FINANCIAL & MANAGEMENT ACCOUNTING
KHARAGPUR COLLEGE
PAPER CODE-1204
2ND SEMESTER

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1. OVERVIEW

This chapter covers the following topics:

- Definition of Accounting
- Objectives & Scope
- Accounting Process
- Accounting Concepts
- Accounting Conventions
- Classification of Accounts
- System of Accounting
- Rules of Double Entry Accounting System

Introduction

Accounting is a business language. We can use this language to communicate financial transactions and their results. Accounting is a comprehensive system to collect, analyze, and communicate financial information.

The origin of accounting is as old as money. In early days, the number of transactions were very small, so every concerned person could keep the record of transactions during a specific period of time. Twenty-three centuries ago, an Indian scholar named *Kautilya* alias *Chanakya* introduced the accounting concepts in his book *Arthashastra*. In his book, he described the art of proper account keeping and methods of checking accounts. Gradually, the field of accounting has undergone remarkable changes in compliance with the changes happening in the business scenario of the world.

A bookkeeper may record financial transactions according to certain accounting principles and standards and as prescribed by an accountant depending upon the size, nature, volume, and other constraints of a particular organization.

With the help of accounting process, we can determine the profit or loss of the business on a specific date. It also helps us analyze the past performance and plan the future courses of action.

Definition of Accounting

The American *Institute of Certified Public Accountant* has defined Financial Accounting as:

"the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which in part at least of a financial character and interpreting the results thereof."

Objectives and Scope of Accounting

Let us go through the main objectives of Accounting:

- To keep systematic records: Accounting is done to keep systematic record of financial transactions. The primary objective of accounting is to help us collect financial data and to record it systematically to derive correct and useful results of financial statements.

- To ascertain profitability: With the help of accounting, we can evaluate the profits and losses incurred during a specific accounting period. With the help of a Trading and Profit & Loss Account, we can easily determine the profit or loss of a firm.

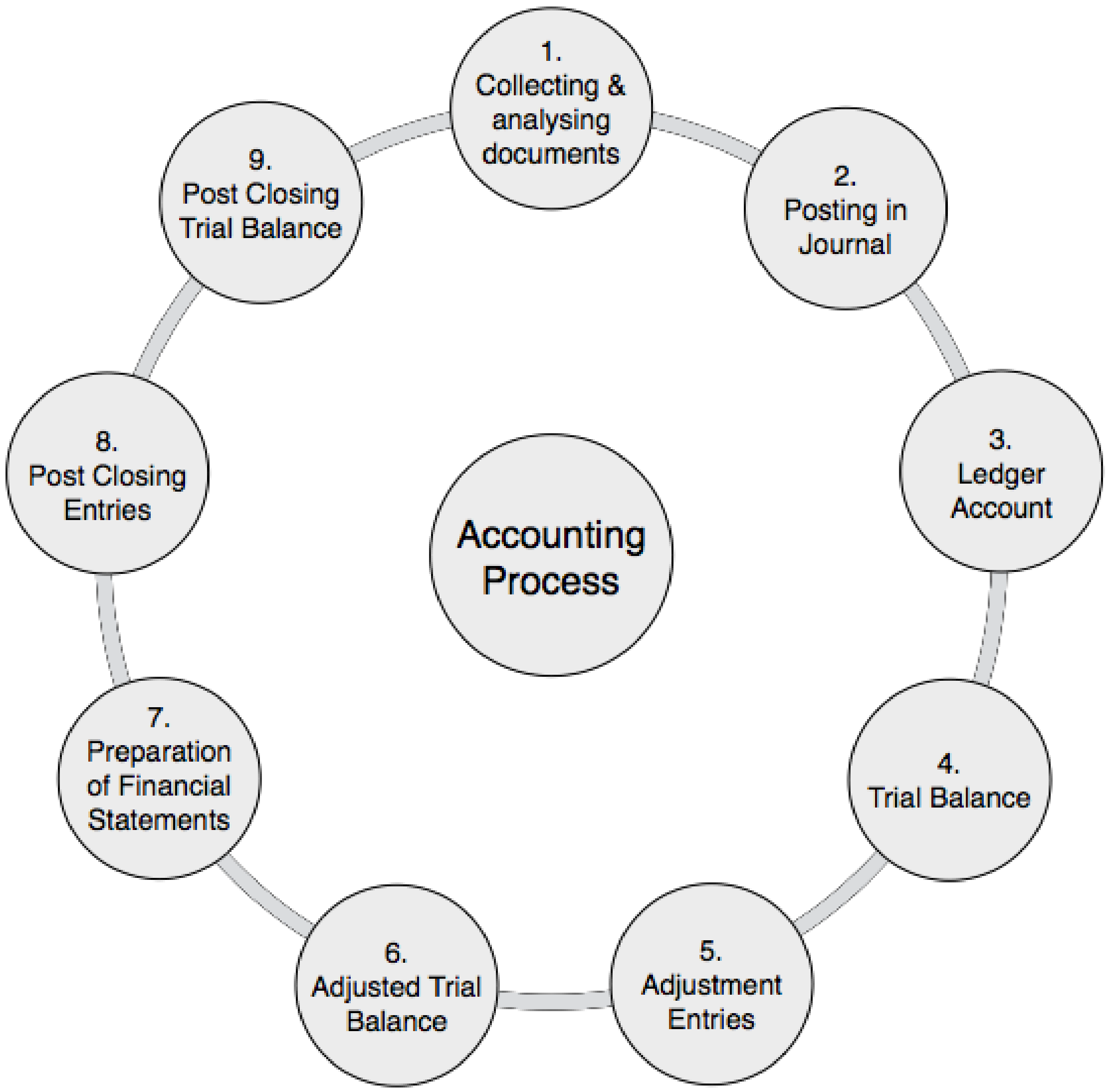
- To ascertain the financial position of the business: A balance sheet or a statement of affairs indicates the financial position of a company as on a particular date. A properly drawn balance sheet gives us an indication of the class and value of assets, the nature and value of liability, and also the capital position of the firm. With the help of that, we can easily ascertain the soundness of any business entity.

