenses	(d)	Shown an the credit side of Trading A/c.

Illustration 1

From the following trial balance of M/s Kaushal Traders, prepare Trading and Profit and Loss Account for the year ended 31st March 2012 and a Balance Sheet as on that date :

Dr. Balances	₹	Cr. Balances	₹
Opening stock on 1st April, 2011	16,000	Capital	80,000
Purchases	75,000	Sales	2,00,000
Sales returns	5,000	Purchases returns	2,000
Carriage inwards	1,500	Discount	500
Plant and Machinery	40,000	Sundry creditors	10,000
Furniture and fixtures	5,000	Bills payable	1,500
Freehold property	45,650		
Cash in hand	5,000		
Carriage outwards	400		
Wages	30,000		
Salaries	18,000		
Lighting (factory)	800		
Sundry debtors	28,000		
Travelling expenses	1,200		
Rent and taxes	4,800		
Drawings	5,000		
Insurance	450		
General expenses	12,200		
	2,94,000		**2,94,000**

Adjustments :

i. Stock on 31st March 2012 was valued at ₹ 38,000 (market value ₹ 20,000).

ii. Wages amounting to ₹ 2,000 and salaries amounting to ₹ 1,500 are outstanding.

iii. Prepaid insurance amounted to ₹ 150.

iv. Provide depreciation on plant and machinery at 5% and on furniture and fixtures at 10%.

Solution

Trading and Profit and Loss Account
Dr. for the year ending 31st March, 2012 Cr.

Particulars		Amount ₹	Particulars		Amount ₹
To Opening stock		16,000	By Sales	2,00,000	
To Purchases	75,000		*Less* : Sales returns	5,000	1,95,000
Less : Purchases returns	2,000	73,000	By Closing stock		20,000[1]
To Carriage inwards		1,500			
To Wages	30,000				
Add : Outstanding wages	2,000	32,000			
To Factory lighting		800			
To Gross profit c/d		91,700			
		2,15,000			**2,15,000**

To Carriage outwards		400	By Gross profit b/d	91,700
To Salaries	18,000		By Discount	500
Add : Outstanding salaries	1,500	19,500		
To Travelling expenses		1,200		
To Rent and taxes		4,800		
To Insurances	450			
Less : Prepaid insurance	150	300		
To General expenses		12,200		
To Depreciation on :				
Pland and machinery	2,000			
Furniture and fixtures	500	2,500		
To Net profit transferred to Capital A/c		51,300		
		92,200		**92,200**

Balance Sheet
as on 31st March 2012

Liabilities		Amount ₹	Assets		Amount ₹
Bills payable		1,500	Cash in hand		5,000
Sundry creditors		10,000	Sundry debtors		28,000
Outstanding wages		2,000	Closing stock		20,000[1]
Outstanding salaries		1,500	Prepaid insurance		150
Capital	80,000		Furnitures and fixtures	5,000	
Add : Net profit	51,300		*Less* : Depreciation	500	4,500
	1,31,000		Plant and machinery	40,000	
Less : Drawings	5,000	1,26,300	*Less* : Depreciation	2,000	38,000
			Freehold property		45,650
		1,41,300			**1,41,300**

Note : (1) Closing stock is valued at cost price or market price whichever is less.

Illustration 2

From the following trial Balance of M/s. Gupta Furnitures as on 31st December, 2012 you are required to prepare a Trading and Profit & Loss A/c for the year ended 31st Dec. 2012 and a Balance Sheet as at that date after making the necessary adjustments. Trial Balance of M/s. Gupta Furniture as at 31.12.2012.

Particulars	Dr (₹)	Cr. (₹)
Capital A/c of Mr. Gupta		80,000
Cash in hand	540	
Cash in bank	2,630	
Purchase A/c	43,120	
Sales A/c		78,100
Wages A/c	10,480	
Fuel and Power A/c	4,730	

Carriage on Sales A/c	3,200	
Carriage on Purchase A/c	2,040	
Stock (on 1-1-2012)	5,760	
Land & Building A/c	40,000	
Machinery A/c	20,000	
Salaries A/c	15,000	
Insurance A/c	600	
Sundry Debtors A/c	20,000	
Sundry Creditors A/c		10,000
	1,68,100	**1,68,100**

Taking into consideration the following adjustments, make necessary journal entries and prepare final accounts.

i. Stock on hand 31.12.2012 is ₹ 5,000
ii. Machinery is to be depreciated @ 10% p.a.
iii. Salaries for the month of December outstanding amounted to ₹ 3,500.
iv. Insurance prepaid for 3 months.

