Accounting Fundamentals 1

This Module Includes

Accounting Fundamentals

SLOB Mapped against the Module

- To obtain in-depth knowledge on the four frameworks within which accounting operates and the principles on which accounting theories and practices are based. (CMLO 4a, b)
- To develop detail application-oriented knowledge on various stages of accounting right from the identification of transactions up to finalisation of accounts. (CMLO 4a, b)

Module Learning Objectives:

After studying this module, the students will be able to:

- Understand the frameworks of accounting;
- Know the principles of accounting i.e. Accounting concepts and Accounting conventions;
- Understand the concept transaction and its different types;
- Understand the Accounting cycle;
- Get the knowledge of different books of accounts and related concepts;
- Learn the preparation and scrutiny of trial balance;
- Pass adjustment entries and rectification entries;
- Do accounting for depreciation, amortisation, bad debts and provisions thereof

Four Frameworks of Accounting

1.1

According to Collins Dictionary, the term 'framework' refers to 'a structure that forms a support or frame for something'. In the context of any system, it is 'a particular set of rules, ideas, or beliefs which you use in order to deal with problems or to decide what to do'.

In accounting, 'framework' provides a common set of rules and guidelines that is used to measure, recognize, present, and disclose the information appearing in an entity's financial statements.

Four Frameworks of Accounting

The framework of accounting has four pillars – Conceptual, Legal, Institutional and Regulatory. These are discussed below.

a. Conceptual Framework

The Conceptual Framework is a body of interrelated objectives and fundamentals. The objectives identify the goals and purposes of financial reporting and the fundamentals are the underlying concepts that help achieve those objectives. Those concepts provide guidance in selecting transactions, events and circumstances to be accounted for, how they should be recognized and measured, and how they should be summarized and reported. It states the objectives of General-Purpose Financial Reporting and the information provided by it. Conceptual Framework also guides on the qualitative characteristics that the financial statements must possess.

Conceptual Framework often plays an important role in the development of Institutional Framework and assists preparers to develop consistent accounting policies when no accounting standard applies to a particular transaction or other event, or when a standard allows a choice of accounting policy.

b. Legal Framework

Businesses are often controlled by various statutes under which they are formed. For example, in India, partnership organisations are governed by Indian Partnership Act, 1932 or Limited Liability Partnership Act, 2008, co-operatives are controlled by the Co-operative Societies Act, 1912, companies are governed by the Companies Act, 2013. In addition, banks are controlled by Banking Regulation Act, 1949, insurance companies are under the Insurance Act, 1938, electricity companies are also governed by the Central Electricity Act, 2003. All these statutes (including various Rules framed under them) not only govern the administrative set up of these organisations, but also provide important guidelines regarding use of resources, financing and also on the maintenance of books of accounts and treatment of specified transactions. For example, the Companies Act, 2013 and Companies (Accounts) Rules, 2014 provide useful provisions on maintenance of accounting records, accounting for issue and redemption of securities, investments to be done, consolidation and even winding up of the company. Companies (Corporate Social Responsibility) Rules, 2014 provides the guidelines regarding accounting of CSR expenses as well as carry forward and set-off of excess amount spent. Thus, legal framework plays an important role in accounting. The Schedules of this Act also provide important guidelines on the form and contents of financial statements.

c. Institutional Framework

Institutional framework refers to the guidelines issued in form of certain pronouncements by institutions entrusted by the sovereign authorities to oversee the development of the respective field. In India, the Institute of Chartered Accountants of India has been entrusted to develop standards in the field of accounting to ensure comparability and consistency in accounting information. The Indian Accounting Standard Board of ICAI thus develops quality accounting standards on different areas of accounting. Currently, there are two sets of accounting standards in India – Accounting Standards as per Companies (Accounting Standards) Rules, 2021 and Ind ASs under Companies (Indian Accounting Standards) Rules, 2015. In addition, the Cost Accounting Standards Board (CASB) of the Institute of Cost Accountants of India has, so far, developed 24 Cost Accounting Standards to facilitate cost accounting and reporting.

d. Regulatory Framework

The activities of organisations often come under the regulatory ambit of various regulators. In India, there are different regulatory authorities in different segments of financial market, such as RBI in money market operations, SEBI in capital market operations, IRDAI in insurance sector, PFRDA in pension funds. In addition, there are Telecom Regulatory Authority of India (TRAI), Competition Commission etc. The regulations imposed by these authorities may also have important bearing on accounting of a concerned entity. For example, regulations issued by SEBI largely shape the accounting and, more importantly, reporting by a listed firm in India. Similarly, regulations framed by IRDAI affect the accounting and reporting in insurance companies. In banking, BASEL Norms and other guidelines issued by RBI largely determine the accounting of NPA (Non-Performing Assets). Central Electricity Regulatory Commission (Terms and Conditions of Tariff) Regulations, 2009 affect the determination of tariff and accounting in an electricity company in India.

The above four frameworks provide the foundation on which accounting and more specifically corporate accounting is based in India. They help to streamline the accounting process and help to improve the quality of the reports generated and thereby contribute in the overall development of accounting.

Accounting Principles, Concepts and Conventions

1.2

The responsibility of the discipline of accounting is to provide financial information to the users of accounting information. For this purpose, it keeps records of the various transactions in its books of accounts. The practice of record keeping may be practiced differently by different organisations. In order to ensure uniformity and consistency in record keeping, the accounting profession has developed rules, conventions, standards, and procedures which are generally accepted and universally practiced. This common set of rules, conventions, standards, and procedures is referred to as **Generally Accepted Accounting Principles (GAAP)**.

The GAAPs indicate how to report economic events and are thus, used by organisations in drafting their financial statements. They are to be followed by organisations so that the users of accounting information have an optimum level of consistency in the financial statements they use, when analyzing companies for investment purposes.

Such accounting principles have been developed from research, accepted accounting practices, and pronouncements of regulators.

In India, financial statements are prepared on the basis of accounting standards issued by the Institute of Chartered Accountants of India (ICAI) and the law laid down in the respective applicable statutes (like, Schedule III to Companies Act, 2013 is required to be followed by all companies).

Concept of Accounting Principles, Accounting Concepts, and Accounting Conventions

Accounting Principles are the basic rules which act as a primary standard for recording business transactions and maintaining books of accounts. They provide standards for scientific accounting practices and procedures. They guide as to how the transactions are to be recorded and reported. They assure uniformity and understandability. Accounting principles are accepted as such if they happen to be (1) objective (2) usable in practical situations (3) reliable (4) feasible (they can be applied without incurring high costs); and (5) comprehensible to those with a basic knowledge of accounting and finance.

The accounting principles can be split into – [A] Accounting Concepts and [B] Accounting Conventions.

[A] Accounting Concepts refer to the assumptions and conditions that define the parameters and constraints within which the accounting operates. They lay down the foundation for accounting principles, and ensure recording of financial facts on sound bases and logical considerations. The common accounting concepts are:

(a) Entity Concept

(b) Going Concern Concept

(c) Periodicity Concept

(d) Money Measurement Concept

(e) Accrual Concept

(f) Dual Aspect Concept

(g) Matching Concept

(h) Realisation Concept

(i) Cost Concept

[B] **Accounting Conventions** are customs, methods, procedures or guidelines associated with the practical application of accounting principles. These are widely accepted, and are the common practices which are used as a guideline when recording transactions. Accounting conventions are a necessary part of the accounting profession, since they result in transactions being recorded in the same way by multiple organizations. This allows for the reliable comparison of the financial facts and figures. However, accounting conventions may change over a period of time, thus reflecting shifts in the general opinion and/ or practice of dealing with a transaction. The different accounting conventions are:

(a) Convention of Conservatism

(b) Convention of Consistency

(c) Convention of Materiality

(d) Convention of Full Disclosure.

Accounting Concepts

(a) Entity Concept: As per this concept, an organisation is treated as distinct and separate from the persons who own or manage it. In other words, this concept assumes that the organization and business owners are two independent entities. Hence, the personal transaction of its owner is different from the transactions of the organisation. Application of this concept enables recording of transactions between the entity and its owners and/ or other stakeholders. The entity concept requires that all the transactions are to be viewed, interpreted and recorded from organisation's point of view.

For example, if the owner pays his personal expenses from business cash, this transaction can be recorded in the books of business entity. This transaction will take the cash out of business and also reduce the obligation of the business towards the owner.

(b) Going Concern Concept: The basic assumption of this concept is that an organisation is assumed to continue to exist for an indefinite period of time. This simply means that every concern has continuity of life. Unless, there is good evidence to the contrary, the accountant assumes that an organisation is a 'going concern'. This concept enables the accountant to carry forward the values of assets and liabilities from one accounting period to the other without asking the question about usefulness and worth of the assets and recoverability of the receivables. The going concern concept forms the basis for preparation of Balance Sheet of an organisation.

(c) Accounting Period Concept: Accounting period concepts assumes that the infinite life of an organisation can be split into smaller periods of equal duration (viz. a quarter, half-year or year). Due to this concept, the operating results are ascertained for a specific period, the financial position is reflected (through the balance sheet) at regular intervals.

(d) Money Measurement Concept: Any event which can be expressed in terms of money is always recorded in the books of accounts. The advantage of this concept is that different types of transactions could be recorded as homogenous entries with money as common denominator. A business may own ₹ 3 Lacs cash, 1500 kg of raw material, 10 vehicles, 3 computers etc. Unless each of these is expressed in terms of money, the assets owned by the business cannot ascertained. When expressed in the common measure of money, transactions could be added or subtracted to find out the combined effect. However, the limitation of this concept is that only the absolute value of the money is considered, whereas the real value may fluctuate from time to time due to inflation, exchange rate changes, etc.

(e) **Accrual Concept:** This concept is based on recognition of both cash and credit transactions. In case of a cash transaction, owner's equity is instantly affected as cash either is received or paid. In a credit transaction, however, a mere obligation towards or by the organisation is created. When credit transactions exist (which is generally the case), revenues are not the same as cash receipts and expenses are not same as cash paid during the period.

(f) **Dual Aspect Concept:** The dual aspect concept assumes that every transaction recorded in the books of accounts is based on two aspects (technically called 'Debit' and 'Credit'). This concept provides the basis for recording business transactions in the books of accounts. This implies that the transaction that is recorded affects two (or more) accounts on their respective opposite sides. Hence, the transaction should be recorded in at least two accounts. For example, goods purchased in cash have two aspects such as 'paying cash' and 'receiving goods'. Such duality of the transaction is commonly expressed in the terms of an equation as: Assets = Liabilities + Capital.

(g) **Matching Concept:** This concept states that the revenues and expenses must be recorded at the same time at which they are incurred. In general, the revenues earned should be matched with the expenses incurred during the accounting period. For the application of this concept several adjustments are made for prepaid expenses, accrued incomes, etc. The operating result of an accounting period can be measured only when incomes are compared with the related expenses incurred.

(h) **Realisation Concept:** The concept of realisation talks about how much of the revenue should be recognized in the books of accounts. It says, amount should be recognized only to the tune of which it is certainly realizable. Thus, mere getting an order from the customer won't make it eligible to be recognized as revenue. The reasonable certainty of realizing the money will come only when the goods ordered are actually supplied to the customer and he is billed. This concept ensures that any income which is unearned or unrealized will not be considered as revenue.

(i) **Cost Concept:** The cost concept states all the business assets should be written down in the book of accounts at the costs incurred for their acquisition, including any capital cost incurred in relation to installation. The assets are not to be recorded at their market price. For example, a packing machine was purchased by Bharat Ltd. for ₹40,00,000. An amount of ₹30,000 was spent on transporting the machine to the factory site, and further ₹20,000 was additionally spent on its installation. Hence, the total amount at which the machine will be recorded in the books of accounts would be the aggregate of all these costs i.e. ₹40,50,000. This cost is also termed as 'Historical Cost'.

Accounting Conventions

(a) **Convention of Conservatism:** The convention of conservatism essentially assumes an uncertain future and as such, advocates providing for all possible losses, but never for possible future gains. As such, application of this convention would always result in understatement of incomes, profits and thus, resources.

(b) **Convention of Consistency:** This convention advocates the continuous observation and application of the rules and practices of accounting. The uniformity and consistency of accounting rules is vital to profit and loss calculations as well as comparisons of company performance. Frequent changes in the treatment of accounts would result in inconsistency and hence, make the accounting information less reliable. It would result in making accounting information truthful, accurate and complete.

(c) **Convention of Materiality:** The convention of materiality advocates the recording and reflection of all material facts (i.e. those pieces of information that can potentially influence the decision of informed investor) in the accounting records, and elimination of insignificant information. It should be noted that any item of fact which is considered material by on organisation may be treated as unimportant by another organisation. In the same way, an item that is considered material during a particular time period may be treated as unimportant in subsequent time periods.

(d) Convention of Full disclosure: This convention advocates the full disclosure of all material information, whether favourable or otherwise, in the accounting statements of a business enterprise. This convention requires that all accounting statements must be prepared honestly. The convention of disclosure holds greater importance in the case of businesses where the ownership is separate from the management.

Conclusion

Accounting principle, concepts and conventions are very vital to the accounting profession, since they bring about uniformity in the process of recording transactions. Such uniformity makes it possible to reliably compare the financial results, financial position, and cash flows of different organizations and also over different periods. These, thus go a long way in helping to standardize the financial reporting process.

Capital and Revenue Transactions

1.3

Proper distinction between transactions of capital and revenue nature is one of the fundamental requirements of accounting. It is very significant as without this being done properly, the very objective of accounting gets affected. The application of accounting concepts of periodicity, accrual and matching leads to the identification of a transaction as either capital natured transaction or revenue natured transaction.

When transactions get properly classified between capital and revenue nature, it achieves the following purposes:

1. Ensures proper accounting of transactions by identifying them either as income or as liability, and expense or asset;
2. Determination of true operating result by correct identification of incomes and expenses;
3. Proper disclosure of financial position in the balance sheet of the entity by correct disclosure of its assets and liabilities.

1.3.1 Capital and Revenue Expenditures

After the incurrence of an expenditure by an entity, that expenditure has to be recognized as either a capital expenditure or a revenue expenditure before being recorded in the books of accounts.

Capital Expenditure refers to that expenditure, benefit from which can be enjoyed by an entity over a number of accounting periods. This type of expenditure happens to be non-recurring in nature. A capital expenditure takes place when an asset or service is acquired or improvement of a fixed asset is affected. These assets resulting from such expenditure are not intended for resale in the ordinary course of business.

Example: Purchase of machinery; Construction of building; Development of website; Heavy repairs of a non-current asset etc.

Accounting Treatment: An expenditure of capital nature is not written off completely (i.e. charged) against income in the accounting period in which it is acquired. Rather, it is capitalised (i.e. recorded) as an asset and gets reflected in the balance sheet. However, over time the amount of capital expenditure sliced for being recognized as revenue expenditure i.e. it gets gradually charged against the profit. For example, the acquisition of a machinery is a capital expenditure, but charging regular depreciation on this machinery is a revenue expenditure.

Revenue Expenditure refers to that expenditure, benefit from which can be enjoyed by an entity in the current accounting period. This type of expenditure happens to be recurring in nature. Revenue expenditures are incurred to carry on the regular course of operations by an organisation.

Example: Purchase of goods for sale; payment of recurring expenses (like salaries, wages, rent, depreciation, conveyance charges, monthly internet charges etc.); Repairs and maintenance of non-current assets etc.

Accounting Treatment: An expenditure of revenue nature charged as an expense against profit of the accounting period in which it is incurred or recognised.

The following are the points of distinction between Capital Expenditure and Revenue Expenditure:

Capital Expenditure	Revenue Expenditure
1. The economic benefits from capital expenditure are enjoyed for more than one accounting period.	1. The economic benefits from revenue expenditure are enjoyed for only one accounting period.
2. It is non-recurring in nature.	2. It is recurring in nature.
3. Normally, it involves heavy cash outlay.	3. Normally, it involves lower cash outlay.
4. It is reflected in the Balance Sheet.	4. It is debited to Income Statement.
5. It may be incurred before or after the commencement of operations of an entity.	5. It is always incurred after the commencement of operations of an entity.
6. It tends to increase the earning capacity or, reduce the operating expenses of an entity.	6. It helps in carrying on the activities in the current accounting period.
7. A portion of capital expenditure may get matched against the revenue to determine the operating result.	7. Entire amount of such expenditure is matched against the revenue to determine the operating result.

Certain Rules for Identification of Capital Expenditure

An expenditure can be recognised as capital if it is incurred for the following purposes:

- An expenditure incurred for the purpose of acquiring long term assets (useful life is at least more than one accounting period) for use in the organisation to carry on its operations (and not meant for resale) will be treated as a capital expenditure. For example, if a second hand motor car dealer buys a piece of furniture with a view to use it in business; it will be a capital expenditure. But if he buys second hand motor cars, for re-sale, then it will be a revenue expenditure because he deals in second hand motor cars.
- When an expenditure is incurred to improve the present condition of a machine or putting an old asset into working condition, it is recognised as a capital expenditure. The expenditure is capitalised and added to the cost of the asset. Likewise, any expenditure incurred to put an asset into working condition is also a capital expenditure. For example, if one acquires a machine for ₹5,00,000 and pays ₹20,000 as transportation charges and ₹40,000 as installation charges, the total cost of the machine coming to ₹5,60,000. Similarly, if a building is purchased for ₹40,00,000 and ₹2,00,000 is spent on registration and stamp duty, the capital expenditure on the building stands at ₹42,00,000.
- An expenditure incurred for improving the earning capacity of an organisation will be considered to be of capital nature. For example, expenditure incurred for shifting the factory for easy supply of raw materials will be a capital expenditure.
- Preliminary expenses incurred before the commencement of business is considered capital expenditure. For example, legal charges incurred by a company for drafting the memorandum of association, articles of association of a company or brokerage paid to brokers, or commission paid to underwriters for raising capital etc.

Deferred Revenue Expenditures

Deferred Revenue Expenditure is the expenditure for which payment has been made or a liability has been incurred but which is carried forward on the presumption that will be of benefit over a subsequent period or periods.

Example: Heavy advertisement expenditure incurred prior to launching a new product; Development expenses of a product etc.

Accounting Treatment: A part of such expenditure (the expense portion) is recorded in the debit-side of the Income Statement, while the unwritten-off portion appears as an asset in the Balance Sheet.

NB: After the issuance of AS-26, the expenditures which were recognised as deferred revenue expenditure has to be treated as simple revenue expense. The accounting standard has specifically mentioned that any expenditure incurred for research, training, advertising and promotional activities should be recognised as an expense of the accounting period in which it has been incurred.

1.3.2 Capital and Revenue Receipts

A receipt of money may be of a capital or revenue nature depending upon the source of the receipt. A clear distinction should be made between capital receipts and revenue receipts to ensure proper determination of operating results.

Capital Receipts refer to the receipts which are obtained by an entity from operations other than the regular operations of the entity. Capital receipts do not have any effect on the operating result (i.e. profits earned or losses incurred) during the course of a year.

Example: A company issues new shares to raise funds for expansion.

Number of share issued: 1000

Issue price per share: 50

Total Capital Raised: ₹ (1000 * 50) = ₹ 50,000.

Accounting Treatment: Such receipt is credited to the respective account of capital nature, and gets reflected in the Balance Sheet.

Revenue Receipts refer to the receipts which are obtained by an entity from its regular course of operations. Receipts of money in the revenue nature increase the profits or decrease the losses of a business and must be set against the revenue expenses in order to ascertain the profit for the period.

Example: A company sells 1000 unit @ ₹ 20 per unit in the normal course of business, in this case Revenue Receipt would be ₹ (1000 * 20) = ₹ 20,000.

Accounting Treatment: These are recognised as income and should be credited to the Income Statement.

The following are the points of difference between capital receipts and revenue receipts:

Capital Receipt	Revenue Receipt
1. These receipts are obtained by an entity from operations other than from the regular operations.	1. These receipts are obtained by an entity from regular day-to-day operations.
2. It is irregular and hence, non-recurring in nature.	2. It is recurring in nature.
3. It is not recognised as an income.	3. It is recognised as an income.
4. It gets reflected in the Balance Sheet.	4. It is credited to Income Statement.
5. It does not affect the operating result of an entity.	5. It affects the operating result of an entity.
6. It may result in creation of liability.	6. It does not create any liability.

The matching of revenues and expenses result in either profit or loss. As such, an extension of the discussion on expenditures and receipts of capital and revenue nature naturally leads to the concepts of 'Capital and Revenue Profits' and 'Capital and Revenue Losses'.

1.3.3 Capital and Revenue Profits

While ascertaining the operating result of an entity in relation to an accounting period, proper distinction is to be made between capital profits and revenue profits.

Capital Profit refers to a profit which arises out of the non-operating activities of an entity. It is non-recurring in nature. Generally, capital profits arise out of the sale of assets other than inventory, or in connection with the raising of capital or at the time of purchasing an existing business.

Examples: Profit prior to incorporation; Premium received on issue of shares; Profit made on re-issue of forfeited shares; Redemption of Debenture at a discount; Profit made on sale or revaluation of a non-current tangible asset etc.