- To assist in decision-making: To take decisions for the future, one requires accurate financial statements. One of the main objectives of accounting is to take right decisions at right time. Thus, accounting gives you the platform to plan for the future with the help of past records.

- To fulfill compliance of Law: Business entities such as companies, trusts, and societies are being run and governed according to different legislative acts. Similarly, different taxation laws (direct indirect tax) are also applicable to every business house. Everyone has to keep and maintain different types of accounts and records as prescribed by corresponding laws of the land. Accounting helps in running a business in compliance with the law.

Accounting Process

Accounting cycle refers to the specific tasks involved in completing an accounting process. The length of an accounting cycle can be monthly, quarterly, half-yearly, or annually. It may vary from organization to organization but the process remains the same. The following chart shows the basic steps in an accounting cycle:



Accounting Process

The following table lists down the steps followed in an accounting process:

1. Collecting and Analyzing Accounting Documents	It is a very important step in which you examine the source documents and analyze them. For example, cash, bank, sales, and purchase related documents. This is a continuous process throughout the accounting period.
2. Posting in Journal	On the basis of the above documents, you pass journal entries using double entry system in which debit and credit balance remains equal. This process is repeated throughout the accounting period.

3. Posting in Ledger Accounts	Debit and credit balance of all the above accounts affected through journal entries are posted in ledger accounts. A ledger is simply a collection of all accounts. Usually, this is also a continuous process for the whole accounting period.
4. Preparation of Trial Balance	As the name suggests, trial balance is a summary of all the balances of ledger accounts irrespective of whether they carry debit balance or credit balance. Since we follow double entry system of accounts, the total of all the debit and credit balance as appeared in trial balance remains equal. Usually, you need to prepare trial balance at the end of the said accounting period.
5. Posting of Adjustment Entries	In this step, the adjustment entries are first passed through the journal, followed by posting in ledger accounts, and finally in the trial balance. Since in most of the cases, we used accrual basis of accounting to find out the correct value of revenue, expenses, assets and liabilities accounts, we need to do these adjustment entries. This process is performed at the end of each accounting period.
6. Adjusted Trial Balance	Taking into account the above adjustment entries, we create adjusted trial balance. Adjusted trial balance is a platform to prepare the financial statements of a company.
7. Preparation of Financial Statements	Financial statements are the set of statements like Income and Expenditure Account or Trading and Profit & Loss Account, Cash Flow Statement, Fund Flow Statement, Balance Sheet or Statement of Affairs Account. With the help of trial balance, we put all the information into financial statements. Financial statements clearly show the financial health of a firm by depicting its profits or losses.
8. Post-Closing Entries	All the different accounts of revenue and expenditure of the firm are transferred to the Trading and Profit & Loss account. With the result of these entries, the balance of all the accounts of income and expenditure accounts come to NIL. The net balance of these entries represents the profit or loss of the company, which is finally transferred to the owner's equity or capital

	account. We pass these entries only at the end of accounting period.
9. Post-Closing Trial Balance	Post-closing Trial Balance represents the balances of Asset, Liabilities & Capital account. These balances are transferred to next financial year as an opening balance.

Accounting Concepts

The most important concepts of accounting are as follows:

- Business Entity Concept
- Money Measurement Concept
- Going Concern Concept
- Cost Concept
- Dual Aspects Concept
- Accounting Period Concept
- Matching Concept
- Accrual Concept
- Objective Evidence Concept

The first two accounting concepts, namely, Business Entity Concept and Money Measurement Concept are the fundamental concepts of accounting. Let us go through each one of them briefly:

Business Entity Concept

According to this concept, the business and the owner of the business are two different entities. In other words, I and my business are separate.

For example, Mr A starts a new business in the name and style of M/s Independent Trading Company and introduced a capital of Rs 2,00,000 in cash. It means the cash balance of M/s Independent Trading Company will increase by a sum of Rs 2,00,000/-. At the same time, the liability of M/s Independent Trading Company in the form of capital will also increase. It means M/s Independent Trading Company is liable to pay Rs 2,00,000 to Mr A.

Money Measurement Concept

According to this concept, "we can book only those transactions in our accounting record which can be measured in monetary terms."

Example

Determine and book the value of stock of the following items: Shirts

Rs 5,000/-

Pants Rs 7,500/-

Coats	500 pieces
Jackets	1000 pieces

Value of Stock = ?

Here, if we want to book the value of stock in our accounting record, we need the value of coats and jackets in terms of money. Now if we conclude that the values of coats and jackets are Rs 2,000 and Rs 15,000 respectively, then we can easily book the value of stock as Rs 29,500 (as a result of 5000+7500+2000+15000) in our books. We need to keep quantitative records separately.

Going Concern Concept

Our accounting is based on the assumption that a business unit is a going concern. We record all the financial transaction of a business in keeping this point of view in our mind that a business unit is a going concern; not a gone concern. Otherwise, the banker will not provide loans, the supplier will not supply goods or services, the employees will not work properly, and the method of recording the transaction will change altogether.

For example, a business unit makes investments in the form of fixed assets and we book only depreciation of the assets in our profit & loss account; not the difference of acquisition cost of assets less net realizable value of the assets. The reason is simple; we assume that we will use these assets and earn profit in the future while using them. Similarly, we treat deferred revenue expenditure and prepaid expenditure. The concept of going concern does not work in the following cases:

- If a unit is declared sick (unused or unusable unit).
- When a company is going to liquidate and a liquidator is appointed for the same.
- When a business unit is passing through severe financial crisis and going to wind up.

Cost Concept

It is a very important concept based on the Going Concern Concept. We book the value of assets on the cost basis, not on the net realizable value or market value of the assets based on the assumption that a business unit is a going concern. No doubt, we reduce the value of assets providing depreciation to assets, but we ignore the market value of the assets.

The cost concept stops any kind of manipulation while taking into account the net realizable value or the market value. On the downside, this concept ignores the effect of inflation in the market, which can sometimes be very steep. Still, the cost concept is widely and universally accepted on the basis of which we do the accounting of a business unit.

Dual Aspect Concept

There must be a double entry to complete any financial transaction, means debit should be always equal to credit. Hence, every financial transaction has its dual aspect:

- we get some benefit, and
- we pay some benefit.