Solution

2012	Adjusting Entries		(₹)	(₹)
Dec. 31	Closing stock A/c	Dr.	5,000	
	To Trading A/c			5,000
	(For closing stock taken into account)			
Dec. 31	Depreciation A/c	Dr.	2,000	
	To Machinery			2,000
	(For depreciation charged on machinery @ 10%)			
Dec. 31	Salaries A/c	Dr.	3,500	
	To Salaries Outstanding			3,500
	(For outstanding salaries provided for)			
Dec. 31	Prepaid Insurance A/c	Dr.	150	
	To Insurance A/c			150
	(For prepaid insurance taken into account)			

Trading Account of M/s. Gupta Furnitures
for the year ended on 31st Dec. 2012

Dr. **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Stock (1.1.12)	5,760	By Sales	78,100
To Purchases	43,120	By Stock (31.12.12)	5,000

To Wages	10,480		
To Fuel and Power	4,730		
To Carriage on Purchase	2,040		
To Gross Profit transferred to Profit & Loss A/c	16,970		
	83,100		**83,100**

Profit and Loss A/c
for the year ended on 31st December, 2012

Particulars		Amount (₹)	Particulars	Amounts (₹)
To Carriage on Sales		3,200	By Gross Profit b/d	16,970
To Salaries	15,000		By Net Loss transferred to	
Add : Outstanding	3,500	18,500	capital A/c of Mr. Gupta	7,180
To Insurance	600			
Less : Prepaid	150	450		
To Depreciation on Machinery		2,000		
		24,150		**24,150**

Balance Sheet of M/s. Gupta Furnishers
as on 31st December, 2012

Liabilities		Amount (₹)	Assets		Amount (₹)
Sundry Creditors		10,000	Cash in hand		540
Outstanding Salaries		3,500	Cash at bank		2,630
Capital A/c of Mr. Gupta	80,000		Sundry Debtors		20,000
Less : Net Loss	7,180	72,820	Closing Stock		5,000
			Prepaid Insurance		150
			Land and Building		40,000
			Machinery A/c	20,000	
			Less : Depreciation	2,000	18,000
		86,320			**86,320**

INTEXT QUESTIONS 15.3

I. Mention whether the following statements are True or False

i. Financial statements prepared without considering adjustments do not reflect the correct financial positions of the business.

ii. The accounting treatment of adjustments is done only in Balance Sheet.

iii. The Accounting treatment of adjustment entry is done only in Trading Account or Profit & Loss Account.

iv. Adjustments are always related to future.

II. Fill in the blanks

i. Closing stock is shown on the .... side of Balance sheet.

ii. Outstanding Expenses are shown on the .... side of Balance Sheet.

iii. Prepaid expenses are shown on the .... side of Balance sheet.

iv. Depreciation is shown on the................. side of profit and loss A/c.

v. Closing stock is shown on the asset side of...............

vi. The decrease in the value of fixed asset due to their use is called.........

vii. Adjustments are made to know the correct.................of a business.

viii. Outstanding wages shown on the................. of the ....

ix. Outstanding office Rent will be shown on the................side of...........and .... side of Balance sheet.

x. Profit and Loss A/c is prepared to know ....of an accounting year.

III. Multiple Choice Questions

i. When no adjustment is done for outstanding wages. Gross profit ascertained will be

a) more than the actual b) less than the actual

c) equal to the actual d) will not be affected

ii. Prepaid expenses are expenses

a) paid in advance b) outstanding expenses

c) expenses incurred for the current year

d) expenses paid for the previous year

iii. Depreciation is debited to

a) Trading account b) profit and loss account

c) concerned asset account d) none of the above

iv. An item of adjustment is shown
a) only in trading account
b) only in profit and loss account
c) only in balance sheet
d) in trading account or P&L A/c and also in Balance Sheet

WHAT YOU HAVE LEARNT

- Necessary adjustments are required at the time of preparation of financial statements in order to ascertain the correct profit and financial position of the business.
- Closing stock is the stock of goods which remains unsold at the end of an accounting year. Adjustment is done in Trading Account and Balance Sheet.
- Outstanding Expenses refer to the expenses relating to current year but which have not been paid during the current year. Adjustments is done in Trading Account, Profit and Loss Account and Balance Sheet.
- Prepaid Expenses or expense paid in advance refer to those expenses which relate to future year. Adjustments is done in trading account, profit & loss account and balance sheet.
- Depreciation on fixed Assets refers to Decrease in the value of fixed assets due to their use, wear and tear. Adjustment is done in profit and loss account and balance sheet.