Accounting Treatment: Capital profits are generally capitalised i.e. transferred to a Capital Reserve Account.

Revenue Profit refers to a profit which arises out of the regular operating activities of an entity. It is recurring in nature.

Example: Profit arising out of the sale of the merchandise that the business deals in; Profit made by rendering regular services to clients; Surplus earned by a non-profit organisation etc.

Accounting Treatment: Revenue profits, which get determined in the Income Statement, are distributed to the owners of the business or transferred to any Reserve Account.

1.3.4 Capital and Revenue Losses

While ascertaining losses, revenue losses are differentiated from capital losses, just as revenue profits are distinguished from capital profits.

Capital Loss refers to a loss which does not arise to an entity in the regular course of its operations.

Example: Capital losses may result from the sale of assets other than inventory for less than written down value; Diminution/ elimination of assets other than as the result of use or sale i.e. from extra-ordinary activities (viz. loss by flood, fire etc.) or in connection with raising debt capital by a company (issue of debentures at a discount) or on the settlement of liabilities for a consideration more than its book value (debenture issued at par but redeemed at a premium).

Accounting Treatment: It is either charged against the revenue i.e. debit-side of Income Statement or reflected in the asset-side of Balance Sheet (as fictitious assets).

Revenue Loss arise to an entity from the normal course of business.

Example: Discount allowed to customers for prompt payment; loss due to bad debts etc.

Accounting Treatment: Such loss is to be recorded in the debit-side of Income Statement.

Example 1

Classify the following items as capital or revenue expenditure:

(i) An extension of railway tracks in the factory area;

(ii) Wages paid to machine operators;

(iii) Installation costs of new production machine;

(iv) Materials for extension to foremen's offices in the factory;

(v) Rent paid for the factory;

(vi) Payment for computer time to operate a new stores control system,

(vii) Wages paid to own employees for building the foremen's offices. Give reasons for your classification.

Solution:

(i) Expenses incurred for extension of railway tracks in the factory area should be treated as a Capital Expenditure because it will yield benefit for more than one accounting period.

(ii) Wages paid to machine operators should be treated as a Revenue Expenditure as it will yield benefit for the current period only.

(iii) Installation costs of new production machine should be treated as a Capital Expenditure because it will benefit the business for more than one accounting period.

(iv) Materials for extension to foremen's offices in the factory should be treated as a Capital Expenditure because it will benefit the business for more than one accounting period.

(v) Rent paid for the factory should be treated as a Revenue Expenditure because it will benefit only the current period.

(vi) Payment for computer time to operate a new stores control system should be treated as Revenue Expenditure because it has been incurred to carry on the normal business.

(vii) Wages paid for building foremen's offices should be treated as a Capital Expenditure because it will benefit the business for more than one accounting period.

Example 2

State with reasons whether the following are Capital Expenditure or Revenue Expenditure:

(i) Expenses incurred in connection with obtaining a license for starting the factory were ₹ 10,000.

(ii) ₹ 1,000 paid for removal of stock to a new site.

(iii) Rings and Pistons of an engine were changed at a cost of ₹ 5,000 to get full efficiency.

(iv) ₹ 2,000 spent as lawyer's fee to defend a suit claiming that the firm's factory site belonged to the Plaintiff. The suit was not successful.

(v) ₹ 10,000 were spent on advertising the introduction of a new product in the market, the benefit of which will be effective during four years.

(vi) A factory shed was constructed at a cost of ₹ 1,00,000. A sum of ₹ 5,000 had been incurred for the construction of the temporary huts for storing building materials.

Solution:

(i) ₹10,000 incurred in connection with obtaining a license for starting the factory is a Capital Expenditure. It is incurred for acquiring a right to carry on business for a long period.

(ii) ₹1,000 incurred for removal of stock to a new site is treated as a Revenue Expenditure because it is not enhancing the value of the asset and it is also required for starting the business on the new site.

(iii) ₹ 5,000 incurred for changing Rings and Pistons of an engine is a Revenue Expenditure because, the change of rings and piston will restore the efficiency of the engine only and it will not add anything to the capacity of the engine.

(iv) ₹ 2,000 incurred for defending the title to the firm's assets is a Revenue Expenditure.

(v) ₹ 10,000 incurred on advertising is to be treated as a Revenue Expenditure. [As per As-26]

(vi) Cost of construction of Factory shed of ₹ 1,00,000 is a Capital Expenditure, similarly cost of construction of small huts for storing building materials is also a Capital Expenditure.

Accounting Cycle, Analysis of Transaction etc.

1.4

The **Accounting Cycle** is a sequence of activities performed by an accountant to document and report an organisation's financial transactions during an accounting period. This cycle follows financial transactions from when they occur to how they affect financial documents. The entire process starting with identification of transactions, their recording and processing all transactions of an organisation, to its representation on the financial statements, and also to closing the accounts, if applicable, is referred to as Accounting Cycle. To keep track of the full accounting cycle from start to finish is one of the main duties of a bookkeeper.

Stages of Accounting Cycle

The accounting cycle consists of the following sequential steps:

1. **Identifying transactions:** The first step in the accounting cycle is to analyze events to determine if they are "transactions". Transactions are the starting point from which the rest of the accounting cycle will follow.
2. **Recording transactions in Books of Original Entry:** The second step in the accounting cycle is to record the identified transactions in the relevant Books of Original Entry as journal entries.
3. **Posting to the ledger:** The next step is to record a summary of the activities in relevant account in the ledger (referred to as Posting).
4. **Drafting of Unadjusted Trial Balance:** At the end of an accounting period, data from the ledger accounts may be taken to draft a trial balance. It is prepared for identifying any errors that may have occurred during the initial stages of the accounting cycle. However, this step is not mandatory.
5. **Passing of adjustment entries:** Identification of necessary adjustments and passing of adjusting entries make up the fifth step in the cycle.
6. **Drafting of Adjusted Trial Balance:** Once all adjusting entries are completed, then an Adjusted Trial Balance can be prepared. This happens to be the last step before the preparation of the financial statements.
7. **Closing of books:** In this stage of the accounting cycle, the ledger accounts are closed and balanced (also referred to as "zoroed out") at the end of every accounting period.
8. **Drafting the Financial Statements:** In the last stage of the accounting cycle, the Income Statement is prepared with the closing balances of the nominal accounts, while the balances of real and personal accounts gets reflected in the Balance Sheet.Financial statements are prepared in the following order: Income Statement, Statement of Retained Earnings, Balance Sheet and Statement of Cash Flows.

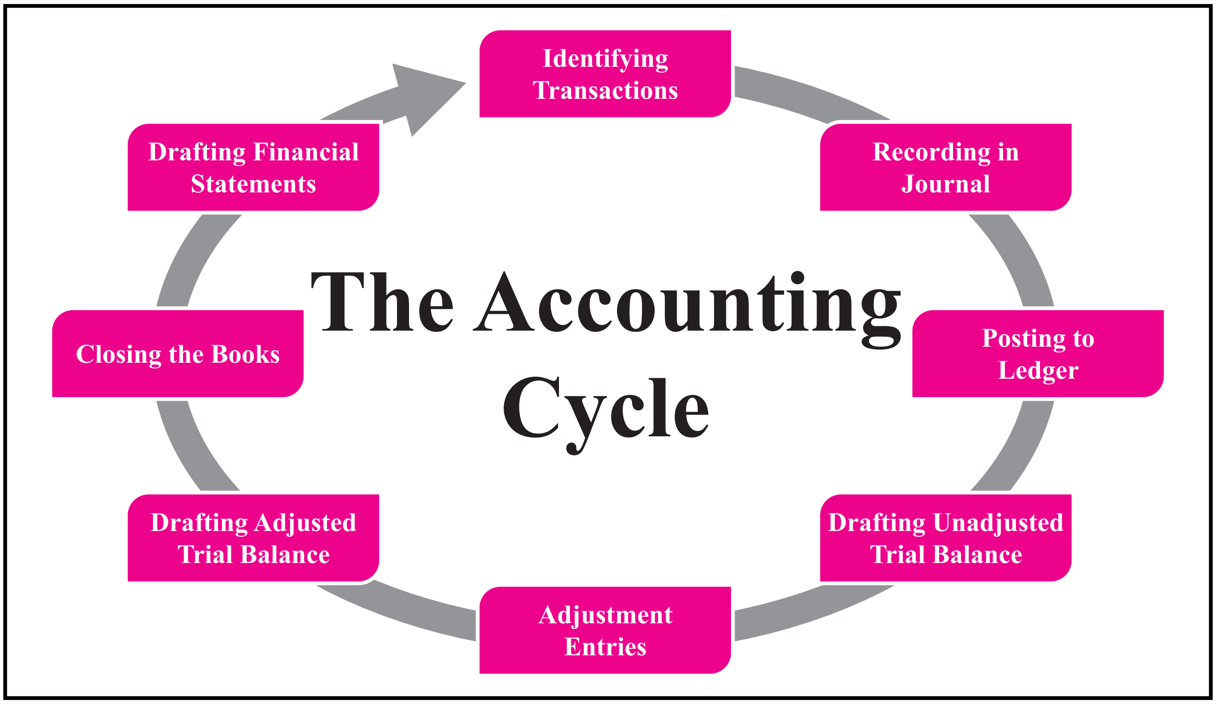


Fig: 1.1 Accounting Cycle

Events & Transactions

The primary purpose of financial accounting is to record the transactions entered into by an organisation during an accounting period. So, transactions are the staring point of the accounting cycle.Transactions are created through events, but all events are not transactions.

- **Events:** Everything that is happening in every moment of human life is an event. Simply stated, any happening is an event. As such, events can be financial (like, purchasing a book, paying cab fare, receiving a cheque etc.) and non-financial (like, visiting a book store, going for morning walk etc.). An event may involve any number of parties, and may be complete and may be incomplete.
- **Transactions:** An accounting transaction is an event which has a monetary impact on the financial position of the organisation. In order to be considered as a transaction, an event has to satisfy the following conditions:
  1. It must be measurable in terms of money.
  2. It must involve atleast two parties.
  3. It involves a monetary exchange for a goods or service.
  4. It must cause a change in the financial position of the entity.

Analysis of Transactions

An organisation enters into various transactions during the course of its operations. These transactions cause changes in financial position of the organisation. **Analysis of transactions** implies observing the changes in financial position of the organisation caused by the transactions entered into by it during an accounting period. A change in financial position means change in one or more of the five basic elements of accounting, they being: Assets, Liabilities, Capital/ Equity, Expenses, and Revenue.

In the following example of a trading proprietorship business, various illustrative transactions are used to understand the changes in different elements of accounting:

Transaction 1: Mr. Suman De commences his business by investing ₹ 5,00,000 in cash.
Changes brought about by this transaction are:
Cash increases in the business by ₹ 5,00,000; (Element changed: Asset increase)
Capital increases by ₹ 5,00,000 (Element changed: Capital/ Equity increase)
Transaction 2: Mr. De opened a current account with the bank by depositing ₹ 2,00,000.
Changes brought about by this transaction are:
Cash balance decreases by ₹ 2,00,000; (Element changed: Asset decrease)
Bank balance increases by ₹ 2,00,000 (Element changed: Asset increase)
Transaction 3: He borrows ₹ 1,20,000 from bank interest @ 10% p.a.
Changes brought about by this transaction are:
Bank balance increases by ₹ 1,20,000 (Element changed: Asset increase);
Bank loan increases by ₹ 1,20,000 (Element changed: Liability increase)
Transaction 4: Mr. De purchases equipments worth ₹ 80,000 for cash.
Changes brought about by this transaction are:
Equipments increase by ₹ 80,000; (Element changed: Asset increase)
Cash decrease by ₹ 80,000 (Element changed: Asset decrease)
Transaction 5: He purchased goods worth ₹ 1,00,000 for resale, out of which 60% was paid in cash, 30% by cheque and balance was due.
Changes brought about by this transaction are:
Purchases increases by ₹ 1,00,000; (Element changed: Expenses increase)
Cash balance decreases by ₹ 60,000 (Element changed: Asset decrease)
Bank balance decreases by ₹ 30,000 (Element changed: Asset decrease)
Creditors/ Payables increases by ₹ 10,000 (Element changed: Liability increase)
Transaction 6: Goods sold in cash ₹ 1,70,000.
Changes brought about by this transaction are:
Cash increases by ₹ 1,70,000; (Element changed: Asset increase)
Sales increase by ₹ 1,70,000 (Element changed: Revenue increase)

Transaction 7: Goods sold on credit for ₹ 80,000.
Changes brought about by this transaction are:
Debtors/ Receivables increases by ₹ 80,000 (Element changed: Asset increase)
Sales increase by ₹ 80,000 (Element changed: Revenue increase)
Transaction 8: Mr. De incurred ₹ 20,000 as wages.
Changes brought about by this transaction are:
Wages increases by ₹ 20,000; (Element changed: Expenses increase)
Cash decreases by ₹ 20,000 (Element changed: Asset decrease)
Transaction 9: Interest on bank loan charged ₹ 3,000.
Changes brought about by this transaction are:
Bank interest increased by ₹ 3,000; (Element changed: Expenses increase)
Bank balance decreased by ₹ 3,000 (Element changed: Asset decrease)
Transaction 10: He collected cash ₹ 20,000 from his customer.
Changes brought about by this transaction are:
Cash increases by ₹ 20,000; (Element changed: Asset increase)
Debtors/ Receivables decreases by ₹ 20,000 (Element changed: Asset decrease)
Transaction 11: Mr. De paid ₹ 8,000 to his supplier.
Changes brought about by this transaction are:
Cash decreases by ₹ 8,000; (Element changed: Asset decrease)
Creditors/ Payables decreases by ₹ 8,000 (Element changed: Liability decrease)
Transaction 12: He withdrew cash ₹ 7,000 for his personal use.
Changes brought about by this transaction are:
Cash decreases by ₹ 7,000; (Element changed: Asset decrease)
Capital decreases by ₹ 7,000 (Element changed: Capital/ Equity decrease)

Such analysis of the transactions helps in identification of the accounts which would be involved for accounting purposes and also helps in identification of the debit and credit aspects of every transaction.

Charts of Accounts and Codification Structure

The primary purpose of financial accounting is to record the transactions entered into by an organisation during an accounting period. To achieve this, various accounts are opened and after the classification exercise the transactions get posted in the ledger (which itself is classified as personal and impersonal). These happen to be the building blocks for developing the financial statements and other management reports of the organisation.

However, with the increase in the complexity of business and flow of data, it has become quite a challenge to retrieve the information stored in the accounting records. It is for the purpose of effective management and retrieval of the already recorded accounting information, Chart of Accounts are developed and they are codified.

Charts of Accounts

- A Chart of Accounts (COA) is a listing of all accounts in the general ledger, each account accompanied by a reference number. It is a financial organizational tool that provides a complete listing of every account in the general ledger of a company, broken down into subcategories.Specifically, it is an index of all the financial accounts in the general ledger of an organisation.
- Chart of Accounts is the driving force behind an organisation's book-keeping and accounting systems, and is considered to be the foundation of financial reporting.
- The basic purpose of such charting is to organize the accounts and group similar ones together.
- It is used to organize finances and give the stakeholders (viz. investors and shareholders) a clearer insight into a company's financial health. This process makes it easier for the users to locate specific accounts.A well-structured chart of accounts is often the single best and most effective way to raise the financial reporting of an organization to the next level.

Codification Structure

- A Chart of Accounts provides the structure for the general ledger accounts of a concern. It lists specific types of accounts, describes each account, and includes account numbers. A chart of accounts typically lists asset accounts first, followed by liability and capital accounts, and then by revenue and expense accounts.
- **Setting up of a Chart of Accounts:** To set up a chart of accounts, the first is to define the various accounts to be used by the organisation. Each account should have a number to identify it. Each chart of accounts typically contains a name, brief description, and an identification code.
- **Ordering of Accounts:** Balance Sheet Accounts tend to follow a standard that lists the most liquid assets first. Revenue Accounts and Expense Accounts tend to follow the standard of first listing the items most closely related to the operations of the business. For example, sales would be listed before non-operating income. In some cases, part of all the expense accounts simply may be listed in alphabetical order.
- **Designing of Chart of Accounts:** The designing of a detailed chart of accounts would typically begin with an initial design which would reflect the major headings of the accounts. Thereafter, the detailed descriptions of the transaction are added, which may act as future references.

Illustration of Account Codification for a small business organisation:

For a small business, three digits code may suffice for the account number, although more digits are desirable. However, in order to allow for new accounts to be added as the business grows with more digits, new accounts can be added while maintaining the logical order. Complex businesses may have thousands of accounts, and require longer account reference numbers.As such, it is worthwhile to put thought into assigning the account numbers in a logical way and to follow any specific industry standards.

The following is an example of some of the accounts that may be included in a chart of accounts and reflecting how the digits might be coded:

Account Numbering & Description of Accounts
1000 to 1999: Asset accounts
2000 to 2999: Liability accounts
3000 to 3999: Equity accounts
4000 to 4999: Revenue accounts
5000 to 5999: Cost of goods sold accounts
6000 to 6999: Expense account
7000 to 7999: Other revenue (for example rent received, bad debt recovery etc.)
8000 to 8999:Other expenses (for example depreciation income taxes etc.)

An alternative presentation of a typical Chart of Accounts is as follows:

Balance Sheet Accounts	Income Statement Accounts
Assets (1000 – 1999)	Operating Revenues (4000 – 4999)
Liabilities (2000 – 2999)	Operating Expense (5000 – 5999)
Owner's Equity (3000 -3999)	Overhead Costs or Expenses (6000 – 6999)
	Non-operating revenue and gains (7000 – 7999)
	Non- operating expenses and Losses (8000 – 8999)

It is to be noted that by separating each account by several numbers many new accounts can be added between any two while maintaining the logical order.

Accounting Equation

The accounting equation is a representation of how the three important components of accounting namely Assets, Liabilities and Equity are associated with each other.

In the most simplistic form, the accounting equation is presented as: **Assets = Liabilities + Equity**.

Assets represent the valuable resources controlled by the company such as cash, accounts receivable, fixed assets, inventory etc. **Liabilities** represent its obligations of an organisation to its external stakeholders, while **Equity** represents owners net claim on the assets. It is to be noted that, the liabilities and equity represent how the assets of the organisation has been financed.

All three components of the accounting equation appear in the balance sheet, which reveals the financial position of an entity at any given point in time.

Expanded Accounting Equation: The above equation can be further expanded by incorporating the various elements of the Equity component as under:

Assets = Liabilities + Equity

or, Assets = Liabilities + [Capital + (Revenue – Expenses) – Drawings]

or, Assets + Expenses + Drawings = Liabilities + Capital + Revenue

This equation is considered to be the foundation of the double-entry accounting system.At a general level, this means that whenever there is a recordable transaction, the choices for recording it all involve keeping the accounting equation in balance.

Illustrative Accounting Equation Transactions

The following table shows a few of the common accounting transactions and their recording within the framework of the accounting equation:

Transaction	Assets + Expenses + Drawings	Liabilities + Capital + Revenue
1. Cash introduced by proprietor	Cash (Assets) increases	Capital increases
2. Purchase of goods in cash	Inventory (Asset) increases; Cash (Assets) decreases	N.A.
3. Purchase of goods in credit	Inventory (Asset) increases	Creditors/ Payables (Liabilities) increases
4. Sale of goods in cash	Cash (Assets) increases; Inventory (Assets) decreases	N.A.
5. Sale of goods in credit	Debtors/ Receivables (Assets) increases; Inventory (Assets) decreases	N.A.
6. Salaries paid	Salaries (Expenses) increases; Cash/ Bank (Assets) decreases	N.A.
7. Rent received	Cash/ Bank (Assets) increases	Rent received (Revenue) increases
8. Goods withdrawn by proprietor	Inventory (Assets) decreases	Capital decreases

Double Entry System

Double Entry System of Bookkeeping is an accounting system which recognizes the fact that every transaction has two aspects and both aspects of the transaction are recorded in the books of accounts.It is a fundamental concept encompassing accounting and book-keeping in present times.

Double entry system records the transactions by understanding them as a Debit item or Credit item. A debit entry in one account gives the opposite effect in another account by credit entry. This means that the sum of all Debit accounts must be equal to the sum of Credit accounts.

This system is based on the accounting equation and requires:

1. Every business transaction to be recorded in at least two accounts.
2. The total debits recorded for each transaction to be equal to the total credits recorded.

Rules of Debit and Credit under Double Entry System

The double-entry accounting system is based on specific rules of debit and credit for recording transactions in the accounts. The rules of debit and credit can be explained by applying two methods:

1. Golden Rules; and
2. Accounting Equation

Successive Processes of the Double Entry System

- Firstly, transactions are recorded in the **Books of Original Entry** (i.e. **Journal and other Subsidiary Books**).