For example, if we buy some stock, then it will have two effects:

- the value of stock will increase (get benefit for the same amount), and
- it will increase our liability in the form of creditors.

Transaction	Effect
Purchase of Stock for Rs 25,000	Stock will increase by Rs 25,000 (Increase in debit balance) Cash will decrease by Rs 25,000 (Decrease in debit balance) Or Creditor will increase by Rs 25,000 (Increase in credit balance)

Accounting Period Concept

The life of a business unit is indefinite as per the going concern concept. To determine the profit or loss of a firm, and to ascertain its financial position, profit & loss accounts and balance sheets are prepared at regular intervals of time, usually at the end of each year. This one-year cycle is known as the accounting period. The purpose of having an accounting period is to take corrective measures keeping in view the past performances, to nullify the effect of seasonal changes, to pay taxes, etc.

Based on this concept, revenue expenditure and capital expenditure are segregated. Revenues expenditure are debited to the profit & loss account to ascertain correct profit or loss during a particular accounting period. Capital expenditure comes in the category of those expenses, the benefit of which will be utilized in the next coming accounting periods as well.

Accounting period helps us ascertain correct position of the firm at regular intervals of time, i.e., at the end of each accounting period.

Matching Concept

Matching concept is based on the accounting period concept. The expenditures of a firm for a particular accounting period are to be matched with the revenue of the same accounting period to ascertain accurate profit or loss of the firm for the same period. This practice of matching is widely accepted all over the world. Let us take an example to understand the Matching Concept clearly.

The following data is received from M/s Globe Enterprises during the period 01- 04-2012 to 31-03-2013:

Particulars	Amount
1. Sale of 1,000 Electric Bulbs @ Rs 10 per bulb on cash basis.	10,000.00
2. Sale of 200 Electric Bulb @ Rs. 10 per bulb on credit to M/s Atul Traders.	2,000.00
3. Sale of 450 Tube light @ Rs.100 per piece on Cash basis.	45,000.00
4. Purchases made from XZY Ltd.	40,000.00
5. Cash paid to M/s XYZ Ltd.	38,000.00
6. Freight Charges paid on purchases	1,500.00
7. Electricity Expenses of shop paid	5,000.00
8. Bill for March-13 for Electricity still outstanding to be paid next year.	1,000.00

Based on the above data, the profit or loss of the firm is calculated as follows:

Particulars	Amount	Total
Sale		
Bulb	12,000.00	
Tube	45,000.00	57,000.00
Less:-		
Purchases	40,000.00	
Freight Charges	5,000.00	
Electricity Expenses	1,500.00	
Outstanding Expenses	1,000.00	47,500.00
Net Profit		9,500.00

In the above example, to match expenditures and revenues during the same accounting period, we added the credit purchase as well as the outstanding expenses of this accounting year to ascertain the correct profit for the accounting period 01-04-2012 to 31-03-2013.

It means the collection of cash and payment in cash is ignored while calculating the profit or loss of the year.

Accrual Concept

As stated above in the matching concept, the revenue generated in the accounting period is considered and the expenditure related to the accounting period is also considered. Based on the accrual concept of accounting, if we sell some items or we rendered some service, then that becomes our point of revenue generation irrespective of whether we received cash or not. The same concept is applicable in case of expenses. All the expenses paid in cash or payable are considered and the advance payment of expenses, if any, is deducted.

Most of the professionals use cash basis of accounting. It means, the cash received in a particular accounting period and the expenses paid cash in the same accounting period is the basis of their accounting. For them, the income of their firm depends upon the collection of revenue in cash. Similar practice is followed for expenditures. It is convenient for them and on the same basis, they pay their Taxes.

Objective Evidence Concept

According to the Objective Evidence concept, every financial entry should be supported by some objective evidence. Purchase should be supported by purchase bills, sale with sale bills, cash payment of expenditure with cash memos, and payment to creditors with cash receipts and bank statements. Similarly, stock should be checked by physical verification and the value of it should be verified with purchase bills. In the absence of these, the accounting result will not be trustworthy, chances of manipulation in accounting records will be high, and no one will be able to rely on such financial statements.

Accounting Conventions

We will discuss the following accounting conventions in this section:

- Convention of Consistency
- Convention of Disclosure
- Convention of Materiality
- Conservation of Prudence

Convention of Consistency

To compare the results of different years, it is necessary that accounting rules, principles, conventions and accounting concepts for similar transactions are followed consistently and continuously. Reliability of financial statements may be lost, if frequent changes are observed in accounting treatment. For example, if a firm chooses *cost or market price whichever is lower* method for stock valuation and *written down value method* for depreciation to fixed assets, it should be followed consistently and continuously.

Consistency also states that if a change becomes necessary, the change and its effects on profit or loss and on the financial position of the company should be clearly mentioned.

Convention of Disclosure

The Companies Act, 1956, prescribed a format in which financial statements must be prepared. Every company that fall under this category has to follow this practice. Various provisions are made by the Companies Act to prepare these financial statements. The purpose of these provisions is to disclose all essential information so that the view of financial statements should be true and fair. However, the term 'disclosure' does not mean all information. It means disclosure of information that is significance to the users of these financial statements, such as investors, owner, and creditors.

Convention of Materiality

If the disclosure or non-disclosure of an information might influence the decision of the users of financial statements, then that information should be disclosed.

For better understanding, please refer to General Instruction for preparation of Statement of Profit and Loss in revised scheduled VI to the Companies Act, 1956:

1. A company shall disclose by way of notes additional information regarding any item of income or expenditure which exceeds 1% of the revenue from operations or Rs 1,00,000 whichever is higher.

2. A Company shall disclose in Notes to Accounts, share in the company held by each shareholder holding more than 5% share specifying the number of share held.

Conservation or Prudence

It is a policy of playing safe. For future events, profits are not anticipated, but provisions for losses are provided as a policy of conservatism. Under this policy, provisions are made for doubtful debts as well as contingent liability; but we do not consider any anticipatory gain.