TERMINAL EXERCISE

1. What is meant by an adjustment entry?
2. Why is it necessary to pass adjusting entries in financial statements?
3. Write short notes on :-
   a) Outstanding Expenses b) Prepaid Expenses
4. Explain the following adjustments and their treatment in the financial statements : a) Closing Stock b) Depreciation

5. From the following trial balance of M/s Sakshi Garments. Prepare Trading & Profit and Loss Account for the year ending 31st March 2012 and Balance Sheet as on that date.

Particulars	Dr. (₹)	Particulars	Cr. (₹)
Stock (1.4.2011)	13,800	Capital	65,000
Purchases	52,000	Sales	74,400
Wages	4,000	Purchase return	1,500

Sales Returns	2,400	Discount	450
Land & Building	40,000	Creditors	6,500
Plant & Machinery	24,500	Interest	600
Debtors	5,250	Commission	700
Cash in hand & bank	8,750	Bank Loan	26,000
Office Rent	2,200		
Postage	400		
Insurance	1,500		
Freight	1,400		
Fuel & Power	2,450		
Furniture	4,500		
Motor Car	12,000		
	1,75,150		**1,75,150**

Adjustments

i. Stock on 31.3.2012 ₹ 25,000

ii. Write off depreciation on furniture 10% and on Plant & Machinery 20%

iii. Wages outstanding amounted to ₹ 650 and rent outstanding was ₹200. Pre-paid insurance amounted to ₹ 300.

6. From the following particulars for the year ending 31.3.2012 of M/s Pant. Bros. prepare Trading Account, Profit & Loss Account and a Balance Sheet as on 31.3.2012

Particulars	Dr. (₹)	Particulars	Cr. (₹)
Capital	4,00,000	Salaries	1,20,000
Opening Stock	85,000	Rent & Taxes	40,000
Purchases	4,20,000	Postage & Telegrams	25,000
Creditors	75,000	Interest Paid	20,000
Debtors	1,20,000	Furniture	2,00,000
Sales	8,10,000	Insurance	1,00,000
Discount received	18,000	Freight	20,000
Discount allowed	16,000	Cash in hand	50,000
Purchases Returns	20,000	Cash at bank	47,000
Sales Returns	10,000	Motor car	50,000

Adjustments

1. Closing stock valued as on 31.3.2012 ₹ 1,70,000
2. Salaries outstanding ₹ 12,000
3. Charge depreciation on Motor Car @ 10% P.A.

7. From the following information of M/s Bhanumati Traders you are required to prepare Trading Account, Profit & Loss Account and Balance Sheet as on 31st March 2012.

Particulars	(₹)	Particulars	(₹)
Capital	2,00,000	Stock on 1-4-11	62,000
Drawings	10,000	Purchases	1,40,000
Plant & Machinery	1,00,000	Sales	2,30,000
Salaries	14,000	Purchases Returns	2,600
Printing & Stationery	2,000	Sales Returns	4,200
Discount Allowed	1,500	Freight	1,200
Debtors	25,000	Cash in hand	32,000
Creditors	40,000	Cash at bank	50,000
Insurance	3,000	Land & Building	50,000
Postage	600		
Office Rent	2,600		

Adjustments

Outstanding wages as on 31 March 2012 - ₹ 2,500
Outstanding Salaries ₹ 700
Prepaid Insurance ₹ 400
Closing stock ₹ 44,000

8. From the following information received from the books of Mr. Sahil on 31.3.2012, you are required to prepare the Trading Account & Profit & Loss Account for the year ending 31.3.2012 and a Balance Sheet as on 31.3.2012

Particulars	(₹)	Particulars	(₹)
Opening Stock	37,000	Capital	1,62,000
Purchases	93,500	Drawings	1,60,000
Wages	28,000	Discount received	1,600
Sales	2,49,000	Sundry Creditors	43,000
Salaries	11,000	Loan	30,000
Rent	5,500	Cash in hand	37,300
Interest Paid	2,700	Cash at bank	37,300
Discount Allowed	2,400	Debtors	86,000
Postage & Telegram	2,000	Furniture	21,400
Printing & Stationery	1,800	Motor Car	20,000
Sales Expenses	2,200	Building	60,000
Insurance Premium	5,500	Plant & Machinery	16,000

Adjustments

i. Closing stock was valued at ₹ 30,000

ii. Depreciate

(a) Building by 5% p.a.