- Secondly, the transactions are classified in a suitable manner and recorded in another book of account known as **Ledger**.
- Thirdly, the arithmetical accuracy of the books of account maychecked by means of drafting a **Trial Balance**.
- Finally, the result of the operations of the accounting period is ascertained through the drafting of **Income Statementand** financial position of the entity at the end of the accounting period is reflected through the **Balance Sheet**.

Books of Original Entry& Subsidiary Books

- Simply stated, **Books of original entry** refer to the accounting books (technically called Journals) in which transactions entered into by an organisation are initially recorded. These are the primary books of accounts which are used by the accountants for recording the transactions in the first place. These are also referred to as Books of Primary Entry or Books of First Entry.
- Whenever an event is recognised as a transaction, it is entered into the accounting system of an entity by first recording it in the journal (with their description and detailed reference to supporting documents).
- The transactions are recorded in the journals in the form of individual entries (referred to as Journal Entries) as and when they occur in chronological order. As because the transactions are recorded on daily basis, the books of original entry are also referred to as Day Books.
- The information in these books is thereafter summarized and posted into the ledger accounts.

Types of Books of Original Entry

The books of original entry are broadly classified into two categories:– Special Journals (Day Books) and General Journal. (Refer to para 1.5- Types of Journal).

Posting in Ledger & Finalization of Accounts

- After the transactions relating to a particular accounting period have been recorded in the journal and/ or subsidiary books, they are posted in respective accounts in the ledger (the Book of Final entry). At the end of the accounting period (viz. quarter, half-year or year), the ledger accounts are balanced and closed.
- The closure of the ledger accounts is based on the nature of the respective accounts. Specifically, the nominal accounts (viz. accounts representing incomes, expenses, gains and losses) are closed by transfer to the Income Statement (namely, Trading A/c and Profit & Loss A/c for a profit-oriented organisation, and Income & Expenditure A/c for a non-profit organisation). The income statement is prepared to ascertain the operating results (viz. profit/ loss or surplus/ deficit) in relation to a specific accounting period.
- The balances of the accounts of real and personal nature are carried forward to the next accounting period. Their balances are reflected in a specific financial statement called the Balance Sheet. It shows the financial position of an organisation at the end of a specific accounting period by reflecting the different assets owned, liabilities and equity of the organisation.

Journal and Ledger

1.5

The first step in the accounting cycle, after the identification of transactions happens to be recording of transactions in the journal, followed by their posting in respective accounts in the ledger.

Journal

Journal is the book of original entry in which financial transactions are firstly recorded after their occurrence in chronological order. It is in this book of accounts where the transactions are recorded in the first place.

The word 'Journal means' a daily record. Journal is derived from French word 'Jour' which means a day. This book of account is also referred to as the Book of Prime Entry or Books of First Entry.

The process of recording the transactions in a journal is called 'Journalizing'. This is the first activity that a book-keeper performs after identification of the transactions which has to be recorded in the books of accounts of a concern.

The entry made in this book is called a 'Journal Entry'. Every entry in the journal is followed by a short summary which describes the particular transaction. This short summary is referred to as 'Narration'. Every entry in the book of original entry must be followed by such a narration.

Example of a Transaction and its Journal Entry:

As per voucher no. 31 of Roy Brothers, on 09.02.2023 goods of ₹ 50,000 were purchased. Cash was paid immediately. The folios of the Purchase A/c and Cash A/c in the ledger are 5 and 17 respectively. Journal entry of the above transaction is given below:

In the books of Roy Brothers

Journal **Dr.** **Cr.**

Date	Particulars	Voucher No.	Ledger Folio	(₹)	(₹)
09.02.2023	Purchase A/c Dr.	31	5	50,000	
	To Cash A/c		17		50,000
	(Being goods purchased for cash)				

- Each journal entry is passed in the books on the basis of some source documents. Some of the common source documents are: purchase invoices (also called inward invoices), sales receipts (also called outward invoices), debit notes, credit notes etc. The process of accounting does not end after recording of transactions in the journal. Rather, with the objective of classification, the transactions are summarized and posted to respective accounts in the ledger(s).

- A journal entry can be a Simple journal entry or a Compound journal entry. When in a journal entry only two accounts are affected – one account is debited and another account is credited, it is called a **Simple journal entry**. For example, the journal entry for the transaction 'Goods worth ₹44,000 sold by Ramesh to Rajesh for cash' will be a simple journal entry as in this case Cash A/c will be debited with ₹44,000 and Sales A/c will get credited with ₹44,000.
- While in case of a **Compound journal entry** at least two debits and at least one credit or at least one debit and two or more credit items are involved. For example, the journal entry for the transaction 'Goods worth ₹54,000 sold by Ramesh to Rajesh involving cash sale ₹44,000 and balance on credit' will be a compound journal entry as in this case Cash A/c as-well as Debtors A/c will be debited with ₹44,000 and ₹10,000 respectively, and Sales A/c will get credited with ₹54,000.

Types of Journal

The books of original entry are broadly classified into two categories:

1. **Special Journal:**
2. **General Journal**

1. Special Journal:

A Special Journal is a book of primary entry in which transactions of a specific type viz. credit purchases, credit sales, return inwards etc. are first recorded before being posted in the respective ledger account. These are also referred to as Subsidiary Books. During the lifecycle of and organisation, when the volume of transactions increases to an extent that a single journal may no longer be adequate to record the transactions effectively, then special purpose books or subsidiary books are required for more efficient record keeping purposes. The different special journals that are usually maintained by an organisation for primary recording of its transactions are:

(a) **Cash Journal or Cash Book** is a special journal which is maintained for recording all transactions which involve cash, whether cash inflows or cash outflows.

(b) **Purchase journal** is a special journal which is used by an organization to record all the credit purchases made by it during an accounting period. It is also known as Purchase Book or Purchase Daybook.

(c) **Sales Journal** is a type of special journal that is used to record credit sale transactions of an organisation. It is also known as Sales Book or Sales Daybook.

(d) **Purchase Return Journal** is the special journal that is used for recording the goods which have been returned by an organisation to its suppliers, for any reason. It is also known as Purchase Return Book or Purchase Daybook.

(e) **Sales Return Journal** is the special journal that is used for recording the goods which have been returned to an organisation by its customers, for any reason. It is also known as Sales Return Book or Sales Daybook.

(f) **Bills Receivable Journal** is the special journal which is used to record the details of bills of exchange received by an entity from its customers during an accounting period. It is also known as Bills Receivable Book or Bills Receivable Daybook.

(g) **Bills Payable Journal** is the special journal which is used to record the details of bills of exchange accepted by an entity towards its suppliers during an accounting period. It is also known as Bills Payable Book or Bills Payable Daybook.

2. General Journal:

This is a book of original entry in which those transactions are recorded for which no specific day book is maintained are recorded.

In the following section, the important subsidiary books have been discussed.

1(a): Cash Journal or Cash Book

Cash Journal or Cash Book is a special journal which is maintained for recording all transactions which involve cash, whether cash inflows or cash outflows. In this book of original entry, transactions of every type (whether capital natured transactions or revenue natured transactions) are entered. This journal records the details of each transaction effected in cash by an organisation. Such details include the date, particulars, voucher number, ledger folio and the amount of the transaction.

The various aspects of the Cash Book has been discussed in detail in Para 1.6 of the study material.

1(b): Purchase Journal

The Purchase Journal is a book of original entry which is meant for recording credit purchase of goods. It is also known as Purchase Day Book or simply, Purchase Book. It is to be noted that cash purchases of goods are not recorded in this day book. Also purchase of other long term assets (like equipment, furniture, machinery etc.) on credit does not find place in purchase day book.

The Purchase journal records the details of the credit purchase of goods made by an organisation. Such details include the date of purchase, particulars of items purchased, inward invoice number, ledger folio and the amount of purchase.

The format of a purchase journal is as given below:

Date	Particulars	Inward Invoice No.	Ledger Folio No.	(₹)

Source document for entry in purchase journal:

All entries in this book are made from the Purchase invoices. A purchase invoice is a statement which is issued by the seller of goods to the buyer of goods reflecting the details of the goods like the date of purchase, the quantity of purchase, the rate per unit, the total amount and also the terms of payment, if any.

Posting from Purchase Journal to Ledger

The Purchase Journal, being a book of original entry, transactions entered here are thereafter required to be posted to the respective ledger accounts in the ledger. The total of the purchases made during a period is posted to Purchases Account in the general ledger, while the individual credit purchase transactions posted in the personal ledger accounts of the respective suppliers (in the suppliers ledger).

1(c): Sales Journal

Sales Journal is the book of original entry which records credit sales of goods. It is also known as Sales Day Book or simply, Sales Book. It is to be noted that sale of goods for cash are not recorded in this day book. Also sale of other long term assets (like equipment, furniture, machinery etc.) does not find place in this book of original entry.

The Sales journal records the details of the credit sales of goods made by an organisation during a period. Such details include the date of sale, particulars of items sold, outward invoice number, ledger folio and the amount of sales.

The format of a typical sales journal is as given below:

Date	Particulars	Outward Invoice No.	Ledger Folio No.	(₹)

Source Document for Entry in Sales Journal:

All entries in this book are made from the Sales invoices. A sales invoice is a statement which is issued by the seller of goods to the buyer of goods reflecting the details of the goods like the date of sale, the quantity of sale, the rate per unit, the total amount and also the terms of payment, if any.

Posting from Sales Journal to Ledger

The Sales Journal, being a book of original entry, transactions entered here are thereafter required to be posted to the respective ledger accounts in the ledger. The total amount of sales made during a period is posted to Sales Account in the general ledger, while the individual entries of credit sale are posted in the personal ledger accounts of the respective customers/ debtors (in the debtors ledger).

1(d): Purchase Returns Journal

The Purchase Returns Journal is a book of original entry which is meant for recording returns of goods purchased on credit from the suppliers. It is also known as Returns Outward Day Book. It is to be noted that returns arising out of cash purchases of goods, or return of any assets other than merchandising goods on credit does not find place in this day book.

The Purchase returns journal records the details of the returns arising out of credit purchase of goods viz. the date of return, particulars of items returned, name of supplier, debit note number, ledger folio and the total amount.

The format of a purchase returns journal is as given below:

Date	Particulars	Debit Note No.	Ledger Folio No.	(₹)

Source Document for Entry in Purchase Returns Journal:

All entries in this book are made from the debit notes issued to respective suppliers or credit notes received from the respective suppliers.

Posting from Purchase Returns Journal to Ledger

The Purchase Returns Book, being a book of original entry, transactions entered here are thereafter required to be posted to the respective ledger accounts in the ledger. The total of the purchase returns made during a period is posted to Purchase Returns or Return Outwards Account in the general ledger, while the individual purchase return transactions posted in the personal ledger accounts of the respective suppliers (in the Creditors Ledger).

1(e): Sales Returns Journal

Sales Return Journal is the book of original entry which records returns of goods earlier sold on credit basis. It is also known as Sales Returns Day Book or simply, Sales Returns Book.

The Sales Returns Book records the details of the goods returned out of credit sales made by an organisation during a period. Such details include the date of return, particulars of items returned, credit note number, ledger folio and the amount of sales returns.

The format of the sales return journal is as given below:

Date	Particulars	Credit Note No.	Ledger Folio No.	(₹)

Source Document for Entry in Sales Returns Journal:

All entries in this day book are made from the Credit Note issued by the seller of goods. A sales invoice is a statement which is issued by the seller of goods to the buyer of goods reflecting the details of the goods like the date of sale, the quantity of sale, the rate per unit, the total amount and also the terms of payment, if any.

Posting from Sales Returns Journal to Ledger

As the Sales Return Journal is a book of original entry, and so transactions recorded here are thereafter required to be posted to the respective accounts in the ledger. The total amount of sales returns made during a period is posted to Returns Inward (or Sales Returns) Account in the general ledger, while the individual entries of sale returns are posted in the personal ledger accounts of the respective customers/ debtors (in the Debtors ledger).

1(f): Bill Receivable Journal

The Bill Receivable Journal is a book of original entry which is meant for recording the bills of exchange received from the customers to whom goods have been sold on credit. This journal records the details like the details of the customer, name of drawer, name of acceptor, date of receipt of the bill, date of drawing of the bill, date of acceptance of the bill, tenure of the bill, date of maturity, ledger folio and the amount of the bill.

Source document for entry in purchase journal:

All entries in this book are made from the bills of exchanges received from the customers.

Posting from Bill Receivable Journal to Ledger

The Bill Receivable Journal, being a book of original entry, transactions entered here are thereafter required to be posted to the respective ledger accounts in the ledger. The total of the bill of exchanges received during a period is posted to Bills Receivable Account in the general ledger, while the individual transactions posted in the personal ledger accounts of the respective customers (in the Debtors Ledger).

1(g): Bill Payable Journal

The Bill Payable Journal is a book of original entry which is meant for recording the bills of exchange issued to the suppliers from whom goods have been purchased on credit. This journal records the details like the details of the supplier, name of drawer, name of acceptor, date of issue of the bill, date of drawing of the bill, date of acceptance of the bill, tenure of the bill, date of maturity, ledger folio and the amount of the bill.

Source document for entry in purchase journal:

All entries in this book are made from the bills of exchanges issued to the suppliers.

Posting from Bill Payable Journal to Ledger

The Bill Payable Journal, being a book of original entry, transactions entered here are thereafter required to be posted to the respective ledger accounts in the ledger. The total of the bill of exchanges issued during a period is posted to Bills Payable Account in the general ledger, while the individual transactions posted in the personal ledger accounts of the respective customers (in the Creditors Ledger).

2. General Journal or Journal Proper

General Journal is the book of original entry in which those transactions for which no special journal is maintained are recorded. In other words, transactions like credit purchases, credit sales, purchase returns, sales returns etc. (for which specific subsidiary books are maintained) are recorded in this book of primary entry. This book of original entry is also known as Journal Proper. The following transactions are recorded in this book of original entry:

- Purchase of a non-current asset on credit,
- Sale of a non-current asset on credit,
- Entries passed to rectify errors made in books of accounts (rectification entries),
- Entries passed to adjust ledger balances (adjustment entries),
- Entries passed to open accounts passed when the business starts operations (opening entries),
- Closing entries to transfer Nominal Accounts to Trading & Profit and Loss Account.

Types of Entries Recorded in Journal Proper

Opening entries: These entries are passed for bringing the balances of certain accounts in the books of the current accounting period. The different accounts whose balances are brought forwards are the assets, liabilities and equity accounts appearing the Balance Sheet of the preceding accounting period.

Transfer entries: In accounting, it is sometimes necessary to transfer an amount or balance of one account to some other account. The journal entries through which the amount of an account are transferred to another account are referred to as Transfer entries. Such entries are used when a wrong booking has been made in respect of any account or to allocate an expense/ revenue from one account to another.

Closing entries: All the expenses and gains or income related nominal accounts must be closed at the end of the year. The entries which are passed at the end of an accounting period for closing the nominal accounts by transferring them to the profit determining accounts like Trading Account, Profit & Loss Account, Consignment Account, Joint Venture Account, Income & Expenditure Account etc.

Adjustment entries: These entries are passed at the time of finalization of accounts for honouring the different generally accepted accounting principles i.e. accounting concepts and accounting conventions.

Rectification entries: These entries are passed for correcting the different errors that get committed while recording, posting, casting, balancing etc. in the books of accounts.

Occasional/Miscellaneous Entries: It means entries other than above for which no specific subsidiary books are maintained.

Rules of Journalising

- The process of passing an entry in a journal is called Journalising. The rule for journalising is same as that of rules of debit and credit. The debiting and crediting of the accounts are done on the basis of certain rules. There are two alternative bases for the rules of debit and credit such as follows.

1. Rules of Debit and Credit based on the types of account; and
2. Rules of Debit and credit based on the accounting equation.

Rules of Debit and Credit Based on the Types of Account (Golden Rules Approach)

- Under double-entry system every account can be classified into any of the following three types: Personal account, Real account and Nominal account. For each of these types of account, there are separate rules of debiting and crediting the transactions. The rules of debit and credit under different types of account are as follows:

Nature of Account	Rule of Debit and Credit	
Nominal Account	Debit	Expenses and Losses
	Credit	Incomes and Gains
Real Account	Debit	What comes in
	Credit	What goes out
Personal Account	Debit	The receiver
	Credit	The giver

Rules of Debit and credit Based on the Accounting Equation (Accounting Equation Approach)

Accounting equation is a statement of equality between the three basic elements of accounting viz. assets, liabilities and equity. Each and every financial transaction affects any one or more of these three basic elements. However, the total of all assets is always equal to the total of liabilities and equity at any point in time. The rules of debiting and crediting an account based on the accounting equation have been summarized hereunder:

Components of Accounting Equation	Rule of Debit and Credit	
Assets	Debit	Increase
	Credit	Decrease
Liabilities	Debit	Decrease
	Credit	Increase
Capital	Debit	Decrease
	Credit	Increase
Drawings	Debit	Increase
	Credit	Decrease
Expenses	Debit	Increase
	Credit	Decrease
Revenue	Debit	Decrease
	Credit	Increase

Steps in Journalising

The process of journalising involves the following steps:

1. Determination of the accounts involved in the transaction.
2. Classifying the accounts either as 'Nominal, Real and Personal' or into 'Assets, Liabilities, Capital, drawings, Expenses and Revenue'.
3. Appling the rules of debit and credit for the identified accounts for identifying which account is to be debited and which accounts is to be credited.
4. Recording the details of the transaction viz. date, particulars and its narration, and also the amount to be debited and credited.
5. Writing a brief summary of the transactions (called narration) at the end.

Functions of Journal

The functions performed by the book of original entry are:

- **Historical Function:** It contains a chronological record of the transactions for future references.
- **Recording Function:** Accountancy is a business language which helps to record the transactions based on the principles. Each such recording entry is supported by a narration, which explains the transaction in simple language.
- **Analytical Function:** Each transaction is analysed into the debit aspect and the credit aspect. This helps to find out how each transaction will financially affect the business.

Advantages of Journal

The book of original entry provides the following advantages:

- **Chronological Record:** It records transactions as and when it happens. So it is possible to get detailed day-to-day information, and also acts as a future reference.
- **Minimising the possibility of errors:** The nature of transaction and its effect on the financial position of the business is determined by recording and analyzing into debit and credit aspect.
- **Narrative explanation of the recorded transactions:** It maintains the detailed record of transactions written immediately after passing the entry, thus provides a highlight of the transaction done.
- **Helps to classify the accounts:** Journal is the basis of ledger posting and the ultimate Trial Balance.
- **Evidence in court:** Information recorded in the journal which certainly serves as a proof or evidence in the court of law.

Limitations of Journal

- When a single journal is maintained, it becomes unsuitable for organizations that enter into a large number of transactions.
- It is not a simple system of recording of transactions.
- The process of journalising is a time consuming process.
- It does not facilitate internal control, because in journal transactions are recorded in chronological order.

Ledger

The book of account in which transactions are recorded in respective account, after they have been entered in the journal is called the Ledger. It is the book of account in which the transactions are recorded in a classified and permanent manner. It is the final destination of all the accounts, and hence, it is also called the Book of Final Entry. The process of recording the entry in the ledger is technically known as Posting. It is the book of account in which transactions are recorded from the journal. It contains various 'ledger accounts'. The transactions are recorded in each of the relevant ledger accounts in a chronological order. It reflects the final position of each account on any particular date. It forms the basis for preparation of Trial Balance. . A ledger account has a specific format, as under:

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

Date	Particulars	J.F.	(₹)	Date	Particulars	J.F.	(₹)

Functions of Ledger

- It acts as a permanent store-house of all the transactions of a concern arranged for ready reference.
- It summarizes the effects of business transactions in terms of the individual accounts, so that a conclusion concerning the status of each account may be drawn periodically. In other words, it shows under each account heading all positive and negative changes pertaining to that account as a result of operations to date, and the balance of the account, if any, at the end of each significant period.
- It is like a 'mirror' reflecting the image of the concern which enables it to analyse business operations for the purpose of deciding future plan of action

Subdivisions of Ledger

On the basis of the nature of accounts maintained, ledger can be classified into Personal Ledger and General Ledger.

1. **Personal Ledger:** The ledger which contains the personal accounts of the debtors and creditors is called Personal Ledger. It can be further sub-divided into:
   (a) Debtors'/Customers'/Sales ledger: It contains the personal accounts of all the customers/trade debtors.
   (b) Creditors'/Suppliers'/Purchase/Bought ledger: It contains the personal accounts of all the suppliers/trade creditors.
2. **Impersonal Ledger or General Ledger:** The ledger which contains the accounts other than those contained in the 'Personal Ledger' is called Impersonal/General Ledger. The types of accounts maintained in this ledger are Real, Nominal and Personal (except Trade Debtors and Trade Creditors).

The advantages of such sub-division are:

- It provides complete and detailed information of all accounts of similar nature in one book.
- It discloses the summarised information by getting the ledger accounts balanced.

Ledger Posting

As and when the transaction takes place, it is recorded in the journal in the form of journal entry. This entry is posted again in the respective ledger accounts under double entry principle from the journal. This is called ledger posting.