For example, If A purchases 1000 items @ Rs 80 per item and sells 900 items out of them @ Rs 100 per item when the market value of stock is (i) Rs 90 and in condition (ii) Rs 70 per item, then the profit from the above transactions can be calculated as follows:

Partiulars	Condition (i)	Condition (ii)
Sale Value (A)	90,000.00	90,000.00
(900 x 100)		
Less:- Cost of Goods Sold		
Purchases	80,000.00	80,000.00
Less Closing Stock	8,000.00	7,000.00
Cost of Goods Sold (B)	72,000.00	73,000.00
Profit (A-B)	18,000.00	17,000.00

In the above example, the method for valuation of stock is *'Cost or market price whichever is lower'.*

The prudence however does not permit creation of hidden reserve by understating the profits or by overstating the losses.

Classification of Accounts

It is necessary to know the classification of accounts and their treatment in double entry system of accounts. Broadly, the accounts are classified into three categories:

- Personal accounts
- Real accounts
  - o Tangible accounts
    - o Intangible accounts
- Nominal accounts

Let us go through them each of them one by one.

Personal Accounts

Personal accounts may be further classified into three categories:

Natural Personal Account

An account related to any individual like David, George, Ram, or Shyam is called as a *Natural Personal Account.*

Artificial Personal Account

An account related to any artificial person like M/s ABC Ltd, M/s General Trading, M/s Reliance Industries, etc., is called as an *Artificial Personal Account.*

Representative Personal Account

Representative personal account represents a group of account. If there are a number of accounts of similar nature, it is better to group them like salary payable account, rent payable account, insurance prepaid account, interest receivable account, capital account and drawing account, etc.

Real Accounts

Every Business has some assets and every asset has an account. Thus, asset account is called a real account. There are two type of assets:

- Tangible assets are touchable assets such as plant, machinery, furniture, stock, cash, etc.

- Intangible assets are non-touchable assets such as goodwill, patent, copyrights, etc.

Accounting treatment for both type of assets is same.

Nominal Accounts

Since this account does not represent any tangible asset, it is called nominal or fictitious account. All kinds of expense account, loss account, gain account or income accounts come under the category of nominal account. For example, rent account, salary account, electricity expenses account, interest income account, etc.

Accounting Systems

There are two systems of accounting followed:

- Single Entry System
- Double Entry System

Single Entry System

Single entry system is an incomplete system of accounting, followed by small businessmen, where the number of transactions is very less. In this system of accounting, only personal accounts are opened and maintained by a business owner. Sometimes subsidiary books are maintained and sometimes not. Since real and nominal accounts are not opened by the business owner, preparation of profit
& loss account and balance sheet is not possible to ascertain the correct position of profit or loss or financial position of business entity.

Double Entry System

Double entry system of accounts is a scientific system of accounts followed all over the world without any dispute. It is an old system of accounting. It was developed by 'Luco Pacioli' of Italy in 1494. Under the double entry system of account, every entry has its dual aspects of debit and credit. It means, assets of the business always equal to liabilities of the business.

Assets = Liabilities

If we give something, we also get something in return and vice versa.

Rules of Debit and Credit under Double Entry System of Accounts

The following rules of debit and credit are called the golden rules of accounts:

Classification of accounts	Rules	Effect
Personal Accounts	Receiver is Debit Giver is Credit	Debit = credit
Real Accounts	What Comes In Debit What Goes Out Credit	Debit = credit
Nominal Accounts	Expenses are Debit Incomes are Credit	Debit = credit

Example:

Mr A starts a business regarding which we have the following data:

Introduces Capital in cash	Rs 50,000
Purchases (Cash)	Rs 20,000
Purchases (Credit) from Mr B	Rs 25,000
Freight charges paid in cash	Rs 1,000
Goods sold to Mr C on credit	Rs 15,000
Cash Sale	Rs 30,000
Purchased computer	Rs 10,000
Commission Income	Rs 8,000

S.No.	Journal Entries	Classification	Rule
1	Cash A/c Dr. 50,000 To Capital A/c 50,000	Real A/c Personal A/c	Debit what comes in; Credit the giver(Owner)
2	Goods Purchase A/c Dr. 20,000 To Cash A/c 20,000	Real A/c Real A/c	Debit what comes in; Credit what goes out
3	Goods Purchase A/c Dr. 25,000	Real A/c	Debit what comes in;

	To B A/c 25,000	Personal A/c	Credit the giver
4	Freight A/c Dr. 1,000 To Cash A/c 1,000	Nominal A/c Real A/c	Debit all expenses; Credit what goes out
5	C A/c Dr. 15,000 To Sale A/c 15,000	Personal A/c Real Account	Debit the receiver; Credit what goes out
6	Cash A/c Dr. 30,000 To Sale A/c 30,000	Real A/c Real A/c	Debit what comes in; Credit what goes out
7	Computer A/c Dr. 10,000 To Cash A/c 10,000	Real A/c Real A/c	Debit what comes in; Credit what goes out
8	Cash A/c Dr. 8,000 To Commission A/c 8,000	Real A/c Nominal A/c	Debit what comes in; Credit all incomes

It is very clear from the above example how the rules of debit and credit work. It is also clear that every entry has its dual aspect. In any case, debit will always be equal to credit in double entry accounting system.

2. FINANCIAL ACCOUNTING

We will cover the following topics in this chapter:

- Rules of Journal
- Posting in Ledger Accounts
- Subsidiary Ledgers and Control Account
- Bank Reconciliation
- Trial Balance
- Final Accounts
- Owner's Equity
- Current Assets
- Current Liabilities

Journal

"The process of recording a transaction in a journal is called journalizing the transactions."

--Meigs and Meigs and Johnson

Journal is a book that is maintained on a daily basis for recording all the financial entries of the day. Passing the entries is called journal entry. Journal entries are passed according to rules of debit and credit of double entry system.

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

Column 1: It represents the date of transaction.

Column 2: Line 1 (******) represents the name of account to be debited. Line 2 (******) represents the name of account to be credited. Line 3 for narration of transaction.

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

Column 4 : Amount(s) to be debited. Column 5 :

Amount(s) to be credited.

Notes:

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

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

Analysis and Treatment of Transactions

Let us go through the nature of transactions and their treatment in our books of accounts. The following accounting entries are commonly used in every business and they come under the category of routine journal entries.