(b) Furniture – 10% p.a.

(c) Land & Building – 15% p.a.

(d) Motor Car – 20% p.a.

iii. Rent outstanding ₹1,500

iv. Prepaid Insurance ₹ 300

ANSWER TO INTEXT QUESTIONS

15.1 (i) closing stock (ii) outstanding expenses
(iii) closing stock (iv) adjustments

15.2 (i) d (ii) c (iii) a (iv) b

15.3 **I.** (i) True (ii) False (iii) False (iv) False

II. (i) asset (ii) Liability (iii) Asset (iv) Debit
(v) Balance Sheet (vi) Depreciation
(vii) Financial position (viii) Liability side, Balance Sheet
(ix) Debit side Trading A/c, Liability
(x) Profit or Losses

III. (i) a (ii) a (iii) a (iv) d

ACTIVITY FOR YOU

- Assuming that your father is a businessmen, running a small shop as a sole proprietor and maintains the accounts of the business of his own. As a student of Accountancy one day you came to know that no adjustment entry was done by your father while preparing final accounts of his business. You are required to reprepare the final accounts by passing necessary adjustment entries in your father business books of account.

MODULE - VI

Maximum Marks	Hours of Studies
9	18

Computer in Accounting

This module will enable the learners to understand the meaning and characteristics of a computer with its components and limitations. It also emphasises on use of computers in Accouning. It will also make you to learn the difference between manual accounting and computerised accounting. One should be able to know the basic requirements of computerised accouning. Once you are able to know the use and importance of computers in accouning you must understand the meaning, features and importants steps for starting Tally ERP 9.0, together with how to create a company in Tally.

Awards Won by NIOS

Web Ratna Awards 2012 Platinum Icon under Outstanding Web Content for Acknowledging exemplary initiatives/practices in the realm of e-Governance for dissemination of information & services instituted by Department of Information Technology, Ministry of Communications & IT (MC&IT) and National Informatic Centre (NIC), Government of India. The award has been conferred by Hon'ble Minister of Communications and Information Technology Shri Kapil Sibal on 10th December 2012 at Dr. D.S Kothari Auditorium, DRDO Bhawan, Dalhousie Road, New Delhi.

TOI Social Impact Award 2012

NIOS has been selected as winner of the Social Impact Award 2012 instituted by Times of India in partnership with J P Morgan The Award is given in the recognition of magnificent work done by an individual or groups or institutions making an impact in the society in various segment including Education. NIOS feels honoured to accept the award.

The award was conferred on 28th January 2013 at a function in presence of President of India and high level dignitaries.

National Awards for the Empowerment of Persons with Disabilities, 2012

The NIOS received the National Award for the Empowerment of persons with disabilities, 2012 Instituted by Ministry Social Justice and Empowerment, Govt. of India. The NIOS got this award under the category of best accessible Website for making its website www.nios.ac.in completely accessible for person with disabilities. The website is bilingual in Hindi and English. It also has provisions of Screen Reader, increasing text size, colour contrast scheme etc. for disabled learners. This award was conferred by the Hon'ble President of India at Vigyan Bhawan, New Delhi on 6th February, 2013. Dr. S.S. Jena Chairman, NIOS received the award.

16

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COMPUTERS IN ACCOUNTING

With the expansion of business, the number of transactions have increased and as a result the manual method of keeping and maintaining records has become unmanageable. With the introduction of computers in business, the manual method of accounting is being gradually replaced. The database technology has revolutionized the accounts department of the business enterprises. In this lesson, we will study about the features of a computer, role of computers in accounting, need of computerized accounting, etc.