The rules for writing up accounts of various types are as follows:

Assets: Increases on the left hand side or the debit side and decreases on the credit side.

Liabilities: Increases on the credit side and decreases on the debit side.

Capitals: The same as liabilities.

Expenses: Increases on the debit side and decreases on the credit side.

Incomes or Gains: Increases on the credit side and decrease on the debit side.

To summarise

Dr.	Assets	Cr.
Increase		Decrease

Dr.	Liabilities & Capital	Cr.
Decrease		Increase

Dr.	Expenses or Loses	Cr.
Increase		Decrease

Dr.	Income or Gains	Cr.
Decrease		Increase

Concepts of Debit and Credit

A debit denotes:

(a) In the case of a person that he has received some benefit against which he has already rendered some service or will render service in future. When a person becomes liable to do something in favour of the firm, the fact is recorded by debiting that person's account : (relating to Personal Account)

(b) In case of goods or properties, that the value and the stock of such goods or properties has increased, (relating to Real Accounts)

(c) In case of other accounts like losses or expenses, that the firm has incurred certain expenses or has lost money. (relating to Nominal Account)

A credit denotes:

(a) In case of a person, that some benefit has been received from him, entitling him to claim from the firm a return benefit in the form of cash or goods or service. When a person becomes entitled to money or money's worth for any reason. The fact is recorded by crediting him (relating to Personal Account)

(b) In the case of goods or properties, that the stock and value of such goods or properties has decreased. (relating to Real Accounts).

(c) In case of other accounts like interest or dividend or commission received, or discount received, that the firm has made a gain (relating to Nominal Account)

Balancing of Ledger Accounts

After all the transactions of a period get posted in the ledger, the net effect of these transactions is ascertained. This process of ascertaining the net effect of all the transactions posted in a particular ledger account for a period is called Balancing of a ledger account. The process of balancing an account involves totaling both the sides (i.e.

debit side and credit side) of an account and ascertaining the difference between the two.

An account can show debit balance, or credit balance or nil balance. An account is said to be having a debit balance when its debit-side total is higher than the credit side total; while an account is said to have a credit balance when its credit-side total is higher than the debit-side total. When both side have same total, the account is said to have nil balance. This is very significant function of accounting as the finalization of accounts is done with the balances of the ledger accounts.

Illustration 1

For the following transactions pass the journal entries and post them in Ledger:

2023
April 1 – Mr. Vikas and Mrs. Vaibhavi who are husband and wife start consulting business by bringing in their personal cash of ₹ 5,00,000 and ₹ 2,50,000 respectively.
April 10 – Bought office furniture of ₹ 25,000 for cash.
April 11 – Opened a Current Account with Bank of BB by depositing ₹ 1,00,000
April 15 – Paid office rent of ₹ 15,000 for the month by cheque.
April 20 – Bought a motor car for ₹ 4,50,000 from Millenium Motors by making a down payment of ₹ 50,000 by cheque and the balance by taking a loan from HH Bank.
April 25 – Vikas and Vaibhabi carried out a consulting assignment for AA Pharmaceuticals and raised a bill for ₹ 10,00,000 as consultancy fees. AA Pharmaceuticals have immediately settled ₹ 2,50,000 by way of cheque and the balance will be paid after 30 days. The cheque received is deposited into bank.
April 30 – Salary of a receptionist at the rate ₹ 5,000 per month and an officer at the rate ₹ 10,000 per month the salary for the current month is payable to them.

Solution: **Books of Vikas and Vaibhavi**

Journal **Dr.** **Cr.**

Date	Particulars		L.F.	V.N.	(₹)	(₹)
2023 April 1	Cash A/c…….	Dr.			7,50,000	
	To Vikas's Capital A/c					5,00,000
	To Vaibhavi's Capital A/c					2,50,000
	(Being capital brought by the partner)					
April 10	Furniture A/c……….	Dr.			25,000	
	To Cash A/c					25,000
	(Being furniture purchased in cash)					
April 11	Bank of BB A/c…….	Dr.			1,00,000	
	To Cash A/c					1,00,000
	(Being current account opened with Bank of BB)					

Date	Particulars	L.F.	V.N.	(₹)	(₹)
April 15	Rent A/c……………. Dr.			15,000	
	To Bank of BB A/c				15,000
	(Being Rent paid)				
April 20	Motor Car A/c ……. Dr.			4,50,000	
	To Bank of BB A/c				50,000
	To Loan from HH Bank A/c				4,00,000
	(Being car purchased from Millenium Motors by making a down payment and Loan arrangements)				
April 25	Bank of BB A/c……. Dr.			2,50,000	
	AA Pharmaceuticals A/c….. Dr.			7,50,000	
	To Consultancy Fees A/c				10,00,000
	(Being amount received and revenue recognized for fees charged)				
April 30	Salary A/c………. Dr.			15,000	
	To Salary Payable A/c				15,000
	(Being the entry to record salary obligation for the month.)				

Ledger

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

Date	Particulars	J.F.	(₹)	Date	Particulars	J.F.	(₹)
1.4.23	To Vikas's Capital A/c		5,00,000	10.4.23	By Furniture A/c		25,000
1.4.23	To Vaibhavi's Capital A/c		2,50,000	11.4.23	By Bank of BB A/c		1,00,000
				30.4.23	By Bal c/d		6,25,000
			7,50,000				7,50,000
1.5.23	To Bal b/d		6,25,000				

Dr. **Mr.Vikas's Capital Account** **Cr.**

Date	Particulars	J.F.	(₹)	Date	Particulars	J.F.	(₹)
30.4.23	To Bal c/d		5,00,000	1.4.23	By Cash A/c		5,00,000
				1.5.23	By Bal b/d		5,00,000

Dr. **Mrs.Vaibhavi's Capital Account** Cr.

Date	Particulars	J.F.	(₹)	Date	Particulars	J.F.	(₹)
30.4.23	To Bal c/d		2,50,000	1.4.23	By Cash A/c		2,50,000
				1.5.23	By Bal b/d		2,50,000

Dr. **Furniture Account** Cr.

Date	Particulars	J.F.	(₹)	Date	Particulars	J.F.	(₹)
1.4.23	To Cash A/c		25,000	30.4.23	By Bal b/d		25,000
1.5.23	To Bal b/d		25,000				

Dr. **Bank of BB Account** Cr.

Date	Particulars	J.F.	(₹)	Date	Particulars	J.F.	(₹)
11.4.23	To Cash A/c		1,00,000	15.4.23	By Rent A/c		15,000
25.4.23	To Consultancy Fees A/c		2,50,000	20.4.23	By Motor Car A/c		50,000
				30.4.23	By Bal c/d		2,85,000
			3,50,000				3,50,000
1.5.23	To Bal b/d		2,85,000				

Dr. **Rent Account** Cr.

Date	Particulars	J.F.	(₹)	Date	Particulars	J.F.	(₹)
15.4.23	To Bank of BB A/c		15,000	30.4.23	By Bal c/d		15,000
1.5.23	To Bal b/d		15,000				

Dr. **Motor Car Account** Cr.

Date	Particulars	J.F.	(₹)	Date	Particulars	J.F.	(₹)
20.4.23	To Bank of Baroda A/c		50,000				
"	To Loan from HH Bank A/c		4,00,000	30.4.23	By Bal c/d		4,50,000
			4,50,000				4,50,000
1.5.23	To Bal b/d		4,50,000				

Dr. Loan from HDFC Bank Account Cr.

Date	Particulars	J.F.	(₹)	Date	Particulars	J.F.	(₹)
30.4.23	To Bal c/d		4,00,000	20.4.23	By Motor Car A/c		4,00,000
				1.5.23	By Bal b/d		4,00,000

Dr. Avon Pharmaceuticals Account Cr.

Date	Particulars	J.F.	(₹)	Date	Particulars	J.F.	(₹)
25.4.23	To Consultancy Fees A/c		7,50,000	30.4.23	By Bal c/d		7,50,000
	To Bal b/d		7,50,000				

Dr. Consultancy Fees Account Cr.

Date	Particulars	J.F.	(₹)	Date	Particulars	J.F.	(₹)
				25.4.23	By Bank of BB A/c		2,50,000
30.4.23	To Bal c/d		10,00,000	"	By AA Pharmaceuticals A/c		7,50,000
			10,00,000				10,00,000
				1.5.23	By Bal b/d		10,00,000

Dr. Salary Account Cr.

Date	Particulars	J.F.	(₹)	Date	Particulars	J.F.	(₹)
30.4.23	To Salary Payable A/c		15,000	30.4.23	By Bal c/d		15,000
	To Bal b/d		15,000				

Dr. Salary Payable Account Cr.

Date	Particulars	J.F.	(₹)	Date	Particulars	J.F.	(₹)
30.4.23	To Bal c/d		15,000	30.4.23	By Salary A/c		15,000
							15,000
				1.5.23	By Bal b/d		

Cash Book, Bank Book, Bank Reconciliation Statement

1.6

Cash Book

Any organisation enters into numerous transactions during an accounting period, and amongst those a majority of the transactions get settled (either received or paid) involving cash. For this purpose, a separate book of account is maintained for recording only the cash transactions (whether effected in liquid cash, cheque or online transfers).

The book of account that records all cash receipts and cash payments of an organisation is referred to as cash book. The receipts are entered on the debit side, while the payments are recorded in the credit side of the cash book.

Features of Cash Book

- This is the book of account in which only cash transactions are recorded.
- All receipts of cash and payments involving cash are recoded in this book of account.
- Transactions are recorded in this book in chronological order.
- The proforma of the cash book is similar to that of a ledger account i.e. having two sides – Debit side and Credit side.
- It is a book of account which is a book of primary entry as-well-as a book of final entry. So, it is referred to as **journalized ledger**.
- Its balance reflect the balance of cash available.

Types of Cash Book

For the purpose of recording cash and bank related transactions at one place cash book is maintained. These cash books can be broadly classified into two categories – Regular Cash Book and Petty Cash Book.

1. **Regular Cash Book:** The cash book which records all cash and sometimes bank related transactions of an entity is called the Regular Cash Book or simply Cash Book. Such cash book can be classified into the following categories based on the number of amount columns maintained on each side of the cash book.

- **Single Column Cash Book:** In this cash book, only one amount column is maintained on each side to record transactions involving liquid cash. This type of cash book is usually maintained by the small organisations which do not have any bank account.Sometimes an organisation having a bank account can also maintain a single column cash book and open a separate bank account in the ledger. This cash book is actually the cash account of the entity.The balance of this cash book represent cash-in-hand at a particular point of time. The proforma of the single column cash book is a under:

Dr. **Cash Book (Single Column)** **Cr.**

Date	Particulars	L.F.	Cash (₹)	Date	Particulars	L.F.	Cash (₹)

- **Double Column Cash Book:** In many cases, two amount columns are maintained by organisation on each side of the cash book. This type of a cash book is called Double Column Cash Book. It is a popular practice to add an amount column to each side – the additional column to record the banking transactions entered into by an entity, instead of opening a separate bank account in the ledger.The balance of this cash book reflects the amounts of Cash-in-hand as-well-as Cash-at-bank at a particular point of time. The proforma of the double column cash book is a under:

Dr. **Cash Book (Double Column)** **Cr.**

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

This type of cash book gives rise to a unique type of entry referred to as the Contra Entry. When any transaction takes place involving Bank A/c and Cash A/c, the posting will happen on both side of the same account (here, the Double Colum Cash Book). Examples of such transactions are: Deposit of cash into bank, Withdrawal of cash from bank etc. For recording such a transaction, the letter 'C' is written on both sides in the Ledger Folio (L.F.) column.

- **Triple Column Cash Book:** A Cash book with three amount columns on each side (namely Cash, Bank and Discount columns) is called the Triple Column Cash Book. The discount columns of each side represent separate discount accounts. Specifically, the discount column of the debit side of cash book represent Discount Allowed and that on the credit side represent Discount Received.

Conceptually, there are two types of discounts – Trade Discount and Cash Discount. The former discount is allowed by the seller to the buyer for making bulk purchases, while the later is allowed to encourage the buyer to make prompt payment. Trade discount is never recorded in the books of account. It is the Cash Discount which is recorded in the discount columns of the treble column cash book.

Further it is to be noted that unlike the cash and bank columns, the discount columns are not balanced; rather they are transferred to the respective discount accounts in general ledger. To be specific, the total of the debit side discount column represents the total discount allowed during a period and it is transferred to Discount Allowed Account in the general ledger, while the total of the credit side discount column represents the total discount received during a period and it is transferred to Discount Received Account in the general ledger. The proforma of the double column cash book is a under:

Dr. **Cash Book (Treble Column)** **Cr.**

Date	Particulars	L.F.	Cash (₹)	Bank (₹)	Discount (₹)	Date	Particulars	L.F.	Cash (₹)	Bank (₹)	Discount (₹)

Multi-columnar Cash Book: This is a customized form of cash book that is maintained by organisations where huge cash transactions take place under certain fixed heads. Generally, organisations like clubs, schools, colleges etc. maintain this type of cash book. The proforma of the multi-columnar cash book is a under:

Dr. **Multi-columnar Cash Book** **Cr.**

Date	Particulars	Subscription	Donation	Interest Received	Misc. Income	Date	Particulars	Salaries & wages	Rent & Taxes	Communication charges	Misc. Expenses

2. **Petty Cash Book:** In organisations where the number of cash transactions are numerous, it becomes tough for one personnel to handle and record all cash and bank related transactions. In such a case, the cash handling is split between two groups – one group handling petty cash transactions and the other handing transactions other than petty cash. This gives rise to a specific type of cash book called the Petty Cash Book. This book of account records only those cash transactions which are not of heavy amount, but the type of transactions are frequently entered into by an entity. The cashier in charge of the petty cash book is known as the Petty Cashier, the cashier of the other group is called the Principal Cashier or Chief Cashier.

   The amount of petty cash is provided to the petty cashier either on Ordinary System or on Imprest System. Under the Ordinary System, a pre-decided amount of cash is given in lump sum by the chief cashier to the petty cashier. When the entire amount of petty cash gets spent, the petty cashier submits the details of petty expenditures to the chief cashier for review, and reimbursement.

   Under theImprest System, the total amount of petty expenses for a particular period is estimated beforehand. This amount if referred to as Imprest Cash or Imprest Float. The imprest cash is advanced by the principal cashier to the petty cashier out of which the later meets all the petty expenses incurred during the period. At the end of the fixed period, petty cashier prepares a State of Petty Cash reflecting the petty expenses incurred and submits the same to the chief cashier. The chief cashier after examination of the petty transactions remit an amount equal to the total petty expenses incurred to the petty cashier. Thus, at the beginning of the next accounting period, the petty cashier will have the same amount of imprest cash to meet the petty expenses of the period. Thus, the amount lying with the petty cashier will never exceed the amount of imprest cash. The proforma of petty cash book is exactly similar to that of a single column cash book. Some organisations, also maintain the petty cash book in multi-columnar format. In such a case, the credit side of the petty cash book has pre-specified columns of the common expenses usually incurred by the organisation.

Illustration 2

Prepare a triple column cash book from the following transactions in the books of Mr.Ratanlal:

1.3.2023	Opening cash balance	20,000
	Bank balance in S.B.I	26,000
2.3.2023	Purchase of printer in cash	12,000
5.3.2023	Sold goods for cash.	34,000
7.3.2023	Received from Hriday on account	32,000

8.3.2023	A laptop purchase for the personal use of the proprietor by cheque	22,000
10.3.2023	Amount deposited into Bank	31,000
17.3.2023	Mr. Sen settled his account against a gross claim of ₹ 24 500.	24000
	Office rent paid by cheque	2,000
19.3.2023	Cash withdrawn from bank for personal use	3,400
	Receive from Mr. Ratul against his account of ₹ 23000.	22,800
	Goods purchased on credit from Sneha	24,000
24.3.2023	Salaries paid to employees	12,000
	Cheque received from Sandeep and kept in cash box	12,800
25.3.2023	The cheque of Sandeep deposited in the bank account	
	Bank charges shown in the bank statement	300
	Interest received from the savings account of bank	200
28.3.2023	The cheque of Sandeep was returned dishonoured by the bank	
	Amount paid to Sneha in full settlement of her claim	23,700

Solution:

Books of Mr. Ratanlal

Dr. **Cash Book (Triple Column)** **Cr.**

Date	Particulars	LF	Cash	Bank	Disc.	Date	Particulars	LF	Cash	Bank	Disc.
2023 Mar 1	To Balance b/f		20,000	26,000		Mar 2	By Office Equipment A/c		12,000		
Mar 5	To Sales A/c		34,000			Mar 8	By Drawings A/c			22,000	
Mar 7	To Hriday A/c		32,000			Mar 10	By Bank A/c		31,000		
Mar 10	To Cash A/c			31,000		Mar 17	By Rent A/c			2,000	
Mar 17	To Mr. Sen A/c		24,000		500	Mar 19	By Drawings A/c			3,400	
Mar 19	To Mr. Rahul A/c		22,800		200	Mar 24	By Salaries A/c		12,000		
Mar 25	To Sandeep A/c			12,800		Mar 25	By Bank Charges A/c			300	
Mar 25	To Interest A/c			200		Mar 28	By Sandeep A/c Dishonour of Cheque			12,800	
						Mar 28	By Sneha A/c		23,700		300
						Mar 28	By Balance c/f		54,100	29,500	
			1,32,800	**70,000**					**1,32,800**	**70,000**	

Cheque received from Sandeep and kept in cash box – will not be added to the balance of Cash Column at all, the amount will be added to the balance of Bank Column on the date on which it was submitted to the bank.

Alternatively, in between this period, a temporary A/c namely Cheque in Hand A/c may be used to record the transactions.

On the date of receipt of the cheque: Cheque in Hand A/c…………..Dr.

To Sandeep A/c

On the date of deposit of the cheque: Bank A/c……………………..Dr.

To Cheque in Hand A/c

When the cheque will dishonour - the amount will get credited in the bank column of the cash book.

Illustration 3

Prepare an Analytical Petty Cash Book on the Imprest System of Ashutosh, Kolkata from the following transactions:

2023 **Jan. 1**	Received Cash for Petty Expenses	20,000
Jan. 2	Paid Bus fare	100
Jan. 2	Paid cartage	500
Jan. 3	Paid for postage	1000
Jan. 3	Paid wages for casual labourers.	1200
Jan. 4	Paid for stationery.	800
Jan. 4	Paid auto charges	400
Jan. 5	Paid for repairs of chairs	3000
Jan. 5	Paid Bus fare.	200
Jan. 6	Paid Conveyance charges	600
Jan. 6	Paid cartage.	600
Jan. 6	Paid for Stationery	400
Jan. 6	Refreshment to customers	1000

In the Books of Ashutosh, Kolkata
Petty Cash Book

Receipts	Date	V/N	Particulars	Total Payment (₹)	Conveyance (₹)	Cartage (₹)	Stationery (₹)	Postage (₹)	Wages (₹)	Sundries (₹)
20,000	2023 Jan. 1		To Cash A/c							
	Jan. 2		By Conveyance A/c	100	100					
	Jan. 2		By Cartage A/c	500		500				

Receipts	Date	V/N	Particulars	Total Payment (₹)	Conveyance (₹)	Cartage (₹)	Stationery (₹)	Postage (₹)	Wages (₹)	Sundries (₹)
	Jan. 3		By Postage A/c	1,000				1,000		
	Jan. 3		By Wages A/c	1,200					1,200	
	Jan. 4		By Stationery A/c	800			800			
	Jan. 4		By Conveyance A/c	400	400					
	Jan. 5		By Repairs of Furniture A/c	3,000						3,000
	Jan. 5		By Conveyance A/c	200	200					
	Jan. 6		By Conveyance A/c	600	600					
	Jan. 6		By Cartage A/c	600		600				
	Jan. 6		By Stationery A/c	400			400			
	Jan. 6		By General Expenses A/c	1,000						1,000
				9,800	1,300	1,100	1,200	1,000	1,200	4,000
	Jan. 6		By Bal. c/d	10,200						
20,000				20,000						
10,200	Jan. 7		To bal B/d							
9,800	Jan. 7		To Cash A/c							

Bank Book

Deviating from the traditional method of keeping an additional column for bank transactions in a double and triple column cash book, today organisations keep a separate subsidiary book similar to cash book to record all receipts and payments made through the bank. This is known as Bank Book or Bank Journal.

Usually, big companies maintain this book where the volume of bank transactions is very high. Small businesses may still continue to record their bank transactions along with the cash book in an additional column.

Similar to a Single Column Cash Book, a Bank Book consists of two sides, receipts side and payment side. Receipts are debited and payments are credited in the bank book.

Maintaining a Bank Book or Bank Journal helps to ease the process of bank reconciliation. It also helps to decrease the chances of missing entries or any mistake. Separate Bank Books can be maintained for each bank account.

Thus, Bank Book can be distinguished from a Pass Book and a Bank Statement. These are basically the copy of a client's account (as it appears in the book's personal ledger).