S.No.	Nature of Transaction	Analysis and treatment
1.	Capital	Capital account is personal account. Whenever the owner introduces capital in the form of cash, goods or assets, the entry will be as hereunder: Cash/Goods/Asset A/c Dr. XX To Capital A/c XX (Being cash/goods/assets introduced as capital)
2	Drawing Account	Drawing account is also a capital account. Whenever the owner of the business withdraws money for his personal use, it is called drawing. The balance of Drawing account is transferred to the capital account at the end of the accounting year. Drawing A/c Dr. XX

<table>
<tr><td></td><td></td><td>To cash A/c XX

(Being withdrawal of cash for personal use)</td></tr>
<tr><td colspan="3">Notes:
1. Introduction of capital as well as withdrawal of capital may occur any time during the accounting year.

2. In addition to cash, there may be other expenses of the owner/proprietor which may pay directly on his behalf debating his account. For example, payment of his insurance, taxes, rent, electricity or personal phone bills.

3. Business account and personal account of proprietor are different as owner of the business and business, both are separate entities.</td></tr>
<tr><td>3</td><td>Trade Discount</td><td>Trade discount is allowed by seller to buyer directly on their sales invoice. Buyer in this case are usually whole- sellers, traders or manufacturers, who further sell this material to their customers or use the material in their manufacturing process. Rate of discount may vary from customer to customer.

Treatment: No need to pass any journal entry in this case. The sale is booked on the net of trade discount. Similarly, if we get trade discount from our supplier, we book our purchase at the net of trade discount.</td></tr>
<tr><td>4</td><td>Cash Discount</td><td>Cash discount is also allowed by seller to his buyer; still it does not come in the category of trade discount. Cash discount is a sort of scheme to inspire their debtors to release their due payment in time. For example, a seller may allow 5% cash discount, if he gets payment within a week against the time limit of 45 days.

Treatment: If A allowed a discount of 5% to B, then

<u>In the books of A</u>
Cash A/c Dr. xx
Discount A/c Dr. xx
To B A/c xxxx

(Being 5% discount allowed to B on payment of Rs........)

<u>In the books of B</u>
A A/c Dr. xxxx
To Cash A/c xx
To Discount A/c xx
(Being payment of Rs........ made to A and getting a discount of 5%)
Note: In the above case, discount is a loss to A and income to B.</td></tr>
<tr><td>5</td><td>Bad Debts</td><td>Part of credit sale which is unrecovered from debtors due to some reason like insolvency, dishonesty, etc. are called bad debts of the company. Bad debts are loss to the company.</td></tr>
</table>

		Treatment: (1) To book bad debts Bad Debts A/c Dr. xx To Debtor A/c xx (Being loss on account of bad debts) (2) To recover bad debts Cash A/c Dr. xx To bad debts recovery A/c xx (Being recovery of bad debts)
6	Expenses on purchase of Goods	There are a few types of expenses incurred on the purchases of goods like inward freight, octroi, cartage, unloading charges, etc. **Treatment**: Inward freight/Cartage/Octroi A/c Dr. xx To Cash A/c xx (Being freight charges paid on purchase of goods)
7	Expenses on Sale of Goods	Expenses are also incurred while selling products to customers such as freight outward, insurance charges, etc. **Treatment**: Freight outward/Insurance Expenses A/c. Dr. xx To Cash A/c xx (Being freight charges paid on sale of goods)
8	Expenses on Purchase of Assets	Sometimes we need to pay expenses on the purchase of fixed assets like transportation charges, installation charges, etc. **Treatment**: Expenses incurred on purchases of fixed asset are added in the value of fixed assets and could not be treated like expenses on purchases of goods: Fixed Asset A/c Dr. XX To Cash A/c XX (Expenses incurred on purchase of asset)
9	Payment of Expenses	**Treatment**: Expenses A/c Dr. XX To Cash A/c XX (Being expenses incurred)
		Sometimes expenses remain outstanding at the end of the financial year, but due to the accrual basis of accounting,

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

		Debtor A/c Dr. XX To Bank A/c XX (Being payment made through .....) If we deposit cash in his bank account, entry will be as follows: Debtor A/c Dr. XX To Cash A/c XX (Being payment made through .....) **(3) Cash withdrawn for office Expenses** Cash A/c Dr XX To Bank A/c XX (Being cash withdrawn from bank for office use) **(4) Cash deposited with Bank** Bank A/c Dr XX To Cash A/c XX (Being cash withdrawn from bank for office use) **Note**: The above entries No. 3 & 4 are called **'contra'** entries. **(5) Bank charge debited by bank** Sometimes banks debit from our account against some charges for service provided by them. For example, cheque book issuing charges, demand draft issuing charges, Bank interest, etc. Bank commission/Charges A/c Dr. XX To Bank A/c XX (Bank charges/commission/interest debited by bank)
14	Interest on Capital	Interest on capital, introduced by sole proprietor or partners of the firm: This entry is passed on the last date of the accounting year as follows: Interest on capital A/c Dr. XX To Capital A/c (Being interest @..... on capital provide)
16	Payment on behalf of others	Some expenses may be on behalf of our debtors or creditors. Debtors/creditors A/c Dr. XX To Cash / Expenses A/c XX (Being expenses debited to party, paid on his behalf)

17	Advance received against supply of goods/services	Sometimes the customers pay an advance amount for the supply of goods/services, which need to be adjusted later: Bank /Cash A/c Dr. XX To Advance from Customers A/c XX (Being advance received from xxxxxxxx)
18	Advance paid against supply of goods/services	As above, we may also pay an advance amount to our supplier against supply of goods/services: Advance against supply of goods A/c Dr. XX To Cash/Bank A/c XX (Being advance paid against supply of goods/services)

Posting in a Ledger

Now let us try to understand how a journal works. With the help of journal entries, we book each and every financial transaction of the organization chronically without considering how many times the same type of entry has been repeated in that particular accounting year or period.

Journal entries in any organization may vary from hundreds to millions depending upon the size and structure of the organization. With the help of a journal, each of the transactions might be recorded; however, we can conclude nothing from a journal. Let us consider the following cases. Suppose we want to know:

- the total sale value or purchase value
- the total of any particular income or expenses
- the total of amount payable to any particular creditor or receivable from a debtor

In such cases, it might be a tedious job for any bookkeeper or accountant. Hence, the next step is ledger accounts.