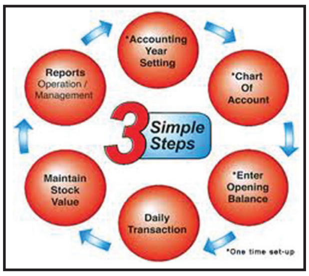
OBJECTIVES

After studying this lesson, you will be able to:

- state the meaning and characteristics of a computer;
- describe the components of a computer;
- explain the limitations of a computer;
- explain the role of computers in accounting;
- differentiate between manual accounting and computerized accounting;
- state the need for computerized accounting and
- describe the basic requirements of computerized accounting.

16.1 COMPUTER AND ITS CHARACTERISTICS

Computer is an electronic device that can perform a variety of operations in accordance with a set of instructions called programme. It is a fast data processing electronic machine. It can provide solutions to all complicated situations. It accepts data from the user, converts the data into information and gives the desired result. Therefore, we may define computer as a device that transforms data into information. Data can be anything like marks obtained in various subjects. It can also be name, age, sex, weight, height, etc. of all the students, savings, investments, etc., of a country. Computer is defined in terms of its functions. Computer is a device that accepts data, stores data, processes data as desired, retrieves the stored data as and when required and prints the result in desired format.



Characteristics of Computer

A computer is better than human being in various aspects and it possesses some characteristics, which are as follows:

i) **Speed :** It can access and process data millions times faster than humans can. It can store data and information in its memory, process them and produce the desired results. It is used essentially as a data processor. All the computer operations are caused by electrical pulses and travels at the speed of light. Most of the modern computers are capable of performing 100 million calculations per second.

ii) **Storage :** Computers have very large storage capacity. They have the capability of storing vast amount of data or information. Computers have huge capacity to store data in a very small physical space. Apart from storing information, today's computers are also capable of storing pictures and sound in digital form.

iii) **Accuracy :** The accuracy of computer is very high and every calculation is performed with the same accuracy. Errors occur because of human beings rather than technological weakness; main sources of errors are wrong program by the user or inaccurate data.

iv) **Diligence :** A computer is free from tiredness and lack of concentration. Even if it has to do 10 million calculations, it will do even the last one with the same accuracy and speed as the first.

v) **Versatility :** Computer can perform wide range of jobs with speed, accuracy, and diligence. In any organization, often it is the same computer that is used for diverse purposes such as accounting, playing games, preparing electric bills, sending e-mails and so on.

vi) **Communication :** Computers are being used as powerful communication tools. All the computers within an office are connected by cable and it is possible to communicate with others in the office through the network of computers.

vii) **Processing Power :** Computer has come a long way today. They began as mere prototypes at research laboratories and went on to help the business enterprises, and today, their reach is so extensive that they are used almost everywhere. In the course of this evolution, they have become faster, smaller, cheaper, more reliable and user friendly.

16.2 COMPONENTS OF A COMPUTER

A computer consists of three major components i.e., Input Unit, central Processing Unit and Output Unit. Diagrammatically, these components may be presented as follows:

- Computer Components
  - Input Unit
  - Central Porcessing Unit (CPU)
    - Control Unit
    - Memory Unit
    - Arithmetic Logic Unit (ALU)
  - Output Unit

Input Unit

Input unit is controlling the various input devices which are used for entering data into the computer. The mostly used input devices are keyboard, mouse and scanner. Other such devices are magnetic tape, magnetic disk, light pen, bar code reader, smart card reader, etc. Besides, there are other devices which respond to voice and physical touch for e.g. Physical touch system is installed at airport for obtaining the online information about departure and arrival of flight. The input unit is responsible for taking input and converting it into binary system.

Central Processing Unit (CPU)

The CPU is the control centre for a computer. It guides, directs and governs its performance. It is the brain of the computer. The main unit inside the computer is the Central Processing Unit. This is used to store program, photos, graphics, and data and obey the instructions in program. It is divided into three sub units: i) Control Unit ii) Memory Unit and iii) Arithmetic Logic Unit (ALU).

i) **Control Unit :** Control Unit controls and co-ordinates the activities of all the components of the computer.

ii) **Memory Unit :** This unit stores data before being actually processed. The data so stored is accessed and processed according to instruction which are also stored in the memory section of computer well before such data is transmitted to the memory from input devices.

iii) **Arithmetic and Logic Unit :** It is responsible for performing all the arithmetical calculations and computations such as addition, subtraction, division and multiplication. It also performs logical functions involving comparisons among variable and data items.