Bank Reconciliation Statement

At any point of time, the balances as per cash book (bank column) and pass book should be equal in amount. But, in reality it rarely happens due to certain specific reasons. To reconcile the balances as reflected by these two related books a statement is prepared, which is referred to as the Bank Reconciliation Statement.

This statement is not a part of the books of accounts of an organisation. These are prepared at periodical intervals for verification of the accuracy of cash book and pass book. It is to be noted that this statement does not rectify any error that may exist in the books. Its primary objective is to identify the causes of discrepancy between the two books as on a particular date.

The main reason for disagreement between the balances of cash book and pass book is caused by time gap and or communication gap between the entries made at the end of the client and bank. Some of the common transactions which cause disagreement between the cash book (bank cloumn) and pass book are:

- Cheque issued but not presented at the bank;
- Cheque deposited in bank, but not yet collected;
- Amount deposited directly in bank by other parties;
- Incidental charges, interest on overdraft etc. debited by bank;
- Interest on deposits credited by bank;
- Dishonor of cheque deposited;
- Clerical errors made in recording of transactions etc. both by customer and Bank
- Payment by Bank under standing instruction.

It is worth mentioning at this point that in this technologically advanced era many of the abovementioned causes of disagreement has been done away with the emergence of digital transactions.

Preparation of Bank Reconciliation Statement

- **Without Amended Cash Book Method:** The preparation of Bank Reconciliation Statement can start with any of the available balances viz. balance of cash book (bank column) or balance of pass book. To this logical adjustments must be made of the transactions that has caused the disagreement – either by making addition or subtraction of the relevant items. Once all the items of disagreement gets adjusted, the balances as per the two books should get tallied.
- **Amended Cash Book Method:** Alternatively, the cash book (amended) can be prepared for ascertaining the correct balance of the cash book (bank column) and thereafter the Bank Reconciliation Statement is to be drafted to reconcile this correct balance of cash book with the balance as per pass book. The amended cash book is drafted with the items that have been correctly recorded in the pass book but is yet to be recorded in the cash book. Moreover, any error committed and appearing in the cash book should also be considered while drafting the amended cash book. But any error Committed by Bank would be reflected in the Reconciliation statement instead of Cash book.

Illustration 4

On comparing the Cash Book of Saksham with the Bank Pass Book for the year ended 31st March, 2023, following discrepancies were noticed:

(a) Out of ₹ 82,000 paid in by cheques into the bank on 25th March, cheques amounting to ₹ 30,000 were collected on 5th April.

(b) Out of cheques drawn amounting to ₹ 31,200 on 28th March a cheque for ₹ 10,000 was presented on 3rd April.

(c) A cheque for ₹ 4,000 entered in Cash Book but omitted to be banked on 31st March.

(d) A cheque for ₹ 2,400 deposited into bank but omitted to be recorded in Cash Book and was collected by the bank on 29th March.

(e) A bill receivable for ₹ 2,080 previously discounted (discount ₹ 80) with the bank had been dishonoured but advice was received on 3rd April.

(f) A bill for ₹ 40,000 was retired/paid by the bank under a rebate of ₹ 600 but the full amount of the bill was credited in the bank column of the Cash Book.

(g) A cheque of ₹ 10,000 wrongly credited in the Pass Book on 29th March was reversed on 2nd April.

(h) Bank had wrongly debited ₹ 20,000 in the account on 31st March and reversed it on 10th April, 2023.

(i) A cheque of ₹ 800 drawn on the Savings Account has been shown as drawn on Current Account in Cash Book.

Prepare a Bank Reconciliation Statement as on 31st March, 2023, if the Balance as per Cash Book on 31st March was ₹ 1,58,280.

Solution:

Bank Reconciliation Statement
as on 31st March 2023

Particulars	(₹)	(₹)
Balance as per Cash Book (Dr.)		1,58,280
Add: (b) Cheques issued on 28th March but not yet presented for payment	10,000	
(d) A cheque deposited into bank but not recorded in Cash Book	2,400	
(f) Rebate on bill not entered in Cash Book (Note)	600	
(g) Cheque wrongly credited by bank	10,000	
(i) Cheque drawn on Savings Bank A/c but wrongly recorded in Current A/c	800	23,800
		1,82,080
Less: (a) Cheques deposited on 25th March but not yet collected till 31st March	30,000	
(c) A cheque entered in Cash Book but not yet banked	4,000	
(e) Discounted Bills Receivable dishonoured but not recorded in Cash Book	2,080	56,080
(h) Amount Wrongly debited by the Bank	20,000	
Balance as per Bank Pass Book (Cr.)		1,26,000

If the same question is solved through amended Cash Book, then all the transactions will be divided into two parts i.e. items to be shown in the cash book and items to be shown in Reconciliation statement. Given below Reconciliation after amending cash book.

Amended Cash Book (Bank column only)

Dr. **as on 31.3.2022** **Cr.**

Date	Particulars	(₹)	Date	Particulars	(₹)
2023 Mar 31	To balance b/d	158280	2023 Mar 31	Discounted B/R dishonored not recorded in cash book	2080
	Cheque deposited not recorded	2400			
	Rebate not entered in cash book	600			
	Cheque drawn recorded in different account	800			
				Balance c/d	160000
		162080			162080

Bank Reconciliation Statement
as on 31st March 2022

Particulars	(₹)	(₹)
Balance as per Cash Book (Dr.)		160000
Add: (b) Cheques issued on 28th March but not yet presented for payment	10,000	
(g) Cheque wrongly credited by bank	10,000	
Less: (a) Cheques deposited on 25th March but not yet collected till 31st March	30,000	
(c) A cheque entered in Cash Book but not yet banked	4,000	
(h) Amount Wrongly debited by the Bank	20,000	
Balance as per Bank Pass Book (Cr.)		126000

Students are advised to analyse Illustration-4 and can understand which items are shown incash book and which items are shown in reconciliation statement.

Illustration 5

On 31st January, 2023, Sethi's cash book showed a bank overdraft of ₹ 2,50,000. On comparing with the pass book, the following differences were noted.

(a) Cash and cheques amounting to ₹ 26,800 were sent to the bank on 27th January, but cheques worth 4600 were credited on 2nd February and one cheque for 900 was returned by them as dishonoured on 4th February.

(b) During the month of January, Sethi issued cheques worth ₹ 33,400 to his creditors. Out of these, cheques worth 27,400 were presented for payment on 5th February.

(c) According to Sethi's standing orders, the bankers have made the following payments during the month of January:

   i. Life insurance premium ₹ 3,840

   ii. Television license fee ₹ 2,400

(d) Sethi's bankers have collected ₹ 3,000 as dividend on his shares.

(e) Interest charged by the bank ₹ 2,500

(f) A bill receivable of ₹ 2,000 discounted with the bank in December, 2022, was dishonoured on 31st January, 2023.

You are required to:

(i) Ascertain the amended cash book balance as on 31st January, 2023

(ii) Prepare a Bank Reconciliation Statement from the amended cash book as on 31st January 2023

Solution:

In the Books of Sethi

Dr. **Cash Book (Bank column only)** **Cr.**

Date	Particulars	(₹)	Date	Particulars	(₹)
2023 Jan-31	To Dividend on shares	3,000	2023 Jan-31	By Balance b/f	2,50,000
	To Bal c/d	2,57,740		By Drawings (₹ 3840 + ₹ 2400)	6,240
				By Interest	2500
				By Debtors- discounted bill dishonoured	2000
		2,60,740			2,60,740
			2022 Feb:1	By Bal b/d	2,57,740

Bank Reconciliation Statement
as on 31.01.2023

Particulars	(₹)	(₹)
Bank balance as per Cash Book (overdrawn)		2,57,740
Add: Cheques deposited but not credited in the Pass Book (4600+ 900)		5,500
		2,65,240
Less: Cheques issued but not presented for payment		27,400
Bank balance as per Pass Book (overdrawn)		2,35,840

Trial Balance (Preparation and Scrutiny)

1.7

The process of accounting involves recording transactions in the journal and thereafter posting them in the respective accounts in the ledger. At the end of an accounting period, these ledger accounts are balanced and now they are ready to be used for drafting of the financial statements. However, before starting the process of finalization of accounts, for ensuring the accuracy of the accounting a document is prepared using the balances of the ledger accounts after they have been closed. This document is called the Trail Balance.

Concept

The Trial Balance is a statement drawn up using the ledger balances to test of the arithmetical accuracy of the ledger account. The primary purpose of drafting a Trial Balance is to ensure that there are no arithmetical errors. However, it is to be noted that after the use of computers in accounting, the requirement of drafting trial balance has substantially reduced. It is a columnar statement having five columns – Serial number, Name of ledger account, Ledger Folio (L.F.), Debit amount, and Credit amount. In case the accounting happen to be correct and complete, the two amount columns of the Trial Balance should tally i.e. be of equal amount. The proforma of a Trail Balance is as under:

Trial Balance of …….. as on ……..

Sl. No.	Ledger Accounts	L.F.	Dr. (₹)	Cr. (₹)

Features

- A trial balance is just a statement, and not an account.
- It does not form part of the double entry system.
- It does not appear in the actual books of accounts. It is usually prepared as a separate document.
- It is prepared as on a particular date, and not for a period.
- A trial balance may be prepared at any time, say, on monthly, quarterly, half-yearly or on annual basis. However, it is to be noted that the Trial Balance must be drafted at the end of every accounting year before the preparation of financial statements.
- If the books are arithmetically accurate, the total of the debit balances must agree with the total of the credit balances.
- The agreement of a trial balance is only a prima facie evidence of the arithmetical accuracy of the books of accounts but not a conclusive proof of absolute accuracy.

Advantages of a Trial Balance

- The agreement of the trial balance provides a useful check upon the ledger postings. It proves that both the aspects of each transaction have been posted into the ledger – debit aspects on the debit side and corresponding credit aspects on the credit side.
- It proves that the accounts are arithmetically correct, i.e., correct amount has been written against each posting in the ledger.
- It facilitates the preparation of financial statements by presenting the ledger balances in a summarised form.
- It acts as a connecting link between ledger accounts and the financial statements of an entity.

Limitations of a Trial Balance

Some of the limitations of trial balance are:

- Trial balance can be drafted only when books are maintained under double entry system of book keeping. As such, smaller concerns who do not follow double entry system cannot draft the trial balance.
- The agreement of a trial balance is not a conclusive proof of absolute accuracy of the books of accounts. It is only a prima facie proof. Certain errors do not get disclosed by the trial balance.

Errors Not Identified by Trial Balance

The errors and omissions not revealed by the trial balance are:

- **Error of Omission or Duplication:** An entry has been completely omitted to be recorded in the book of original entry.
- **Error of Commission:** When a wrong amount has been entered in the correct accounts, or a account is involved while recording the transactions.
- **Errors of Principle:** recording not in accordance with accounting principles, e.g., the purchase of office furniture debited to purchases account, instead of furniture and fittings account.
- **Errors of Original Entry** – if the amount of a transaction is entered incorrectly in a subsidiary book.
- **Compensating Errors** – two or more mistakes in the books which result in cancelling each other out.

Preparation of Trial Balance

There are two recognised methods of preparing Trial Balance. They are **(1) Total Method, and (2) Balance Method**.

(1) Total Method: In this method, for each ledger account the total of debit side and total of credit side are collected and placed on the debit and credit columns of the Trial Balance. Trial Balance can be drafted under this method even though the ledger accounts have not been balanced.

(2) Balance Method: Under this method, Trial Balance is prepared only after each ledger account has been balanced. So, for each ledger account only one amount is posted in the Trial Balance.

Illustration 6

From the following ledger account balances, prepare a Trial Balance of Mr. Sen for the year ended 31st March, 2023.

Capital ₹ 80,000 ; Sales ₹ 10,00,000; Adjusted Purchase ₹ 8,00,000; Current A/c(Cr) ₹ 10,000; Petty Cash ₹ 10,000; Sales Ledger Balance ₹ 1,20,000; Purchase Ledger Balance ₹ 60,000; Salaries ₹ 24,000; Carriage Inwards ₹ 4,000; Carriage Outward ₹ 6,000; Discount Allowed ₹ 10,000; Building ₹ 80,000; Outstanding Expenses ₹ 10,000; Prepaid

Insurance ₹2,000 ; Depreciation ₹4,000 ; Cash at Bank ₹80,000 ; Loan A/c (Cr) ₹66,000; Profit & Loss A/c(Cr) ₹20,000; Bad Debts Recovered ₹2,000 ; Stock at 31.03.2022 ₹1,20,000; Interest Received ₹10,000; Accrued Interest 4,000; Investment 20,000; Provision for Bad Debts (01.04.2021) ₹6,000 ; General Reserve ₹20,000.

Solution:

Trial Balance of Mr. Sen

Dr. **as on 31st March, 2023** **Cr.**

Heads of Accounts	(₹)	Heads of Accounts	(₹)
Adjusted Purchase	8,00,000	Capital	80,000
Petty Cash	10,000	Sales	10,00,000
Sales Ledger Balance	1,20,000	Current A/c	10,000
Salaries	24,000	Purchase Ledger Balance	60,000
Carriage Inward	4,000	Outstanding Expenses	10,000
Discount Allowed	10,000	Loan A/c	66,000
Building	80,000	Profit & Loss A/c (Cr.)	20,000
Prepaid Insurance	2,000	Bad Debts Recovered	2,000
Depreciation	4,000	Interest Received	10,000
Cash at Bank	80,000	Provision for Bad debts	6,000
Stock (31.03.2022)	1,20,000	General Reserve	20,000
Accrued Interest	4,000		
Investment	20,000		
Carriage outward	6,000		
	12,84,000		**12,84,000**

Note: Closing Stock will appear in Trial Balance since there is adjusted purchase.

Adjusted purchase = Opening Stock + Purchase - Closing Stock.

It may be noted that if only adjusted purchase is considered then the matching concept is affected. Hence, to satisfy the matching concept, closing stock is also considered in Trial Balance.

Illustration 7

The given trial balance of MM Bakery for the quarter January to March, 2023 has been prepared by an intern.

Ledger Accounts	Dr. (₹)	Cr. (₹)
Cost of Goods Sold	7,50,000	
Closing Stock		1,20,000
Sundry Debtors		1,80,000

Ledger Accounts	Dr. (₹)	Cr. (₹)
Sundry Creditors		90,000
Fixed assets	1,50,000	
Opening Stock	1,80,000	
Expenses		60,000
Sales		9,00,000
Capital	2,70,000	
	13,50,000	**13,50,000**

You are the senior accountant of the concern and has been given responsibility to check the same and redraft it if required.

Solution:

The Trial Balance drafted by the intern has tallied, but it has some errors. The correct Trial Balance is redrafted and presented hereunder:

Redrafted Trial Balance of MM bakery as on 31.03.2023

Sl. No.	Ledger Accounts	Dr. (₹)	Cr. (₹)	Remarks
1	Cost of Goods Sold.	7,50,000		Expense
2	Closing Stock	1,20,000		Asset
3	Sundry Debtors.	1,80,000		Asset
4	Sundry Creditors		90,000	Liability
5	Fixed assets	1,50,000		Asset
6	Wages, Salaries & other expenses	60,000		Expenses
7	Sales		9,00,000	Income
8	Capital		2,70,000	Equity
		12,60,000	**12,60,000**	

Adjustments and Rectifications

1.8

1.8.1 Depreciation and Amortisation

Fixed Assets are purchased in the business for long-term use. During the course of their use, every year a part of fixed assets expires (i.e., is consumed or utilised or lost) due to physical wear and tear, passage of time, obsolescence etc. The gradual decline in the value of a tangible asset is termed as Depreciation. Thus, it can be stated that depreciation is a part of cost of tangible fixed asset which has expired because of its usage, lapse of time etc.

The purpose of providing for depreciation is to write off cost of fixed assets over their estimated useful life. It is important to note that depreciation is charged on all fixed assets except freehold land. The reason is that unlike other fixed assets like machinery and furniture, useful life of land (because it has infinite life) is not limited to few years.

Characteristics of Depreciation

- Depreciation is a reduction in the book value of fixed assets (except freehold land).
- Such reduction in the book value of a fixed asset is permanent, gradual and of continuing nature.
- Depreciation is a continuous process i.e. provided every year because the book value is reduced either due to use or with the passage of time.
- It occurs gradually unless there is a quick physical deterioration or obsolescence due to technological developments.

The processes of Depreciation in case of Corporate Entities have been given in Schedule-II of Companies Act, 2013 which is effective w.e.f. 1.4.14. students are advised to refer MCA notification in this regard.

Depreciation, Amortisation and Depletion

Depreciation: The term 'Depreciation' is a measure of wearing out, consumption or other loss of value of a depreciable asset, arising from use, efflux of time or obsolescence through technology and market changes. It is an allocation of cost of fixed asset as expense over its estimated useful life. Depreciation expense is charged on all tangible fixed assets whose useful life is limited. For example, cost of the machine is written off over its estimated useful life. On the other hand, useful life of freehold land is normally infinite. As a result, it is not depreciated.

Amortisation: Amortisation is a gradual and systematic writing-off of intangible asset over its estimated useful life. For example, patents, purchased goodwill, copyrights are amortised over their useful life being intangible assets.

Depletion: Depletion is the value of wasting asset extracted from quarry, mine, etc. Extraction reduces the available quantity of material. For example, extraction of coal from a coal mine is depletion of coal stock.

Methods of Recording (Accounting) Depreciation

There are two alternative methods of recording depreciation.

1. When depreciation is charged to the Asset Account; and They are:
2. When Provision for Depreciation/Accumulated Depreciation Account is opened.

1. When Depreciation is charged against asset

Under this method, the amount of depreciation is credited to the concerned Asset Account. Depreciation Account, being a nominal account, is transferred to the Profit and Loss Account at the end of every accounting period. In the Balance Sheet, asset is shown at its written down value (i.e., cost less depreciation provided till date).

Journal entries for charging depreciation and transferring it to Profit and Loss Account are:

- Depreciation A/c Dr
  To Asset A/c.
  (Being the depreciation on asset charged)

- Profit and Loss A/c Dr.
  To Depreciation A/c
  (Being the depreciation transferred to Profit and Loss A/c)

2. When Provision for Depreciation/Accumulated Depreciation Account is maintained

Under this method, depreciation is not credited to the Asset Account but is credited to Provision for Depreciation Account or Accumulated Depreciation Account.

- As a result, Asset Account continues to be shown at its cost. The balance of Provision for Depreciation/ Accumulated Depreciation Account shows total depreciation till date (year after year). In the Balance Sheet, asset is shown at Cost less Provision for Depreciation.

  Journal entries for charging depreciation and closing the Depreciation Account are as follows:

- Depreciation A/c Dr.
  To Provision for Depreciation A/c
  (Being the depreciation on asset charged)
- Profit and Loss A/c Dr.
  To Depreciation A/c
  (Being the depreciation transferred to Profit and Loss Account)

Methods of calculating depreciation

There are a number of methods that have been developed from calculating the amount of depreciation. Some of the most commonly used methods are:

1. Fixed Installment Method or Straight Line Method
2. Reducing Balance Method/ Diminishing Balance Method
3. Sum of Years' Digit Method
4. Sinking Fund Method
5. Annuity Method
6. Insurance Policy Method

Straight Line Method

Under this method, a fixed portion of the cost of a fixed asset is allocated and charged as periodic depreciation. Such depreciation becomes an equal amount in each period. The formula for calculation of depreciation is as under:

Depreciation = (V-S)/n

where,

V = Cost of the asset

S = Residual value or the expected scrap value of the asset

n = Estimated life of the asset

Reducing Balance Method/ Diminishing Balance Method/ Written Down Value Method

Under this method, depreciation is calculated at a fixed percentage on the original cost in the first year, and in subsequent years it is calculated at the same percentage on the written down values i.e. book value over the expected working life of the asset. In this case, the rate of allocation is constant (usually a fixed percentage) but the amount allocated for every year gradually decreases.

Under this method, Depreciation p.a. is calculated as under:

For newly acquired Fixed Asset = Original Cost × Rate of Depreciation

For existing Fixed Asset = Opening WDV × Rate of Depreciation

Provision for Depreciation Account

Provision of depreciation is the collected value of all depreciation. Provision of depreciation account is the account of provision of depreciation. With making of this account we are not crediting depreciation in asset account, but transfer every year depreciation to provision of depreciation account. Every year we adopt this procedure and when assets are sold we will transfer sold asset's 'total depreciation' to credit side of asset account, for calculating correct profit or loss on fixed asset. This provision uses with any method of calculating depreciation.

There are the following features of provision for depreciation account:

- Fixed asset is made on its original cost and every year depreciation is not transfer to fixed asset account.
- Provision of depreciation account is Conglomerated value of all old depreciation.
- This system can be used both in straight line and diminishing method of providing depreciation. The journal entries will be :

(i) For purchase of asset

Asset A/c Dr.

To Cash/Bank A/c

(ii) For providing depreciation at end of year

Depreciation A/c Dr.

To Provision for depreciation A/c

(iii) For sale of assets

Cash/Bank A/c Dr.

Provision for depreciation A/C Dr.