The ledger helps us in summarizing journal entries of same nature at single place. For example, if we pass 100 times a journal entry for sale, we can create a sales account only once and post all the sales transaction in that ledger account date- wise. Hence, an unlimited number of journal entries can be summarized in a few ledger accounts. Transferring journal entries into a ledger account is called ‘posting’.

Ruling of Account in Ledger Account

Let us see various formats of ledger accounts:

Format-1

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

Format-2

Nowadays, the handwritten books are being replaced by computerized accounts. The companies majorly use a six-column format to maintain ledger accounts of their customers. It looks as follows:

In the books of M/s. ABC Bank Ltd.						
Ledger account of M/s XYZ Ltd.						
Date	Particulars	LF	Debit Amount (Rs.)	Credit Amount (Rs.)	Balance	
					Dr. or Cr.	Amount

Format-1 is used for academic purpose. Hence, this format is useful to learn the basics and principles of accounting.

Format-2 is used by banking and financial organization as well as well as by most of the business organizations.

Important Points Regarding Ledger

- Each side of a journal entry is posted in the same side of the ledger. It means the debit entry of a journal is posted in the debit side and vice-a- versa.
- Balance c/d refers to the balance carried down and balance b/d refers to the balance brought down.
- After posting in ledger, balancing of ledger is done. In the column named Total, the figure comes on the basis of '**whichever is higher**'. Means, if the total of debit side is Rs 10,000 and the total of credit is Rs 5,000, we write Rs 10,000 in the column named Total of both, the debit and the credit side.
- The difference of both sides (in this case, it is Rs 5,000) is written in the last row of the credit side as **'balance c/d'**. This balance is called the debit balance of account or vice-a-versa.
- All expenses and assets represent debit balance.
- All the income and liabilities represent credit balance including capital account.
- Debit balance of personal account represents **'Amount Receivable'.** This comes under the category of assets. For example debtors.
- Credit balance of personal accounts signifies '**Amount Payable'.** This comes under liabilities side and represents that we need to pay this amount which is credited due to goods, service, loan, or advance received.
- Debit side of real account means stock in hand or any kind of assets. Credit balance of Real account is not possible.
- Debit balance of nominal account means expenses of organization.
- Credit balance of nominal accounts means income earned.
- Debit balance of cash book means cash in hand.
- Debit side of Bank book means balance at bank.
- Credit balance of Bank book indicates **'Bank Overdraft'.**
- Debit and credit balances of nominal account (Expenses and income will be nil, because these balances get transferred to trading, and profit & loss account to arrive at profit and loss of the company.
- Balances of real and personal account appear in balance sheet of the company and to be carried forward to next accounting years.

Illustration:

Journalize the following transactions and post them in to ledger account:

S.No.	Transctions	Amount
1	Commenced business and introduced cash	400,000.00
2	Goods purchased for cash	50,000.00
3	Goods purchaed from Mr. Abdul	135,000.00
4	Freight charges paid on purchases	1,500.00
5	Computer purchased- cash	35,000.00
6	Freight charges paid on purchases of computer	500.00
7	Sale made to Mr. Ram	200,000.00
8	Rent paid	12,000.00
9	salary paid	15,000.00
10	Cash received from Mr. Ram	150,000.00
11	Cash deposited in bank	75,000.00
12	Office Expenses paid	25,000.00

Journal Entries

S.No.	Particulars	L.F.	AMOUNT	
			Debit (Rs.)	Credit (Rs.)
1.	Cash A/c Dr. To Capital A/c (Being capital introduced)	**	4,00,000	4,00,000
2.	Purchase A/c Dr. To Cash A/c (Being cash purchase made)	**	5,00,000	5,00,000
3.	Purchase A/c Dr. To Abdhul A/c (Being goods purchase from Abdhul)	**	135,000	1,35,000
4.	Inward Freight Charges A/c Dr.	**	1,500	

	To Cash A/c (Being freight charges Paid)			1,500
5	Computer A/c Dr. To Cash A/c (Being computer purchased on cash)	**	35,000	35,000
6.	Computer A/c Dr. To Cash A/c (Being freight charges on computer paid)	**	500	500
7.	Ram A/c Dr. To Sale A/c (Being sold to Mr. Ram)	**	2,00,000	2,00,000
8	Rent A/c Dr. To Cash A/c (Being rent paid)	**	12,000	12,000
9.	Salary A/c Dr. To Cash A/c (Being salary paid)	**	15,000	15,000
10.	Cash A/c Dr. To Ram A/c (Being cash Received from Mr. Ram)	**	1,50,000	1,50,000
11.	Bank A/c Dr. To Cash A/c (Being cash deposited in Bank)	**	75,000	75,000
12.	Office Expenses A/c Dr. To Cash A/c (Being office expenses paid)	**	25,000	25,000

3. SUBSIDIARY BOOKS

This chapter covers the following:

- Cash Book
- Simple cash book or single column cash book
- Double column cash book (with discount column)
- Three column cash book (with discount & Bank column)
- Petty Cash Book
- Purchase Book
- Sale Book
- Purchase Return Book
- Sale Return Book
- Bills receivable book
- Bills payable book
- Bank reconciliation
- Trial balance
- Financial statements
- Depreciation and its roles

Let us go through each one of them in detail.

Cash Book

Cash book is a record of all the transactions related to cash. Examples include: expenses paid in cash, revenue collected in cash, payments made to creditors, payments received from debtors, cash deposited in bank, withdrawn of cash for office use, etc.

In double column cash book, a discount column is included on both debit and credit sides to record the discount allowed to customers and the discount received from creditors respectively.

In triple column cash book, one more column of bank is included to record all the transactions relating to bank.

Note: In modern accounting, simple cash book is the most popular way to record cash transactions. The double column cash book or three column cash book is practically for academic purpose. A separate bank book is used to record all the banking transactions as they are more than cash transactions. These days, cash is used just to meet petty and routine expenditures of an organization. In most of the organizations, the salaries of employees are paid by bank transfer.

Note: Cash book always shows debit balance, cash in hand, and a part of current assets.