Output Unit

After processing the data, it ensures the convertibility of output into human readable form that is understandable by the user. The commonly used output devices include monitor, plotter, printer, speaker, etc.

INTEXT QUESTIONS 16.1

Fill in the blanks with correct word/words

i. Computer is a fast data __________ electronic machine.

ii. All the computer operations are caused by _________ pulses and travels at the speed of light.

iii. A computer is free from __________ and lack of concentration.

iv. Computers are being used as powerful __________ tools.

v. The mostly used input devices are keyboard, __________ and scanner.

vi. Central Processing Unit is to computer, as the __________ is to human body

vii. The commonly used output devices include __________ printer etc.

16.3 LIMITATIONS OF A COMPUTER

The limitations of computer are due to the operating environment they work in. These limitations are given as below :

i) **High Cost of Installation :** Computer hardware and software need to be updated from time to time with availability of new versions. As a result heavy cost is incurred to purchase a new hardware and software every time there is a change in the existing version.

ii) **High Cost of Training :** To ensure efficient use of computers in accounting, new versions of hardware and software are introduced. This requires training and cost is incurred to train the personnel.

iii) **Self Decision Making Not Possible :** The computer cannot make a decision like human beings. It is to be guided by the user, and work only the way it is programmed to function.

iv) **Costly Maintenance :** Computers require to be maintained properly to help maintain its efficiency. It requires a neat, clean and controlled temperature to work efficiently which results into costly maintenance.

v) **Dangers for Health :** Extensive use of computer may lead to many health problems such as muscular pain, eyestrain, and backache, etc. This affects adversely the working efficiency and increasing medical expenditure.

16.4 APPLICATIONS OF COMPUTER IN ACCOUNTING

The most popular system of recording of accounting transaction is manual which requires maintaining books of accounts such as Journal, Cash Book, Special purpose books, Ledger and so on. The accountant is required to prepare summary of transactions and financial statements manually. The advance technology involves various machines capable of performing different

accounting functions, for example, a billing machine known as computer. This machine is capable of computing discount, adding net total and posting the requisite data to the relevant accounts.

With substantial increase in the number of transactions, a machine was developed which could store and process accounting data in no time. Such advancement leads into the growth of successful enterprises. A newer version of machine is evolved with increased speed, storage, and processing capacity. A computer to which these were connected operated these machines. As a result, the maintenance of accounting records become more convenient with the computerized accounting.

The computerized accounting uses the concept of databases. For this purpose an accounting software is used to implement a computerized accounting system. It does away the necessity to create and maintain journals, ledgers, etc., which are essential part of manual accounting. Some of the commonly used accounting softwares are Tally, Cash Manager, Best Books, Busy, etc.

Accounting software is used to implement computerized accounting. The computerized accounting is based on the concept of database. It is basic software which allowed access to the data contained in the data base. It is a system to manage collection of data ensuring at the same time that it remains reliable and confidential.

Following are the applications of computers in accounting:

i) **Preparation of accounting documents :** Computer helps in preparing accounting documents like Cash memo, Bills, and Invoices etc., and preparing accounting vouchers.

ii) **Recording of transactions :** Everyday business transactions are recorded with the help of computer software. Logical scheme is implied for codification of accounts and transaction. Every account and transaction is assigned a unique code which put that account in a particular group. This process simplifies the work of recording the transactions.

iii) **Preparation of Trial Balance and Financial Statements :** After recording of transaction, the data is transferred into ledger accounts automatically by the computer. Trial balance is prepared by the computer to check accuracy of the records. With the help of the trial balance the computer can be programmed to prepare Trading and Profit and Loss Account and Balance Sheet.

16.5 COMPUTERIZED ACCOUNTING

Transaction processing system (TPS) is the first stage of computerized accounting system. The purpose of any TPS is to record, process, validate and store transaction that occur in various functional areas of a business for subsequent retrieval and usage. TPS involves following steps in processing a transaction: Data Entry, Data Validation, Processing and Revalidation, Storage, Information and Reporting. It is one of the transaction processing systems which is concerned with financial transactions only. When a system contains only human resources it is called manual system; when it uses only computer resources, it is called computerized system and when it uses both human and computer resources, it is called computer-based system. These steps can be explained with an example making use of automatic Teller Machine (ATM) facility by a Bank-customer.

i) **Data Entry :** Processing presumes data entry. A bank customer operates an ATM facility to make a withdrawal. The actions taken by the customer constitute data which is processed after validation by the computerized personal banking system.