To Asset Sales A/c

Or if sale of Asset A/C is opened :

(a) When asset Sold

Asset Disposal A/c Dr.

To Asset A/c (original cost)

(b) Cash Realised on sale of Asset

Cash/Bank/ Debtor A/c Dr.

Provision for depreciation A/C Dr.

P/L Account Dr (in case of loss)

To Asset Sales A/c

To P/L Account (in case of profit)

Illustration 8

Machine No.	Cost of Machine (₹)	Expenses incurred at the time of purchase to be capitalized (₹)	Estimated Residual Value (₹)	Expected Useful Life in years
1	90,000	10,000	20,000	8
2	24,000	7,000	3,100	6
3	1,05,000	20,000	12,500	3
4	2,50,000	30,000	56,000	5

Compute the amount of depreciations to be charged and the rate of depreciations under SLM method.

Solution:

Machine No	Cost of Machine (₹)	Expenses incurred at the time of purchase to be capitalize (₹)	Total Cost of Asset = (b+c) (₹)	Estimated Residual Value (₹)	Expected Useful Life in years	Depreciation = (d-e)/f (₹)	Rate of Depreciation under SLM = (g/d)×100
a	b	c	d	e	f	g	h
1	90,000	10,000	1,00,000	20,000	8	10,000	10%
2	24,000	7,000	31,000	3,100	6	4,650	15%
3	1,05,000	20,000	1,25,000	12,500	3	22,500	30%
4	2,50,000	30,000	2,80,000	56,000	5	22,400	16%

Illustration 9

A machine is purchased for ₹ 7,00,000. Expenses incurred on its cartage and installation ₹ 3,00,000. Calculate the amount of depreciation @ 20% p.a. according to Straight Line Method for the first year ending on 31st March, 2023 if this machine is purchased on:

(a) 1st April, 2022

(b) 1st July, 2022

(c) 1st October, 2022

(d) 1st January, 2023

Solution:

Here, Total Cost of Asset = Purchased Price + Cost of Cartage and Installation

= ₹ 7,00,000 + ₹ 3,00,000 = ₹ 10,00,000

Amount of Depreciation:

$$= \text{Total Cost of Asset} \times \text{Rate of Depreciation} \times \frac{\text{Period from the date of purchase to date of closing accounts}}{12}$$

(a) The machine was purchased on 1st April, 2022:

$$\text{Amount of Depreciation} = ₹\ 10{,}00{,}000 \times 20\% \times \frac{12}{12} = ₹\ 2{,}00{,}000$$

(b) 1st July, 2022

$$\text{Amount of Depreciation} = ₹\ 10{,}00{,}000 \times 20\% \times \frac{9}{12} = ₹\ 1{,}50{,}000$$

(c) 1st October, 2022

$$\text{Amount of Depreciation} = ₹\ 10{,}00{,}000 \times 20\% \times \frac{6}{12} = ₹\ 1{,}00{,}000$$

(d) 1st January, 2023

$$\text{Amount of Depreciation} = ₹\ 10{,}00{,}000 \times 20\% \times \frac{3}{12} = ₹\ 50{,}000$$

Reducing / Diminishing Balance Method or Written Down Value Method

Features:

(i) Depreciation is calculated at a fixed percentage on the original cost in the first year. But in subsequent years it is calculated at the same percentage on the written down values gradually reducing during the expected working life of the asset.

(ii) The rate of allocation is constant (usually a fixed percentage) but the amount allocated for every year gradually decreases.

Illustration 10

On 1.1.2021 a machine was purchased for ₹ 1,00,000 and ₹ 50,000 was paid for installation. Assuming that the rate of depreciation was 10% on Reducing Balance Method, calculate amount of depreciation upto 31.12.2023.

Solution:

Year	Opening Book Value (₹)	Rate	Depreciation (₹)	Closing Book Value (₹)
2021	1,50,000	10%	15,000	1,35,000
2022	1,35,000	10%	13,500	1,21,500
2023	1,21,500	10%	12,150	1,09,350

Note: Cost of the machine (i.e. Opening Book Value for the year 2021)

= Cost of Purchase + Cost of Installation

= ₹ 1,00,000 + ₹ 50,000 = ₹ 1,50,000

Sum of the Units Method:

Depreciation for the period —

Production during the year / Estimated Total Production

Illustration 11

A machine is purchased for ₹60,00,000, estimated life of which is 10 years residual value is ₹ 4,00,000. Expected production of the machine is 2,00,000 during its useful life.

Production pattern is as follows:

Year	Units
1-2	20,000 per year
3-6	15,000 per year
7-10	25,000 per year

Compute the amount of depreciation for each year applying Sum of the Units Method.

Solution:

Year	Computation	Depreciation (₹)
1-2	$\frac{20,000}{2,00,000} \times (60,00,000 - 4,00,000)$	5,60,000
3-6	$\frac{15,000}{2,00,000} \times (60,00,000 - 4,00,000)$	4,20,000
7-10	$\frac{25,000}{2,00,000} \times (60,00,000 - 4,00,000)$	7,00,000

Illustration 12

On 1.1.2021 machinery was purchased for ₹ 80,000. On 01.07.2022 additions were made to the amount of ₹ 40,000. On 31.3.2023, machinery purchased on 1.7.2022, costing ₹ 12,000 was sold for ₹ 11,000 and on 30.06.2023 machinery purchased on 01.01.2021 costing ₹ 32,000 was sold for ₹ 26,700. On 1.10.2023, additions were made to the amount of ₹ 20,000. Depreciation was provided at 10% p.a. on the Diminishing Balance Method.

Show the Machinery Accounts for three years from 2021-2023. (year ended 31st December)

Solution:

Statement of Depreciation.

Date	Particulars	Machines – I Cost = ₹ 80,000		Machines – II Cost = ₹ 40,000		Machines – III Cost = ₹ 20,000	Total Depreciation
		(₹)	(₹)	(₹)	(₹)	(₹)	(₹)
01.01.2021	Book Value	48,000	32,000				
31.12.2021	Depreciation	4,800	3,200				8,000
01.01.2022	W.D.V.	43,200	28,800				
01.07.2022	Purchase			28,000	12,000		
31.12.2022	Depreciation	4,320	2,880	1,400	600		9,200
01.01.2023	W.D.V.	38,880	25,920	26,600	11,400		
31.03.2023	Depreciation				285		285

Date	Particulars	Machines – I Cost = ₹ 80,000		Machines – II Cost = ₹ 40,000		Machines – III Cost = ₹ 20,000	Total Depreciation
		(₹)	(₹)	(₹)	(₹)	(₹)	(₹)
	W.D.V.				11,115		
	Sold For				11,000		
	Loss on sale				115		
30.06.2023	Depreciation		1,296				1,296
	W.D.V.		24,624				
	Sold For		26,700				
	Profit on Sale		2,076				
01.10.2023	Purchase					20,000	
31.12.2023	Depreciation	3,888		2,660		500	7,048
01.01.2024	W.D.V.	34,992		23,940		19,500	

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

Date	Particulars	(₹)	Date	Particulars	(₹)
01.01.21	To Bank A/c	80,000	31.12.21	By Depreciation A/c	8,000
				,, Balance c/d	72,000
		80,000			**80,000**
01.01.22	To Balance b/d	72,000	31.12.22	By Depreciation A/c	9,200
01.07.22	" Bank A/c	40,000		,, Balance c/d	1,02,800
		1,12,000			**1,12,000**
01.01.23	To Balance b/d	1,02,800	31.3.23	By Bank (Sale) A/c	11,000
30.06.23	" P & L A/c (Profit on Sale)	2,076		,, Depreciation A/c	285
	" Bank A/c	20,000	30.6.23	,, P & L A/c (Loss on Sale)	115
				,, Bank A/c (Sale)	26,700
			31.12.23	,, Depreciation A/c	1,296
				,, Depreciation A/c	7,048
				,, Balance c/d	78,432
		1,24,876			**1,24,876**

Illustration 13

S & Co. purchased a machine for ₹ 1,00,000 on 1.1.2021. Another machine costing ₹1,50,000 was purchased on 1.7.2022. On 31.12.2023, the machine purchased on 1.1.2021 was sold for ₹ 50,000. The company provides depreciation at 15% on Straight Line Method. The company closes its accounts on 31st December every year. Prepare – (i) Machinery A/c, (ii) Machinery Disposal A/c and (iii) Provision for Depreciation A/c.

Solution:

S & Co.

Machinery Account

Dr. **Cr.**

Date	Particulars	(₹)	Date	Particulars	(₹)
01.01.21	To Bank A/c	1,00,000	31.12.21	By Balance c/d	1,00,000
		1,00,000			1,00,000
01.01.22	To Balance b/d	1,00,000			
01.07.22	To Bank A/c	1,50,000	31.12.22	By Balance c/d	2,50,000
		2,50,000			2,50,000
01.01.23	To Balance b/d	2,50,000	31.12.23	By Machinery Disposal A/c	1,00,000
			31.12.23	By Balance c/d	1,50,000
		2,50,000			2,50,000
01.01.24	To Balance b/d	1,50,000			

Provision for Depreciation Account

Dr. **Cr.**

Date	Particulars	(₹)	Date	Particulars	(₹)
31.12.21	To Balance c/d	15,000	31.12.21	By Depreciation A/c	15,000
		15,000			15,000
31.12.22	To Balance c/d	41,250	01.01.22	By Balance b/d	15,000
			31.12.22	By Depreciation A/c (₹ 15,000 + ₹ 11,250)	26,250
		41,250			41,250
31.12.21	To Machinery Disposal A/c	30,000	01.01.23	By Balance b/d	41,250
31.12.23	To Balance c/d	33,750	31.12.23	By Depreciation A/c	22,500
		63,750			63,750
			01.01.24	By Balance b/d	33,750

Dr. **Machinery Disposal Account** Cr.

Date	Particulars	(₹)	Date	Particulars	(₹)
31.12.23	To Machinery A/c	1,00,000	31.12.23	By Provision for Depreciation A/c	30,000
				By Depreciation A/c	15,000
				By Bank A/c	50,000
				By Profit & Loss A/c(Loss on Sale)	5,000
		1,00,000			**1,00,000**

Working Notes:

1. Depreciation for the machine purchased on 1.7.2022
   For the year 2022 (used for 6 months) = ₹ 1,50,000 × 15% × 6/12 = ₹ 11,250
   For the year 2023 (used for full year) = ₹ 1,50,000 × 15% = ₹ 22,500
2. Depreciation for the machine purchased on 1.1.2021
   Depreciation = ₹ 1,00,000 × 15% = ₹ 15,000
   So, Depreciation for 2 years = ₹ 15,000 × 2 = ₹ 30,000

Profit or Loss on Sale of Assets – Method of Depreciation Calculation

Sometimes an asset is sold before the completion of its useful life for some unavoidable circumstances (due to obsolescence etc.) including a part of the asset which is no longer required in future. If the sale price is less than the WDV, there will be loss, and vice versa. The profit & loss on sale of asset is adjusted in the year of Sale in Profit & Loss Account.

Accounting Treatment

a. Where no provision for depreciation account is maintained:

WDV of the amount sold will be transferred to 'Assets Disposal Account'. The entries will be as follows:

(i) WDV of asset has been transferred to Asset Disposal A/c

Asset Disposal A/c	Dr.
To Asset A/c	

(ii) In case of Sale of an Asset

Cash/Bank A/c	Dr.
To Asset Disposal A/c	

(iii) For depreciation (if any)

Depreciation (P & L A/c)	Dr.
To Asset Disposal A/c	

(iv) In case of Profit on Sale of Asset

Asset Disposal A/c	Dr.
To Profit & Loss A/c	

(v) In case of Loss on Sale of Asset

Profit & Loss A/c	Dr.
To Asset Disposal A/c	

b. Alternative Approach

In this situations, all adjustments are to be prepared through the assets account. The entries are as follows:

(i) In case of Assets sold

Cash/Bank A/c Dr.

To Assets A/c

(ii) In case of Depreciation

Depreciation (Profit & Loss) A/c Dr.

To Assets A/c

(iii) In case of Profit on Sale

Assets A/c Dr.

To Profit & Loss

(iv) In case of Loss on Sale

Profit & Loss A/c Dr.

To Assets A/c

Illustration 14

On 1st April, 2021, Som Ltd. purchased a machine for ₹66,000 and spent ₹5,000 on shipping and forwarding charges, ₹7,000 as import duty, ₹1,000 for carriage and installation, ₹500 as brokerage and ₹500 for an iron pad. It was estimated that the machine will have a scrap value of ₹ 5,000 at the end of its useful life which is 15 years. On 1st January, 2022 repairs and renewals of ₹3,000 were carried out. On 1st October, 2023 this machine was sold for ₹ 50,000. Prepare Machinery Account for the 3 years, assuming year ends as 31st March.

Solution:

In the books of Som Ltd.

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

Date	Particulars	(₹)	Date	Particulars	(₹)
01.04.21	To Bank A/c	66,000	31.03.22	By Depreciation A/c	5,000
	To Bank A/c	14,000		By Balance c/d	75,000
		80,000			80,000
01.04.22	To Balance b/d	75,000	31.03.23	By Depreciation A/c	5,000
				By Balance c/d	70,000
		75,000			75,000
01.04.23	To Balance b/d	70,000	01.10.23	By Depreciation A/c	2,500
				By Bank A/c (sale)	50,000
				By Profit & Loss A/c (Loss)	17,500
		70,000			70,000

Working Note:

1. Total Cost = ₹ 66,000 + ₹ 5,000 + ₹ 7,000 + ₹ 1,000 + ₹ 500 + ₹ 500 = ₹ 80,000

$$\text{Depreciation} = \frac{\text{Total Cost – Scrap Value}}{\text{Expected life}} = \frac{80,000 - 5,000}{15} = ₹\ 5,000$$

The amount spent on repairs and renewals on 1st January, 2022 is of revenue nature and hence, does not form part of the cost of asset.

Change of Method

The depreciation method used should reflect the pattern in which the future economic benefits of the asset are expected to be consumed by the enterprise. The depreciation method applied to an asset should be reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method should be changed to reflect the changed pattern. Such a change should be accounted for as a change in an accounting estimate in accordance with AS 5.

Depreciation is an Accounting estimate and not accounting policy. The depreciation method selected should be applied consistently from period to period. Change in depreciation method , if required to match with revenue, should be done prospectively.

1.8.2 Adjustment Entries and Rectifications of Errors

Adjustment Entries

- The financial statements are prepared at the end of an accounting period by considering the ledger balances appearing in the books of accounts. But, in many cases, the balances reflected by the ledger accounts are not true. Certain adjustments are required to reflect the true picture of the actual happenings in the organisation. These journal entries are referred to as adjustment entries as they adjust the ledger account balances to reflect the reality. These entries update accounting records at the end of a period for any transactions that have not yet been properly reflected.
- The passing of adjusting entry(s) is a fundamental book keeping and accounting process. The primary purpose for the adjusting process is to reflect true essence of the transactions and the proper situation of the organisation as on the date of passing of such entries. It happens to be a necessary part of the accounting cycle and has to be built into the accounting system.
- The adjustment entries are passed at the end of an accounting period, and these entries usually have reflections in the income statement as-well-as the balance sheet. These entries are not passed on the basis of source documents like invoice, bill etc.
- Once the adjusting entries are complete, the adjusted trial balance can be drafted, which can ultimately be used to prepare the financial statements, the balance sheet, the income statement, and the statement of equity.

Features of Adjustment Entries

The features of adjustment entries are:

- These are a special type of journal entries.
- These entries are recorded on the General Journal/ Journal Proper.
- They are passed to reflect the reality.
- These entries are passed to comply with the accounting principles.
- Adjustment entries are pass**ed at the end of an accounting** period.

Classification of Adjustment Entries

Adjustment entries are classified into three main types:

- Pre-payments and Pre-receipts: The transactions under pre-payments category involve – Prepaid expenses and Unearned revenues. The forme**r refers t**o money paid in advance for expenses not yet incurred, while the **later are** money received in advance but yet to be earned.

  Example : Prepaid insurance, subscription received by a club in advance.

- Accruals: The accrual transactions can be either accrued expenses or accrued incomes. Accrued expenses, also referred to as outstanding expenses, are expenses which have actually taken place, but for which no payment has yet been made. As such, they **are not a**ccounted for in the books. On the other hand, accrued incomes **are incomes earned, but not ye**t recorded nor money received.

  Example 3: Monthly electricity bill outstandings 31.03.2022 expense.

- Non-cash expenses (Estimates):

Adjustment	Adjustment Entry	
Closing stock	Stock-in-trade A/c To Purchases/ Trading A/c	Dr.
Goods withdrawn by owner for personal use	Drawing A/c To Purchases A/c	Dr.
Goods distributed as free samples to public	Advertisement A/c To Purchases A/c	Dr.
Goods distributed as free samples to employees	Wages/ Salaries A/c To Purchases A/c	Dr.
Goods-in-Transit	Goods-in-transit A/c To Purchases/ Trading A/c	Dr.
Abnormal loss of stock	Abnormal Loss A/c To Purchase/ Trading A/c	Dr.
Stock used as stationary	Stationery A/c To Purchases/ Stock A/c	Dr.
Materials used for constructing Fixed Assets	Fixed Assets A/c To Purchases/ Stock A/c	Dr.
Goods sent on approval basis, pending approval on Balance Sheet date	Sales A/c To Sale or Return Suspense A/c	Dr.
	Stock on Sale or Return A/c To Trading A/c	Dr.
Outstanding expenses	Expenses A/c To Outstanding Expenses A/c	Dr.

Adjustment	Adjustment Entry	
Prepaid expenses	Prepaid Expenses A/c To Expenses A/c	Dr.
Pre-received Incomes	Income A/c To Pre-received Income A/c	Dr.
Accrued Incomes	Accrued Income A/c To Income A/c	Dr.
Depreciation/Amortisation on fixed assets	Depreciation/Amortisation A/c To Fixed Assets A/c	Dr.
Provision for Bad Debts	P/L A/c To Provision for Bad Debts A/c	Dr.
Provision for Discount on Debtors	P/L A/c To Provision for Discount on Debtors A/c	Dr.
Mutual Set-off between debtors and creditors	Creditors A/c To Debtors A/c	Dr.

1.8.3 Accounting Treatment of Bad Debts, Provision for Doubtful Debts, Provision for Discount on Debtors and Provision for Discount on Creditors

For any business, purchase and sales are the most regular and main activity. This attracts business connection with lots of people either giving or taking benefits of credit. Debtors refer to those entities who take the benefit of delayed payment and creditors allow credit period to pay later. That means in each case there is a time gap between the date of sale or purchase and the date of recovery of cash or payment of cash.

The amount which is receivable from a person or a concern for supplying goods or services is called Debt. On the basis of the chances o**f collectio**n from the debtors, debts may be classified into the following three categories: Good debts, Doubtful debts and Bad debts.

Good Debts: The debts which are not bad i.e., there is neithe**r any possibili**ty of bad debts nor any doubts about its realization, is called good debts. As such, no provision is necessary for it.

Doubtful Debts: The debts which will be receivable or cannot be ascertainable at the date of preparing the final accounts (i.e., the debts which are doubtful to realise) is known as doubtful debts. Practically it cannot be treated as a loss on that particular date, as such, it cannot be written off. But, it should be charged against Profit and Loss Account on the basis of past experience of **the firm.** This is done as per matching principle so that the anticipated loss of the year charged against the revenue of that year.

Bad Debts: Bad debts are uncollectable or irrecoverable debt or debts which are impossible to collect is called Bad Debts. If it is definitely known that amount recoverable from a customer cannot be realized at all, it should be treated as a business loss and should be adjusted against profit. In short, the amount of bad debt should be transferred to Profit and Loss Account for the current year to confirm the principles of matching.

Bad Debts Account is by nature a nominal account. For recording the bad debt in the journal, Bad Debts A/c is debited and Debtors A/c is credited. At the end of an accounting period the total amount of bad debts may be either transferred to Profit & Loss Account or Provision for Doubtful debts A/c as the case may be.

Provisions for Doubtful Debts

The amount charged against the profit by an entity to provide for the possible collection loss from customers is known as Provision for Doubtful Debts. Provision for Doubtful debts account is a credit balance account and it reflected in the Balance Sheet by was of deduction from the balance of Debtors/ Accounts Receivable.

The accounting for bad debts and provision for doubtful debts is as under:

In the 1st year

(a) For Bad Debts

Bad Debts A/c Dr.

To Sundry Debtors A/c

(b) For creating provision for Doubtful Debts

Profit and Loss A/c Dr.

To Provision for Doubtful Debts A/c

(c) For Transferring Bad Debts

Profit and Loss A/c Dr.

To Bad Debts A/c

In Second/ Subsequent Year

(a) (i) For Bad Debts

Bad Debts A/c Dr.

To Sundry Debtors A/c

(ii) Profit and Loss A/c Dr.

To Bad Debts A/c

(b) For provision of Doubtful Debts

(i) If closing provision is more than the opening provision-

Profit and Loss A/c Dr.