Single Column Cash Book

Cash book is just like a ledger account. There is no need to open a separate cash account in the ledger. The balance of cash book is directly posted to the trial balance. Since cash account is a real account, ruling is followed, i.e. what comes in – debit, and what goes out – credit. All the received cash is posted in the debit side and all payments and expenses are posted in the credit side of the cash book.

Format:

CASH BOOK(Single Column)							
Dr.							Cr.
Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount

Double Column Cash Book

Here, we have an additional Discount column on each side of the cash book. The debit side column of discount represents the discount to debtors of the company and the credit side of discount column means the discount received from our suppliers or creditors while making payments.

The total of discount column of debit side of cash book is posted in the ledger account of **'Discount Allowed to Customers'** account as **'To Total As Per Cash Book'**. Similarly, credit column of cash book is posted in ledger account of **'Discount Received'** as **'By total of cash book'**.

Format:

CASH BOOK(Single Column)									
Dr.									Cr.
Date	Particulars	L.F.	Discount	Amt.	Date	Particulars	L.F.	Discount	Amt.

Triple Column Cash Book

When one more column of Bank is added in both sides of the double column cash book to post all banking transactions, it is called triple column cash book. All banking transactions are routed through this cash book and there is no need to open a separate bank account in ledger.

Petty Cash Book

In any organization, there may be many petty transactions incurring for which payments have to be done. Therefore, cash is kept with an employee, who deals with it and makes regular payments out of it. To make it simple and secure, mostly a constant balance is kept with that employee.

Suppose cashier pays Rs 5,000 to Mr A, who will pay day-to-day organization expenses out of it. Suppose Mr A spend Rs 4,200 out of it in a day, the main cashier pays Rs 4,200, so his balance of petty cash book will be again Rs 5,000. It is very useful system of accounting, as it saves the time of the main cashier and provides better control.

We will soon discuss about **'Analytical or Columnar Petty Cash Book'** which is most commonly used in most of the organizations.

Format:

PETTY CASH BOOK									
Amt Recd	C.B.F	Date	Particulars	Amt Paid	Stationery & Printing	Cartage	Loading	Postage	L.F

Purchase Book

Purchase book is prepared to record all the credit purchases of an organization. Purchase book is not a purchase ledger.

Format:

PURCHASE BOOK				
Date	Particulars	Inward Invoice No.	L.F.	Amount

Sale Book

The features of a sale book are same as a purchase book, except for the fact that it records all the credit sales.

Format:

SALE BOOK				
Date	Particulars	Outward Invoice No.	L.F.	Amount

Purchase Return Book

Sometimes goods are to be retuned back to the supplier, for various reasons. The most common reason being defective goods or poor quality goods. In this case, a debit note is issued.

Format:

PURCHASE RETURN BOOK				
Date	Particulars	Credit Note No.	L.F.	Amount

Sale Return Book

The reason of Sale return is same as for purchase return. Sometimes customers return the goods if they don't meet the quality standards promised. In such cases, a credit note is issued to the customer.

Format:

SALE RETURN BOOK

Date	Particulars	Debit Note No.	L.F.	Amount

Bills Receivables Book

Bills are raised by creditors to debtors. The debtors accept them and subsequently return them to the creditors. Bills accepted by debtors are called as **'Bills Receivables'** in the books of creditors, and **'Bills Payable'** in the books of debtors. We keep them in our record called **'Bills Receivable Books'** and **'Bills Payable Book'**.

Format:

BILLS RECEIVABLE BOOK					
Date	Received From	Term	Due Date	L.F.	Amount

Bills Payable Book

Bills payable issues to the supplier of goods or services for payment, and the record is maintained in this book.

Format:

BILLS PAYABLE BOOK					
Date	To Whom Given	Term	Due Date	L.F.	Amount

Key Features of Subsidiary Books

There is a difference between a purchase book and a purchase ledger. A purchase book records only credit purchases and a purchase ledger records all the cash purchases in chronical order. The daily balance of purchase book is transferred to purchase ledger. Therefore, purchase ledger is a comprehensive account of all purchases.

The same rule applies to sale book and sale ledgers.

1. It is quite clear that maintaining a subsidiary book is facilitation to journal entries, practically it is not possible to post each and every transaction through journal entries, especially in big organizations because it makes the records bulky and unpractical.

2. Maintenance of subsidiary books gives us more scientific, practical, specialized, controlled, and easy approach to work.

3. It provides us facility to divide the work among different departments like sale department, purchase department, cash department, bank department, etc. It makes each department more accountable and provides an easy way to audit and detect errors.

4. In modern days, the latest computer technology has set its base all over the world. More and more competent accounts professionals are offering their services. Accuracy, quick results, and compliance of law are the key factors of any organization. No one can ignore these factors in a competitive market.

Bank Reconciliation

On a particular date, reconciliation of our bank balance with the balance of bank passbook is called bank reconciliation. The bank reconciliation is a statement that consists of:

- Balance as per our cash book/bank book
- Balance as per pass book
- Reason for difference in both of above

This statement may be prepared at any time as per suitability and requirement of the firm, which depends upon the volume and number of transaction of the bank. ri

In these days, where most of the banking transactions are done electronically, the customer gets alerts for every transaction. Time to reconcile the bank is reduced more.

Format:

BANK RECONCILIATION STATEMENT		
PARTICULARS	(1) Debit Bank	(2) Credit Bank Balance as per Bank

	Balance as per Bank Book	Book (Overdraft)
Balance as per Bank Book	50,000	-50,000
1. Add: Cheque issued to parties but not presented in bank	3,25,000	3,25,000
2. Less: Cheque deposited in bank but not cleared yet	-50,000	-50,000
3. Less: Bank Charges debited by bank but not entered in our books of accounts	-1,200	-1,200
4. Less: Bank interest charged by bank but not entered in our books of accounts	-10,000	-10,000
5. Add: Payment direct deposited by party without intimation to us	1,75,000	1,75,000
Balance as per Bank Pass Book/ Statement	4,88,800	3,88,800

Trial Balance

Trial balance is a summary of all the debit and credit balances of ledger accounts. The total of debit side and credit side of trial balance should be matched. Trial balance is prepared on the last day of the accounting cycle.