ii) **Data Validation :** It ensures the accuracy and reliability of input data by comparing the same with some predefined standards or known data. This validation is made by the 'Error Detection' and 'Error Correction' procedures. The control mechanism, wherein actual input data is compared with predetermined norms is meant to detect errors while error correction procedures make suggestions for entering correct data input. The Personal Identification Number (PIN) of the customer is validated with the known data. If it is incorrect, a suggestion is made to indicate the PIN is invalid. Once the PIN is validated, the amount of withdrawal being made is also checked to ensure that it does not exceed a pre-specified limit of withdrawal.

iii) **Processing and Revalidation :** The processing of data occurs almost instantaneously in case of Online Transaction Processing (OLTP) provided a valid data has been fed to the system. This is called check input validity. Revalidation occurs to ensure that the transaction in terms of delivery of money by ATM has been duly completed. This is called check output validity.

iv) **Storage :** Processed actions, as described above, result into financial transaction data i.e. withdrawal of money by a particular customer, are stored in transaction database of computerized personal banking system. This makes it absolutely clear that only valid transactions are stored in the database.

v) **Information :** The stored data is processed making use of the Query facility to produce desired information.

vi) **Reporting :** Reports can be prepared on the basis of the required information content according to the decision usefulness of the report.

INTEXT QUESTIONS 16.2

Fill in the blanks with correct word/words:

1. Computer hardware and __________ need to be updated from time to time.
2. The ___________ cannot make a decision itself like human beings.
3. _______ requires a neat, clean and controlled temperature to work efficiently.
4. The most popular system of recording of accounting transactions is _______.
5. The computerized accounting uses the concept of __________.
6. Accounting ________ is used to implement a computerized accounting.

16.6 NEED AND REQUIREMENTS OF COMPUTERIZED ACCOUNTING

The need for computerized accounting arises from advantages of speed, accuracy and lower cost of handling the business transactions. These have been explained below:

i) **Numerous transactions :** The computerized accounting system is capable of handling large number of transactions with speed and accuracy.

ii) **Instant reporting :** The computerized accounting system is capable of offering quick and quality reporting because of its speed and accuracy.

iii) **Reduction in paper work :** A manual accounting system requires large physical storage space to keep accounting records/books and vouchers/ documents. The requirements of stationary and books of accounts along with vouchers and documents is directly dependent on the volume of transactions beyond a certain point. There is a need to reduce the paper work and dispense with large volume of books of accounts. This can be achieved by introducing computerized accounting system.

iv) **Flexible reporting :** The reporting is flexible in computerized accounting system as compared to manual accounting system. The reports of a manual accounting system reveal balances of accounts on periodic basis while computerized accounting system is capable of generating reports of any balance as and when required and for any duration which is within the accounting period.

v) **On-line facility :** Computerized accounting system offers online facility to store and process transaction data so as to retrieve information to generate and view financial reports.

vi) **Scalability :** Computerized accounting systems are fully equipped with handling the growing transactions of a fast growing business enterprise. The requirement of additional manpower in Accounts department is

Notes

restricted to only the data operators for storing additional vouchers. There is absolutely no additional cost of processing additional transaction data.

vii) **Accuracy :** The information content of reports generated by the computerized accounting system is accurate and therefore quite reliable for decision making. In a manual accounting system the reports and information are likely to be distorted, inaccurate and therefore cannot be relied upon. It is so because by many people, especially when the number of transactions to be processed to produce such information and report is quite large.

viii) **Security :** Under manual accounting system it is very difficult to secure such information because it is open to inspection by any one dealing with the books of accounts. However, in computerized accounting system only the authorized users are permitted to have access to accounting data. Security provided by the computerized accounting system is far superior compared to any security offered by the manual accounting system.

16.7 BASIC REQUIREMENTS OF THE COMPUTERIZED ACCOUNTING SYSTEM

The basic requirements of any computerized accounting system are the following:-

i) **Accounting framework :** It is the application environment of the computerized accounting system. A healthy accounting framework in terms of accounting principles, coding and grouping structure is a pre-condition for any computerized accounting system.

ii) **Operating procedure :** A well-conceived and designed operating procedure blended with suitable operating environment of the enterprise is necessary to work with the computerized accounting system. The computerized accounting is one of the database-oriented applications wherein the transaction data is stored in well-organized database. The user operates on such database using the required interface and also takes the required reports by suitable transformations of stored data into information.