To Provision for Doubtful debts A/c

(ii) If Closing Balance is less than opening provision –

Provision for Doubtful Debts A/c Dr.

To Profit and Loss A/c

Illustration 15

M/s Adhuna & Co. had a provision for bad debts of ₹13,000 against their book debts on 1st April, 2022. During the year ended 31st March, 2023, ₹8,500 proved irrecoverable and it was desired to maintain the provision for bad debts @ 5% on Debtors which stood at ₹3,90,000 before writing off Bad Debts.

Prepare the provision for Bad Debt Account for the year ended March 31, 2023.

Solution

Books of M/s Adhuna & Co.

Dr. **Provision for Bad Debt Account** **Cr.**

Date	Particulars	(₹)	Date	Particulars	(₹)
31.03.23	To Bad Debts A/c	8,500	01.04.22	By Balance b/d	13,000
31.03.23	To Balance c/d 5% of (3,90,000 - 8,500)	19,075	31.03.23	By Profit& Loss A/c (Balancing figure) (further provn. required)	14,575
		27,575			**27,575**

Illustration 16

On 1st April, 2022 the balance of provision for bad and doubtful debts was ₹13,000. The bad debts during the year 2022-23 were ₹9,500. The sundry debtors as on 31st March, 2023 stood at ₹3,25,000 out of these debtors of ₹2,500 are bad and cannot be realized. The provision for bad and doubtful debts is to be raised to 5% on sundry debtors. You are required to:

(i) Pass necessary adjustment entries for bad debts and its provision on 31st March, 2023.

(ii) Prepare the necessary ledger accounts.

(iii) Show the relevant items in the Profit & Loss Account and Balance Sheet.

Solution

(i) **In the books of ……………….**

Journal

Date	Particulars		Debit (₹)	Credit (₹)
31.03.23	Bad Debts A/c To Sundry Debtors A/c (Being Bad Debts)	Dr.	2,500	 2,500
31.03.23	Provision for Bad & Doubtful Debts A/c To Bad Debts A/c (2500 + 9500) (Being Bad Debts during the year)	Dr.	12,000	 12,000
31.03.23	Profit and Loss A/c To Provision for Bad & Doubtful Debts A/c (Being Provision for Bad Debts transferred to Profit & Loss A/c)	Dr.	15,125	 15,125

(ii) Ledger Accounts

Dr. **Bad Debts Account** **Cr.**

Date	Particulars	(₹)	Date	Particulars	(₹)
31.03.23	To Balance b/d	9,500	31.03.23	By Provision for Bad & Doubtful Debts A/c	12,000
31.03.23	To Sundry Debtors A/c	2,500			
		12,000			**12,000**

Dr. **Provision for Bad & Doubtful Debts Account** **Cr.**

Date	Particulars	(₹)	Date	Particulars	(₹)
31.03.23	To Bad Debts A/c	12,000	01.04.22	By Balance b/d	13,000
31.03.23	To Balance c/d [5% on (3,25,000 - 2,500)]	16,125	31.03.23	By Profit and Loss A/c (b/fig)	15,125
		28,125			**28,125**

Dr. **Sundry Debtors Account (includes)** **Cr.**

Date	Particulars	(₹)	Date	Particulars	(₹)
31.03.23	To Balance b/d	3,25,000	31.03.23	By Bad Debts A/c	2,500
			31.03.23	By Balance c/d	3,22,500
		3,25,000			**3,25,000**

(iii) Profit and Loss Account for the year ended 31st March, 2023 (includes)

Particulars	(₹)	(₹)
To Provision for Bad & Doubtful Debts:		
Provision as on 31.3.2023	16,125	
Add: Bad Debts (9,500 + 2,500)	12,000	
	28,125	
Less: Provision as on 1.4.2022	13,000	15,125

Balance Sheet as on 31st March, 2022 (includes)

Liabilities	(₹)	Assets		(₹)
		Sundry Debtors	3,25,000	
		Less: Further Bad Debts	2,500	
			3,22,500	
		Provision for Bad Debts	16,125	3,06,375

Provisions for Discount on Debtors

It is a common practice of the suppliers to allow cash discount to its customers for prompt settlement of cash. For such loss, it would be prudent to create a provision. Thus, the provision which is created on Sundry Debtors for allowing discount on receipt of cash in that accounting period is called Provision for Discount on Debtors.

It is needless to say that if the customer pays their debts before the due dates, they may claim discounts and that is why it would be prudent to create a separate provision for the amount of discount that might be allowed to debtors for prompt settlement. The provision for discount on debtors is made on the basis of past experience and predicting at an estimate rate on the balance of Sundry Debtors.

Provision for discount allowed should be calculated at a specified rate on of debtors (i.e. after deducting bad debts and provision for bad debts). The debtors becoming bad are deleted from the list of debtors and the amount is deducted for the amount of gross debtors. The balance remains is all doubtful and hence provision for doubtful debt is maintained on the amount of doubtful debt. When such provision is also deducted from the net debtors the balance remains is expected to be good and are supposed to clear their dues in due time. Therefore a provision for discount allowed is made on such amount.

The accounting for provision for discount on debtors' as follows:

For the First year:

(a) (i) For Discount Allowed-

Discount Allowed A/c Dr.

To Sundry Debtors A/c

(ii) When Discount Allowed is transferred

Profit & Loss A/c Dr.

To Discount Allowed A/c

(b) For Provision for Discount on Debtors –

Profit & Loss A/c Dr.

To Provision for Disc on Debtors A/c

For the Second/ Subsequent year

(a) (i) For Discount Allowed-

Discount Allowed A/c Dr.

To Sundry Debtor A/c

(ii) For Provision for Discount on Debtors –

Provision for Discount on Debtor A/c Dr.

To Discount Allowed A/c

(b) Next year provision is estimated-

(i) If new provision is more than old one-

Profit and Loss A/c Dr.

To Provision for Discount on Debtor A/c

(ii) If new provision is less than old one-

Provision for Discount on Debtor A/c Dr.

To Profit and Loss A/c

Illustration 17

A company maintains its provision for bad debts @ 5% and a provision for discount on debtors @ 2%. You are given the following details: (in '000s)

Particulars	2022 (₹)	2023 (₹)
Bad debts	800	1,500
Discount allowed	1,200	500
Sundry debtors (before providing all bad debts and discounts)	60,000	42,000

On 01.01.2022, Provision for bad debts and Provision of discount on debtors had balance of ₹4,550 and ₹800 respectively.

Show Provision for Bad Debts and Provision for Discount on Debtors Account for the year 2022 and 2023.

Solution:

In the Books of ……

Dr. Provision for Bad Debts A/c Cr. (in '000s)

Date	Particulars	₹ '000	Date	Particulars	₹ '000
31.12.22	To Bad Debts A/c	800	01.01.22	By Balance b/d	4,550
31.12.22	To Profit & Loss A/c	850			
31.12.22	To Balance c/d 5% of (₹58,000)	2,900			
		4,550			**4,550**
31.12.23	To Bad Debts A/c	1,500	01.01.23	By Balance b/d	2,900
31.12.23	To Balance c/d 5% of (₹40,000)	2,000	31.12.23	By Profit & Loss A/c	600
		3,500			**3,500**

Dr. Provision for Discount on Debtors Account Cr. (in '000s)

Date	Particulars	₹ '000	Date	Particulars	₹ '000
31.12.22	To Discount A/c	1,200	01.01.22	By Balance b/d	800
31.12.22	To Balance c/d [2% on (₹58,000 – ₹2,900)]	1,102	31.12.22	By Profit & Loss A/c	1,502
		2,302			**2,302**
31.12.23	To Discount	500	01.01.23	By Balance b/d	1,102
31.12.23	To Balance c/d [2% on (₹40,000 – ₹2,000)]	760	31.12.23	By Profit & Loss A/c	158
		1,260			**1,260**

Recovery of Bad Debts

We know that bad debt is a loss and as such, transferred to current year's Profit and Loss Account, either directly or indirectly. However, if in any case the amount of bad debt is received from any debtor in any succeeding accounting period, the same is referred to as Bad Debt Recovery. This happens to be an item of income for the organisation and as such is credited to Profit and Loss of the year of receipt. It is accounted for as under:

(a) When bad debts are recovered

Cash/Bank A/c. Dr.

To Bad Debts Recovery A/c.

(b) When the same is transferred

Bad Debts Recovery A/c. Dr.

To Profit & Loss A/c.

Illustration 18

On 31.12.2022, Sundry Debtors and Provision for Doubtful Debts are ₹50,000 and ₹5,000 respectively. During the year 2023, ₹3,000 are bad and written off on 30.9.2023, an amount of ₹400 was received on account of a debt which was written off as bad last year. On 31.12.2023, the debtors ledger was verified and it was found that sundry debtors stood in the books were ₹40,000 out of which a customer Mr. X who owed ₹800 was to be written off as bad.

Prepare Bad Debt A/c and Provision for Doubtful A/c assuming that same percentage should be maintained for provision for Doubtful debt as it was on 31.12.2022.

Also show how the illustration appear in Profit & Loss A/c and Balance Sheet.

Solution:

In the Books of ....

Dr. Bad Debt Account Cr.

Date	Particulars	(₹)	Date	Particulars	(₹)
2023 Sept. 30	To Sundry Debtors A/c	3,000	2023 Dec. 31	By Provision for Bad Debt A/c	3,800
Dec. 31	To X A/c.	800			
		3,800			**3,800**

Dr. Provision for Doubtful Debt Account Cr.

Date	Particulars	(₹)	Date	Particulars	(₹)
2023 Dec. 31	To Bad Debt A/c " Balance c/d	3,800 3,920	2023 Dec. 31	By Balance b/d	5,000
	[10% on ₹ 39,200 (₹ 40,000 - ₹ 800)]			" Profit & Loss A/c (for the provision required)	2,720
		7,720			**7,720**

Profit & Loss Account (Extract)

Dr. For the year ended 31.12.2023 Cr.

Particulars	(₹)	(₹)	Particulars	(₹)	(₹)
To Provision for Doubtful Debts		2,720	By Bad Debts Recovery A/c		400

Balance Sheet (Extract) as at 31.12.2023 (includes)

Liabilities	(₹)	Assets	(₹)	(₹)
		Sundry Debtors	40,000	
		Less: Bad Debts	800	
			39,200	35,280
		Less: Provision for Bad Debts	3,920	

Working Notes:

Calculation of Rate of Provision for bad debts — (5,000/50,000 × 100) = 10%

Provision for Discount on Creditors

On the purchase of goods/ services by an entity on credit basis, payment is required to be made at a future date. In such a case, the party to whom amount remains payable is referred to as Creditors or Trade Payables. With the object of ensuring prompt collection, many times discount may be allowed by the suppliers. This option, when availed by the customer happens to be Discount Received for the customer, and is a gain to the paying organisation.

In line with discount that is allowed by a seller to its customers, as this anticipated income may accrue in a future accounting period, some organisations may create and maintain a provision for discount received from the creditors. This provision account is known as Provision for Discount Received or Provision for Discount on Creditors. The closing balance of this account is usually maintained at a fixed percentage on the closing creditors balance. It is accounted for as under:

Provision for Discount Received A/c Dr.

To Profit & Loss A/c

Provision for Discount on Creditors Account is shown in the liabilities-side of Balance Sheet as deduction from the balance of Sundry Creditors.

However, creation and maintenance of p**rovision on creditors is a** violation to the conservatism convention or the doctrine of prudence.

Rectification Entries

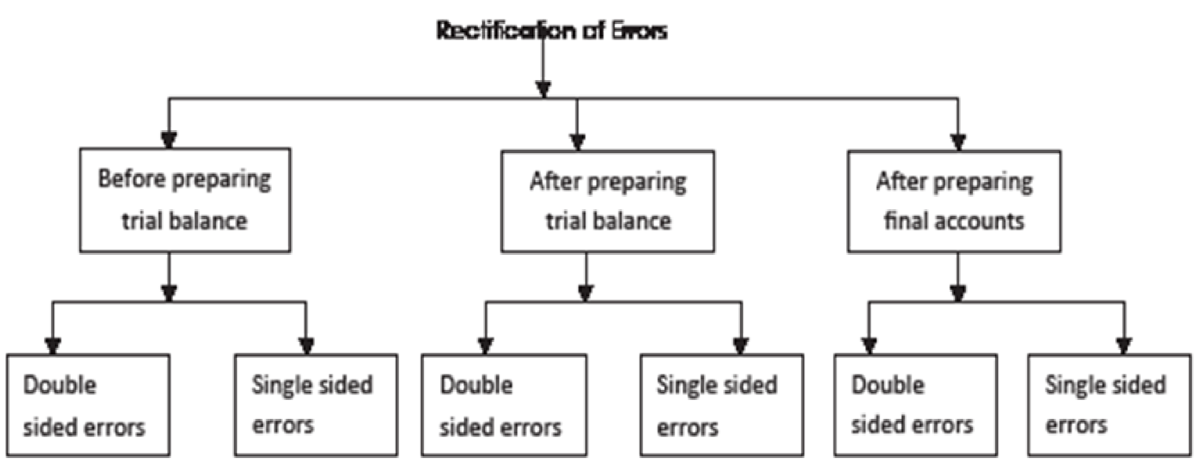
Rectification Entries (Rectification of errors): These entries are passed when errors or mistakes are discovered in accounting records. These entries are also known as Correction Entries. These entries are also passed in Journal Proper.

In this study note, you were introduced to the reasons why errors could occur and to the fact that while some errors affect trial balance and some errors do not affect it. In this section, we will see in depth how the corrections are made to the wrong entries.

When the errors affecting the T.B. are made, the normal practice is to put the difference to an A/c called as 'Suspense A/c' till the time errors are located. On identification of errors, the one effect goes to the correct A/c and the other effect to the Suspense A/c. This is done for one sided errors e.g. if sales book total is wrongly taken, but individual customers are correctly debited. Such error will cause difference in trial balance as only Sales A/c is wrongly credited. In such cases the rectification entry will be passed through Suspense A/c. In all other cases the rectification is done by debiting or crediting the correct A/c head and by crediting or debiting the wrong A/c head.

Let us recapitulate the types of errors and the ways to rectify them in the following table

Type of error	Rectification
Error of principle – entering revenue expense as capital expense or vice versa or entering revenue receipt as capital receipt or vice versa.	A journal entry is passed to give correct effect.
Error of Omission – transaction forgotten to be entered in books of accounts.	Simply, the correct entry is passed.
Errors of commission – entering to wrong head of account.	Debit or credit wrong A/c head and post it to correct head.
Compensating errors – more than one error that could compensate effect of each other.	Pass correcting entry
Wrong totaling of subsidiary books	As it affects T.B., pass through Suspense A/c
Posting on wrong side of an A/c	Pass an entry with double effect – one to cancel wrong side and other to give effect on correct side
Posting of wrong amount	Pass entry with differential amount



A. Before Preparation of Trail Balance

If errors are detected before the preparation of Trail Balance, the effect of each error should be known.

The errors are of two types: viz

(a) Double Sided Error; (b) Single Sided Error

(a) Double Sided Error:

The following principles should be followed for the purpose.

(i) What was the correct entry?

(ii) What entry had been done?

(iii) Rectifying entry.

Example: Purchased a Building for ₹ 3,00,000 wrongly passed through purchase account.

Solutions:

(i)	Building A/c	Dr.	3,00,000	
	To Cash A/c			3,00,000
(ii)	Purchase A/c	Dr.	3,00,000	
	To Cash A/c			3,00,000
(iii)	Building A/c	Dr.	3,00,000	
	To Purchase A/c			3,00,000

(b) Single Sided Error:

Under the circumstances, no separate entry is required but the affected account should be rectified by appropriate posting.

Example: Purchase account was overcast by ₹ 10,000.

Solution:

The correction to be made in Purchase Account in the following manner.

Dr. Purchase Account Cr.

Particulars	₹	Particulars	₹
		By Error - Wrong posting	10,000

So, purchase account should be credited by ₹ 10,000.

A. After Preparation of Trial Balance

If the errors are detected after the preparations of trial balance, the following procedure should be followed:

(a) Double Sided Errors; and (b) Single Sided Errors.

(a) Double Sided Errors:

- Same as method (A) above i.e., before preparation of Trial Balance.

(b) Single Sided Errors:

- In case of Single side errors, relevant account to be rectified by applying Suspense Account.

Suspense Account

If the Trial Balance does not agree we cannot prepare final accounts. In order to prepare final account, the difference so appeared in trail balance is to be passed through Suspense Account. When the errors will be located and rectified suspense account will automatically be Nil or closed. The suspense account will appear in the Balance Sheet. When it appears in the debit side of trial balance, the same will appear in the assets side of the Balance Sheet and vice-versa.

Example: Sales Day Book was overcast by ₹ 1,000.

Particulars	Dr. (₹)	Cr. (₹)
Sales A/c	1,000	
To Suspense A/c		1,000

C. After Preparation of Final Accounts

If the errors are detected after the preparation of final accounts, the following steps should carefully be followed.

(a) For Double Sided Errors

(i) Same as (A) before preparation of Trial Balance or (B) after preparation of Trail Balance. But all the nominal accounts are to be replaced by Profit and Loss Adjustment Account. And the rest one will be same as (A) or (B) stated earlier.

(ii) Suspense Account will be carried forward to the next year; and

(iii) Real and Personal Accounts are to be carried forward to the next year.

Example: Purchase a Plant wrongly debited to Purchase Account for ₹ 10,000

Solution:

(i) If after Trial Balance

Plant A/c Dr.

To Purchase A/c

(ii) If after Final Account

Plant A/c Dr.

To Profit and Loss Adjustment A/c

(b) for Single Sided Errors:

Same principle is to be followed like (B) after preparation of Trial Balance and all the nominal account are to be preplaced by Profit and Loss Adjustment Account.

Example – Discount allowed was not posted to discount Account.

Solution:

(i) If after Trial Balance

Discount Allowed A/c Dr.

To Suspense A/c

(ii) If after Final Account

Profit and Loss Adjustment A/c Dr.

To Suspense A/c

SUMMARY: -

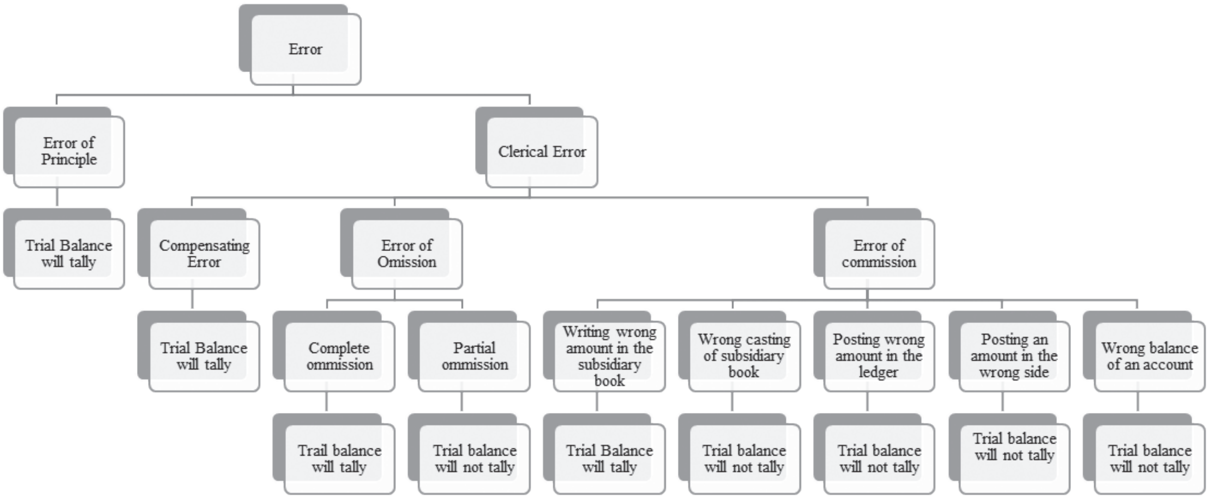


Illustration 19

Rectify the following errors assuming that the errors were detected (a) Before the Preparation of Trial Balance; (b) After the preparation of Trial Balance and (c) After the preparation of Final Accounts.

(i) Purchase Plant for ₹ 10,000 wrongly passed through Purchase Account.

(ii) Sales Day Book was cast short by ₹ 1,000.

(iii) Cash paid to Mr. X for ₹ 1,000 was posted to his account as ₹ 100.

(iv) Purchase goods from Mr. T for ₹ 3,500 was entered in the Purchase Day Book as ₹ 500.

(v) Paid salary for ₹ 3,000 wrongly passed through wages account.

Solution:

In the Books of ……………………..