Trial balance provides us a comprehensive list of balances. With the help of that, we can draw financial reports of an organization. For example, the trading account can be analyzed to ascertain the gross profit, the profit and loss account is analyzed to ascertain the profit or Loss of that particular accounting year, and finally, the balance sheet of the concern is prepared to conclude the financial position of the firm.

Format:

TRIAL BALANCE				
S.NO.	Ledger Accounts	L.F.	DEBIT (Rs)	Credit (Rs.)
1	ADVANCE FROM CUSTOMERS			XX
2	ADVANCE TO STFF		XX	
3	AUDIT FEES		XX	
4	BALANCE AT BANK		XX	
5	BANK BORROWINGS			XX
6	BANK INTEREST PAID			XX
7	CAPITAL			XX
8	CASH IN HAND		XX	
9	COMMISSION ON SALE		XX	
10	ELECTRICITY EXPENSES		XX	
11	FIXED ASSETS		XX	
12	FREIGHT OUTWARD		XX	

13	INTEREST RECEIVED			XX
14	INWARD FREIGHT CHARGES		XX	
15	OFFICE EXPENSES		XX	
16	OUTSTANDING RENT			XX
17	PREPAID INSURANCE		XX	
18	PURCHASES		XX	
19	RENT		XX	
20	REPAIR AND RENUWALS		XX	
21	SALARY		XX	
22	SALARY PAYABLE			XX
23	SALE			XX
24	STAFF WELFARE EXPENSES		XX	
25	STOCK		XX	
26	SUNDRY CREDITORS			XX
27	SUNDRY DEBTORS		XX	
	TOTAL		XXXXX	XXXXX

Financial Statements

Financial statements are prepared to ascertain the profit or loss of the business, and to know the financial position of the company.

Trading, profit & Loss accounts ascertain the net profit for an accounting period and balance sheet reflects the position of the business.

All the above has almost a fixed format, just put all the balances of ledger accounts into the format given below with the help of the trial balance. With that, we may derive desired results in the shape of financial equations.

Trading & Profit & Loss Account of M/s ABC Limited (For the period ending 31-03-2014)			
Particulars	Amount	Particulars	Amount
To Opening Stock	XX	By Sales	XX
To Purchases	XX	By Closing Stock	XX
To Freight charges	XX	By Gross Loss c/d	XXX
To Direct Expenses	XX		
To Gross Profit c/d	XXX		
Total	XXXX	Total	XXXX
To Salaries	XX	By Gross Profit b/d	XXX
To Rent	XX		
To Office Expenses	XX	By Bank Interest received	XX
To Bank charges	XX	By Discount	XX
To Bank Interest	XX	By Commission Income	XX
To Electricity Expenses	XX	By Net Loss transfer to Balance sheet	XX
To Staff Welfare Expenses	XX		

To Audit Fees	XX		
To Repair & Renewal	XX		
To Commission	XX		
To Sundry Expenses	XX		
To Depreciation	XX		
To Net Profit transfer to Balance sheet	XX		
Total	XXXX	Total	XXXX

Balance sheet of M/s ABC Limited as on 31-03-2014			
Liabilities	Amount	Assets	Amount
Capital XX Add: Net Profit XX	XX	Fixed Assets XXXX Less: Depreciation XX	XX
Bank Borrowings	XX	Current Assets	XX
Long Term Borrowing	XX	Stock	XX
Current Liabilities:	XX	Debtors	XX
Advance From Customers	XX	Cash In hand	XX
Sundry Creditors	XXX	Cash at Bank	XX
Bills payable		Bills receivables	XX
Expenses Payable			
Total	XXXX	Total	XXXX

Owner's Equity

The equation of equity is as follows: Owner

Equity = Assets – liability

The owner or the sole proprietor of a business makes investments, earns some profit on it, and withdraws some money out of it for his personal use called drawings. We may write this transaction as follows:

Investment (capital) +- Profit or Loss – drawings = Owner's Equity

Current Assets

Assets that are convertible into cash within the next accounting year are called current assets.

Cash in hand, cash in bank, fixed deposit receipts (FDRs), inventory, debtors, receivable bills, short-term investments, staff loan and advances; all these come under current assets. In addition, prepaid expenses are also a part of current assets.

Note: Prepaid expenses are not convertible into cash, but they save cash for the next financial or accounting year.

Current Liabilities

Like current assets, current liabilities are immediate liabilities of the firm that are to be paid within one year from the date of balance sheet.

Current liabilities primarily include sundry creditors, expenses payable, bills payable, short-term loans, advance from customers, etc.

Depreciation

Depreciation reduces the value of assets on a residual basis. It also reduces the profits of the current year.

Depreciation indicates reduction in value of any fixed assets. Reduction in value of assets depends on the life of assets. Life of assets depends upon the usage of assets.

There are many deciding factors that ascertain the life of assets. For example, in case of a building, the deciding factor is time. In case of leased assets, the deciding factor is the lease period. For plant and machinery, the deciding factor should be production as well as time. There can be many factors, but the life of assets should be ascertained on some reasonable basis.

Why Do We Need to Account for Depreciation?

Here is why we need to provide depreciation:

- To ascertain the true profit during a year, it is desirable to charge depreciation.
- To ascertain the true value of assets, depreciation should be charged. Without calculating the correct value of assets, we cannot ascertain the true financial position of a company.
- Instead of withdrawal of overstated profit, it is desirable to make provisions to buy new assets to replace old asset. The accumulated value of depreciation provides additional working capital.
- Depreciation helps in ascertaining uniform profit in each accounting year.
- Depreciation allows to take the advantage of tax benefit.

Accounting Entries Related to Assets and Depreciation

Let us see the accounting entries related to assets and depreciation:

S. No.	Journal Entries
1	Purchase of Fixed Assets Asset A/c Dr. To Bank A/c
2	Expenses on purchase of Fixed Assets Related Asset A/c Dr. To Cash/Bank A/c
3	For Providing depreciation Depreciation A/c Dr. To Assets A/c
4	Transfer of Depreciation to Profit and Loss A/c Profit & Loss A/c Dr. To Depreciation A/c
5	Sale of Assets Bank A/c Dr. To Assets A/c