16.8 DIFFERENCE BETWEEN MANUAL ACCOUNTING AND COMPUTERIZED ACCOUNTING

Basis	Manual Accounting	Computerized Accounting
1. Recording	Recording of financial transactions is through books of original entry.	Data content of these transactions is stored in well designed data base.

2. Classification	Transactions recorded in the books of original entry are further classified by posting them into ledger accounts.	No such data duplications is made. In order to produce ledger accounts the stored transaction data is processed to appear as classified so that same is presented in the form of report.
3. Summarising	Transactions are summarized to produce trial balance by ascertaining the balances of various accounts.	The generation of ledger accounts is not a necessary condition for preparation of Trial Balance.
4. Adjusting	Adjusting entries are made to adhere to the principle of matching.	There is nothing like making adjusting entries for errors and rectifications.
5. Financial Statements	The preparation of financial statements assumes availability of trial balance.	The preparation of financial statements is independent of producing the trial balance.

INTEXT QUESTIONS 16.3

I. Fill in the blanks with correct word/words :

i. In a manual accounting system, transactions recorded in the books of __________.

ii. The generation of ledger accounts is not a necessary condition for making __________ in a computerized accounting system.

iii. The computerized accounting system if capable of handling __________ of transactions.

iv. The __________ accounting system is capable of offering quick and quality reporting.

v. Computerized accounting system offers __________ facility to store transaction data.

vi. Computerized accounting system is ________ to the manual accounting system.

vii. The computerized accounting is one of the ______ oriented applications.

II. Multiple Choice Questions

i. Which one is not the characteristic of computer?

a) Speed b) Artificial Intelligence

c) Storage d) Versality

ii. Central Processing Unit (CPU) does not include
a) Control Unit b) Memory Unit
c) Arithmetic Logic Unit d) Output Unit

iii. The main limitation of computer is
a) Speed b) Storage
c) Self decision making not possible d) versality

iv. Commonly accounting software is
a) Tally b) Window
c) Easy Books d) Credit Manager

v. Which one is not the basic requirements of Computerized Accounting System?
a) Accounting framework b) Operating Procedure
c) Well Organised database d) Bank account

WHAT YOU HAVE LEARNT

- Computer is an electronic device that can perform a variety of operations in accordance with a set of instructions called programme. It is a fast data processing electronic machine. It can provide solutions to all complicated situations.
- Characteristics of Computer : Speed, storage, accuracy, diligence, versatility, communication, processing, power
- Components of Computer :Input Unit, Central Processing Unit, Output Unit, Control Unit, Memory, Arithmetic Unit and Logic Unit
- Limitations of a Computer : Cost of maintenance, installation, training, dangers for health, self-decision making not possible
- Computerized Accounting : Transaction Processing System (TPS) is the first stage of computerized accounting system.
- Need for computerized accounting : Numerous, instant reductions, flexible, online, accuracy, security, transactions reporting in paper, reporting facility.
- Difference between manual accounting and computerized accounting on the basis of recording, classification, summarizing, adjusting and financial statement

TERMINAL EXERCISE

1. What is meant by a Computer?
2. State the characteristics of a Computer.
3. Explain the components of computer.

4. Explain the limitations of a computer.
5. Explain the role of computers in accounting.
6. Differentiate between manual accounting and computerized accounting system.
7. Enumerate the basic requirements of any computerized accounting system.
8. Briefly explain the applications of computerized accounting.
9. Describe the stages of transaction processing system.
10. Why is computerized accounting needed? Explain.

ANSWER TO INTEXT QUESTIONS

16.1 (i) Processing (ii) Electrical (iii) Tiredness (iv) Communication
(v) Mouse (vi) Brain (vii) Monitor

16.2 (i) Software (ii) Computer (iii) Computer (iv) Manual
(v) Databases (vi) Software

16.3 **I.** (i) Original entry (ii) Trial balance (iii) Large number
(iv) Computerized (v) Online (vi) Superior
(vii) Database

II. (i) b (ii) d (iii) c (iv) a (v) d

ACTIVITY FOR YOU

- Visit a shop or business organisation near your residence where computer are used to maintain accounts and note ten points as benefits of using computers in accounting than manual accounting.