Journal (without narration)

Date	Before preparation of Trial Balance	After preparation of Trial Balance	After preparation of Final Accounts
(i)	Plant A/c Dr. 10,000 To Purchase A/c 10,000	Plant A/c Dr. 10,000 To Purchase A/c. 10,000	Plant A/c Dr. 10,000 To P&L Adjustment A/c 10,000
(ii)	Sales account will be credited with ₹ 1,000	Suspense A/c Dr. 1,000 To Sales A/c 1,000	Suspense A/c Dr. 1,000 To P&L Adjustment A/c 1,000
(iii)	X Account will be debited when ₹ 900	X A/c Dr. 900 To Suspense A/c 900	X A/c Dr. 900 To Suspense A/c 900
(iv)	Purchase A/c Dr. 3,000 To T A/c 3,000	Purchase A/c Dr. 3,000 To T A/c 3,000	P&L Adjustment A/c Dr. 3,000 To T's A/c. 3,000
(v)	Salary A/c Dr. 3,000 To Wages A/c 3,000	Salary A/c Dr. 3,000 To wages A/c 3,000	

Illustration 20

A merchant, while balancing his books of accounts notices that the T.B. did not tally. It showed excess credit of ₹1,700. He placed the difference to Suspense A/c. Subsequently he noticed the following errors:

(a) Goods brought from Narayan for ₹ 5,000 were posted to the credit of Narayan's A/c as ₹ 5,500

(b) An item of ₹ 750 entered in Purchase Returns Book was posted to the credit of Pandey to whom the goods had been returned.

(c) Sundry items of furniture sold for ₹ 26,000 were entered in the sales book.

(d) Discount of ₹ 300 from creditors had been duly entered in creditor's A/c but was not posted to discount A/c. Pass necessary journal entries to rectify these errors. Also show the Suspense A/c.

Solution:

(a) Goods bought from Narayan are posted to credit of his A/c as ₹ 5,500 instead of ₹ 5,000. Here, it is correct to credit Narayan's A/c. But the mistake is extra credit of ₹ 500. This is one sided error, as posting to purchases A/c is correctly made. So the rectification entry will affect the suspense A/c. This needs to be reversed by the rectification entry:

Narayan's A/c Dr. 500

To Suspense A/c 500

(b) Goods bought from Pandey were returned back to him. It should have appeared on the debit side of his A/c. For rectifying we will need to debit his A/c with double the amount i.e. ₹ 1500 (₹ 750 to cancel the wrong credit and another ₹ 750 to give effect for correct debit) and the effect will go to Suspense A/c. The correction entry is:

Pandey A/c Dr. 1,500

To Suspense A/c 1,500

(c) Sale of furniture was recorded in sales book. What's wrong here? Remember that sales book records sale of goods only and nothing else. Sale of furniture will appear in either cash book (if sold for cash) or journal proper (if sold on credit). Hence, wrong credit to Sales A/c must be removed and credit should be given to Furniture A/c. It's important to note that this rectification entry will not affect the Suspense A/c. The correction entry is:

Sales A/c Dr. 26,000

To Furniture A/c 26,000

(d) The discount received from creditor is not entered in discount A/c but was correctly recorded in creditors' A/c. This is one sided error and will therefore be routed through suspense for correction. A discount is received; it must be credited being an income.

Suspense A/c Dr. 300

To Discount received A/c 300

Let us now see how suspense A/c will Look like. Excess credit of ₹1,700 in Trial Balance will be shown on the debit side of suspense A/c. This will bring in total debit equal to total credit.

Dr Suspense Account Cr

Date	Particulars	J. F.	Amount (₹)	Date	Particulars	J. F.	Amount (₹)
	To Balance b/d		1,700		By Narayan		500
	To Discount received		300		By Pandey		1,500
			2,000				2,000

Please observe that after correcting passing all rectification entries, the Suspense A/c tallies automatically.

Illustration 21

Pass necessary journal entries to rectify the following errors:

(a) An amount of ₹ 200 withdrawn by owner for personal use was debited to trade expenses.

(b) Purchase of goods of ₹ 300 from Nathan was wrongly entered in sales book.

(c) A credit sale of ₹ 100 to Santhanam was wrongly passed through purchase book.

(d) ₹ 150 received from Malhotra was credited to Mehrotra.

(e) ₹ 375 paid as salary to cashier Dhawan was debited to his personal A/c.

(f) A bill of ₹ 2,750 for extension of building was debited to building repairs A/c.

(g) Goods of ₹ 500 returned by Akashdeep were taken into stock, but returns were not recorded.

(h) Old furniture sold for ₹ 200 to Sethi was recorded in sales book.

(i) The period end total of sales book was under cast by ₹ 100.

(j) Amount of ₹ 80 received as interest was credited to commission.

Solution:

Sl. No.	Type of Entry	Particulars	Debit (₹)	Credit (₹)
a.	Wrong Entry	Trade Expenses To Cash	200	 200
	Correct entry	Drawings To cash	200	 200
	Rectification entry	Drawings To Trade Expenses	200	 200
b.	Wrong Entry	Nathan To Sales	300	 300
	Correct entry	Purchases To Nathan	300	 300
	Rectification entry	Purchases Sales To Nathan	300 300	 600

c.	Wrong Entry	Purchases To Santhanam	100	 100
	Correct entry	Santhanam To Sales	100	 100
	Rectification entry	Santhanam To Sales To Purchases	200	 100 100
d.	Wrong Entry	Cash To Mehrotra	150	 150
	Correct entry	Cash To Mehrotra	150	 150
	Rectification entry	Mehrotra To Malhotra	150	 150
e.	Wrong Entry	Dhawan To cash	375	 375
	Correct entry	Salary To cash	375	 375
	Rectification entry	Salary To Dhawan	375	 375
f.	Wrong Entry	Building Repairs To Cash	2,750	 2,750
	Correct entry	Buildings To Cash	2,750	 2,750
	Rectification entry	Buildings To Building Repairs	2,750	 2,750
g.	Wrong Entry	No entry passed		
	Correct entry	Sales Returns To Akashdeep	500	 500
	Rectification entry	Sales Returns To Asashdeep	500	 500

h.	Wrong Entry	Sethi To Sales	200	 200
	Correct entry	Sethi To Furniture	200	 200
	Rectification entry	Sales To Furniture	200	 200
i.	Wrong Entry	No entry passed		
	Correct entry	Suspense To Sales	100	 100
	Rectification entry	Suspense To Sales	100	 100
j.	Wrong Entry	Cash To Commission	80	 80
	Correct entry	Cash To Interest	80	 80
	Rectification entry	Commission To Interest	80	 80

Effect of Errors on Profit or Loss

Some errors may affect the profit or loss for the period while other won't. How to find it out? Remember, the P&L A/c reflects items of incomes, gains, expenses and losses. All these accounts are nominal accounts. When an error occurs which affects a nominal account, it will affect profit or loss otherwise not. So, errors that affect real and personal accounts will not affect profit or loss.

Illustration 22

The books of accounts of A Co. Ltd. for the year ending 31.3.2023 were closed with a difference of ₹21,510 in books carried forward. The following errors were detected subsequently:

(a) Return outward book was under cast by ₹ 100.

(b) ₹ 1,500 being the total of discount column on the credit side of the cash book was not posted.

(c) ₹ 6,000 being the cost of purchase of office furniture was debited to Purchase A/c.

(d) A credit sale of ₹ 760 was wrongly posted as ₹ 670 to the customers A/c. in the sales ledger.

(e) The Sales A/c was under casted by ₹ 10,000 being the carry over mistakes in the sales day book.

(f) Closing stock was over casted by ₹ 10,000 being casting error in the schedule or inventory. Pass rectification entries in the next year.

Prepare suspense account and state effect of the errors in determination of net profit of last year.

Solution:

In the Books of A Co. Ltd.

Journal

Date	Particulars		L/F	Dr. Amount (₹)	Cr. Amount (₹)
(a)	Suspense A/c	Dr.		100	
2023	To Profit & Loss Adjustment A/c				100
April 1	(Returns outward book was under cast now rectified).				
(b)	Suspense A/c	Dr.		1,500	
	To Profit & Loss Adjustment A/c				1,500
	(Discount received was not recorded, now rectified).				
(c)	Office Furniture A/c	Dr.		6,000	
	To Profit & Loss Adjustment A/c				6,000
	(Office furniture purchased wrongly debited to Purchase A/c, now rectified.)				
(d)	Debtors' A/c	Dr.		90	
	To Suspense A/c				90
	(Debtors account was posted ₹ 670 in place of ₹ 760, now rectified.)				
(e)	Suspense A/c	Dr.		10,000	
	To Profit & Loss Adjustment A/c				10,000
	(Sales account was under casted, now rectified)				
(f)	Profit & Loss Adjustment A/c	Dr.		10,000	
	To Closing Stock A/c				10,000
	(Closing Stock was overcastted, now rectified.)				

Dr. Suspense Account Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2023	To Profit & Loss Adjustment A/c	100	2023	By Difference in Trial Balance	21,510
April	To Profit & Loss Adjustment A/c	1,500	April	By Debtors A/c.	90
1	To Profit & Loss Adjustment A/c	10,000	1		
	To Profit & Loss Adjustment A/c	10,000			
		21,600			21,600

Effect on Profit

	Increase (+) (₹)	Decrease (-) (₹)
Item		
(a)………………………………..	---	100
(b)………………………………..	---	1,500
(c)………………………………..	---	6,000
(d) No effect	---	---
(e)………………………………..	---	10,000
(f)………………………………..	10,000	---
	10,000	17,600
Profit will be decreased by	7,600	---
	17,600	17,600

Illustration 23

The Trial Balance of a concern has agreed but the following mistakes were discovered after the preparation of final Accounts.

(a) No adjustment entry was passed for an amount of ₹2,000 relating to outstanding rent.

(b) Purchase book was overcast by ₹1,000.

(c) ₹ 4,000 depreciation of Machinery has been omitted to be recorded in the book.

(d) ₹ 600 paid for purchase of stationary has been debited to Purchase A/c.

(e) Sales books was overcast by ₹ 1,000.

(f) ₹ 5,000 received in respect of Book Debt had been credited to Sales A/c.

Show the effect of the above errors in Profit and Loss Account & Balance Sheet.

Solution:

Effects of the errors in profit and loss A/c and Balance Sheet

Profit & Loss A/c.	Balance Sheet
(a) Profit was overstated by ₹ 2,000	(a) Capital was also overstated by ₹2,000 & outstanding Liability was understated by 2,000.
(b) Gross profit was under stated by ₹ 1,000 & also the Net Profit.	(b) Capital was understated by ₹ 1,000.
(c) Net Profit was overstated by ₹ 4,000.	(c) Machinery was overstated by ₹ 4,000 & so the Capital A/c was also overstated by ₹ 4,000.
(d) No effect on Net Profit.	(d) No effect in Balance Sheet.
(e) Gross Profit and Net Profit were overstated by ₹1,000.	(e) Capital was overstated by ₹ 1,000.
(f) Gross Profit & Net Profit were overstated by ₹5,000.	(f) Capital & Sundry Debtors were overstated by ₹5,000.

Adjusting Entry: Adjusting Entries are passed in the journal to bring into the books of accounts certain unrecorded items like closing stock, depreciation on fixed assets, etc. These are needed at the time of preparing the final accounts.

E.g. Depreciation A/c Dr.

To Fixed Assets A/c

EXERCISE

A. Theoretical Questions:

- Multiple Choice Questions

1. __________ concept assumes that the infinite life of an organisation can be split into smaller periods of equal duration.
   (a) Accounting Period
   (b) Entity
   (c) Going concern
   (d) None of the above
2. The accounts related to expenses or losses and incomes or gains are called __________.
   (a) Personal Account
   (b) Representative Personal Account
   (c) Nominal Account
   (d) Real Account
3. The accounting equation is presented as:
   (a) Assets = Liabilities + Equity
   (b) Assets = Liabilities + [Capital + (Revenue – Expenses) – Drawings]
   (c) Assets + Expenses + Drawings = Liabilities + Capital + Revenue
   (d) All of the above
4. The book of account which records only those cash transactions which are not of heavy amount, but the type of transactions is frequently entered into by an entity is ___________.
   (a) Triple Column Cash Book
   (b) Petty Cash Book
   (c) Ledger
   (d) None of the above
5. Which of the following is/ are true regarding Trial Balance?
   (a) It is prepared for a particular period.
   (b) A trial balance is just a statement.
   (c) The agreement of a trial balance is a conclusive proof of absolute accuracy of the books of accounts.
   (d) All of the above
6. A resource owned by the business with purpose of using it for generating future profit, is known as ------ ---------------.
   (a) Capital
   (b) Asset
   (c) Liability
   (d) Surplus
7. Which of the following transaction is of capital nature?

(a) Commission on purchases
(b) Cost of repairs
(c) Rent of factory
(d) Wages paid for installation of machinery

8. At the end of the accounting year the capital expenditures are shown in the:
(a) assets side of the Balance Sheet.
(b) liabilities side of the Balance Sheet.
(c) debit side of the Profit and Loss A/c.
(d) credit side of the Profit and Loss A/c.

9. Which of the following book is both a journal and a ledger?
(a) Cash Book
(b) Sales Day Book
(c) Bills Receivable Book
(d) Journal Proper

10. Purchase of a laptop for office **use wrongly debite**d to Purchase Account. It is an error of _________.
(a) Omission
(b) Commission
(c) Principle
(d) Misposting

Answer:

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

- State True or False

1. There are four frameworks of accounting.
2. Revenue Expenditures are recognised as expenses and losses in the debit-side of the income statements.
3. Provision for depreciation account is a debit balance account.
4. Cash Book is a book of account which is, by nature, a book of primary entry as-well-as a book of final entry.
5. Errors which are identified and rectified before the preparation of Trial Balance may involve Suspense Account.
6. One of the objectives achieved by providing depreciation is saving cash resources for future replacement of assets.
7. As per full disclosure principle, the financial statements should disclose all irrelevant information.
8. Trade discount is recorded in the books of original entry.
9. Bad debts recovered i**s credited to debtor**'s personal account.

10. Mistake in balancing an account will affect the agreement of a Trial balance.

Answer:

1	**True**	**2**	**True**	**3**	**False**	**4**	**True**	**5**	**False**
6	**True**	**7**	**False**	**8**	**False**	**9**	**True**	**10**	**True**

- Fill in the Blanks

1. _________ are the assumptions and conditions that define the parameters and constraints within which the accounting operates.
2. ________ is a listing of all accounts in the general ledger, each account being accompanied by a reference number.
3. ________ is prepared to reconcile the balances as reflected by two related books, namely Cash Book and Pass Book.
4. The method of preparing Trial Balance under which the Trial Balance can be prepared only after each ledger account has been balanced is called the ________ method.
5. The amount charged by an entity against the profits to provide for the possible collection loss from customers is known as ________.
6. The___________ discount is never entered in the books of accounts.
7. The Bank A/c is a ________ Account.
8. While posting an opening entry in the ledger, in case of an Account having debit balance, in 'Particulars' column the words ___________ are written on debit side.

Answer:

1	**Accounting Concepts**	**2**	**Chart of Accounts**
3	**Bank Reconciliation Statement**	**4**	**Balance**
5	**Provision for bad& doubtful debts**	**6**	**Trade**
7	**Personal**	**8**	**To, Balance b/f**

- Short Essay Type Questions

1. What is capital loss? How is it reflected in the financial statements of an entity?
2. What is meant by Accounting Cycle? Discuss the different stages of an accounting cycle.
3. State the conditions which an event has to satisfy to be **considered as a tran**saction.
4. What do you mean by Compensating Error? Give an example.
5. State the features of adjustment entries.

- Essay Type Questions

1. What are Accounting Conventions? Discuss the different conventions of accounting.
2. Distinguish between capital expenditure and revenue expenditure.

3. Give an overview of the different types of cash book that are prepared by a large organisation.

4. Discuss the advantages of a Trial Balance.

5. What do you mean by Depreciation? Differentiate depreciation from amortization and depletion.

B. Numerical Questions

⊙ Multiple Choice Questions

1. Provision for Doubtful Debt on 1st April, 2022 was ₹ 13,000.During the year 2022-23 the Bad-debt was ₹ 9,500 . The Sundry Debtors on 31st March, 2023 were ₹3,25,000. Provision is to be made @ 5% on Debtors. If on 31st March, 2023, there was additional Bad debt of ₹2,500 then Provision for doubtful-debt will be:
   (a) debited to Profit & Loss Account by ₹ 16,125.
   (b) debited to Profit & Loss Account by ₹15,125.
   (c) debited to Profit & Loss Account by ₹ 3,000.
   (d) debited to Profit & Loss Account by ₹ 900.

2. Original cost of a machine is ₹ 1,50,000, residual value ₹ 10,000, if depreciation is charged @ 10% per annum under WDV method then depreciation for 3rd year will be
   (a) ₹12,240
   (b) ₹11,340
   (c) ₹12,150
   (d) ₹14,000

3. Purchased goods from Mr. R for ₹ 3,600 but wrongly recorded as ₹6,300 to the debit of Mr. R. In the rectification entry, Mr. R's account will be credited with —
   (a) ₹9,900
   (b) ₹2,700
   (c) ₹2,600
   (d) ₹6,300

Answer:

1	**b**	**2**	**c**	**3**	**a**

⊙ Comprehensive Numerical Problems

1. Classify the following transactions between capital and revenue:
   (a) A plant constructed for ₹ 10,50,000.
   (b) Profit earned by sale of fixed assets ₹ 25,000.
   (c) Amount received from customers for services rendered ₹ 2,00,000
   (d) Regular repairs and maintenance incurred on old machine ₹ 24,000.
   (e) Annual rates and taxes paid to local authority ₹ 2,000.

2. KK Transport Co. of Ludhiana purchased 4 Trucks at ₹ 12,50,000 each on July 1, 2020. On Jan. 1, 2023 one of the trucks met with a massive accident and as a result was completely destroyed. Insurance company paid ₹ 7,00,000 in full and final settlement of the claim. On the same day the company purchased a used truck for ₹ 8,70,000 and spent ₹ 1,30,000 on its overhauling.

   You are required to show the treatment of these transactions in the final accounts and Balance Sheet of KK Transport Co. for the three years ending on March 31,2023, given that the company writes off depreciation @ 20% p.a. on straight line basis.

   Ans: Written Down Value as on 31.03.2023 - ₹26,37,500

3. The following errors were detected in the books of M/s S R Traders while preparing the Trial Balance.
   a. Freight paid for bringing purchased goods wrongly debited to Machinery Account ₹ 72,600.
   b. Equipments purchased worth ₹ 8,50,000 wrongly passed through Purchases A/c.
   c. Returns Outward book was overcast by ₹ 54,000.
   d. Goods purchased from Rohan worth ₹ 79,000 has been debited to his account.
   e. An amount of rent outstanding ₹ 13,000 in the previous year, had not been brought forward as an opening balance in the current year.
   f. Fresh cash introduced by the proprietor of ₹ 44,000 was not posted in ledger account.

   You are required to pass necessary journal entries to rectify the errors.

4. The total of debit side of the Trial Balance of SR Ltd. as at 31.3.2023 is ₹ 2,92,000 and that of the credit side is ₹ 1,80,800. After detailed checking, the following errors were identified:

Name of Accounts	Correct Figures (as it should be)	Figures as it appears in the Trial Balance
Opening stock	12,000	8,000
Salaries	28,800	50,400
Accounts Receivable	83,200	1,26,400
Trade Creditors	64,800	14,400

   You are required to ascertain the correct total of the Trial Balance.

   Ans: ₹2,31,200

Unsolved Case

Mr. Rishan Chaudhury is a trader engaged in retailing of computer hardware items. The name of his business is M/s TechnoLink, which is a proprietary form of business. The business procures the different items and goods of trade from a number of wholesalers, both on cash as-well-as on credit. The primary customers of TechnoLink were different academic institutions like schools and colleges. The books of accounts of the business are maintained by two accountants, and at the end of the financial year 2022-23, after balancing the ledger accounts, they drafted the Trial Balance to check the arithmetical accuracy of the books. But to their discomfort the Trial Balance did not tally and reflected excess credit ₹ 37,200. The difference in books was posted to Suspense Account. On critical checking of the books, the accountants could identify the following three errors:

(i) Purchase of four office chairs (costing ₹ 10,000 each) and two office tables (costing ₹ 40,000 each) from Godrej Interio has been passed through Purchase Day Book.

(ii) Purchase of USB drives worth ₹ 26,800 has been posted to the Supplier's Account as ₹ 12,000.

(iii) A cheque worth ₹ 80,000 received from ABS Higher Secondary School has been dishonoured, but debited to Allowances Account.

Mr. Chaudhury, himself an honour graduate in Commerce with speciailisation in Accounting from City College, Kolkata, himself sat with the accounts. He managed to identify two more errors that existed in the books but were missed by the accountants. He identified that the total of the Returns Inward Book has been cast short by ₹ 40,000, and that ₹ 1,50,000 paid for making showcases of the shop has been charged to Wages Account. However, he too was still uncertain whether he has been able to locate the errors.

1. Develop the rectification entries that would be recorded in the Journal Proper of M/s TechnoLink.
2. Ascertain by what amount would Furniture Account change after the necessary rectifications are carried out?
3. State whether all the errors that existed in the books have been identified? If not, what is the amount of such undetected error(s)?
4. What can be the possible reasons for which the Trial Balance is still not tallying?